Supervisory Insights

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Vol. 2, Issue 1 Summer 2005

Inside

FDIC

Supervisory Insights

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Issue at a Glance

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Letter from the Director

In June 2004, the Basel Committee on Banking Supervision introduced a new capital adequacy framework for large, internationally active banking organizations. The proposed new capital framework, the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (known as "Basel II"), will implement a new "three-pillar" approach for ensuring prudential capital supervision: (1) minimum capital requirements, (2) capital adequacy and systems review, and (3) enhanced market discipline through required disclosure. The Federal Deposit Insurance Corporation (FDIC), as a member of the Basel Committee, has agreed to the revised international framework and is working with our colleagues at the other U.S. federal banking and thrift regulatory agencies toward its domestic implementation through notice and comment rulemaking.

Only certain aspects of the international framework will be presented for U.S. implementation. Once adopted in the United States, Basel II will allow large and complex banking organizations to make greater use of their own internal risk measurement systems as inputs to capital calculations. Today, international supervisors are working toward the implementation of Basel II, and are developing final supervisory standards and detailed guidelines and review procedures. Twenty-six U.S. banking organizations are participating in a fourth quantitative impact study (QIS 4) to assess the impact of the new standards. Should these 26 banks ultimately adopt Basel II, fully 56 percent of U.S. banking assets will be subject to the new capital regime, at institutions in possession of over 40 percent of FDIC-insured deposits. Understandably, the FDIC is dedicating significant resources to the development and implementation of Basel II capital standards and qualification guidelines.

On May 11, 2005, FDIC Director Thomas Curry testified before Congress regarding the FDIC's views on the implementation of Basel II in the United States. The testimony focused on the potential impact of Basel II on minimum capital requirements and on the competitive playing field for U.S. banks. Director Curry reported the FDIC's preliminary conclusion that the results of QIS 4 do not provide comfort that the Basel II framework will require an adequate level of capital. He went on to outline FDIC concerns about the consistent applicability of the framework across banks and the potentially significant competitive implications. While acknowledging the significant concerns outlined in his testimony, Director Curry expressed a belief that these issues could be resolved, and that the FDIC stands ready to move forward with Basel implementation when this is done.

As we move toward adoption of this more risk-sensitive regulatory capital framework, many issues, questions, and challenges have been presented. This Letter from the Director is intended to answer some of your questions. It also gives me a forum to thank the many FDIC employees who have been working to achieve a successful framework that will properly measure risk for capital adequacy purposes. I thank them for their effort and dedication.

Why do we need a new international capital standard? The 1988 Capital Accord was adopted to advance a uniform capital system for internationally active banks that was more sensitive to banks' risk profiles. The 1988 Capital Accord sought to address industry innovations, correct improper incentives, and strengthen the industry's capital position. Basel II shares the same goals. Basel II is designed to better align risk-based regulatory capital requirements with the risks underlying most activities conducted by large, internationally

active banks and to address financial innovations that have occurred in recent years.

How does Basel II change the way capital adequacy is determined? A key innovation of Basel II is the use of banks' internal risk estimates as inputs to the calculation of minimum capital requirements. Basel II requires banks to determine capital requirements for exposures to credit risk, operational risk, and market risk (for institutions with significant trading activity). The Basel II qualification standards and guidelines impose significant demands to ensure banks are making fair, accurate, and effective measurements of risk exposures and assessing their capital adequacy relative to overall risk. Disclosure requirements are imposed to allow market participants access to key information about an institution's overall risk profile so the market can comprehensively assess an institution's capital adequacy.

Are all banks required to adopt Basel II capital standards? In the United States, only "core" banks would be required to adopt the Basel II standards. Core banks would be those with total banking assets in excess of $250 billion or on-balance-sheet foreign exposures in excess of $10 billion. Other institutions, "opt-in" banks, are banking organizations not subject to Basel II on a mandatory basis but that choose to apply those approaches voluntarily. In each instance, supervisory approval is required prior to the adoption of the advanced approaches. Given the stringent standards and guidelines under development, it is estimated only around 20 of the largest and most sophisticated U.S. banks will become subject to the new framework.

What about the remaining institutions not subject to the Basel II revisions? Inherent in establishing "qualifying" criteria for a bank to be allowed to use the Basel II capital standards is that all nonqualifying banks are effectively subject to a different capital regime. This brings to the forefront a host of issues of paramount importance to the industry and supervisors. Several community banks and trade groups have indicated that if Basel II is implemented, the current capital framework must be revised to enhance its risk sensitivity in order to minimize the competitive inequities that may flourish under a bifurcated capital framework.

Some banks have indicated Basel II may place community banks and thrifts at a competitive disadvantage because the advanced Basel II approaches would likely yield lower capital charges on many types of products offered by both large and small banks, such as residential mortgage, retail, and small business loans. Many well-respected observers have indicated the competitive equity disparities that may arise from a bifurcated capital framework merit a closer look at the current rules. These concerns warrant close review and consideration by the agencies. To that end, U.S. banking agencies are considering ways to revise the existing rules for the nearly 9,000 institutions that will not be subject to Basel II, to ensure capital remains broadly representative of the risks inherent in these institutions.

Where do the bank examiners fit into this process? One of the most challenging, and important, aspects of the new proposal will be the judgment of the bank examiner who will have to determine whether a core or opt-in bank has developed sufficient operating systems and information to qualify for the Basel II capital approach. Quantitative models and methods are vital to the process, but the importance of rigorous evaluation of the risk management environment by our examination force cannot be overstated.

To face this challenge, the FDIC is taking steps to ensure we bring the

Letter from the Director

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right expertise to bear on the Basel II effort. Numerous initiatives are designed to build upon the strength of the FDIC's existing large bank operations and to focus personnel with quantitative and supervisory expertise on understanding banks' rating systems, models, and capital assessment strategies. Enhanced training programs are under development to allow our supervisory staff to develop and maintain such expertise.

In conclusion, Basel II is a progressive approach to the determination of capital adequacy. It is a novel and complex capital framework proposed to be adopted by the largest internationally active insured depository institutions in the United States. The core of the framework is greater use of internal risk assessments to determine overall institution exposure. The FDIC is working with its sister regulatory agencies to develop detailed minimum operating standards to ensure the integrity of banks' internal assessments. The application and supervision of these new standards will present significant challenges, but I am confident the FDIC is well prepared to fulfill our crucial role as both supervisor and insurer.

