

# Supervisory Insights

*Devoted to Advancing the Practice of Bank Supervision*

Vol. 1, Issue 2

Winter 2004

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and the Assessment  
of Capital Adequacy

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## Supervisory Insights

*Supervisory Insights* is published by the Division of Supervision and Consumer Protection of the Federal Deposit Insurance Corporation to promote sound principles and best practices for bank supervision.

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# Letter from the Director

Even as the U.S. banking industry continues to perform strongly, the responsibilities and skills of examiners remain as important today as they were during the last banking crisis. For it is during this time that examiners and supervisors continue to work to ensure that the industry is prepared to handle future problems effectively. Input from our field examiners offers key insights into any potentially troublesome trends that emerge from on-site examinations. This ongoing communication, as well as outreach with bankers, helps us develop and implement appropriate supervisory strategies.

At mid-year 2004, there were 102 problem banks (banks examiners rate “4” or “5” on a five-point scale, with “5” being the worst rating), or about 1 percent of all insured institutions. A more inclusive group of banks about which supervisors have heightened concern includes, in addition to problem banks, banks rated “3.” Even this more inclusive group of troubled banks comprises only 6.6 percent of insured institutions.<sup>1</sup> This favorable distribution of examination ratings is being reinforced by current trends, as examination upgrades of FDIC-supervised institutions are outpacing downgrades.

In good times such as these, bankers sometimes ask supervisors what we are seeing in banks that concerns us. Recently we conducted an informal review of our reports of examination to address that question. We asked if there are common factors driving those few downgrades to a 3, 4, or 5 rating that are occurring, as well as what weaknesses examiners most frequently cited in banks rated 1 or 2.

Among banks downgraded to a composite rating of 3, 4, or 5 during

their most recent examination cycle, lax underwriting and credit administration as well as the fallout from weak management and board oversight were the two most frequently cited reasons for the downgrade. Weaknesses in these areas, if not corrected, have traditionally been a leading indicator of more serious problems.

Deficiencies in credit administration also rank among the most frequently identified weaknesses for well-rated banks. Weakness in the credit administration function was reported in roughly one-third of a sample of examination reports completed during the past three years. This should not be taken to suggest that one-third of all banks are in danger of becoming troubled. Virtually every institution has some weakness, and the examiner’s job is to detect and report those weaknesses and alert bank management to areas that should receive attention as a means of heading off potentially more adverse consequences in the future. This communication and the ongoing attention of bank management to identified weaknesses are, in the overwhelming majority of instances, sufficient to ensure the bank remains in a sound condition.

However, if deficiencies are not addressed, further deterioration could occur. For example, examiners may identify specific factors that are contributing to weakening in a bank’s asset quality. Although not currently a significant problem, should economic conditions turn down or other operational stresses occur within the institution, the effect of these same factors could become more serious.

When significant deterioration in asset quality does occur, it is generally because of weaknesses in loan underwriting,

<sup>1</sup>Federal Deposit Insurance Corporation, Division of Insurance and Research, *Quarterly Banking Profile*, second quarter 2004 (<https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2004jun/qbp.pdf>). Supervisory Risk Subgroups, published in the *Quarterly Banking Profile*, are based primarily on CAMELS (capital, asset quality, management, earnings, liquidity, and sensitivity to market risk) ratings, with some additional adjustments. However, no exact match exists between CAMELS ratings and the Supervisory Risk Subgroups.

credit administration, and risk selection. Overall, factors contributing to weak underwriting and credit administration practices include intense competition that contributes to aggressive risk taking and growth strategies as well as management-related issues, such as weak oversight of the credit administration function. Our examiners report that specific deficiencies cited most frequently are lack of cash flow analysis, excessive loan renewals with capitalized interest, poorly documented appraisals or lack of proper officer review of appraisals, and failure to maintain appropriate credit memos.

In response, supervisors continue to emphasize the critical importance of a strong loan review function and an effective grading system. Both safeguards allow for prompt identification and correction of credit administration weaknesses, and they improve the accuracy of the assessment of the allowance for loan and lease losses. Moreover, the development and implementation of a comprehensive loan policy promote the monitoring of shifts in portfolio concentrations and the early identification of any signs of weakening in asset quality. “The Importance of a Loan Policy ‘Tune-Up’” in this issue of *Supervisory Insights* discusses the importance of an effective and up-to-date loan policy and outlines steps management should take to ensure the loan policy continues to evolve with the institution.

In several examinations, supervisors have identified poor management practices, high-risk business plans that are not supported by appropriate expertise, and boards of directors who rely too heavily on the judgment and assurances of a bank’s chief executive officer. These deficiencies, for the most part, seem to occur in institutions characterized by rapid deposit and loan growth that is not accompanied by adequate internal controls. Additionally, examiners point to a failure to implement

appropriate risk management policies and practices and address prior exam recommendations as a cause for deterioration in some of these institutions. Weak internal controls also have resulted in large losses for some institutions and represent key areas of concern for our examiners.

Strengthening an insured institution’s management presents significant challenges for examiners, as bank officers may be reluctant to implement appropriate controls or allocate additional financial resources. However, examiners continue to emphasize the value of both a well-informed and involved board of directors and an effective audit program. A strong, responsible, and independent board will insist that they receive pertinent information, engage in sound strategic planning, and fairly weigh the pros and cons of key issues. An effective audit function helps ensure that all necessary internal controls are in place, exam recommendations are promptly addressed, and any deficiencies are reported directly to the board.

Our supervisory staff also is concerned that a rising interest rate environment could be particularly challenging for certain groups of institutions, such as banks and thrifts that have ramped up portfolio concentrations in commercial real estate loans. Increasing competition in various real estate markets across the country has contributed to aggressive risk selection that may compromise an institution’s ability to price appropriately for the level of risk assumed. On the consumer side, many residential lenders have reported strong growth in adjustable rate mortgages, increasing affordability for many first-time homebuyers during a period of historically low interest rates. However, should rates spike upward, these consumers could be squeezed, particularly if they have taken on high levels of consumer debt in other areas, contributing to deterioration in consumer credit quality.

# Letter from the Director

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This issue of *Supervisory Insights* focuses on other critical issues that are challenging examiners and supervisors as well as bank management. “Economic Capital and the Assessment of Capital Adequacy” describes how an increasing number of banking organizations are using economic capital modeling techniques to quantify and manage risk and allocate capital commensurate with their business risk profile. The article emphasizes how bank regulatory agencies are now incorporating these industry efforts into the supervisory evaluation of capital adequacy. “Linking International Remittance Flows to Financial Services: Tapping the Latino Immigrant Market” explores how recent demographic shifts will continue to influence banks’ strategies for tapping new markets. The article discusses the implications of the rapid growth and significant size of the Latino market for the U.S. banking industry. Large and small banks are capitalizing on remittance flows as a means of bringing “unbanked” immigrants into the banking system.

This issue’s “From the Examiner’s Desk” focuses on the key role of the bank examiner in the real estate appraiser referral process, details what situations typically result in referrals, and describes how the referral process works. The “Accounting News” feature describes accounting procedures for the various products offered under the Mortgage Partnership Finance programs by several Federal Home Loan Banks and highlights the participation of insured institutions in these programs.

We thank those of you who submitted positive, instructive feedback on the inaugural issue of *Supervisory Insights*. We encourage our readers to continue to comment on articles and suggest topics for future issues by sending an e-mail to [SupervisoryJournal@fdic.gov](mailto:SupervisoryJournal@fdic.gov).

**Michael J. Zamorski, Director**  
*Division of Supervision and  
Consumer Protection*

# Economic Capital and the Assessment of Capital Adequacy

The assessment of capital adequacy is one of the most critical aspects of bank supervision. In completing this assessment, examiners focus on a comparison of a bank's available capital protection with its capital needs based on the bank's overall risk profile.

Bank management must likewise continuously evaluate capital adequacy in relation to risk. In recent years, many banks have adopted advanced modeling techniques intended to improve their ability to quantify and manage risks. These modeling techniques frequently incorporate the internal allocation of "economic capital" considered necessary to support risks associated with individual lines of business, portfolios, or transactions within the bank. As a result, economic capital models can provide valuable additional information that bankers and examiners can use in their overall assessment of a bank's capital adequacy.

As will be discussed later, economic capital models or similar risk and capital adequacy assessment processes are important to banks adopting the revised Basel framework. But revisions to capital regulations have not been the driving force behind the development of these models as such methodologies have been in use for more than ten years at some of the nation's largest banks. Economic capital has also become a useful and sometimes necessary tool for other insured institutions. Several regional banks and some community banks have developed or are exploring implementation of economic capital models with more banks likely to do so in the future. This article provides an introduction to the concept of economic capital, describes the relationship between economic capital and the revised Basel framework, and discusses examiner review of economic capital models as

a part of the supervisory assessment of capital adequacy.

## Economic Capital

Economic capital is a measure of risk, not of capital held. As such, it is distinct from familiar accounting and regulatory capital measures. The output of economic capital models also differs from many other measures of capital adequacy. Model results are expressed as a dollar level of capital necessary to adequately support specific risks assumed. Whereas most traditional measures of capital adequacy relate existing capital levels to assets or some form of adjusted assets, economic capital relates capital to risks, regardless of the existence of assets. Economic capital is based on a probabilistic assessment of potential future losses and is therefore a potentially more forward-looking measure of capital adequacy than traditional accounting measures. The development and implementation of a well-functioning economic capital model can make bank management better equipped to anticipate potential problems.

Conceptually, economic capital can be expressed as protection against unexpected future losses at a selected confidence level. This relationship is presented graphically in Chart 1 (see next page).

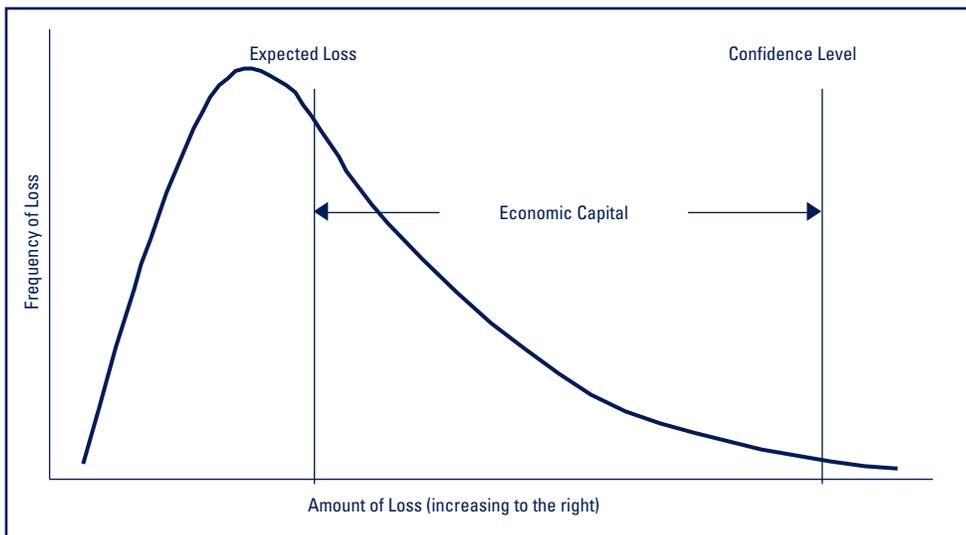
**Expected loss** is the anticipated average loss over a defined period of time. Expected losses represent a cost of doing business and are generally expected to be absorbed by operating income. In the case of loan losses, for example, the expected loss should be priced into the yield and an appropriate charge included in the allowance for loan and lease losses.

**Unexpected loss** is the potential for actual loss to exceed the expected loss

# Economic Capital

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Chart 1. Economic Capital



and is a measure of the uncertainty inherent in the loss estimate.<sup>1</sup> It is this possibility for unexpected losses to occur that necessitates the holding of capital protection.

**Economic capital** is typically defined as the difference between some given percentile of a loss distribution and the expected loss. It is sometimes referred to as “unexpected loss at the confidence level.”

The **confidence level** is established by bank management and can be viewed as the risk of insolvency during a defined time period at which management has chosen to operate. The higher the confidence level selected, the lower the probability of insolvency. For example, if management establishes a 99.97 percent confidence level, that means they are accepting a 3 in 10,000 probability of the bank becoming insolvent during the next twelve months. Many banks using economic capital models have selected a confidence level between 99.96 and

99.98 percent, equivalent to the insolvency rate expected for an AA or Aa credit rating.

The primary value of economic capital and the reason that banks have already adopted such methodologies is its application to decision making and risk management. Specifically, the use of such models can:

- contribute to a more **comprehensive pricing system** that covers expected losses,
- assist in the evaluation of the **adequacy of capital** in relation to the bank’s overall risk profile,
- develop **risk-adjusted performance measures** that provide for better evaluation of returns and the volatility of returns,<sup>2</sup> and
- enhance **risk management** efforts by providing a common currency for risk.

The following example illustrates how each of these potential uses could be applied at a bank.<sup>3</sup> This example

<sup>1</sup>Unexpected loss is often described as the volatility of loss around the average over time.

<sup>2</sup>Risk-adjusted performance is typically measured at the business unit level, but can also be used to evaluate how individual business unit returns contribute to a bank’s overall profitability and risk profile.

<sup>3</sup>Specific methodologies, such as the use of a default-only measure of credit risk discussed in the example, should be viewed as potential approaches rather than as the only or best alternative.

describes only *credit risk* quantification and its translation to economic capital for *commercial lending activities*. Obviously risks are evident in activities other than commercial lending, and commercial lending itself involves numerous risks in addition to credit risk.<sup>4</sup> Banks that use economic capital models generally identify and quantify *all types of risk* across *all lines of business* throughout the bank.

