

# Letter from the Director

Between July 2004 and January 2007, we witnessed the longest period in FDIC history without a bank failure. Today, disruptions in the financial markets, the downturn in the U.S. housing market, and other credit quality concerns are creating a more formidable set of conditions for insured institutions. Featured articles in this edition of *Supervisory Insights* deal with three issues that I believe would rank high on anyone's short list of key regulatory and policy challenges we are facing in the current environment.

An issue that has featured prominently in the discussions of policymaking groups around the world is how to enhance transparency and restore confidence in securitization markets, especially with regard to certain complex structured securities that have generated significant write-downs during this period. The current market turmoil has focused attention on the complexity and lack of disclosure about some of these products and highlighted the need for greater transparency. *"Enhancing Transparency in the Structured Finance Market"* details in specific terms some disclosure concerns with these products and summarizes actions the author believes would improve transparency.

The significant deterioration in lending standards in the U.S. mortgage market that has occurred in recent years is generally agreed to be a key causal factor in the current market difficulties. The federal banking agencies, and most states, published two significant guidance documents that addressed underwriting practices, one on nontraditional mortgage lending and another more specifically targeted to subprime mortgage lending—and adjustable-rate

subprime mortgage products in particular.<sup>1</sup> In addition, other legislative, regulatory, and private sector initiatives that remain under active debate have been put forward as remedies for the current instability in the mortgage market.



*"Hybrid ARMs: Addressing the Risks, Managing the Fallout"* describes the underwriting weaknesses and potentially deceptive marketing practices that contributed to the subprime mortgage crisis and discusses key principles for protecting consumers and managing the risks of hybrid ARMs.

The effects of the housing downturn are spilling over to the commercial real estate (CRE) sector, straining credit quality and profitability among banks with large undiversified CRE portfolios. The FDIC recently issued a Financial Institution Letter (FIL) on managing CRE concentrations that reemphasizes the importance of strong capital, an appropriate allowance for loan and lease losses, and robust risk management practices.<sup>2</sup> Against the backdrop of more difficult market conditions in certain geographical regions, an issue that FDIC examiners have been seeing with increasing frequency is the potentially inappropriate use of interest reserves. *"A Primer on the Use of Interest Reserves"* describes the use of interest reserves in Acquisition, Development, and Construction (ADC) lending, examines the risks this strategy presents, and identifies red flags that should alert lenders to potential problems at each stage of the ADC cycle.

The *"Accounting News"* feature examines communication of internal control deficiencies as a part of the audit process. This article summarizes the development of internal control audit-

<sup>1</sup> *Interagency Guidance on Nontraditional Mortgage Product Risks*, **Federal Register**, Vol. 71, No. 192, October 4, 2006, pp. 58609–58618. Also see FDIC FIL-89-2006 at <http://www.fdic.gov/news/news/financial/2006/fil06089.html> and *Statement on Subprime Mortgage Lending*, **Federal Register**, Vol. 72, No. 131, July 10, 2007, pp. 37569–37575. Also see FDIC FIL-62-2007 at <http://www.fdic.gov/news/news/financial/2007/fil07062.html>.

<sup>2</sup> Federal Deposit Insurance Corporation, "Managing Commercial Real Estate Concentrations in a Challenging Environment," FIL-22-2008, March 17, 2008, at <http://www.fdic.gov/news/news/financial/2008/fil08022.html>.



ing and attestation standards, provides examples of internal control deficiencies, explains how external auditors evaluate and communicate these deficiencies to management and boards of directors, and discusses how examiners can use the auditors' written internal control reports in examinations.

As always, we encourage our readers to continue to provide feedback on articles and suggest topics for future issues. Please e-mail your comments and questions to [SupervisoryJournal@fdic.gov](mailto:SupervisoryJournal@fdic.gov).

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