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

A Changing Rate Environment Challenges Bank Interest Rate Risk Management

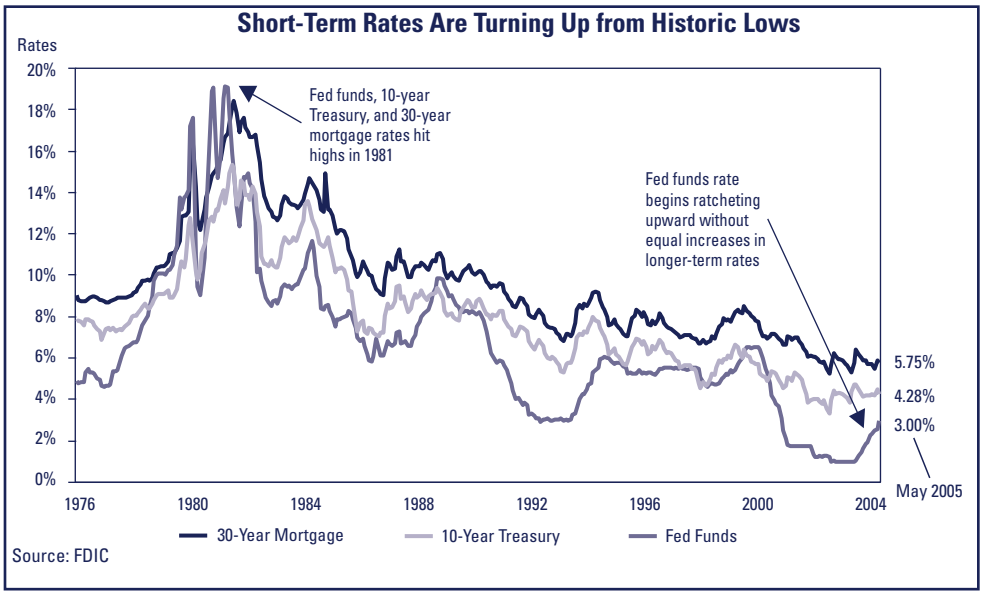
Interest rate risk is fundamental to the business of banking. Changes in interest rates can expose an institution to adverse shifts in the level of net interest income or other rate-sensitive income sources and impair the underlying value of its assets and liabilities. Examiners review an insured institution's interest rate risk exposure and the adequacy and effectiveness of its interest rate risk management as a component of the supervisory process. Examiners consider the strength of the institution's interest rate risk measurement and management program and conduct a review in light of that institution's risk profile, earnings, and capital levels. When a review reveals material weaknesses in risk management processes or a level of exposure to interest rate risk that is high relative to capital or earnings, a remedial response can be required.

In today's changing rate environment, bank supervisors are monitoring industry balance sheet and income statement trends to assess the industry's overall exposure to and management of interest rate risk. This article reviews the current interest rate environment, discusses potential risks associated with a rising rate environment and a continued flattening of the yield curve, and analyzes banking industry aggregate balance sheet information and trends. It also reviews findings from recent bank examination reports in which interest rate risk or related management practices raised concern and highlights common weaknesses in risk management, measurement, and modeling practices.

The Current Rate Environment

Since the 1980s, and despite upward rate spikes in 1994 and 2000, the level of interest rates has generally been declining (see Chart 1). In September 1981, the rate on the 10-year Treasury bond reached a high of over 15 percent; it has since declined to a low of just over 3 percent in June 2003. During roughly the same period, other rate indices also fell in generally the same manner, though not always in tandem. For example, the Federal funds rate fell from over 19 percent to 1 percent, and the

Chart 1



Interest Rate Risk

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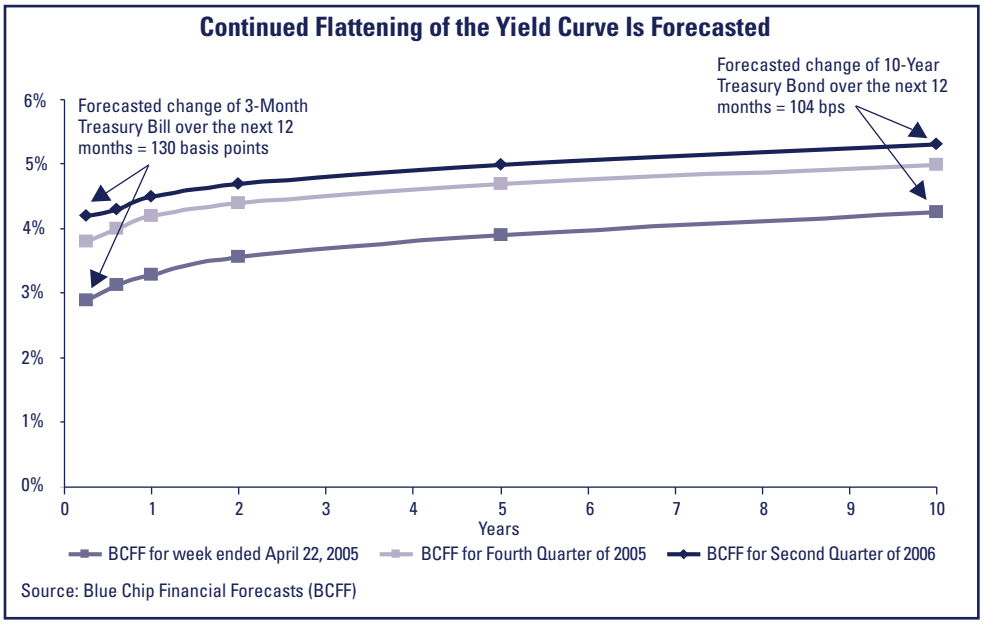
30-year mortgage rate average peaked at over 18 percent and dropped to under 6 percent.

During the past 12 months, however, the banking industry has sustained a well-forecasted series of "measured" increases to the target Federal funds rate. Since June 2004, the Federal Open Market Committee (FOMC) has steadily increased the intended Federal funds rate in moderate 25 basis point increments to its current level of 3 percent. Generally, changes in the Federal funds rate will affect other short-term interest rates (e.g., bank prime rates), foreign exchange rates, and less directly, long-term interest rates. However, increases to the Federal funds rate have yet to drive similar increases in longer-term yields. In fact, over the 12 months that the FOMC has moved the target Federal funds rate steadily upward, the nominal yield on the 10-year treasury has rarely crested above 4.5 percent and actually has declined from its July 2, 2004, level. This "conundrum," evidenced by nonparallel movement in short- and long-term rates, has resulted in a flattening of the yield curve.[1]

Looking forward, many market participants anticipate further measured increases in the Federal funds rate and similar, although not equal, increases in longer-term rates. Over the next year, Blue Chip Financial Forecasts[2] is predicting an additional 130 basis point increase in short-term rates and a 104 basis point increase in longer-term rates—a forecast that portends continued flattening of the yield curve (see Chart 2).

Chart 2



[1]The Federal funds rate is the interest rate at which depository institutions lend balances overnight from the Federal Reserve to other depository institutions. The intended Federal funds rate is established by the FOMC of the Federal Reserve System. Federal Reserve Board Chairman Alan Greenspan said during his February 16, 2005, monetary policy testimony to the Senate Banking Committee, "For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum." (Source: Bloomberg News)

[2]Blue Chip Financial Forecasts is based on a survey providing the latest in prevailing opinions about the future direction and level of U.S. interest rates. Survey participants such as Deutsche Banc Alex Brown, Banc of America Securities, Fannie Mae, Goldman Sachs & Co., and JPMorganChase provide forecasts for all significant rate indices for the next six quarters.