### Example: Economic Capital Allocation for Commercial Credit Risk

At its most fundamental level, credit risk is associated with loan losses resulting from the occurrence of default and the subsequent failure to collect in full the balances owed at the time of default.<sup>5</sup> Expected credit losses associated with default can therefore be determined from parameters associated with the likelihood of a loan defaulting, or an estimate of the probability of default (PD) during a defined time period, and the severity of loss expected to be experienced in the event of a default, or an estimate of loss given default (LGD). Naturally, this ratio would be applied to a measure of estimated exposure at default (EAD) to convert loss expectations to dollar amounts. The resulting formula:

$$\text{Expected losses (\$)} = \text{PD}(\%) * \text{LGD}(\%) * \text{EAD}(\$).$$

PD and LGD parameter estimates are drawn from the bank's historical performance or from a mapping of internal portfolio risk assessments to

external information sources for PD and LGD parameters. This requires that banks have in place processes that enable them to periodically assess credit risk exposures to individual borrowers and counterparties with robust internal credit rating systems that reflect implicit, if not explicit, assessments of loss probability. Definitions of credit grades should be sufficiently detailed and descriptive to clearly delineate risk level between grades and should be applied consistently across all business lines.

For example, a bank could have a ten grade credit rating system with associated one-year probabilities of default drawn from their historical default experience within each grade as shown in Table 1 (next page). In this example, the historical default rate experienced for loans internally graded as a "6" has been one percent, which is approximately equivalent to the long-term default frequency associated with an S&P credit rating of BB.

Estimates for loss severity in the event of default could likewise be constructed. LGD grades assigned to loans are often associated with factors such as loan type, collateral type, collateral values, guarantees, or credit protection such as credit default swaps.<sup>6</sup>

*Pricing Implications:* A credit facility which is the same in all other respects may be priced differently based on its expected loss.<sup>7</sup> Table 2 shows expected losses for three different borrowers with the same loan structure and collateral

<sup>4</sup>Such as interest rate risk and operational risk associated with underwriting and servicing of loans.

<sup>5</sup>The example describes a default-only perspective to derive a loss distribution; i.e., loan defaults create credit losses. Some banks have adopted a more robust perspective for credit loss which considers the probability distribution of obligor grade migration and resulting changes in the economic value of the loan; i.e., a decline in the credit quality of a loan regardless of any default creates credit losses.

<sup>6</sup>Some banks consider guarantees and credit protection as substitutes for the borrower and therefore use guarantor or counterparty PDs in place of borrower PDs, while other banks retain the borrower PD and consider guarantees and credit protection in determining LGD.

<sup>7</sup>Pricing models are considerably more complex than the simplistic approach shown in this example. This discussion is merely intended to show that expected losses are often built into the pricing of loans.

# Economic Capital

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Table 1

Example Obligor Grades and Associated Default Probabilities										
Internal Loan Grade	1	2	3	4	5	6	7	8	9	10
Average Probability of Default	0.03%	0.06%	0.10%	0.25%	0.50%	1.00%	2.50%	8.00%	22.00%	100.00%
Mapping to External Ratings	AA	A	BBB+	BBB	BB+	BB	B+	B	CCC	D

Note: The mapping to equivalent external credit ratings, in this case S&P ratings, is an approximation and provided here only for reference.

support resulting in a 40 percent loss severity in the event of default. The higher risk credit grade has five times the expected loss of the lower risk credit grade.

If a bank made middle market loans which fell into the three grade bands shown in Table 2, but priced most of these loans with an implicit loss expectation of 50 basis points, the bank is overcharging stronger borrowers and undercharging weaker borrowers. One

Table 2

Expected Loss				
Loan Grade	PD	*	LGD	= Loss
5	0.50%		40%	20 basis points
6	1.00%		40%	40 basis points
7	2.50%		40%	100 basis points

potential result is that the bank could end up with stronger borrowers exiting the bank and find its loan pool progressively weaker and portfolio returns inadequate for losses experienced.

Although such a highly quantitative process may appear somewhat foreign to many bankers, a form of probability of default estimates is considered in the use

of consumer FICO scores or banks' own internal loan scorecards. Furthermore, many banks, including many community banks, are already relating this type of analysis to their allowance for loan and lease loss determination.

*Capital Adequacy:* The allocation of economic capital to support credit risk begins with similar inputs to derive expected losses but considers other factors to determine unexpected losses, such as credit concentrations and default correlations among borrowers. Because borrower defaults are not perfectly correlated, the default risk of a credit portfolio is less than the sum of the risks contained in the underlying loans. Economic capital credit risk modeling therefore measures the incremental risk that a transaction adds to a portfolio rather than the absolute level of risk associated with an individual transaction. Complex models are required to derive this measure of portfolio loss volatility and translate that into an associated economic capital charge.

Table 3 shows an example of credit risk economic capital allocations (*credit risk only*) determined using the PD and LGD parameters previously discussed and a model translation of those parameters into a credit risk capital charge.<sup>8</sup> The

<sup>8</sup>The credit economic capital allocations shown in the table were derived using the regulatory capital calculation for corporate credit exposures under the revised Basel framework. Refer to *International Convergence of Capital Measurement and Capital Standards*, June 2004 text, Basel Committee on Banking Supervision. As discussed later in this article, the regulatory capital calculation under the revised framework differs in important ways from economic capital methodologies, but is used for illustrative purposes in this example as a proxy for an economic capital methodology to avoid disclosing information about proprietary models used by any bank. The table includes nine obligor grades and nine facility grades; the tenth borrower grade previously discussed was for defaulted loans and is not shown as the methodology for estimating risk in defaulted exposures varies considerably among institutions.

Table 3

Example Economic Capital Allocations (\$) for \$100 1-Year Maturity Commercial Loan										
Facility Grades and Associated Loss Given Default		Obligor Grades and Associated Default Probabilities								
		1 0.03%	2 0.06%	3 0.10%	4 0.25%	5 0.50%	6 1.00%	7 2.50%	8 8.00%	9 22.00%
A	10%	\$0.13	0.23	0.33	0.62	0.93	1.30	1.84	2.84	4.05
B	20%	0.27	0.46	0.66	1.23	1.85	2.61	3.67	5.69	8.10
C	30%	0.40	0.69	1.00	1.85	2.78	3.91	5.51	8.53	12.14
D	40%	0.54	0.91	1.33	2.46	3.71	5.21	7.35	11.38	16.19
E	50%	0.67	1.14	1.66	3.08	4.64	6.51	9.18	14.22	20.24
F	60%	0.81	1.37	1.99	3.70	5.56	7.82	11.02	17.06	24.29
G	70%	0.94	1.60	2.32	4.31	6.49	9.12	12.86	19.91	28.33
H	80%	1.08	1.83	2.66	4.93	7.42	10.42	14.69	22.75	32.38
I	90%	1.21	2.06	2.99	5.55	8.35	11.72	16.53	25.60	36.43

bank's obligor grades and associated PDs are shown at the top of this table. The bank's facility grades and associated loss severity estimates are shown on the left-hand side of the table. The associated capital charges represent the dollar amount of capital needed to support a \$100 one-year maturity commercial loan based on parameter inputs (such as the PD estimate) and model assumptions (such as default correlations).

Credit economic capital allocations for a non-defaulted \$100 one-year maturity commercial loan using this model would range from as low as 13 cents to as high as \$36.43. Everyone intuitively expects increased risk to be associated with lower-quality graded loans or loans with higher loss severity, but the allocation of economic capital estimates the level of risk associated with a particular grade band and differentiates risk among bands.

For example, commercial loans graded as a 5 or a 6 with an LGD of 40 percent in the table above would not likely be subject to regulatory classification or criticism; i.e., both credits would be "pass" credits. However, the economic

capital allocations show a considerable difference in the inherent risk between these loans. A \$100 one-year maturity commercial loan that is graded a 6 would receive a \$5.21 credit economic capital allocation compared with a \$3.71 allocation for a similar loan graded 5, an approximately 40 percent increase in estimated risk.

*Risk-Adjusted Performance Measures:* Economic capital is also used to evaluate risk-adjusted performance; without some quantification of risk associated with an activity, it is not possible to measure performance on a risk-adjusted basis. Several techniques have been developed with two such approaches that incorporate economic capital allocations demonstrated below:

- Risk Adjusted Return On Capital (RAROC), a percentage measure of performance =  $\text{Economic Net Income} / \text{Economic Capital Allocation}$
- Economic Profit, or Shareholder Value Added (SVA), a dollar measure of performance =  $\text{Economic Net Income} - (\text{Economic Capital Allocations} * \text{Hurdle Rate})^9$

<sup>9</sup>The hurdle rate can be viewed as the firm-wide cost of capital. Returns above the hurdle rate add to shareholder value and those below, while perhaps profitable, detract from shareholder value.

Table 4

Example Risk-Adjusted Performance Measures		
	Portfolio X	Portfolio Y
Portfolio Balances	\$100,000,000	\$100,000,000
Net Income before Losses*	\$1,400,000	\$1,100,000
Loan Parameters:		
- PD	0.50%	0.25%
- LGD	50%	40%
- EL (in bps)	25	10
Expected Losses	\$250,000	\$100,000
Income after Expected Losses	\$1,150,000	\$1,000,000
Economic Capital (credit only)**	\$4,640,000	\$2,460,000
RAROC	24.8%	40.7%
Economic Profit (10% hurdle rate)	\$686,000	\$754,000

\* Net income before losses = loan interest + fees + soft dollars - funding costs - operating costs.  
 \*\* Determined from the economic capital charges shown in Table 3.

Assume that a bank is considering the performance of two loan portfolios: Portfolios X and Y, with Portfolio X assumed to be higher risk and producing a higher return relative to Portfolio Y (see Table 4). Using internal grading parameters and economic capital modeling for credit risk, management can strengthen its evaluation of the risk return trade-off of the two portfolios.<sup>10</sup>

Please note, this example considers only credit risk. Bank management would incorporate assessments of other risks in determining risk-adjusted performance.

Initially, bank management may have been inclined to select Portfolio X, based on simple return characteristics, as shown below. On a risk-adjusted basis, however, Portfolio Y is the preferred alternative. Although Portfolio X produces higher *expected* book and economic net income, the volatility of Portfolio X's return (i.e., risk) is not adequately compensated for in comparison to Portfolio Y. Portfolio Y generates a higher RAROC and results in a greater economic profit on a significantly lower economic capital allocation.<sup>11</sup>

Income after Expected Losses	\$1,150,000	\$1,000,000
Flat Capital Charge (e.g., 8%)	\$8,000,000	\$8,000,000
Return on Equity	14.4%	12.5%

<sup>10</sup>In many banks, risk-adjusted performance measures are built into the determination of compensation for line of business managers and staff, directly influencing behavior at the business line level. Often, both a dollar level of risk-adjusted performance, such as SVA, and a percentage measure, such as RAROC, are used.

- Percentage measures of performance are often used because dollar measures may not provide sufficient information to distinguish between alternative acceptable investments. For example, two portfolios could produce the same dollar measure of risk-adjusted performance, but one could require substantially larger capital allocations.
- Dollar measures of performance may be used because managers might be inclined to reject an investment that would generate positive SVA if that investment generated a RAROC that was lower than their existing business line RAROC. For example a manager might choose to reject an otherwise desirable investment with a 20 percent RAROC if his line of business had an average RAROC of 25 percent.

<sup>11</sup>Note that Portfolio X and Portfolio Y, when considering credit risk only, would be acceptable to management as both generate positive economic profit assuming a hurdle rate of 10 percent.

Although the decision reached in this example resulted in lower overall credit risk, economic capital models are not designed to always favor strategies that produce lower risk. Economic capital should be viewed as a tool to enhance risk identification and selection. Decisions resulting in the acceptance of higher credit risk can be expected to occur when supported by transaction level returns that compensate for higher risk or increased portfolio diversification benefits.

*Risk Management:* The implications for loan pricing, capital analysis, and risk-adjusted performance measures relate directly to risk management, but economic capital, as a common currency of risk, can provide additional potential applications to the risk management process. For example, some banks use credit economic capital allocations in place of or in addition to more traditional credit hold limits based on notional exposures which may not fully capture factors such as potential loss severity, default correlations with the rest of the credit portfolio, or maturity effects on default probability.<sup>12</sup>

The preceding example focused on credit risk. But similar assessment and quantification efforts can help banks identify, monitor, and manage other risks in other lines of business as well.

The effectiveness of a bank's risk management practices is an important consideration in the supervisory evaluation of an institution and directly influences the regulatory assessment of capital adequacy. Strong risk management practices can compensate in part for higher levels of inherent

risk in a bank's business activities. Recognizing this relationship, the revised Basel capital framework promotes the adoption of stronger risk management practices throughout the banking industry by incorporating industry advances in risk modeling and management into regulatory capital requirements.

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## Economic Capital and Basel II

The revised Basel framework seeks to create more risk-sensitive regulatory capital requirements in order to address concerns that the regulatory capital measures established by the 1988 Basel Accord do not adequately differentiate risk, and to reduce regulatory capital arbitrage activities which have eroded the relevance of current risk-based capital measures at some institutions. Many industry participants and observers have associated economic capital with the calculation of minimum regulatory capital requirements under the first pillar of the revised framework and the supervisory review process under the second pillar. As discussed below, however, economic capital and regulatory capital under the revised framework are not synonymous.

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### The First Pillar—Minimum Capital Requirements

The calculation of minimum regulatory capital under the revised framework relies heavily on certain inputs from the bank's assessment of its individual risk profile. For example, the calculation of the capital charge for credit risk considers the distribution of a bank's specific credit exposures among inter-

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<sup>12</sup>Intuitively, longer maturity loans to the same borrower entail greater credit risk; i.e., the default risk of a five year loan to a borrower, even a borrower of strong credit quality, is significantly greater than a six-month loan to the same borrower. However, traditional credit hold limits, such as notional exposures by loan grade, rarely capture this maturity effect. Credit economic capital allocations frequently adjust the one-year PD estimates for an obligor to reflect the differences in credit risk resulting from facility maturity.

nally assigned PD and LGD grades. The translation of that risk profile into a capital charge, however, is consistent for all institutions. The required inputs follow specific slotting criteria and are applied against regulatory risk weight curves which are the same for all institutions.<sup>13</sup> This need to ensure consistency necessarily creates differences between a bank's internal capital allocations and the minimum regulatory capital charge.