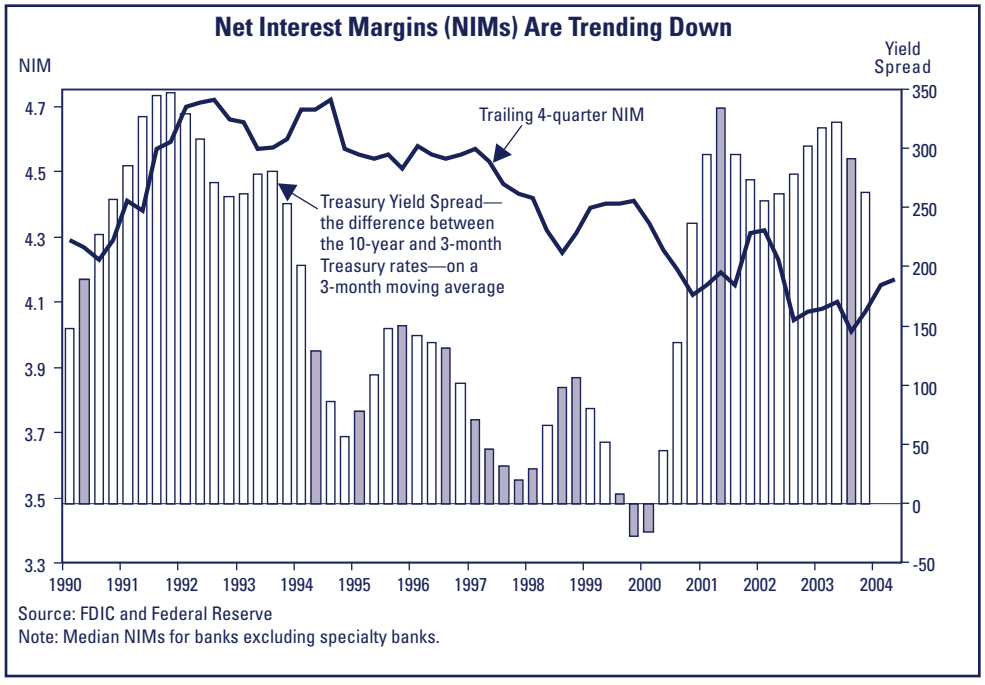
Assessing Banks' Interest Rate Risk Exposure

A rising rate environment in conjunction with a continued flattening of the yield curve presents the potential for heightened interest rate risk. A flattening yield curve can pressure banks' margins generally, and rising rates can be particularly challenging to institutions with a "liability-sensitive" balance sheet—an asset/liability profile characterized by liabilities that reprice faster than assets. The extent of this mismatch between the maturity or repricing of assets and liabilities is a key element in assessing an institution's exposure to interest rate risk.

The shape of the yield curve is an important factor in assessing the overall rate environment. A steep yield curve provides the greatest spread between short- and long-term rates and is generally associated with favorable economic conditions. Long-term investors, anticipating an improving economy and higher rates, will demand greater yields to compensate for the risk of being locked into longer-term assets. In such a favorable environment, opportunities exist to generate spread-related earnings driven by asset and liability term structures. A flattening yield curve can deprive banks of these opportunities and raises concern about a possible inversion in the yield curve. An inverted yield curve, where long-term rates are lower than short-term rates, can present a most challenging environment for financial institutions. Also, an inverted yield curve is associated with the potential for economic recession and declining rates. Given recent rising rates and flattening of the yield curve, bank supervisors have been monitoring trends in bank net interest margins (NIMs) and balance sheet composition.

While various factors (competition, earning asset levels, etc.) affect NIMs, a flattening yield curve is associated with declining NIMs. Chart 3 shows that during the 1990s, generally declining industry NIMs followed the overall flattening of the yield curve. As the spread between long- and short-term rates (the bars) generally decreased from 1991 to

Chart 3



Source: FDIC and Federal Reserve
Note: Median NIMs for banks excluding specialty banks.

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1999—resulting in a flattening of the Treasury yield curve—bank NIMs also declined (the line on Chart 3 plots trailing four-quarter NIM). Beginning in 2000, after a brief period of inversion, the yield curve steepened dramatically, and over the next five quarters, bank NIMs increased. NIMs have since continued their general decline, and recent quarters have seen the yield curve continue to flatten, raising the potential for continued pressure on bank NIMs.

Even though median bank NIMs have been declining since 1994, this trend has been accompanied by strong and, in recent years, record levels of profitability. Noninterest income sources (combined with overall strong industry performance) have helped mitigate the effects of declining NIMs. Institutions with over $1 billion in assets report significant reliance on noninterest income; it accounts for more than 43 percent of their net operating revenue. While this diversification of income sources is less prevalent in smaller community banks (institutions that hold less than $1 billion in assets derive only 25 percent of net operating revenue from noninterest income sources), NIMs reported by these smaller institutions generally are higher and recently have improved compared to those of the larger institutions.

In short, while individual banks may be experiencing margin pressures, the downward trend in bank NIMs has yet to result in an industry-wide decline in levels of net income. It is too early to gauge the effects of a continuing or prolonged period of flattening in the shape of the yield curve.[3]

Bank Balance Sheet Composition—The Asset Side

Despite strong industry profitability, bank supervisors are monitoring changes in the nature, trend, and type of exposures on bank balance sheets. Recent aggregate balance sheet information shows the industry increasing its exposure to longer-term assets, holding greater proportions of mortgage-related assets, and relying more on rate-sensitive, noncore funding sources—all factors that can contribute to higher levels of interest rate risk.[4]

In general, the earnings and capital of a liability-sensitive institution will be affected adversely by a rising rate environment. A liability-sensitive bank has a long-term asset maturity and repricing structure relative to a shorter-term liability structure. In an increasing interest rate environment, the NIM of a liability-sensitive institution will worsen (other factors being equal) as the cost of the bank's funds increases more rapidly than the yield on its assets. The higher its proportion of long-term assets, the more liability-sensitive a bank may be.

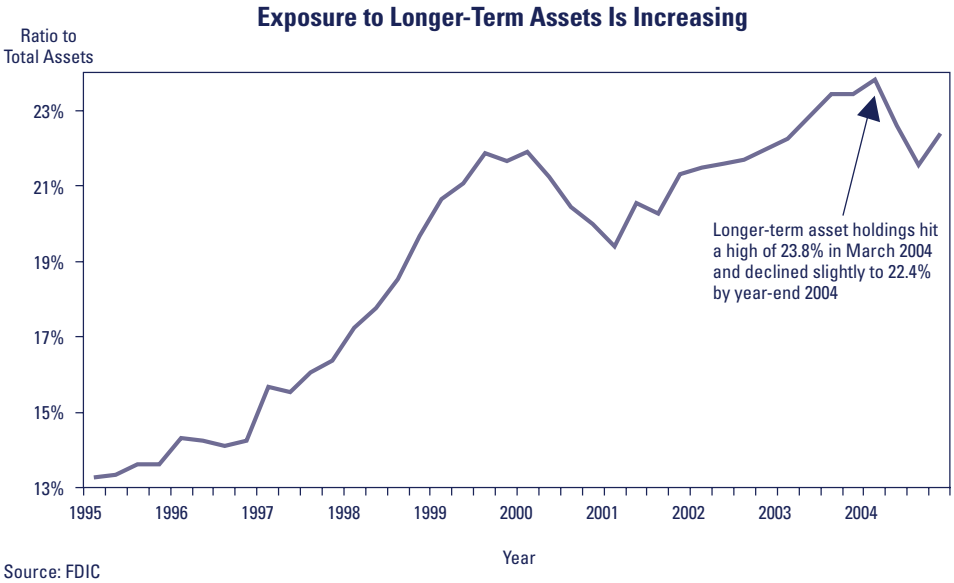
The industry's exposure to long-term assets increased during the 1990s (see Chart 4). Exposure to long-term assets in relation to total assets has risen steadily, from 13 percent in 1995 to nearly 24 percent in 2004, indicating the potential for heightened liability sensitivity.[5] Significant exposure to longer-term assets could generate further inquiry from examiners about the precise cash flow characteristics of a particular bank's assets and a review of the bank's assessment of the

[3]Refer to the Fourth Quarter 2004 FDIC *Quarterly Banking Profile* for complete 2004 industry performance results.

[4]Except where noted otherwise, data are derived from the December 31, 2004, Consolidated Reports of Condition and Income (Call Reports). Call Reports are submitted quarterly by all insured national and state nonmember commercial banks and state-chartered savings banks and are a widely used source of timely and accurate financial data.