Potential differences also exist in the inputs used. For example, in its economic capital model, a bank may use a long-term estimate of LGD that covers all economic cycles, but for regulatory capital purposes, the LGD estimate should reflect economic downturn conditions for exposures where loss severities are expected to vary substantially with economic conditions.<sup>14</sup>

More fundamentally, the risks captured under regulatory and economic capital differ. The regulatory capital charge captures only credit, market, and operational risk. Furthermore, the regulatory capital calculation does not fully address certain aspects of these risks, such as credit concentration risk. As previously discussed, economic capital models generally address all risks arising from the bank's business activities.

Economic capital also typically incorporates a diversification benefit which is not considered in the regulatory capital calculation. This diversification benefit is a top-line measure of how changes in the risk associated with each business activity occur in relation to changes in risk in all other activities.

Chart 2 (next page) provides a graphic example of some of the potential differences between regulatory capital under the revised Basel framework and economic capital at a hypothetical bank. In this example, total economic capital allocations are higher than the regulatory minimum capital charge. While this typically may be expected to be the case, in some instances a bank could reasonably have lower economic capital allocations than regulatory capital requirements depending on the specific risk characteristics of the bank and the significance of the diversification benefit.

As demonstrated by the above discussion, a bank is not required to have a fully functional economic capital model to develop the necessary inputs for the calculation of the minimum regulatory capital charge. These inputs generally can be determined independent of any comprehensive risk measurement and management process. However, the second pillar of the revised framework creates a more direct link to a bank's own risk and capital adequacy assessments.

## The Second Pillar— Supervisory Review Process

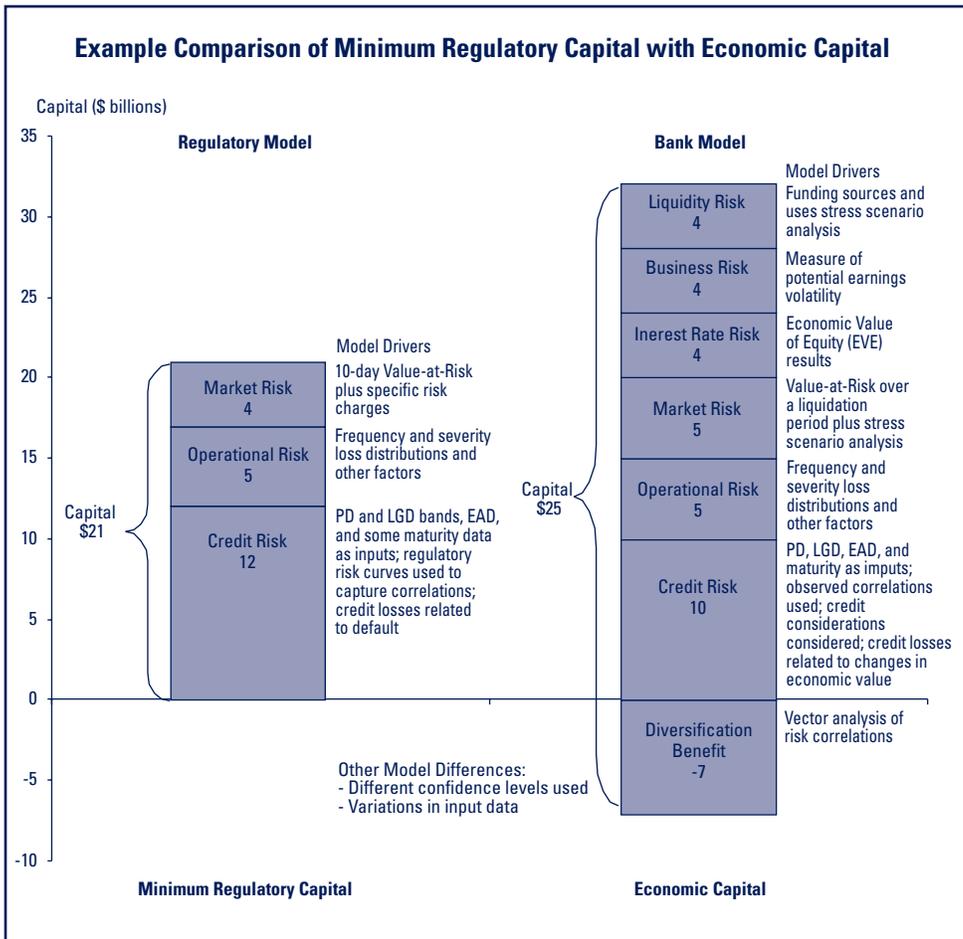
The second pillar establishes a regulatory expectation for the evaluation of how well banks assess their own capital needs. The second pillar does not explicitly require banks to adopt economic capital models. It does, however, establish an expectation for banks to perform a comprehensive assessment of the risks they face and to relate capital adequacy to these risks.<sup>15</sup>

<sup>13</sup>The regulatory risk-weight curves serve as a proxy for default correlations, with the expected default experience among weaker commercial borrowers (credits with higher PDs) assumed to be less correlated with systemic risk (overall economic conditions).

<sup>14</sup>Paragraph 468 of the revised Basel framework. *International Convergence of Capital Measurement and Capital Standards*, June 2004, Basel Committee on Banking Supervision.

<sup>15</sup>Paragraph 732 of the revised Basel framework: "All material risks faced by the bank should be addressed in the capital assessment process. While the Committee recognizes that not all risks can be measured precisely, a process should be developed to estimate risk." *International Convergence of Capital Measurement and Capital Standards*, June 2004, Basel Committee on Banking Supervision.

Chart 2



Furthermore, the bank’s own capital analysis is expected to encompass all risks, not only those risks captured by the minimum regulatory capital calculation. The revised Basel framework describes three areas not addressed in the minimum capital calculation that should be specifically considered under the second pillar:

- Risks that are not fully captured under the first pillar, such as credit concentration risk
- Risks that are not considered under the first pillar, such as interest rate risk, and

- Factors external to the bank, such as economic conditions.<sup>16</sup>

The supervisory qualification and ongoing validation of a bank’s compliance with regulations implementing the revised framework will necessarily incorporate review of a bank’s risk quantification efforts and capital analysis. While there is no supervisory requirement for economic capital methodologies to be employed in this process, many large institutions appear likely to use their economic capital models to demonstrate capital adequacy in relation to risk under Pillar 2.

<sup>16</sup>Paragraph 724, *International Convergence of Capital Measurement and Capital Standards*, June 2004, Basel Committee on Banking Supervision.

## Supervisory Review of Economic Capital

Regulators expect certain large or complex banks to perform appropriate risk quantification and capital analysis regardless of whether the bank is subject to the revised Basel framework. This is particularly important at banks where more traditional capital adequacy measures may not adequately capture the inherent risk of their business activities, such as at banks heavily engaged in securitization activities. An economic capital model is one tool available for such analysis.

At banks where economic capital models are used, considerable supervisory effort is focused on the process. Examiners consider both the adequacy of economic capital processes and the results of such processes in their supervisory evaluation of the bank. Furthermore, as discussed later in this article, examiners may find it beneficial to modify certain traditional examination procedures to more fully evaluate risk management practices associated with the economic capital process and other risk modeling techniques.

### Process Review

When properly used, economic capital models can improve risk management and the evaluation of capital adequacy. However, these models can suffer from data limitations, erroneous assumptions, inability to sufficiently quantify risks, and potential misuse or misunderstanding of model outputs. Examiner assessment of the appropriateness of a bank's capital adequacy analysis, potentially including economic capital methodologies, can be a consideration in the supervisory evaluation and rating of bank management. Institutions found to have material weaknesses in their methodologies may be directed to strengthen risk measurement and management capabilities.

The supervisory approach used to evaluate a bank's economic capital process will necessarily vary based on the complexity of the institution and the extent of use of the economic capital process by bank management. Examination guidance on economic capital models is limited. Federal Reserve Board Supervisory Letter SR 99-18 and the second pillar of the revised Basel framework do not specifically address economic capital methodologies, but both documents describe the supervisory review of a bank's capital analysis process. Many of the principles discussed in these documents are included in the general review concepts examiners may want to consider that are discussed below.

*Evaluate the adequacy of board and management oversight concerning economic capital.* Management is responsible for understanding the nature and level of risks undertaken in the bank's activities and how these risks fit within the overall business strategy of the bank. To evaluate this oversight, examiners could review:

- specific board approval of risk tolerances and associated capital levels
- periodic economic capital reports provided to the board and senior management. Such reports should be sufficient to allow the board and management to evaluate risk exposures, determine that the bank holds sufficient capital relative to identified risk, and incorporate capital needs into the strategic planning process.

*Determine that economic capital methodologies appropriately incorporate all material risks.* At a minimum, this should include assessments of credit, market, operational, liquidity, and business risks. To make this determination, examiners could review:

- a mapping of data inputs to material exposures, ensuring accuracy and completeness

- documentation supporting the appropriateness of specific risk quantification techniques
- analysis supporting the reasonableness and validity of stress tests and scenarios used
- analysis and testing of model sensitivity to key assumptions and data inputs used
- model validation work, including, where appropriate, the evaluation of developmental evidence, process verification, benchmarking, and back-testing.

*Evaluate the control environment.*

Controls should be in place to ensure the integrity of data inputs and the overall management process. In evaluating such controls, examiners could consider:

- the quality of management information systems, including the timeliness of incorporation of changes in the bank's risk profile
- internal or external audit program review of economic capital methodologies
- the corporate governance structure as it relates to risk management and economic capital.

*Determine the extent to which the economic capital process is used in decision making, such as in setting risk limits or evaluating performance.* Economic capital processes that are in place but not integrated with the institution's risk management procedures generally are ineffective.

## Results Review

The results of economic capital models can provide examiners another tool in the supervisory evaluation of capital adequacy, enabling examiners to compare tangible capital levels (cap-

ital available to support risk) with economic capital levels (the bank's own measure of its risk). As has always been the case, an institution found to hold inadequate capital in relation to risk, regardless of the institution's compliance with minimum regulatory capital requirements, is expected to take appropriate actions to reduce risk or increase capital.

Banks generally operate with a capital cushion above the level of risk measured by the economic capital model, recognizing the imprecision inherent in such estimation and the need for the bank to be responsive to potential changes in conditions. Several factors can be considered in determining the appropriate cushion, including:

- the robustness of the bank's economic capital methodologies,
- the quality of data inputs, assumptions, and parameters,
- volatility of the business model,
- the composition of capital,<sup>17</sup> and
- external factors, such as business cycle effects and the macroeconomic environment.

## Incorporation into the Overall Supervisory Process

The development and implementation of risk models such as economic capital often represents a significant change in a bank's overall risk management philosophy and practices. Likewise, the overall supervisory process for banks adopting economic capital models can be affected as examination focus may shift more to process evaluation. Transactional testing would continue to figure prominently in the examination function, but the purpose of transactional testing may be redirected to validation.

<sup>17</sup>This is particularly critical when considering the capacity of various elements of capital to absorb losses under stress scenarios.

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For example, the earlier discussion of commercial lending credit risk highlights the need for examiners to focus on validating the accuracy of the loan grading process at all grade bands rather than concentrating their attention primarily on large or criticized facilities. The classification of individual loans becomes integrated with the evaluation of the bank's internal loan grading system.

Furthermore, economic capital results can provide useful information for risk-scoping. Examiners can incorporate the bank's risk quantification efforts and trends in economic capital allocations as another tool to better focus supervisory efforts on areas of high or increasing risk.

The use of economic capital and other risk modeling techniques is expected to continue to evolve and expand to more industry participants. Supervisory evaluations of banks are also changing to appropriately incorporate such advances by the industry.

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# Linking International Remittance Flows to Financial Services: Tapping the Latino Immigrant Market

## Introduction

The flow of immigrants from a number of countries continues to shape the economic and demographic makeup of communities across the United States. Recent rapid growth and the overall size of the immigrant population from Latin American countries, in particular, have increased this group's political and economic influence. As a result, the U.S. banking industry is becoming keenly aware of the significant business potential that the Latino market represents.

The most significant recent waves of immigrants to this country, according to the 2000 Census, are from Latin American countries. This group's purchasing power is expected to almost double from \$491 billion in 2000 to \$926 billion by 2007.<sup>1</sup> The international remittance market, particularly in Latin America and the Caribbean, also is expected to grow considerably. Billions of dollars are flowing from the United States to Mexico and other countries, and a significant share of these transactions is taking place outside the formal banking system.

These impressive numbers provide a compelling incentive for U.S. banks to enter this largely untapped market. Studies show that as many as 10 million households in the United States are "unbanked" (without access to main-

stream bank products and services) and a significant number of these unbanked households are Latino immigrants. This article focuses on the size and economic potential of the Latino immigrant market, the innovative approaches that some banks are using to capture this new customer base, and key risks and regulatory issues that banks should consider in offering remittance products.

## Immigration and Remittance Flows

For the past decade, economic globalization has helped fuel immigration and remittance flows across international borders. More than 13 million people immigrated to the United States during the 1990s. Data from the 2000 Census estimate that more than 31 million immigrants are living in America today, comprising nearly 11 percent of the total population. Latin Americans represent 16 million, or 52 percent, of the total immigrant population. Mexico alone accounts for 9 million, or 30 percent, of this population.<sup>2</sup>

A major motivation in many Latinos' decision to come to the United States is the opportunity to earn money that can be returned to their homelands.<sup>3</sup> Results of the 2003 National Survey of Latinos conducted by the Pew Hispanic Center and the Kaiser Family Foundation indi-

<sup>1</sup> For more information, see Sanchez, Adrian R., Jeffrey A. Ayres, and Stephen L. Kiser. "Banks Are Still Sizing Up Opportunities in the Growing Hispanic Market." *FDIC Outlook*, Winter 2004. This article assesses the strong and growing purchasing power of Hispanics and categorizes this group's financial services needs as their demand for these services evolves. The article also provides insights into how banks can reach out to this group.

<sup>2</sup> Capps, Randy, Jeffrey S. Passel, Daniel Perez-Lopez and Michael Fix. *The New Neighbors: A User's Guide to Data on Immigrants in the U.S. Communities*. Washington DC: prepared by The Urban Institute, p. 4.

<sup>3</sup> Pew Hispanic Center. *The Multilateral Investment Fund, Billions in Motion: Latino Immigrants, Remittances and Banking*, p. 6.

# Remittance Flows

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cate that 42 percent of adult foreign-born Latinos who live in the United States send money to their homelands regularly.<sup>4</sup>

International financial flows have been as dynamic as immigration flows across national borders. According to a study by the World Bank, remittances (the portion of an immigrant's earnings returned to family members in his or her country of origin) through formal channels totaled \$93 billion dollars worldwide in 2003.<sup>5</sup> According to some analysts, remittances through informal mechanisms (e.g., hand delivery or regular mail) are roughly equal to transfers through formal channels such as wire transfer companies, banks and credit unions.<sup>6</sup>

The flow of labor and the subsequent financial flows from immigrant workers to their families in the home countries are most apparent between Latin America and the United States, with the United States and Mexico being the single largest bilateral remittance market. Research by the Inter-American Development Bank (IADB) has documented that remittance flows to Latin America and the Caribbean will reach nearly \$40 billion by the end of 2004. Approximately \$30 billion of these flows originate in the United States,<sup>7</sup> and if

future growth rates are maintained, the remittance market to Latin America could reach \$300 billion by the end of 2010.<sup>8</sup> Remittances sent to relatives in the home countries, for the most part, help pay for basic family needs such as food, clothing, and shelter. A recent study by the IADB reports that 10 million immigrants living in the United States send money home on average 12.6 times a year, generally a few hundred dollars at a time.<sup>9</sup>

Of particular interest to bankers, many Latin American remittance senders living in the United States do not have a bank account. For example, 35 percent of Ecuadorians, 64 percent of Salvadorans and 75 percent of Mexican immigrants are unbanked.<sup>10</sup> For many Latin American immigrants, legal status and a lack of traditional identification are the principal reasons for not having an account, causing most remitters to rely on currency exchanges to cash checks and high-cost wire transfer companies to send money to their relatives in Latin America.

Wire transfer companies such as Western Union and Money Gram are among the largest beneficiaries of these financial flows and the lucrative fees associated with remittances. The former has 6,000 offices throughout Mexico, including branches in post offices.<sup>11</sup> These two

<sup>4</sup> Suro, Roberto. "Sending Home the \$30 Billion Bacon." *Miami Herald*, November 28, 2003, p. 1.

<sup>5</sup> "Monetary Lifeline: Remittances from Migrant Workers in Rich Countries Are Increasingly Important to Developing Countries." *The Economist*, July 31–Aug 6 issue, 2004.

<sup>6</sup> *Informal Funds Transfer Systems in the Asia Pacific Economic Cooperation Region: Initial Findings and a Framework for Further Analysis*; prepared by APEC Alternative Remittance Systems Working Group and core team of the World Bank, Phuket, Thailand; September 1–5, 2003, p. 8.

<sup>7</sup> Remarks by Donald F. Terry, manager, Multilateral Investment Fund before the Multilateral Investment Fund/Inter-American Development Bank Regional Conference on *Sending Money Home: Remittances to Latin America from the United States*, May 17, 2004.

<sup>8</sup> Remarks by Sheila C. Bair, assistant secretary for financial institutions before the Multilateral Investment Fund/Inter-American Development Bank. Second Regional Conference on Impact of Remittances as a Developmental Tool, 2004.

<sup>9</sup> *Sending Money Home*. 2004, p. 1.

<sup>10</sup> Orozco, Manuel. 2004. Pew Hispanic Center Report, *The Remittance Marketplace: Prices, Policy and Financial Institutions*. Washington, DC: Georgetown University. Institute for the Study of International Migration, p. 19.

<sup>11</sup> "Remittances to Mexico Hit Record \$13.3 Billion," Associated Press, January 30, 2004.

companies controlled 40 percent of remittance transactions from the United States to Mexico several years ago; however, because of increasing competition from other wire transfer companies and, to a lesser extent, competition from banks and credit unions, their market share has dropped to 15 percent.<sup>12</sup> The competition has reduced the cost considerably, from 15 percent of the amount remitted in the late 1990s to an average of 7.32 percent in early 2004.<sup>13</sup>

Although a growing number of community and large banks in the United States are trying to capitalize on the opportunities presented by the emerging remittance market by linking them to banking services, banks capture less than 3 percent of the market.<sup>14</sup> Of the 100 million separate remittance transactions every year from the United States to Latin America, almost all are outside the formal banking system.<sup>15</sup> This creates an opportunity for banks to develop strategies around remittance services as a vehicle to draw unbanked immigrants into the banking system and offer a broader range of financial services.

Recognizing this opportunity, Citigroup Inc. and Bank of America Corporation have laid the foundation for future market penetration through acquisitions of two large Mexican banks, Banamex and Serfin. Citigroup recently launched a binational credit card to make it easier for migrants to send money across the border. Both the U.S. cardholder and the designated person in Mexico are issued a Banamex USA credit card. The latter can use the card anywhere it is accepted in Mexico, and the U.S. cardholder can pay

the entire credit card bill in dollars and adjust the spending limit at any time. The cardholder in Mexico also is allowed to withdraw money from automated teller machines (ATMs). Bank of America announced that the number of bank transfer accounts via the U.S.-Mexico channel soared 1,500 percent in the first half of 2004.<sup>16</sup>

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## Strategies for Facilitating Remittance Transfers

During the past several years, bilateral agreements and U.S. banking laws and regulations have facilitated remittance transfers for immigrants and helped bring the unbanked into the formal banking system. For example, in 2001 the United States and Mexico launched the U.S.-Mexico *Partnership for Prosperity* which fosters economic and labor opportunities in less developed parts of Mexico and expands access to capital in Mexico. The *Partnership* also addresses the high cost of sending money from the United States to Mexico and encourages banking institutions to market accounts that offer remittance features to Mexican workers. In addition, the G-8 countries are promoting programs to alleviate poverty in developing countries, including Latin America.<sup>17</sup> These programs facilitate remittances through the formal banking system and, at the same time, attempt to reduce the cost of these transfers.

In June 2004, in an effort to encourage more banks to enter the remittance market and improve access to the U.S. banking system among recent Latin

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<sup>12</sup> "Hispanic Banking: The Race Is On," from Knowledge@Wharton special to HispanicBusiness.com. August 26, 2004.

<sup>13</sup> Orozco, 2004, p. 2.

<sup>14</sup> Ibid.

<sup>15</sup> *Sending Money Home*. 2004. p. 1.

<sup>16</sup> "B of A's Mexico Transfer Accounts Proliferating," *Los Angeles Times*, from Reuters. August 18, 2004.

<sup>17</sup> The G-8 countries are Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States.

# Remittance Flows

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American immigrants, bank regulatory agencies clarified that financial institutions offering low cost international remittance services would receive credit under the Community Reinvestment Act (CRA).<sup>18</sup> Regulated financial institutions are required under the CRA to serve the convenience and credit needs of their entire communities, including low- and moderate-income areas. Most remittance senders to Latin America are low- to moderate-income immigrant wage earners who operate outside the formal banking system.

In addition, a growing number of U.S. banks accept alternative forms of identification to help taxpaying immigrants open bank accounts and secure other banking services; these include the Individual Taxpayer Identification Number (ITIN) and foreign government issued identification, such as the Mexican *Matricula Consular* card. The USA PATRIOT Act allows financial institutions to accept both forms of identification, enabling insured financial institutions to serve unbanked immigrants who live and work in the United States.

The ITIN, created by the U.S. Internal Revenue Service (IRS) for foreign-born individuals who are required to file federal tax returns, is a nine-digit number similar to the social security number (SSN) and is issued to individuals who are not eligible for the SSN. The *Matricula Consular* card is an identification card issued by the Mexican consulate to individuals of Mexican nationality who live in the United States. According to the Mexican government, an estimated 4 million

*Matricula* cards have been issued in the United States.<sup>19</sup>

As an example of the effectiveness of using this form of identification, Wells Fargo opened more than 400,000 new accounts for Mexican immigrants, using the *Matricula Consular* card between November 2001 and May 2004. In recent months, Wells Fargo has averaged 22,000 new accounts per month, many of which feature the bank's remittance product.<sup>20</sup> For example, the bank offers InterCuenta Express, an account-to-account wire transfer service that charges \$8 to transfer up to \$3,000 per day directly into a beneficiary's bank account in Mexico. Transfers can be initiated at the bank's branch or ATM in the United States, and the receiving party can access monies via the bank's sizeable remittance distribution network of more than 4,000 banking offices and 10,700 ATMs in Mexico. According to the Mexican government, 178 banks in the United States accept the *Matricula Consular* card to open bank accounts; 86 of these institutions are in the Midwest.<sup>21</sup>

## Provision of Remittance Services: Key Risks and Regulatory Issues

According to a recent study, at least 60 U.S.-based depository institutions offer remittance products.<sup>22</sup> The entry of banks into the remittance market has coincided with the growing number of institutions willing to accept foreign government issued identification and ITINs in lieu of SSNs. Remittance prod-

<sup>18</sup> An interagency letter dated June 3, 2004, states that regulated institutions that offer international remittance services will receive favorable consideration during a CRA evaluation.

<sup>19</sup> Boletín Especial, Lazos. *Preguntas Mas Frecuentes Sobre La Matricula Consular*, Instituto De Los Mexicanos En El Exterior, July 21, 2004.

<sup>20</sup> Interview with Daniel Ayala, senior vice president, cross-border payments, Wells Fargo Bank, September 29, 2004.

<sup>21</sup> Boletín Especial, Lazos. July 21, 2004.

<sup>22</sup> Orozco, 2004, p. 4.

ucts can pose a money laundering risk because they allow for quick, inexpensive transmission of funds across borders and, depending on the method of transaction, provide an uncertain audit trail. Implementation of the following can help mitigate this heightened risk:

- Imposing daily or monthly limits on the amount that can be transferred.
- Limiting the number of debit or stored-value cards issued to a customer.
- Instituting monitoring programs to flag unusual remittance activity.
- Limiting the maximum balance on an account/debit card.
- Controlling the mailing of debit cards or the distribution of funds to recipients.<sup>23</sup>

Other controls that will help to minimize the risk of money laundering and terrorist financing are outlined in Section 326 of the USA PATRIOT Act. Section 326 requires that banks adopt a Customer Identification Program (CIP) for all new accounts, whether the customer is a U.S. citizen or foreign national. The CIP must establish procedures for identifying and verifying the identity of customers seeking to open an account.<sup>24</sup>

The final CIP rule provides that, for non-U.S. citizens, a bank must obtain a taxpayer identification number (such as an ITIN) or a government-issued document (for example, the *Matricula Consular* identity card) that shows proof

of nationality or residence and bears a photograph or similar safeguard. The CIP must have procedures in place to establish the identity of the customer within a reasonable period after the account is opened.<sup>25</sup> Separately, institutions must check both purchasers and beneficiaries of remittances against the Office of Foreign Assets Control (OFAC) list, which includes known or suspected terrorists, in order to ensure both compliance with OFAC regulations and that funds are not supporting terrorists or other sanctioned groups.<sup>26</sup>

The Treasury Department and the bank regulatory agencies emphasize that the final CIP rule neither endorses nor prohibits bank acceptance of information from particular types of identification documents issued by foreign governments.<sup>27</sup> Essentially, the use of foreign-issued documents is a decision for banks to make and should be based on appropriate risk factors, including the types of accounts maintained by the bank and whether the information presented by the customer is reliable. In its report to Congress, the Treasury Department recognized the need to strike a balance between law enforcement objectives and the ability of financial institutions to serve unbanked immigrants living and working in the United States.<sup>28</sup>

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## Targeting the Unbanked Latino Immigrant Population

Several other key barriers contribute to the high number of unbanked immi-

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<sup>23</sup> See *Comptroller's Handbook*, "Bank Secrecy Act/Anti-Money Laundering," Office of the Comptroller of the Currency, December 2000, at <http://www.occ.treas.gov/handbook/bsa.pdf>. Discussion of these risk mitigation strategies also appears in Frumkin, Samuel, 2004. "Remittances: A Gateway to Banking for Unbanked Immigrants," *Insights*, Washington, DC: Office of the Comptroller of the Currency, p. 6.

<sup>24</sup> Customer Identification Programs for Banks, Savings Associations, Credit Unions and Certain Non-Federally Regulated Banks, 31 C.F.R. pt. 103, RIN 1506-AA (2004).

<sup>25</sup> *Ibid.*

<sup>26</sup> Frumkin, 2004, 8. See Frequently Asked Questions: Final CIP Rule at <http://www.fincen.gov/finalciprule.pdf>.

<sup>27</sup> 31 C.F.R. pt. 103 (2004).

<sup>28</sup> Department of the Treasury, *supra* note 22.

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## New Alliance Task Force

- Comprises representatives from the FDIC, Mexican Consulate, 34 banks, community-based organizations, federal bank regulatory agencies, government agencies, secondary market companies, and private mortgage insurance companies.
- Organized into four working groups that provide updates during the NATF's quarterly meetings.
  - Financial Education — educates immigrants on the benefits and importance of holding accounts, the credit process, and mainstream banking.
  - Bank Products and Services Working Group — encourages banks and thrifts to develop financial service products with remittance features as a strategy to reach the unbanked immigrant community.
  - Mortgage Products — created the New Alliance Model Loan Product for potential homeowners who pay taxes using an ITIN.
  - Social Projects — provides scholarship funds for immigrant students and fosters economic support for *Plazas Comunitarias*, a program that will give Mexican citizens an opportunity to finish their high school education.

grants, primarily a limited ability to understand and speak English and cultural distrust of financial institutions. These barriers create real challenges. However, in Chicago and other parts of the Midwest, organizations are bringing unbanked Latino immigrants into the financial mainstream with the right mix of innovative products, financial education programs, effective outreach programs, and a strong commitment from banks to serve this market, all of which are being facilitated by the development and activities of a few organizations, including the New Alliance Task Force (NATF).