[5]Long-term assets include fixed- and floating-rate loans with a remaining maturity or next repricing frequency of over five years; U.S. Treasury and agency, mortgage pass-through, municipal, and all other nonmortgage debt securities with a remaining maturity or repricing frequency of over five years; and other mortgage-backed securities (MBS) like collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and stripped MBS with an expected average life of over three years.

Chart 4



Source: FDIC
Note: All FDIC-Insured Commercial Banks.

nature and extent of its asset-liability mismatch and resulting rate sensitivity.

In addition to increasing its exposure to long-term assets, the industry has increased its exposure to mortgage-related assets. Current data show that bank holdings of mortgage loans and mortgage-backed securities comprise 28 percent of all bank assets (see Chart 5),[6] compared to 18 percent in 1990.

Mortgage-related assets present unique risks because of the prepayment option that is granted the borrower and embedded within the mortgage loan. Due to lower prepayments in a rising rate environment, the duration of lower-coupon, fixed-rate mortgages will extend and banks will be locked into lower-yielding assets for longer periods. Like mortgage loans, longer-term, fixed-rate mortgage-backed securities are also exposed to extension risk.

It is difficult to assess fully the current magnitude of liability sensitivity or extension risk confronting the banking industry. Even though exposure to long-term and mortgage-related assets has been moving steadily upward in recent years, there are signs that bank risk managers are responding to a changing rate environment and altering their asset mix. Since June 2003, banks have reduced their exposure to fixed-rate mortgage assets and are recently offering more adjustable-rate mortgage loan products (ARMs). As shown in Chart 6, industry exposure to fixed-rate mortgages, while generally increasing since 1995, began to turn sharply downward in the third quarter of 2003.

And, according to Federal Housing Finance Board data, the percentage of adjustable-rate, conventional single-family mortgages originated by major

[6]Mortgage-related assets includes loans secured by one- to four-family residential properties, including revolving lines of credit, and closed-end loans secured by first and junior liens; mortgage pass-through securities and MBS, including CMOs, REMICs, and stripped MBS. Extension risk can be explained as follows: Changes in interest rates can pressure the value of mortgages and MBS because of the embedded prepayment option held by the mortgage debtor. These options can affect the holder of such assets adversely in a falling or rising rate environment. As rates fall, mortgages likely will experience higher prepayments, requiring the bank to reinvest the proceeds in lower-yielding assets. Conversely, as rates rise, prepayments will slow and result in a longer, extended period for principal return.

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Chart 5

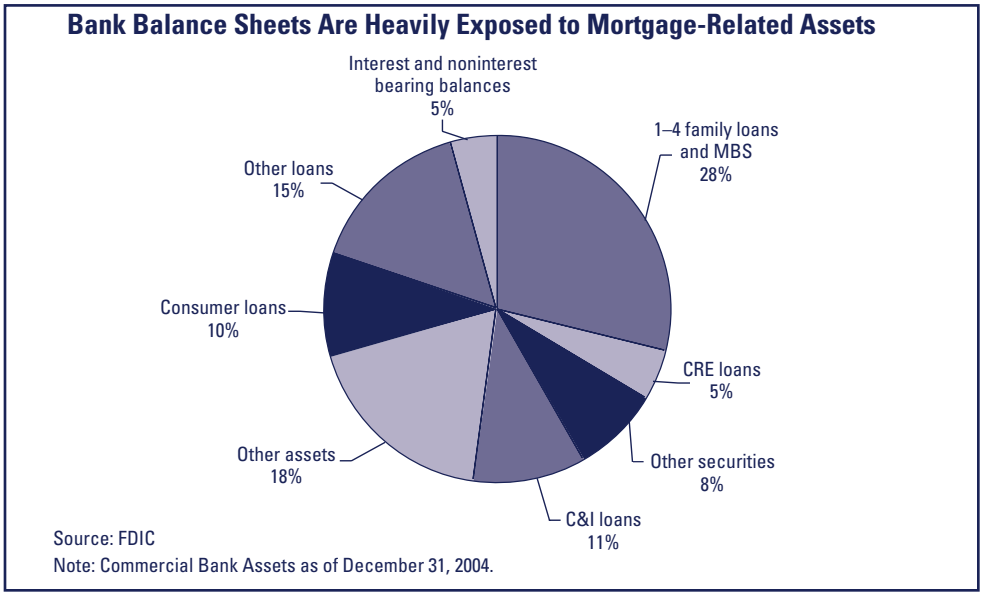
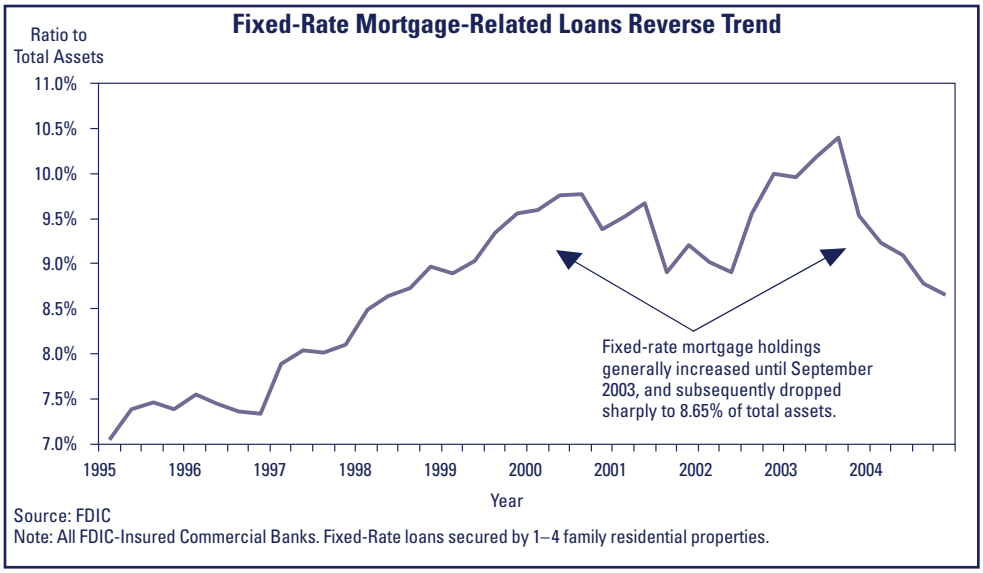


Chart 6



lenders increased from 15 percent in 2003 to a recent peak of 40 percent in June 2004. Lower levels of fixed-rate mortgages would reduce an institution's exposure to extension risk. In addition, higher levels of ARMs could increase an institution's asset sensitivity. Such changes in balance sheet structure could mitigate potential exposure to rising interest rates.[7]

[7]All ARMs are not the same, and the degree of asset sensitivity will depend on each product's unique structure. ARMs with an initial fixed-rate period of one to five years ("hybrid" loans) have grown in popularity. Freddie Mac's 2004 ARM Survey found that 40 percent of all adjustable-rate mortgages were hybrid products, primarily 3/1 and 5/1 structures. The interest rate on such hybrid loans are fixed for three or five years, respectively, adjusting annually thereafter based on some interest rate index. Accordingly, such hybrid products will not reduce liability sensitivity during the fixed-rate period of the loan.

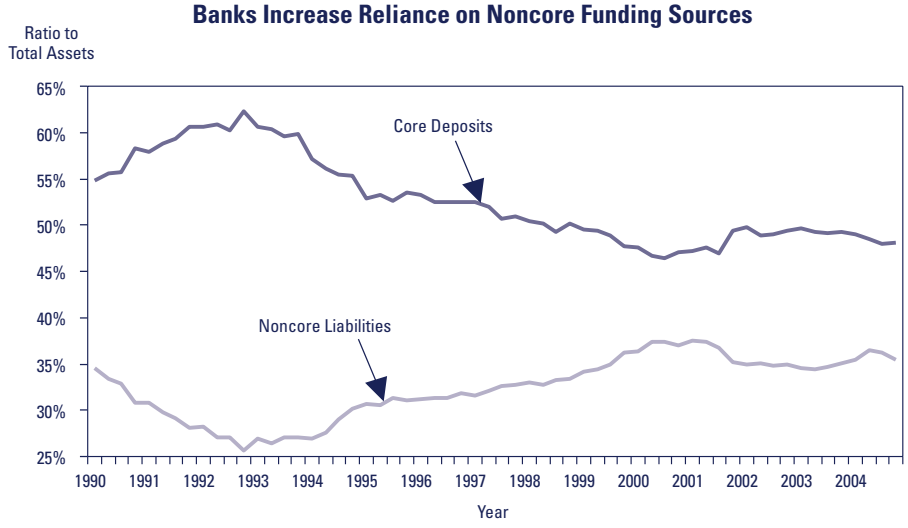
Bank Balance Sheet Composition—The Liability Side

The potential for interest rate risk driven by maturity or repricing mismatch cannot be assessed by looking only at the asset side of the balance sheet. Information on the nature and duration of banks' liabilities is also needed. Banks that rely heavily on short-term and more rate-sensitive funding sources could experience a material increase in funding costs as interest rates rise. Some banks may not be able to offset such higher funding costs through increased asset yields. Increased exposure to short-term, rate-sensitive wholesale funding sources can render a bank more liability sensitive, increasing its exposure to rising rates.

Over the past several years, banks have increased their reliance on wholesale, noncore funding sources such as overnight funds, certificates of deposit (greater than $100,000), brokered deposits, and Federal Home Loan Bank (FHLB) advances. Noncore funding sources have climbed steadily from about 25 percent of total assets in 1992 to over 35 percent today. This trend is mirrored by core deposits falling from 62 percent of total assets in 1992 to 48 percent in 2004 (see Chart 7). Combined with an increase in holdings of long-term assets, a shorter-term and more volatile liability structure could expose an institution to significant interest rate risk in a rising rate environment.

To assess fully the impact of the increase in noncore funding sources and the decrease in core deposits, more information about the tenor of noncore liabilities is needed. FHLB advances are a significant component of noncore funding for many institutions and illustrate the importance of looking deeper into the repricing structure of a bank's funding sources. Call Report data provide some information on the maturity structure of FHLB advances, but the picture is clouded. Recent reports show that while the use of shorter-term FHLB advances (under one year) has been on the rise, 67 percent of all FHLB advances have a maturity greater than one year (see Chart 8).

Chart 7



Source: FDIC

Note: All FDIC-Insured Commercial Banks. Noncore liablities include time deposits over $100 million, other borrowed money, Federal funds purchased and securities sold, insured brokered deposits less than $100,000, and total foreign office deposits.

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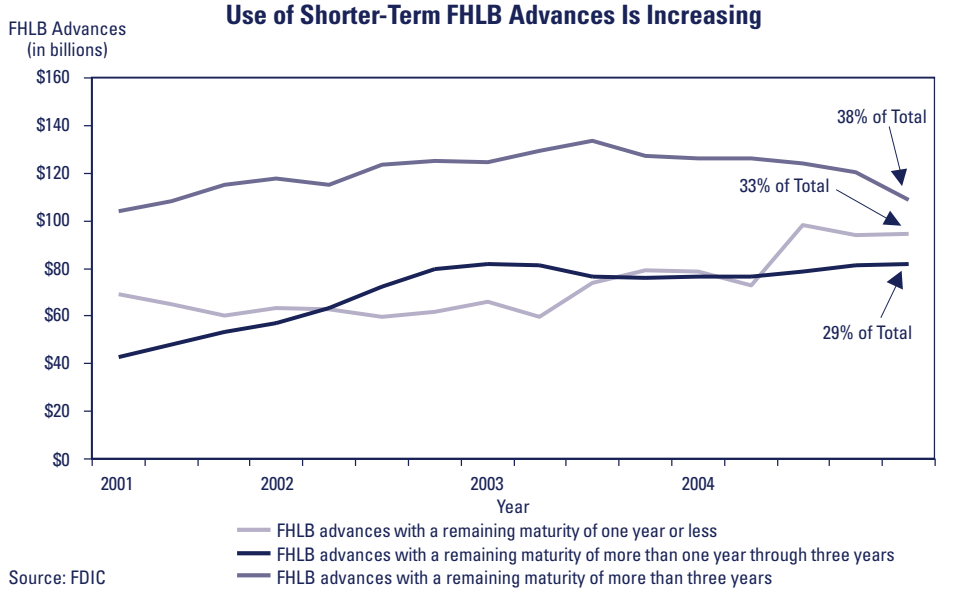
Chart 8



The Call Report, however, does not capture the nature and extent of options embedded within the FHLB advance structures. Call Report instructions provide that FHLB advances with a three-year (or longer) contractual maturity are to be recorded in the long-term bucket, even if the advance is callable or convertible by the FHLB at any time. A callable or convertible advance allows the FHLB to convert the advance from fixed- to floating-rate or terminate the advance and renew the extension at current market rates. Therefore, advances such as those reported as having a three-year maturity may actually reprice in the near term, depending on the rate environment.[8]

Many advances contain embedded options. The FHLB Combined Financial Report (as of June 30, 2004) reflects that of then-outstanding advances, approximately 55 percent were callable and 22 percent were convertible. Translated to bank balance sheets, these data indicate the presence of a greater level of option risk on banks' balance sheets than currently included in Call Report information. In a rising rate environment, the probability increases that the FHLB will exercise its option to call or convert lower-yielding advances, thereby exposing the borrowing institution to higher funding costs.

In conclusion, aggregate industry trends—specifically higher levels of exposure to long-term assets, mortgage-related assets, and noncore funding sources that exhibit optionality—raise concerns about the potential for heightened levels of interest rate risk in today's environment. These concerns must be tempered by awareness that off-site data provide only a rough, opaque, and end-of-period view of banks' balance sheet cash flow characteristics and composition. Each bank is unique in terms of asset and liability mix, risk appetite, hedging activities, and related risk profile. Moreover, bank risk exposures are not static. Interest rate risk management strategies can change an institution's risk profile quickly—even overnight—through the use of financial derivatives (e.g., interest rate swaps).

[8]See Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041) at RC-M–Memorandum Item 5, which provides, "Callable Federal Home Loan bank advances should be reported without regard to their next call date unless the advance has actually been called."

Thus, it is difficult to draw conclusions about the level of interest rate risk strictly from off-site information. Off-site and industry-wide analyses must be joined with on-site examination results to derive a more comprehensive supervisory assessment of interest rate risk exposure, its measurement, and its management.

Supervisory Assessment of Interest Rate Risk

Bank examiners assess the level of interest rate risk exposure in light of a bank's asset size, complexity, levels of capital and earnings, and most important, the effectiveness of its risk management process. At the core of the interest rate risk examination process is a supervisory assessment of how well bank management identifies, monitors, manages, and controls interest rate risk.[9] This assessment is summarized in an assigned risk rating for the component known as sensitivity to market risk, which is part of the CAMELS rating system.[10]

An unsatisfactory rating for sensitivity to market risk (the "S" component of CAMELS) represents a finding of material weaknesses in the bank's risk management process or high levels of exposure to interest rate risk relative to earnings and capital. Chart 9 indicates that the number of FDIC-insured institutions with an unsatisfactory "S" component rating is minimal out of the population of nearly 9,000 insured institutions. Fewer than 5 percent of insured institutions are rated 3 or worse for this component, and most of those are in the less severe 3 rating category. Moreover, since 2000, the number of institutions with an adverse "S" component rating has declined steadily.