The NATF was launched in May 2003 by the Consulate General of Mexico in Chicago and the Chicago Office of the FDIC's Community Affairs Program in support of the U.S.-Mexico *Partnership for Prosperity*. The NATF is a broad-based coalition of 62 members, including the Mexican Consulate, 34 banks, community-based organizations, federal bank regulatory agencies, government agencies, and representatives from the secondary market and private mortgage insurance (PMI) companies. The major-

ity of the participating financial institutions are community banks in Illinois, Indiana and Wisconsin. The coalition's programs and initiatives address the critical need among Mexican immigrants, both established and recently arrived, to successfully develop asset-building strategies to improve their quality of life in the United States. This goal is critical as Latinos continue to have lower homeownership rates and less access to mainstream financial services and credit instruments.

In addition to promoting general educational opportunities for immigrants, NATF members sponsor financial education programs and are developing financial products that include remittance features and mortgage products that help immigrants overcome barriers to homeownership.

The NATF's Financial Education Working Group educates immigrants on the benefits and importance of holding accounts, the credit process, and mainstream banking as an alternative to the "fringe" banking system. Ten thousand immigrants have participated in financial education classes and workshops using the FDIC's *Money Smart*, a Spanish-language adult financial education curriculum, and similar financial education programs in the Chicago area. A number of delivery channels exist, including financial institutions, churches, housing organizations, job training centers, and community colleges. In addition to these programs, the Mexican Consulate of Chicago, in collaboration with local banks, launched a financial education program in Spanish in January 2004. Several institutions donated simulated ATMs to train immigrants on banking technologies.

The NATF Bank Products and Services Working Group encourages banks and thrifts to develop financial service products with remittance features as a strategy to reach the unbanked immigrant community. In recent years, banks in the Midwest have begun to realize the signifi-

cant dollar amounts generated by remittance transfers and have taken steps to break down some of the barriers preventing immigrants' access to the banking system. Community banks in Chicago and Milwaukee, for example, have taken the lead in offering international remittance services. Second Federal Savings and First Bank of the Americas were the first community banks in the country to accept the Mexican *Matricula Consular* card and develop remittance products through dual ATM cards. Soon afterward, Mitchell Bank and North Shore Bank in Milwaukee followed suit. These institutions are aware that many immigrants, regardless of their current immigration status, will eventually settle in this country. This offers an opportunity for banks to cross-sell other products and offer a wider range of financial services.

Fifteen of the 34 NATF banks are now offering products with remittance services that allow immigrants to open bank accounts, avoid high-cost wire services, and incur lower remittance costs for sending money back home. Dual ATM cards or stored-value cards offer the lowest transfer cost: 1.5 percent of the amount sent.<sup>29</sup> In the past two years, 50,000 new accounts totaling \$100 million (with an average account balance of \$2,000) have been opened at NATF banks in the Midwest. Many of these accounts were opened using the banks' remittance services. Other NATF banks, including South Central Bank and Lakeside Bank, are using the Federal Reserve System's recently unveiled FedAutomated Clearing House International Mexico Service as a cost-effective alternative to expensive wire transfers.<sup>30</sup>

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## Conclusion

Recent economic and demographic trends, coupled with increased financial flows across international borders, have significant implications for U.S. banks and thrifts. As more insured financial institutions reach out to the Latino immigrant market, these institutions are expected to experience more rapid deposit and loan growth. In the Midwest, both small and large banks are capitalizing on remittance flows as a short-term strategy to draw immigrants into the formal banking system. Leveraging these relationships will help these institutions offer a broader range of financial services, positively contributing to their bottom line.

Many Latino immigrants will eventually settle in the United States and raise families. Banks in the Midwest are taking steps to capitalize on the growing presence of this immigrant group. The continued success of the New Alliance Task Force demonstrates that unbanked Latin American immigrants can be brought into the financial mainstream. As a result, the FDIC is considering the feasibility of expanding the NATF pilot to other parts of the country where there are significant immigrant populations. These broad-based private-public sector alliances will help immigrants increase savings, build assets, and strengthen their financial security.

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<sup>29</sup> Orozco, 2004, p. 22.

<sup>30</sup> FedAutomated Clearing House International Mexico Service allows monies to be transferred from depository financial institutions in the United States to a receiver's account in depository financial institutions in Mexico.

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# The Importance of a Loan Policy “Tune-Up”

The fortunes of FDIC-insured institutions have been closely tied historically to how well they managed credit risk. A written loan policy, approved by a bank’s board of directors and adhered to in practice, is of critical importance in ensuring that the bank operates within prescribed risk tolerances. In today’s fiercely competitive and challenging lending environment, an up-to-date policy, appropriate to an institution’s lending function and business plan, may be more important than ever. This article summarizes features and benefits of an effective policy, details warning signs and potential consequences of an outmoded policy, and offers practical advice about reviewing and updating a loan policy.

## Elements of an Effective Loan Policy

Written loan policies vary considerably in content, length, and specificity, as well as style and quality. No two institutions share the same tolerance for risk, offer the same product mix, and face the same economic conditions. An effective loan policy should reflect the size and complexity of a bank and its lending operations and should be tailored to its particular needs and characteristics. Revisions should occur as circumstances change, and the policy should be flexible enough to accommodate a new lending activity without a major overhaul.

During risk management examinations, examiners make a determination about the adequacy of an institution’s

loan policy. Bank examiners are guided in their review by regulations, examination guidelines, and common sense: Is the policy up-to-date and are important areas adequately addressed? The *FDIC Manual of Examination Policies* lists broad areas that should be addressed in written loan policies, regardless of a bank’s size or location (see box on p. 26).<sup>1</sup>

A loan policy should include more detailed guidelines for each lending department or function. For example, the real estate lending department should comply with specific guidelines appropriate to the size and scope of its operations. In fact, as part of the *Interagency Guidelines for Real Estate Lending Policies*, the federal banking agencies list 57 areas to be considered in written policies on real estate lending, ranging from zoning requirements to escrow administration.<sup>2</sup>

In addition, in 1995, the federal banking regulatory agencies established basic operational and managerial standards for loan documentation and credit underwriting.<sup>3</sup> These standards also should be incorporated into a bank’s written loan policy. For example, loan documentation practices should take into account the size and complexity of a loan, the purpose and source of repayment, and the borrower’s ability to repay the indebtedness in a timely manner. And among other things, underwriting practices should include a system of independent, ongoing credit review and appropriate communication to management and the board of directors.

<sup>1</sup> See *FDIC Manual of Examination Policies*, Section 3.2 – Loans (I. Loan Administration – Lending Policies).

<sup>2</sup> The *Interagency Guidelines for Real Estate Lending Policies* describes the criteria and factors that the bank regulatory agencies expect insured institutions to consider when establishing real estate lending policies. These guidelines, which took effect March 19, 1993, address loan-to-value limits for various categories of real estate loans.

<sup>3</sup> *The Interagency Guidelines Establishing Standards for Safety and Soundness*, which implements Section 39 of the Federal Deposit Insurance Act, was adopted on July 10, 1995.

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## A Loan Policy Should Address...

- General fields of lending
- Normal trade area
- Lending authority of loan officers and committees
- Responsibility of the board of directors in approving loans
- Guidelines for portfolio mix, risk diversification, appraisals, unsecured loans, and rates of interest
- Limitations on loan-to-value, aggregate loans, and overdrafts
- Credit and collateral documentation standards
- Collection procedures
- Guidelines addressing loan review/grading systems and the allowance for loan and lease losses
- Safeguards to minimize potential environmental liability

## Benefits of an Effective and Up-to-Date Loan Policy

A sound loan policy, established and overseen by the board of directors, reflects favorably on the board and management. When a board sets forth its expectations clearly in writing, management is better positioned to control lending risks, ensure the institution’s stability and soundness, and fulfill oversight responsibilities. An effective and up-to-date loan policy increases the likelihood that actual loan documentation and underwriting practices will satisfy the board’s expectations. Furthermore, a well-conceived policy clearly and comprehensively describes management’s system of controls and helps examiners identify high-risk areas and prioritize and allocate examination time.

In 1997, the FDIC began implementing new, risk-focused examination processes.<sup>4</sup> During a risk-focused exami-

nation, examiners focus on areas that represent the greatest risk to the insured institution. A written policy is tangible evidence of the processes that have been established to identify, measure, monitor, and control risks in the lending area. An incomplete or inadequate policy makes it more difficult to identify potentially high-risk areas and may raise supervisory concerns about an institution’s risk management practices.

## Signs That a Loan Policy Needs a Tune-Up

A recent cover date does not provide adequate assurance that a policy is current. Only a careful review of the entire policy will reveal the extent of any shortcomings; however, even a cursory review can provide clues that a policy needs an overhaul. Common red flags include:

- The policy has not been revised or reapproved in more than a year.
- Multiple versions of the policy are in circulation.
- The table of contents is not accurate.
- The policy is disorganized or contains addendums from years past that have never been incorporated into the body of the policy.
- The policy contains misspellings, typos, and grammatical errors.
- Officers and directors who no longer serve are listed, or new ones are not listed.
- The designated trade territory includes areas no longer served, or new areas are omitted.

<sup>4</sup> On October 1, 1997, the FDIC, Federal Reserve, and state banking departments implemented a risk-focused examination process. To allocate examination resources effectively, on-site procedures are customized on the basis of a bank’s overall risk profile. In April 2002, the FDIC implemented a streamlined examination program called MERIT (*M*aximum *E*fficiency, *R*isk-Focused, *I*nstitution *T*argeted Examinations). This program was applicable to banks that met basic eligibility criteria, such as total assets of \$250 million or less and satisfactory regulatory ratings. In February 2004, the FDIC expanded the use of MERIT to eligible, well-rated banks with total assets of \$1 billion or less; see FIL 13-2004 - <https://www.fdic.gov/news/inactive-financial-institution-letters/2004/FIL1304.html>.

- Discontinued products are included, or new products are not addressed.

- New regulations are not addressed.

In addition, a review of lending decisions may identify areas where management is departing from the specifics of the loan policy, such as:

- Actual lending practices vary significantly from those outlined in the policy.

- Numerous exceptions to policy requirements have been approved.

- Policy limits are being ignored.

Exceptions to policy should be few in number and properly justified, approved, and tracked. If actual practices vary materially from the written guidelines and procedures, the source of this discrepancy should be identified, and either actual practices or the written policy should be changed. Management may conclude that specific sections of the written policy are no longer relevant. A case is then made to the board of directors to amend the policy to reflect different, but still prudent, procedures and objectives.

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## Potential Consequences of an Inadequate Loan Policy

Outdated and ineffective loan policies can contribute to a range of problems. Introducing a loan product that is not adequately addressed in the written loan policy can create a variety of challenges for the lending staff and involve risks that management did not anticipate.

If lending authorities, loan-to-value limits, and other lending limitations are not revised when circumstances change, a bank could be operating within guidelines that are too restrictive, too lenient, or otherwise inappropriate in light of the bank's current situation and lending environment. If guidelines do not comply

with current laws and regulations, lending decisions may not reflect best practices or regulatory requirements.

Imprudent lending decisions can have a ripple effect. A loan policy that does not anticipate the risks inherent in an insured institution's lending practices can lead to asset quality problems and poor earnings. In turn, earnings that do not fully support operations increase an institution's vulnerability to adverse movements in interest rates, a downturn in the local economy, or other negative economic events.

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## The Loan Policy Updating Process

A bank's loan policy is not a static document, but rather should be revised as the institution, business conditions, or regulations change. A comprehensive annual review, in addition to more limited reviews as needed, will help ensure that a loan policy does not become outdated and ineffective. The frequency and depth of the reviews will depend on circumstances specific to each institution, such as growth expectations, competitive factors, economic conditions, staff expertise, and level of capital protection. Planned changes to an institution's lending function or business plan should prompt a modification to the policy. Pertinent criticisms and recommendations made during recent audits and regulatory examinations should be considered during the updating process.

In certain situations, a loan policy can be updated effectively through addendums or supplemental memorandums, but if carried too far, such "cobbling together" can result in a cumbersome and disorganized document. It is best to merge supplementary materials periodically into a logical place in the main document. The updating process also includes identifying obsolete or irrelevant sections of the policy. For example,

# Loan Policy “Tune-Up”

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a bank might have entered a new field of lending a few years ago and modified its loan policy at that time. However, when it became obvious the bank could not compete successfully in this field, management wound down the operations. The loan policy should reflect the decision to exit that lending niche.

Compliance testing, conducted as part of the updating and audit processes, will help management determine whether staff is aware of and adhering to the provisions of a loan policy. An institution’s board of directors should demonstrate their commitment by emphasizing that noncompliance is unacceptable. Loan staff, executive officers, and directors should be able to demonstrate some level of familiarity with all provisions — more so with the provisions that affect their daily responsibilities. Awareness and knowledge of the policy’s specific provisions can be promoted through periodic training that stresses the need for the policy to keep pace with current lending activities and clarifies any areas of ambiguity or uncertainty. Specific areas that may benefit from review are

- ranges for key numerical targets, such as loan-to-value ratios or loan portfolio segment allocations
- responsibility for monitoring and enforcing loan policy requirements
- documentation requirements for various classes of loans

- remedial measures or penalties for loan policy infractions
- preparation and content of loan officer memorandums
- individual and committee lending authorities

## Conclusion

A current and effective loan policy is a tool to help management ensure that a bank’s lending function is operating within established risk tolerances. Such a policy is more likely to be consulted and followed by staff and contributes to uniform and consistent board-approved practices. Therefore, insured institution staff, borrowers, and regulators will be well served by the implementation of a process that helps ensure that a bank’s loan policy remains comprehensive, effective, and up to date.