To capture emerging trends, FDIC supervisors are conducting periodic reviews of bank examination reports in an effort to discern the nature and cause of adverse "S" component ratings. A review of recent examination reports that presented supervisory concerns about interest rate risk reveals several commonalities in the banks' operating activities:

- Concentrations in mortgage-related assets,
- Ineffective or improperly managed "leverage" programs,[11] and
- Acquisition of complex securities without adequate prepurchase and ongoing risk analyses.

[9] "Effective board and senior management oversight of a bank's interest rate risk activities is the cornerstone of a sound risk management process." Joint Agency Policy Statement on Interest Rate Risk, 12 FR 33166 at 33170 (1996); distributed under Financial Institution Letter 52-96 (hereafter Interest Rate Risk Policy Statement).

[10] Sensitivity to market risk is rated under the Uniform Financial Institutions Rating System (UFIRS), which is used by the Federal Financial Institutions Examination Council member regulatory agencies. Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations: the adequacy of capital (C), the quality of assets (A), the capability of management (M), the quality and level of earnings (E), the adequacy of liquidity (L), and the sensitivity to market risk (S). The resulting acronym is referred to as the CAMELS rating. Composite and component ratings are assigned based on a 1 to 5 numerical scale. 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and, therefore, the highest degree of supervisory concern. In general, fundamentally strong or sound conditions and practices are reflected in 1 and 2 ratings, whereas supervisory concerns and unsatisfactory performance are increasingly reflected in 3, 4, and 5 ratings.

[11] A "leverage" strategy is a coordinated borrowing and investment program with the goal of achieving a positive net interest spread. Leverage programs are intended to increase profitability by leveraging the bank's capital through the purchase of earning assets using borrowed funds. While "leverage" in general defines banking, a typical leverage strategy focuses on a bank's acquisition of wholesale funding, such as Federal Home Loan Bank advances, and the targeted investment of such proceeds into bonds with a different maturity or credit rating, or both, such that a higher yield is earned from the bonds than the interest rate on the borrowings. Profitability may be achieved if a positive net interest spread is maintained, despite changes in interest rates. When improperly managed, these strategies cause increased interest rate risk and supervisory concern.

Interest Rate Risk

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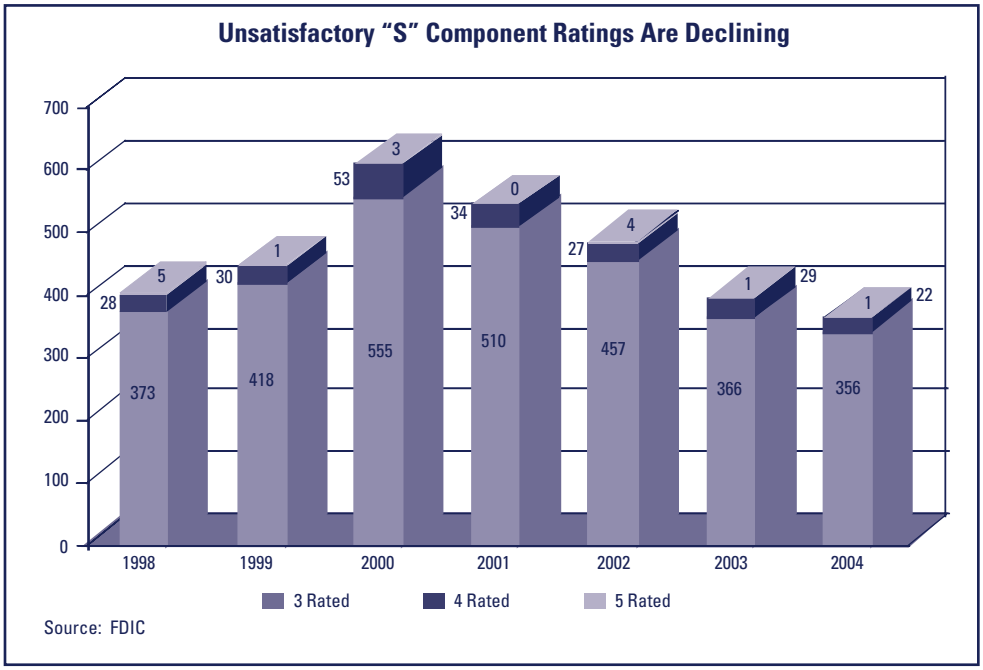
Chart 9



In addition, concerns have emerged about the adequacy and effectiveness of bank management's use of interest rate risk models. Weaknesses center on (1) the accuracy of model inputs as well as the accuracy and testing of assumptions, (2) whether the models are capturing the cash flow characteristics of complex instruments, specifically instruments with embedded options, and (3) whether management is using adequate stress tests to determine sensitivity to interest rate changes. Key supervisory concerns identified from a review of examination comments specific to interest rate risk models include:

- *Data input should be accurate, complete, and relevant.* Many loans, securities, or funding items may present complex or unique cash flow structures that require special, tailored data entry. Aggregating structural information at too high a level may result in the loss of necessary detail, and the reliability of the cash flows projections may become questionable.
- *Assumptions must be appropriate and tested.* Model results are extremely sensitive to the assumptions used; these assumptions should be reasonable and reviewed periodically. For example, prepayment speeds can change significantly in any given rate environment. And a bank's historical prepayments experience may differ materially from vendor-supplied prepayment speeds. The model's sensitivity to changes in key material assumptions should be evaluated periodically.
- *Option risk embedded in assets and funding sources should be captured effectively.* Many banks have options embedded in their balance sheet through exposure to mortgage-related assets, callable or convertible advances, or other structured products. Interest rate risk measurement systems should be capable of identifying and measuring the effect of embedded options.

- *Significant leverage programs should be understood fully.* Management should understand fully the nature of the leverage programs and the risks of the instruments used, and effectively assess the impact of adverse rate movements or yield curve changes. Given that leverage programs often are designed to take advantage of spreads between short- and long-term rates, measurement systems should capture the effects of nonparallel shifts of the yield curve.
- *Sensitivity stress tests should include a reasonable range of unexpected rate shocks; for example, stress tests should not simply approximate market expectations of a modest ratcheting up of the yield curve over the next 12 months.* Bank management should provide for stress tests that include potential interest rate changes and meaningful stress situations using a sufficiently wide range in market interest rates, immediate and gradual shifts in market rates, as well as changes in the shape of the yield curve. The Interest Rate Risk Policy Statement suggests at least a 200 basis point shock over a one-year horizon.
- *The variance between the model's forecasted risk levels and actual risk exposures should be analyzed routinely (sometimes called "back-testing").* This exercise will highlight areas of material variance and improve identification of errors in assumptions, inputs, or calculations.

Lessons from History Help Place Concerns About Rising Rates in Context

Current concerns about the risks of a rising rate environment should be viewed in historical context. An internal FDIC review of bank and thrift failures discloses that interest rate risk is not a common cause of insured depository institution insolvencies.