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# From the Examiner's Desk...

## A Focus on the Appraiser Referral Process

*This regular feature focuses on developments that affect the bank examination function. We welcome ideas for future columns, and readers can e-mail suggestions to [SupervisoryJournal@fdic.gov](mailto:SupervisoryJournal@fdic.gov).*

During the 1980s real estate crisis, flawed and fraudulent appraisals sometimes masked the risk in speculative real estate loans at federally insured institutions. At that time there were no universally accepted appraisal content standards, no system of licensing appraisers, no appraiser education and experience qualification standards, and no laws requiring the use of appraisals. The underwriting of high-risk real estate projects supported by misleading and poorly documented appraisals contributed significantly to the insolvency of many banks and savings and loans during this time.<sup>1</sup> In response, Congress passed the appraisal reform provisions of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

In part, Title XI mandated the development of a regulatory structure built on state agencies with the authority to sanction appraisers who do not conform to appraisal standards (see box, "An Overview of the Appraisal Regulatory Framework"). These state appraiser agencies have pursued disciplinary actions against certain appraisers. The National Registry database, a compre-

hensive source of information on disciplinary actions that have been brought against individual appraisers, shows that since 1994 the states have imposed 630 suspensions, 725 revocations, 230 voluntary surrenders in lieu of disciplinary action, and 4,440 other actions such as fines, remedial education, and probationary periods.<sup>2</sup> These statistics represent a relatively high number of sanctions in relation to the nation's 79,000 state licensed and certified appraisers, demonstrating how critical the appraiser referral process is to maintaining the quality of the profession.<sup>3</sup>

Bank examiners play a key role in alerting state agencies to inappropriate appraiser activity. Title XI charges the Federal Deposit Insurance Corporation (FDIC) and the other federal bank and thrift regulatory agencies with making referrals of appraisers who have submitted flawed appraisals.<sup>4</sup> In certain situations, the agencies also have the authority to sanction appraisers directly.<sup>5</sup> This article explains when and how appraiser referrals are made and provides an overview of the appraiser referral process at the FDIC.

### When an Appraiser Referral Should Be Made

An examiner makes a referral to a state appraiser agency when an

<sup>1</sup> Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future. Vol. I: An Examination of the Banking Crises of the 1980s and Early 1990s*, Washington, DC: FDIC, 1997, pp. 156–158, <http://www.fdic.gov/bank/historical/history/index.html>.

<sup>2</sup> Title XI created a National Registry of state licensed and certified appraisers that is maintained by the Appraisal Subcommittee. The Registry, available on the Internet, allows the public to determine whether a person is certified or licensed to perform appraisals in connection with federally related transactions and whether that person's credential has been suspended, revoked or surrendered in lieu of state enforcement action.

<sup>3</sup> Appraisal Subcommittee Annual Report 2003, p. 3.

<sup>4</sup> Title XI, Section 1119(c): "The Appraisal Subcommittee, any other Federal agency or instrumentality, or any federally recognized entity shall report any action of a State certified or licensed appraiser that is contrary to the purposes of this title, to the appropriate State agency for a disposition of the subject of the referral."

<sup>5</sup> Title IX, Section 901 of FIRREA granted the banking agencies enforcement authority over independent contractors including appraisers, attorneys, and accountants as institution-affiliated parties.

# From the Examiner's Desk...

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Table 1

Situations That Typically Result in a Referral	
The appraiser...	Example
"Readdresses" an appraisal <sup>6</sup>	Conceals that the original client was the loan applicant
Accepts a contingent fee	Accepts a fee contingent on the appraisal obtaining a predetermined value
Inaccurately describes improvements	Overstates square footage and number of rooms
Misrepresents the condition of property	States that the property is in good condition when major repairs are needed
Fails to disclose extraordinary assumptions and hypothetical conditions	Does not disclose that the estimated value depends on obtaining a change in zoning
Presents faulty analysis	Uses appraisal methodology applicable for higher valued owner-occupied condos when the property is rental apartment units
Omits relevant information	Fails to disclose that a number of new office building permits have been issued that would adversely affect the absorption of the proposed office building
Includes misleading information	In the case of a property that requires a zoning change, appraisal describes the current political environment as favorable when it is probable the incumbent zoning officials will be replaced by anti-growth candidates
Includes a series of material technical errors that will affect the credibility of the valuation	Appraisal includes multiple errors such that there is no way to conclude that the valuation is realistic
Fails to follow the supplemental appraisal standards contained in the agencies' appraisal regulation <sup>7</sup>	Reports the sum of retail values of units for a tract development project as representing the market value of the whole property

appraiser is involved in ethical violations or the appraisal does not comply with the procedures in the Uniform Standards of Professional Appraisal Practice (USPAP). The USPAP, the generally accepted standards for professional appraisal practice in North America, is referenced in Title XI, the appraisal regulations implemented by the federal banking agencies, and state laws as the source for appraisal standards. Table 1 summarizes situations that typically prompt a referral to a state appraiser agency.

The information in Table 1 is not all-inclusive. A referral also should be considered when an appraiser's failure

to use standard appraisal methodology in compliance with the USPAP could reasonably be expected to result in a state disciplinary action. It is important to note that not all mistakes or inadequate documentation require a referral. Common typographical and clerical errors that do not affect the assigned value of the property should not be referred unless a pattern or practice of exceptions on a number of appraisals is identified.

Once the decision has been made to initiate a referral to a state appraiser agency, field examiners and other FDIC regional office staff work together. The steps in processing an appraiser referral

<sup>6</sup> To readdress is to alter references to the original client to mislead the reader about who originally engaged the appraiser.

<sup>7</sup> Statement on Appraisal Standards No. 10, FIL-20-2001, March 7, 2001, <http://www.fdic.gov/news/news/financial/2001/fil0120.html>.

are outlined in the box entitled “Processing an Appraiser Referral at the FDIC.”

## Enforcement and Criminal Referrals

Title XI of FIRREA also granted the federal banking agencies authority to sanction appraisers directly. An FDIC regional office would consider an enforcement action when an appraiser participates in a violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes a financial loss to an insured depository institution. For example, if a flawed real estate appraisal contributed to identifiable loss or exposure to loss in classified and charged-off loans, other real estate, or restructured troubled debt, an enforcement action could result. In addition, if an appraisal is used to defraud an insured financial institution, the appraiser could be referred to law enforcement authorities on a Suspicious Activity Report Form.<sup>10</sup>

## The FDIC’s Experience

FDIC regional offices have reviewed and forwarded referrals to state appraiser agencies since the early 1990s. Much less commonly, the FDIC also has initiated enforcement actions and made criminal referrals. Generally, referral activity has been greater in geographic areas where insured financial institutions are experiencing problems. The existence of flawed or fraudulent appraisals becomes more apparent to examiners when lax underwriting standards contribute to a higher volume of real estate credits that reach nonperforming

### Processing an Appraiser Referral at the FDIC<sup>8</sup>

The FDIC notifies a state appraiser agency when state certified or licensed appraisers appear to have acted in an unethical or incompetent manner that could reasonably be expected to result in a state disciplinary action.<sup>9</sup> The roles and responsibilities of field examiners and regional office staff are as follows.

#### Field Examiner

- prepares a memorandum that describes the deficiencies of the appraisal report, the degree of incompetence or severity of the misconduct, and any observable pattern or practice
- drafts a referral letter to the state appraiser agency that includes factual information about the apparent noncompliance with the USPAP or state appraisal law and other relevant information that assists a state in its investigation
- talks with insured institution management about the possible referral

#### Regional Office Staff

- reviews the examiner’s analysis and referral letter for appropriate editing and disposition
- forwards the letter to the Regional Counsel, who checks the information for privacy, confidentiality, and other legal issues
- sends the referral letter to the appropriate state appraiser agency
- considers requests for additional information by the state agency and provides documents that are not subject to federal privacy laws or do not represent confidential examination material

status. At that point, examiners are scrutinizing loans in default more closely.

The FDIC has issued enforcement actions and criminal referrals involving egregious conduct on the part of appraisers. For example, in Kansas and Missouri during the mid-1990s, the FDIC determined that appraisers were submitting property valuations to fit a specific bank’s loan requirements. In this situation, loan officers supplied the necessary information as well as target appraisal values. In addition to inflating the value of the properties, the appraisals did not comply with the USPAP. In some

<sup>8</sup> The FDIC’s appraiser referral process is described in Regional Director Memo Transmittal Number 94-119, Classification #6910, August 1, 1994, *Complaints Against Appraisers*.

<sup>9</sup> Title XI recognizes two types of appraisers: certified and licensed. In general, certified appraisers are more knowledgeable and experienced than licensed appraisers.

<sup>10</sup> The Bank Fraud Statute, 18 U.S.C. 1344, makes it a crime to defraud an insured financial institution. Loans based on fraudulent appraisals could be referred to law enforcement authorities on a Suspicious Activity Report Form prescribed pursuant to Part 353 of the *FDIC Rules and Regulations*.

## An Overview of the Appraisal Regulatory Framework

Before the enactment of Title XI, there were no universally accepted appraisal content standards, no system of licensing appraisers, no appraiser education and experience qualification standards, and no laws requiring the use of appraisals. Title XI created a regulatory framework that includes federal bank regulatory agencies, a federal agency with authority to monitor state activities, a nonprofit appraisal organization, and state agencies that license and certify appraisers. Their roles are summarized below.

### Federal Bank Regulatory Agencies

Part 323 of the *FDIC Rules and Regulations*, as well as uniform regulations implemented by the other banking agencies, specify transactions that require an appraisal, require appraisers to be licensed or certified by state agencies, and mandate that appraisals comply with the USPAP. Examiners enforce compliance with Title XI at federally insured institutions by detailing violations of appraisal regulations in examination reports and referring appraisers to state appraiser agencies. In particularly egregious situations, the FDIC has recommended enforcement actions and made criminal referrals.

### Appraisal Subcommittee

The Appraisal Subcommittee (ASC) is an independent agency that is a subcommittee of the Federal Financial Institutions Examination Council. All federal bank regulatory agencies, the National Credit Union Administration, and the U.S. Department of Housing and Urban Development appoint representatives to the ASC. The ASC conducts on-site reviews of each state appraiser agency once every three years, with more frequent visits to states with weak enforcement programs. The ASC has the authority to disapprove a state appraiser regulatory program. Disapproval disqualifies the appraisers in that state from conducting appraisals for federally insured institutions. Each state certified or licensed appraiser pays \$25 each year to support the ASC National Registry. This fee funds the ASC's operations and provides a grant to the Appraisal Foundation to be used for Title XI-related activities, such as updating the USPAP.

The Appraisal Subcommittee website ([www.asc.gov](http://www.asc.gov)) contains useful information about state appraiser agencies and individual appraisers:

- current status of all appraisers, including any formal sanctions outstanding (National Registry)
- summaries of state appraiser requirements
- listings of state agency contacts and links to state appraiser licensing agency websites
- ASC supervisory letters that describe the findings of ASC state reviews
- current ASC Annual Report, copy of Title XI of FIRREA, and all ASC policies

### Appraisal Foundation

The Appraisal Foundation is a private, not-for-profit corporation that sponsors two independent boards: the Appraiser Qualifications Board (AQB) and the Appraisal Standards Board (ASB). The AQB establishes minimum education and experience requirements for appraisers. The ASB issues the USPAP, industry standards for conducting real estate appraisals. The Appraisal Foundation is funded by a grant from the ASC, revenue from the sale of the USPAP, and fees from USPAP courses and other activities.

The Appraisal Foundation website ([www.appraisalfoundation.org](http://www.appraisalfoundation.org)) provides the following information:

- copy of the USPAP, as well as questions and answers related to the USPAP
- appraiser qualification criteria
- state regulatory update (periodic electronic publication for state regulators) and descriptions of current Foundation initiatives

### State Appraiser Agencies

State appraiser agencies license and certify appraisers and establish appraiser education and experience requirements that, at a minimum, must satisfy AQB criteria. State agencies review appraiser referrals and discipline appraisers who do not comply with state law or the USPAP.

instances, the FDIC could prove that the appraiser had not inspected the property, despite having stated so in the appraisal. The FDIC banned the appraisers from the business of banking, and the state appraiser authorities took appropriate disciplinary action.

In 2004, a bank funded a \$440,000 loan to a borrower to purchase a 24-unit apartment complex. The borrower failed to make the first payment, and the bank foreclosed on the property. A real estate appraisal performed for the loan showed an “as is” fee simple interest market value of \$585,000. A second appraisal performed six months later by another appraiser estimated the market value “as is” at \$230,000. Clearly, the two appraisals differed significantly. Conflicting information was provided about the number of buildings on the property, number of stories in each building, landscaping on the property, occupancy rate, the year the property was built, the owner of record of the

property, whether the property was boarded up and tagged for back taxes, and whether the property was inhabitable. In this case, the FDIC did not make a criminal referral because the bank had reported the possible criminal activity to the authorities.

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## **A System That Works**

Title XI of FIRREA resulted in the development and implementation of a regulatory structure that mandates close supervision of real estate appraisers. The referral process helps ensure the early identification and sanctioning of appraisers who are not complying with applicable regulations. As a result, lenders and borrowers at insured institutions can have greater confidence in the appraisal valuations they are receiving.

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*This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to [SupervisoryJournal@fdic.gov](mailto:SupervisoryJournal@fdic.gov).*

## Guidance on Accounting for the Mortgage Partnership Finance Program

The Federal Home Loan Bank (FHLB) of Chicago created the Mortgage Partnership Finance (MPF) program in 1997 to provide its member institutions with an alternative to holding fixed-rate residential mortgage loans in their loan portfolios or selling them in the secondary market.<sup>1</sup> Institutions that participate in the MPF program originate loans that are purchased or funded by the FHLBs, but the institutions receive fees for managing the credit risk of the loans and servicing them. The FHLBs manage the interest rate and prepayment risks of the mortgages they acquire, thereby also taking on the liquidity risk arising from holding the loans in their portfolios. The MPF program now offers several product structures, and eight more FHLBs have joined the program.<sup>2</sup>

The interest of depository institutions in the MPF program has grown steadily during the past seven years. As of June 30, 2004, the FHLB of Chicago reported that the number of institutions participating in the MPF program was approaching 800, up more than 40 percent from a year earlier, with another 100 in the process of joining. Since

1997, the program has funded more than \$145 billion in residential mortgages throughout the United States. The vast majority of participants in the program are community institutions.

Differences in the features of the various MPF products and the growing number of institutions joining the program continue to prompt questions from bankers and examiners about the proper accounting and reporting treatment for these products. Although the program information available from the FHLBs describes the MPF products and their regulatory capital implications, guidance on accounting has been sparse. In this article we will summarize the MPF products and attempt to answer these accounting questions.<sup>3</sup>

## How the Mortgage Partnership Finance Program Works

An institution participating in the MPF program enters into a Master Commitment agreement with the FHLB of which it is a member. This agreement specifies the dollar amount of loans to be delivered under the commitment and details the terms and conditions, including the credit enhancements, that govern these loans. The FHLB provides the long-term funding for MPF loans.

Credit risk is shared between the participating institution and the FHLB by structuring the potential loss exposure into several layers. The initial layer of losses (after any private mortgage insurance coverage) on loans delivered under a Master Commitment is absorbed by a

<sup>1</sup> Most institutions that participate in the MPF program are insured banks and savings associations. A small percentage are credit unions and insurance companies.

<sup>2</sup> The FHLBs of Atlanta, Boston, Chicago, Dallas, Des Moines, New York, Pittsburgh, San Francisco, and Topeka participate in the MPF program. The FHLB of Seattle has developed a separate Mortgage Purchase Program (MPP) that differs from the MPF program discussed in this article. The FHLBs of Atlanta, Cincinnati, and Indianapolis also participate in the MPP.

<sup>3</sup> Product descriptions and term sheets for the various MPF products are available at [www.fhlbmpf.com](http://www.fhlbmpf.com).

“first loss” account (FLA) established by the FHLB. If losses extend beyond this account, they are absorbed by a second loss credit enhancement provided by the institution. If the first and second loss credit enhancements are exhausted, the FHLB is in a third loss position and absorbs any further losses. The size of the institution’s second loss credit enhancement is the difference between the size of the FLA and the size of the overall amount of enhancement needed to achieve an “AA” rating from a rating agency on the FHLB’s third loss position on the loans.

An institution receives credit enhancement fees, generally paid by the FHLB on a monthly basis, for sharing and continuing to manage the credit risk of the MPF loans. The size of these fees is based on the unpaid principal balance of the loans delivered under the Master Commitment and, for certain MPF products, is adjusted for loan losses absorbed by the FHLB’s FLA. In effect, these fees compensate the institution for providing the second loss credit enhancement.

Institutions participate in the MPF program either by originating loans on a “flow” basis or by selling closed loans to the FHLB. For the single flow loan product (designated MPF 100), the institution acts as an originating agent for the FHLB, for which it may receive agent fees in addition to the loan origination fees paid by the borrower. The institu-

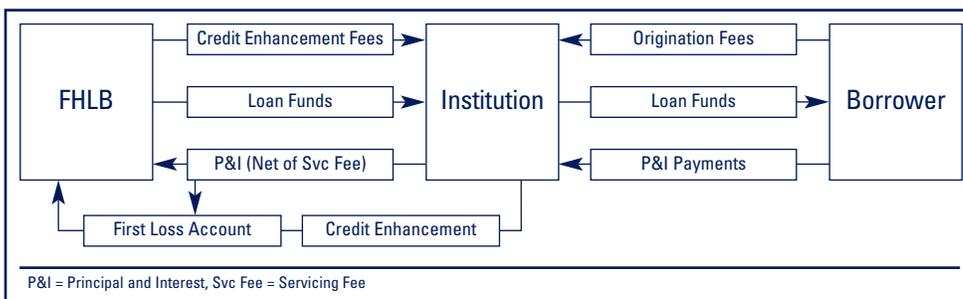
tion closes the loan in the name of the FHLB, which provides the funding for the mortgage at closing and legally owns the loan from the moment it is created. The loan is never carried on the agent institution’s balance sheet.

The closed loan products offered by the FHLBs include Original MPF, MPF 125, and MPF Plus.<sup>4</sup> For all three products, an institution originates residential mortgages, closes the loans in its own name, and sells them to the FHLB in a manner similar to a secondary market sale to Fannie Mae or Freddie Mac. The chart below illustrates the typical cash flows for a loan sold to the FHLB in the MPF closed loan products.

For both flow loans and closed loans, participating institutions are paid specified servicing fees (typically 25 basis points for conventional loans) for servicing MPF loans. The option of selling rather than retaining servicing has recently been created for closed loans.

### Accounting and Reporting Considerations

The proper accounting and financial reporting for the various MPF products is dictated by the type of product. For example, in the case of the MPF 100 flow loan product, an institution is not selling loans to an FHLB but rather is acting as its originating agent. Therefore, the criteria for sale accounting, as



<sup>4</sup> The FHLBs also offer Original MPF for Federal Housing Administration/Veterans Administration (FHA/VA) loans, a closed loan product for these U.S. government-guaranteed/insured loans. However, this product does not require the institution selling the FHA/VA loans to an FHLB to undertake a second loss credit enhancement obligation.

outlined in Financial Accounting Standards Board (FASB) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), do not apply. In contrast, the MPF closed loan products involve loan sales to an FHLB, and the institution must account for these transactions in accordance with FAS 140. The institution would remove the assets that have been sold from its balance sheet, continue to carry on its balance sheet any servicing assets retained, recognize any assets obtained and liabilities incurred at fair value, and recognize any gain or loss on the sale in earnings.

## Credit Enhancement

The second loss credit enhancement obligation undertaken by an institution in all the MPF products represents a guarantee that must be accounted for in accordance with FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), which was issued in November 2002. FIN 45 requires a guarantor "to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee." In this regard, FIN 45 distinguishes between guarantees issued "in a standalone arm's-length transaction with an unrelated party" and those "issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset)."

An institution's second loss credit enhancement for the MPF 100 flow loan product falls within the standalone category because the institution acts as the FHLB's origination agent, and no asset sale takes place. In this situation, FIN 45 provides that "the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor." For the MPF 100 product, the "premium" that will compensate

the institution for undertaking the second loss credit enhancement obligation is the sum of two components: the fair value of the credit enhancement fees receivable from the FHLB over the life of the mortgage loans delivered under the Master Commitment plus the fair value of the servicing asset, the measurement of which is discussed below. The fair value of the credit enhancement fees receivable would need to be estimated using expected present value measurement techniques. Thus, the institution must estimate the amount and timing of the cash flows to be received as credit enhancement fees. The amount of these fees is a function of the remaining unpaid principal balance of the mortgage loans in a Master Commitment, which means that the institution must estimate the prepayment rate on these loans. In addition, for performance-based credit enhancement fees, the loan losses that will be incurred on the loans in the Master Commitment must be estimated. The institution must also determine an appropriate discount rate for the present value calculation.

On the other hand, the guarantee provided for the MPF closed loan products represents a recourse obligation that results from the FAS 140 asset sale to the FHLB. To estimate the fair value of this guarantee (the recourse obligation), FIN 45 states that the guarantor "should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party." Under FAS 140, this fair value estimate typically is described as the amount that a willing (unrelated) party would charge the guarantor to assume the recourse obligation. The fair value also would be calculated using present value measurement techniques, but would take into account the estimated amount and timing of the payments to the FHLB under the recourse obligation for those loan losses in excess of the FLA that are expected to occur over the life of

the loans in the Master Commitment, up to the maximum amount of the second loss obligation. The institution also must estimate the fair value of the credit enhancement fees receivable asset, as described above.

However, these two fair value estimates may differ because, under FIN 45, they are separate elements of a multiple element transaction that also includes cash sale proceeds for the loans delivered to the FHLB and servicing. In essence, the fair value of the credit enhancement fees receivable for closed loan MPF products may be viewed as part of the proceeds of the sale. The fair value of the recourse obligation should be treated as a reduction of the proceeds. Both the asset for the fees receivable and the liability for the credit enhancement obligation should initially be recorded at their fair values. When applying sale accounting to the closed loan MPF products, these fair values will enter into the institution's measurement of the gain or loss on the sale under FAS 140.

After the asset for credit enhancement fees receivable initially has been recorded at its fair value (which becomes its cost basis), the ongoing accounting for this asset, regardless of whether it arose from a flow loan or a closed loan MPF product, is governed by the provision of FAS 140 on financial assets subject to prepayment. Because the mortgage loans in the Master Commitment contractually can be prepaid and the credit enhancement fees receivable are a function of the principal amount outstanding on the mortgages, the receivable could be settled in such a way that the institution would not recover all of its recorded investment. As a result, FAS 140 requires this receivable to "be subsequently measured like investments in debt securities classified as available-for-sale or trading" under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

As for the liability for an institution's second loss credit enhancement obligation, FIN 45 "does not describe in detail how the guarantor's liability...would be measured subsequent to its initial recognition." However, FIN 45 notes that this liability "would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee." Because of the long-term nature of the second loss credit enhancement obligation for all MPF products and the decreasing likelihood that an institution will be called upon to reimburse the FHLB for losses that exceed the amount in the FLA as the loans become more seasoned, it would be reasonable for the institution to use a systematic and rational amortization method to reduce the liability over the life of the credit enhancement.

One element of the accounting for the second loss credit enhancement obligation after its initial recognition remains. By entering into this guarantee obligation, the institution takes on a contingent obligation to make future payments to the FHLB if loan losses exceed the FHLB's FLA. At the inception of this guarantee, it would normally *not* be probable that the institution would be called on to make payments to the FHLB to cover credit losses in excess of the FLA. However, for each Master Commitment, the institution would need to reevaluate this contingent obligation regularly in accordance with FASB Statement No. 5, *Accounting for Contingencies*. If available information about the performance of these loans indicates that it is probable that the institution will have to reimburse the FHLB for losses in excess of the FLA, and the amount of the loss can be reasonably estimated, the institution must accrue the estimated loss. This loss would be charged to earnings and an offsetting liability would be recorded for the institution's obligation to the FHLB. As payments are made to the FHLB, the liability would be reduced.

## Servicing

When an institution services the mortgages it has delivered to the FHLB, it must also consider the accounting for the servicing under FAS 140. For the MPF closed loan products, it must determine whether it has retained a servicing asset or incurred a servicing liability.

Under the servicing released option for closed loan MPF products, a designated financial institution that is a large mortgage servicer stands ready concurrently to purchase the servicing rights to the mortgage loans that an institution sells to its FHLB. The premiums the designated institution will pay are specified in a pricing schedule, which is updated from time to time. An example of such a schedule is shown below. The establishment of the servicing released option with its related premiums confirms that an institution that services its MPF loans has a servicing asset. The institution must estimate the fair value of this servicing asset using a quoted market price if one is available. In this regard, the FAS 140 implementation guidance notes that an unsolicited bid from a third-party servicer that is a major market participant, such as the prices set forth on the MPF program's servicing released pricing schedule, should be used as the basis for determining the fair value of the institution's servicing asset "as it represents a quoted market price for its asset."<sup>5</sup> When accounting for the sale of the mortgage loans with servicing retained under FAS 140, the institution must initially measure the servicing asset at its "allocated previous carrying amount based on relative fair values."

For the MPF 100 flow loan product, the originating institution typically retains the servicing, but the original owner of the loan is the FHLB. In essence, the FHLB is transferring the servicing to the institu-

tion, but there is no cash payment from the institution to the FHLB for the institution's assumption of servicing responsibilities. Although the MPF servicing released option is not available for flow loans, it is reasonable to believe that, consistent with the closed loans, the institution, as originating agent, has obtained a servicing asset from the flow loans it delivers to the FHLB.

According to the FAS 140 implementation guidance, this servicing asset results from an exchange transaction and represents "consideration for goods or services provided by the transferee to the transferor of the servicing."<sup>6</sup> It would be

### Servicing Released Premium (SRP) Schedule

Conventional Loans Assumes 25 basis points (bps) Servicing Fee		
Loan Amount	30/20-Year Fixed	15-Year Fixed
\$200,000—conforming limit	1.500	0.975
\$100,000—\$199,999	1.375	0.850
\$50,000—\$99,999	1.125	0.600
\$0—\$49,999	0.375	0.225

The SRP will be reduced by 25 bps (0.25%) if the loan does not escrow for both taxes and insurance.

Escrow account can not be waived if

- Loan amount is less than \$50,000, or
- Loan-to-value ratio is greater than 80%, or
- Any borrower's credit score is less than 620.

Processing fee: \$100

Tax service fee: \$89

#### Volume Incentive

##### 5 bps (0.05%) bonus:

For all loans delivered in a given month if loans boarded for that month are  $\geq$  \$5M and  $<$  \$10M.

##### 10 bps (0.10%) bonus:

For all loans delivered in a given month if loans boarded for that month are  $\geq$  \$10M.

<sup>5</sup> See Question 81 of the FAS 140 implementation guidance.

<sup>6</sup> See Question 98 of the FAS 140 implementation guidance.

reasonable to conclude that this consideration is additional compensation to an institution for undertaking the second loss credit enhancement obligation. Thus, as discussed above, the fair value of the second loss credit enhancement guarantee for the MPF 100 flow loan product has two components: the fair value of the premium receivable from credit enhancement fees and the fair value of the servicing asset. When estimating the latter fair value, however, the servicing released pricing schedule for closed loans would not represent a quoted market price because it does not apply to the MPF 100 product. Nevertheless, the pricing schedule would be one of the factors the institution should consider when estimating the initial fair value of its servicing asset.