The FDIC review studied the causes of the bank insolvencies that occurred during three periods of rising rates: the period from 1978 to 1982 and the rate spikes in 1994 and 2000. The analysis revealed that no institution failures in the 1990s were caused by the movement of interest rates. However, certain insolvencies in the early 1980s, primarily of savings and loan institutions, were affected by changes in the interest rate environment. The review determined that these insolvencies followed a period of rapid and prolonged increases in short- and long-term rates, during which the yield curve was inverted (for the most part, the yield curve was inverted from September 1978 through April 1982). These institutions were heavily concentrated in longer-term, fixed-rate mortgage loans, and were also challenged by a new and unregulated market for deposits. Additional factors that contributed to these early insolvencies were economic recession, capital weakness, and regulatory forbearance. A historical depiction of institution failures, in relation to the 10-year Treasury bond yield and general periods of yield curve inversion, is shown in Chart 10. From a historical perspective, only in the unique circumstances of the early 1980s can rising rates be associated with bank or thrift insolvency.

Today's environment is markedly different. Despite rising rates and a flattening yield curve, the curve remains upward sloping. The economy generally has been improving, and the regulatory environment has changed considerably. Stricter regulatory capital standards were mandated in 1988, and limits on permissible investments were adopted in 1989. Prudential standards were implemented following the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991, and

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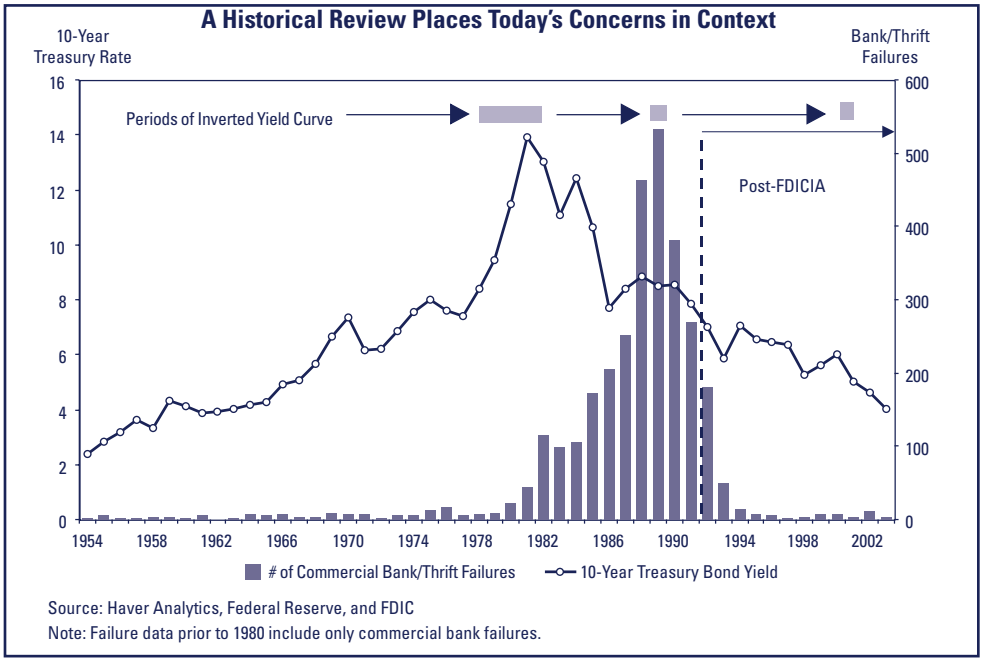
Chart 10



Source: Haver Analytics, Federal Reserve, and FDIC
Note: Failure data prior to 1980 include only commercial bank failures.

interest rate risk and investment activities policy statements were issued in 1996 and 1998. In addition, the industry now relies on more advanced interest rate risk measurement and management methodologies. Taken together, these developments mitigate the level of supervisory concern about the aggregate level of interest rate risk in the industry today.

Conclusion

Interest rate risk is garnering attention given the changing rate environment and trends in aggregate bank balance sheet and income statement information. Rising rates and a flattening yield curve could pressure NIMs, particularly for institutions that exhibit liability sensitivity, given their relatively greater exposure to long-term assets. In addition, banks are exhibiting increased exposure to more volatile, rate-sensitive funding sources with degrees of optionality not fully captured by Call Report data. However, these aggregate measures of bank balance sheet and income statement composition serve only as indicators of the possible presence of interest rate risk. Off-site analysis and on-site examinations identify excessive or poorly managed interest rate risk relative to a particular institution's risk profile, earnings, and capital levels. Examination findings, while revealing weaknesses in some circumstances, overall indicate that bank risk managers are acting effectively to moderate their institutions' exposure to interest rate risk in this challenging environment.

Keith Ligon
Chief, Capital Markets Branch

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Enforcement Actions Against Individuals in Fraud-Related Cases: An Overview

In recent years, fraud committed by insiders has exposed insured financial institutions and the deposit insurance funds to significant potential or actual losses. Fraud proved particularly costly to a few institutions, as evidenced by one failure and one near-failure. The FDIC, through its examination program, promotes sound internal control structures that help banks detect and prevent fraud. However, the FDIC recognizes that insider fraud will always present a risk to financial institutions.

Banks can mitigate exposure to fraud loss by discovering schemes early, taking aggressive corrective actions, and carrying adequate fidelity insurance. In addition, the FDIC, through the efforts of its Division of Supervision and Consumer Protection (DSC), can minimize exposure by pursing appropriate enforcement actions. The importance that the FDIC places on combating fraud is underscored by the fact that of the 65 removal/prohibition actions issued during 2004, 61 (94 percent) involved fraud against a financial institution.

This article is the first in a series relating to fraud and other misconduct by insiders that resulted in FDIC enforcement actions. It reviews the enforcement action process, identifies recent trends in the number and type of actions, describes the most prevalent types of insider fraud, and summarizes insured institution weaknesses that contribute to the perpetration of fraud. The box at the conclusion of the article provides an overview of the statutory authority and policies that form the basis for FDIC enforcement actions.

The Enforcement Action Process

Often the FDIC learns of insider misconduct during an examination. In other instances, the misconduct is brought to the FDIC's attention by bank management or through the filing of a Suspicious Activity Report.[1] After learning of misconduct, DSC examiners conduct an extensive review of the alleged activities to determine if grounds exist to pursue an enforcement action and obtain evidence to support the action. The FDIC's Legal Division will become involved during the investigation to help focus the examiners' inquiries and identify necessary documentation.

The FDIC and other Federal banking agencies have broad discretion in determining the appropriate enforcement remedy to address fraud and other misconduct committed by insiders against insured depository institutions. In determining whether and what kind of enforcement action(s) is appropriate, the FDIC has traditionally considered whether the proposed remedy is likely to achieve the particular supervisory objective. Because cases are fact-specific and present unique circumstances, the administrative remedies are determined on a case-by-case basis. The FDIC Board of Directors has delegated authority to the DSC to issue Notices or Orders against institution-affiliated parties (IAPs) for removal/prohibition actions, for assessments of civil money penalties (CMPs), and for restitution. The use of the full range of enforcement tools is particularly appropriate in cases involving insider fraud.

[1] A Suspicious Activity Report is a standard form used by all Federally insured financial institutions to report suspected criminal violations of Federal law or suspicious transactions potentially related to money laundering activities.

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A common remedy is action under Section 8(e) of the Federal Deposit Insurance Act (FDI Act). A prohibition order issued under Section 8(e) has been interpreted to impose an industry-wide ban, preventing the individual from moving on to another institution and repeating the same or other forms of fraud.[2] A CMP removes the incentive for financial gain from an individual's misconduct. It punishes the particular offense, deters similar abuses by the individual being penalized, and, by its public nature, deters others in the banking industry. Remedial action by the institution may be warranted to address internal control weaknesses. In addition, reimbursement of losses or disgorgement of unjust gains by the individual may be appropriate.