After a servicing asset has been recognized on the balance sheet, FAS 140 provides that it must be amortized in proportion to, and over the period of, estimated net servicing income (i.e., servicing revenue in excess of servicing cost). A servicing asset must be evaluated for impairment quarterly based on its fair value.

## Examination Considerations

The FHLB of Chicago's literature describes the MPF program as "combining the credit expertise of a local lender with the funding and hedging advantages of a FHLB," which means that "lenders can retain the credit risk and customer relationship of their loans while shifting the interest rate and prepayment risks to the FHLB." Although the interest rate and prepayment risks arising from holding mortgage loans in portfolio have been shifted for the most part, these risks are inherent in the credit enhancement fees receivable and servicing assets carried on an institution's balance sheet.

Examiners should ensure that the credit risk management process of an institution that participates in the MPF program adequately addresses the credit exposure arising from the second loss credit enhancement provided on the loans delivered to the FHLB and from any performance-based credit enhancement fees receivable. A prudent risk management process includes effective senior management and board oversight; comprehensive policies and procedures, including appropriate limits; and an effective ongoing system of risk assessment, management, monitoring, and internal control, including appropriate coverage by the internal audit and compliance functions.

In addition, while the MPF program is not per se a securitization activity, it is nonetheless similar because a participating institution provides a credit enhancement to the FHLB and may retain the responsibility for servicing the mortgages. Thus, many of the standards applicable to retained interests that are outlined in the December 1999 *Interagency Guidance on Asset Securitization Activities* would be relevant to the second loss credit enhancement guarantee and the related credit enhancement fees receivable.<sup>7</sup> The guidance on risk management activities, including valuation, in the February 2003 *Interagency Advisory on Mortgage Banking* would be pertinent to servicing assets.<sup>8</sup>

An institution significantly involved in the MPF program should ensure that its accounting policies governing the resulting assets and liabilities are applied consistently and include approved valuation methods and procedures for the formal approval of changes to these methods. Moreover, management should employ reasonable and conservative valuation assumptions and cash flow

<sup>7</sup> The securitization guidance can be accessed at [www.fdic.gov/news/news/financial/1999/FIL99109.pdf](http://www.fdic.gov/news/news/financial/1999/FIL99109.pdf).

<sup>8</sup> The mortgage banking advisory can be accessed at [www.fdic.gov/news/news/press/2003/PR1403a.html](http://www.fdic.gov/news/news/press/2003/PR1403a.html).

projections and maintain verifiable, objective documentation of fair value estimates used in the accounting for enhancement-related assets and liabilities and servicing assets. When deficiencies are identified, examiners should seek management's commitment to institute appropriate corrective action.

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# Regulatory and Supervisory Roundup

This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release (PR) or Financial Institution Letter (FIL) designations are included so the reader can obtain more information.

Subject	Summary
<b>FDIC Adopts Revised Guidelines for Appeals of Material Supervisory Determinations and for Appeals of Deposit Insurance Assessments (FIL-113-2004, October 13, 2004)</b>	Both sets of revised guidelines, which took effect June 28, 2004, govern appeals by FDIC-supervised institutions. One set governs appeals by institutions that choose to dispute decisions made by onsite FDIC examiners or an FDIC Regional Office regarding supervisory ratings, the adequacy of loan loss reserve provisions, certain violations of laws and regulations, and other material supervisory determinations. The second set of guidelines sets forth procedures to be followed when an institution disputes the computation of its deposit insurance assessment or the risk classification used in computing the assessment.
<b>FDIC Announces Steps to Help Rebuild Areas Affected by Recent Hurricanes and Severe Storms (FIL-107-2004, September 17, 2004)</b>	The FDIC has distributed guidelines that encourage FDIC-supervised banks to work constructively with borrowers who, because of recent natural disasters, are experiencing difficulties beyond their control. The guidelines address extending payment terms, restructuring existing loans, easing terms for new loans, and other types of regulatory relief.
<b>Agencies Publish Informational Brochure to Help Consumers Identify Internet "Phishing" Scams (FIL-103-2004, September 13, 2004)</b>	The federal banking, thrift, and credit union regulatory agencies have published an informational brochure to help consumers identify and prevent a new type of fraud called "phishing," a scam that includes fraudulently obtaining and using an individual's personal or financial information. The brochure explains the basics of phishing, the steps consumers can take to protect themselves, and the actions that consumers can take if they become a victim of identity theft.
<b>FDIC Seeks Additional Comments on Proposed Rule Regarding the Community Reinvestment Act (FIL-96-2004, August 23, 2004)</b>	The proposed change to Part 345 of the FDIC's Rules and Regulations would change the definition of "small bank" to include banks up to \$1 billion in asset size, add a community development activity criterion to the streamlined evaluation method for small banks with assets greater than \$250 million and less than \$1 billion, and expand the definition of "community development." Comments were due by October 20, 2004.
<b>Agencies Seek Comment on Interim Rule Regarding Community Reinvestment Act (CRA) Regulations (FIL-91-2004, August 5, 2004)</b>	The joint interim rule makes the federal banking and thrift agencies' CRA regulations conform to recent changes in (1) the Standards for Defining Metropolitan and Micropolitan Statistical Areas, published by the Office of Management and Budget; (2) definitions related to census tracts as designated by the U.S. Bureau of the Census; and (3) Federal Reserve Board Regulation C, which implements the Home Mortgage Disclosure Act.
<b>Guidance Issued on Customer Identification Programs (FIL-90-2004, July 28, 2004)</b>	The federal banking, thrift and credit union regulatory agencies, the Financial Crimes Enforcement Network, and the Department of the Treasury have jointly issued interpretive guidance regarding the Customer Identification Program required by Section 326 of the USA PATRIOT Act. The guidance augments the procedures issued in FIL-79-2003, "New Examination Procedures for Assessing Anti-Money Laundering Programs and Bank Secrecy Act Compliance."
<b>Updated Guidance Issued on Managing Information Technology (IT) Services and Outsourcing Technology Services (FIL-89-2004, July 29, 2004)</b>	The Federal Financial Institutions Examination Council (FFIEC) issued two more booklets as part of its ongoing effort to update the <i>1996 FFIEC Information Systems Examination Handbook</i> . The <i>Management Booklet</i> provides guidance on the risks and risk management practices applicable to IT activities. The <i>Outsourcing Technology Services Booklet</i> provides guidance applicable to the outsourcing of IT activities.

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Subject	Summary
<b>Agencies Issue Final Rule on Capital Requirements for Commercial Paper Programs (FIL-87-2004, July 28, 2004)</b>	The four federal bank and thrift regulators issued a final rule establishing more risk-sensitive, risk-based capital standards for liquidity facilities related to asset-backed commercial paper (ABCP) programs. Such facilities are generally provided by large banking institutions; therefore, the rule is expected to have no impact on most community banks. The rule makes permanent the exclusion of ABCP program assets consolidated under Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities.
<b>FDIC Proposes Several Amendments Relating to International Banking (FIL-85-2004, July 22, 2004)</b>	The proposed amendments concern Parts 303, 325, 327, and 347 of the FDIC's Rules and Regulations. The amendments would reorganize existing rules for clarity, expand the availability of general consent for foreign branching and investments, address the transferability of grandfathered U.S. branches, and provide for asset maintenance based on an insured branch's daily third-party liabilities. A risk-based asset pledge requirement would replace the existing 5 percent fixed percentage. Comments were due by September 17, 2004.
<b>FDIC Issues Guidance on the Risks Associated with Instant Messaging (FIL-84-2004, July 21, 2004)</b>	The guidance contains information on the risks associated with instant messaging (IM) and network file sharing and how these risks can be mitigated. These real-time communication channels were not developed with commercial use in mind and lack standard security features. IM can expose financial institutions to security, privacy, and legal risks. After examining the business need for IM and assessing the risks involved, banks should establish policies governing employees' use of IM.
<b>Proposed Rule Requires Financial Institutions to Allow Consumers to Opt Out of Marketing Solicitations That Use Information Obtained from an Affiliate (FIL-82-2004, July 15, 2004)</b>	Financial institution regulatory agencies have proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer's election to opt out would be applicable for at least five years. The proposed rules would implement Section 214 of the Fair and Accurate Credit Transactions Act. Comments were due by August 16, 2004.
<b>Comment Solicited on Proposed Rule by the SEC Regarding the Securities Activities of Banks (FIL-79-2004, July 6, 2004)</b>	Banks were invited to comment on proposed rulemaking by the Securities and Exchange Commission (SEC) that would implement provisions of the Gramm-Leach-Bliley Act of 1999 (GLBA). Prior to GLBA, banks were excluded from the definition of "broker" contained in the Securities Exchange Act of 1934. The proposed rule provides four primary exceptions to the broker definition and several targeted exceptions. Comments were due to the SEC by August 2, 2004.
<b>Agencies Propose Rules on Disposal of Consumer Information (FIL-73-2004, June 17, 2004)</b>	The federal bank and thrift regulators have invited public comment on an interagency proposal to amend customer information security guidelines to require financial institutions to properly dispose of consumer information derived from credit reports. The proposed rule implements Section 216 of the Fair and Accurate Credit Transactions Act. Comments were due by July 23, 2004.

Subject	Summary
<p><b>New Rules and Reference Materials Issued for HMDA Data Collected during 2004 (FIL-71-2004, June 15, 2004)</b></p>	<p>Federal Reserve Board Regulation C, which implements the Home Mortgage Disclosure Act (HMDA), has been revised in several ways that affect application and loan data collected for calendar year 2004; these data must be submitted by March 1, 2005.</p>
<p><b>Revised Guidance Issued on the Uniform Classification of Assets and Appraisal of Securities (FIL-70-2004, June 15, 2004)</b></p>	<p>The federal bank and thrift regulatory agencies have jointly issued the “Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts,” which replaces the policy of the same title last revised in 1979. The policy provides substantive changes to guidance on the appraisal and classification of securities, making it consistent with current accounting literature.</p>
<p><b>Court Reaffirms Safe Harbor Provision Pertaining to the Filing of Suspicious Activity Reports (FIL-67-2004, June 10, 2004)</b></p>	<p>The Financial Crimes Enforcement Network and the five federal financial institution supervisory agencies have jointly issued findings from a recent court case reaffirming the “safe harbor” protections that apply to financial institutions and their employees when they file Suspicious Activity Reports as required by the Bank Secrecy Act and related rules and regulations. The federal district court found the safe harbor provision to afford unqualified protection from civil suit.</p>
<p><b>Updated Guidance Issued on the Development and Acquisition of Information Technology Systems (FIL-64-2004, June 8, 2004)</b></p>	<p>The Federal Financial Institutions Examination Council (FFIEC) has issued a booklet containing guidance on the development and acquisition of information technology. The booklet is the eighth in a series of updates that will eventually replace the <i>1996 FFIEC Information Systems Examination Handbook</i>. The booklet provides guidance to examiners, financial institutions, and technology service providers on development, acquisition, and maintenance projects, including project risks and project management techniques.</p>
<p><b>Regulatory Agencies Seek Comment on Proposed Interagency Guidance on Overdraft Protection (FIL-63-2004, June 7, 2004)</b></p>	<p>The federal financial institution regulatory agencies have proposed guidance on certain fee-based overdraft protection programs. The guidance discusses these bounced-check protection programs, outlines various federal regulations that apply to them, presents existing and potential concerns about the programs, and lists a variety of best practices. Comments were due by August 6, 2004.</p>
<p><b>FDIC Issues Guidance to Banks on Developing Effective Computer Virus Protection Programs (FIL-62-2004, June 7, 2004)</b></p>	<p>The FDIC issued guidance to financial institutions on designing and maintaining programs to mitigate the risks that viruses present to a bank’s computer network, its reputation, and the confidentiality of data. The guidance complements the <i>FFIEC Information Security IT Examination Handbook</i> issued December 2002 and supplements FIL-68-99, “Risk Assessment Tools and Practices for Information System Security.”</p>
<p><b>FDIC Enhances Failed Bank Data on Its Website (PR-62-2004, June 7, 2004)</b></p>	<p>The FDIC has added to its website balance sheet summaries on all failed banks placed in FDIC receivership since October 2000. The website provides information about each failure, the acquiring financial institution, the continuation of banking services after the failure, and special information for loan customers and claimants.</p>

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<b>Subject</b>	<b>Summary</b>
<b>FDIC Issues Examiner Guidance on Agency-Issued Step-Up Bonds and Other Structured Note Holdings (FIL-59-2004, May 27, 2004)</b>	FDIC examiners were informed that structured-note holdings have increased significantly at certain banks and were provided additional examination guidance. During an examination, examiners should obtain enough information to assess management's compliance with the "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities" (FIL-45-98). Absent other concerns with interest rate risk, the aggregate levels of structured notes alone should not prompt an expanded review of such activity.
<b>FDIC Notifies Institutions to Begin Planning for the Implementation of the Check Clearing for the 21st Century Act (FIL-54-2004, May 21, 2004)</b>	The FDIC asked the banks it supervises to start considering the operational changes associated with the Check 21 Act. The Act, which took effect October 28, 2004, facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a "substitute check," which is the legal equivalent of an original check. Whether they decide to truncate or exchange electronic check images, all banks must be prepared to handle substitute checks after the effective date of the Act.
<b>Regulatory Agencies Seek Comment on a Proposed Statement on Sound Practices for Managing Complex Structured Finance Activities (FIL-52-2004, May 20, 2004)</b>	The federal bank regulatory agencies and the Securities and Exchange Commission drafted guidance on the internal controls and risk management procedures that financial institutions may find particularly effective in identifying and addressing the reputational, legal, and other risks associated with <i>complex</i> structured finance transactions arranged either for customers or for the institutions' own purposes. The guidance encourages certain policies and procedures to ensure that such specially structured and nonstandard transactions are not illegal or inappropriate. Comments were due by July 19, 2004.

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