The Investigation Phase

When examiners believe that matters are being misrepresented or documentation is inadequate, especially where evidence is in the possession of third parties outside the bank, the FDIC may initiate an investigation under the powers conferred by Section 10(c) of the FDI Act. These powers include the ability to subpoena witnesses, administer oaths, take and preserve testimony under oath, and require the production of records.

The investigation may be conducted simultaneously with a criminal investigation by the U.S. Department of Justice (DOJ) or State criminal authorities. In the case of a parallel criminal proceeding, the FDIC will coordinate with the respective criminal authority and seek to obtain a stipulation to a prohibition action (and to a CMP or restitution when appropriate) as part of any criminal plea agreement. Where the criminal prosecutor has made no formal request to defer administrative action, the FDIC will determine which enforcement action(s) to pursue and the timing of the case after evaluating a variety of factors, including what criminal penalties might likely be imposed. It is FDIC policy to cooperate fully with the criminal authorities. The FDIC normally will delay its enforcement action in favor of the criminal action if the DOJ formally requests it.

Supervisory and Legal Division staff in the FDIC's Regional Offices review the findings of the investigation and decide whether to proceed with an action. When a case is to be pursued, Regional Office staff forward a recommendation memorandum to the Washington Office for review and action. Under current delegations of authority, generally only the Washington Office may issue enforcement actions against individuals.[3] As shown in the next section, enforcement action activity has been ratcheting upward in recent years.

Enforcement Action Activity Continues to Increase

The number of administrative actions issued by the FDIC has increased since fourth quarter 2002, almost doubling between 2003 and 2004 (see Table 1).

Of the 40 CMP actions issued during 2004, 22, involving penalties totaling $290,000, were associated with a companion removal/prohibition action. Of the 18 cases not associated with a companion removal/prohibition action, none principally involved fraud. Half the actions not associated with a companion removal/prohibition action were against members of an institution's board of directors who failed to provide proper oversight of individuals involved in misconduct. The remainder involved regulatory violations where no fraud was involved—typically, violations of regulations governing insider lending or legal lending limits.

[2]An IAP subject to a Section 8(e) Order can petition to lift or modify the Order.

[3]Current delegations of authority to issue enforcement actions can be found at www.fdic.gov/regulations/laws.

Table 1

FDIC Enforcement Actions	2004	2003	2002
Removal/Prohibition Actions Issued	65	35	21
Civil Money Penalty Actions (number/amount)	40/$457,000	42/$1,892,737	29/$5,411,500
Restitution Actions (number/amount)	1/$22,142	1/$1,400,000	2/$34,000,000

A Focus on Fraud-Related Prohibition Actions

Of the 65 removal/prohibition Orders or Notices issued during 2004, 61 (94 percent) principally involved fraud against one or more financial institutions; however, not all of the cases involved a criminal prosecution, primarily due to the lack of substantial loss to the bank. Of the fraud-related actions, the individual committed fraud against the employing bank in 57 cases. Three individuals committed fraud against one or more insured depository institutions, and one individual was a bank employee who committed fraud against two other institutions.

Our review of the fraud-related prohibition cases during 2004 identified common trends and characteristics. The individual's specific motivation (other than apparent greed) could not be identified in every situation; however, our review did reveal situations in which individuals were motivated by the desire to conceal loan problems in a branch or portfolio, or by a financial vulnerability, such as lifestyle expenses, debts from a divorce, or gambling debts. In attempting to hide the misappropriations, the respondents (a respondent is the individual against whom the FDIC issues, or seeks to issue, one or more enforcement actions) would typically manipulate various bank records (usually general ledger accounts). In most cases, manipulation of bank records was discovered within a relatively short time, usually by internal auditors or bookkeepers but often by bank employees, including subordinates, who became suspicious of the respondent's transactions. However, several frauds were conducted over five to ten years. Our review noted some relationship between the amount of funds embezzled and the duration of the fraud; in most cases, gains to the respondent exceeding $100,000 occurred over a period of several years.

Generally, fraud-related cases fall into one of two categories—embezzlement and loan fraud. While the instances of fraud being committed by outsiders (a bank employee against a non-employing bank) were not as prevalent as insider fraud, the losses to institutions in two of the three cases (one case had two respondents) were extremely large, and in one instance contributed to the failure of the bank.

Embezzlement

The embezzlement cases involved respondents misappropriating or misapplying bank funds for personal gain. Respondents often targeted high-volume accounts or transactions, apparently in the hope that the relatively small fraction of fraudulent transfers would go unnoticed. Most respondents targeted deposit accounts from which to transfer funds and then laundered the proceeds through false entries to various accounts. Respondents made false entries to various general ledger accounts, but no particular account appeared to be more at risk than others.

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In other instances, respondents attempted to misappropriate, or skim, funds due the bank by diverting fees or other income into a personal account. One respondent stole cash from the bank's vault by falsifying records concerning shipments of mutilated currency to the Federal Reserve Bank.

Loan Fraud

Loan fraud cases involved respondents originating nominee loans (a nominee loan is a loan in which the borrower named in the loan documents is not the party receiving the use or benefit of the loan proceeds), originating loans to fictitious entities or unwitting borrowers, failing to properly record collateral that allowed the transfer of the property to another party and left the bank's loan unsecured, or altering the terms of a loan. While the motives discussed previously would also apply to loan fraud, certain motives were specific to this type of fraud, including gaining access to loan funds, making existing loan terms more favorable to family or associates, or concealing poor performance at a branch or in a loan portfolio. Respondents often failed to disclose receiving an economic benefit from loans they originated to borrowers with troubled financial positions who likely would not have qualified for or been granted credit. Such loans were made outside the bank's policy requirements and were a contravention of safe and sound banking principles.

Respondents usually attempted to conceal illegitimate activity by making fraudulent account entries, including unauthorized or unrecorded advances and fictitious payments. Nominee or fictitious loans were often originated to provide funds to make payments on other illicit loans so that such loans would appear performing and legitimate. Inflated appraisals or other collateral manipulations were sometimes used to allow advances greater than justified.

Insured Institution Weaknesses

Certain financial institution weaknesses were apparent in the fraud cases, with the overarching weakness being lax internal controls. Many banks lacked proper segregation of duties, and individuals were able to process a transaction from start to finish. One individual could initiate, approve, and possibly reconcile a transaction without the involvement of another bank employee. Respondents often functioned without proper supervision, either by their immediate supervisor or by management and the bank's board of directors in general. Several of the respondents were longtime employees who, even if they had not achieved management positions, had established a level of trust that appears to have given them the leeway to commit fraud. Respondents who held senior positions may have been able to avoid oversight or misuse their authority to ensure that their subordinates unknowingly aided the fraud.

Conclusion

Is insider fraud always preventable? Probably not. However, the early detection of fraud is key to limiting risk to an insured institution and the deposit insurance funds. Prevention and detection of insider fraud are possible only through the vigilance of financial institution management and employees, examiners, and external auditors. The FDIC's zero tolerance policy toward insider fraud is evidenced by its continuing efforts to protect the industry through the use of administrative remedies to punish the perpetrators of fraud and to deter other insiders from attempting fraud.

Subsequent articles in this series will feature case studies of enforcement actions issued against individuals for misconduct that involves fraud or other violations of law. These articles will highlight the critical role that enforcement actions play in the FDIC's, and the banking industry's, continuing efforts to combat fraud.

Enforcement Actions Against Individuals: Statutory Authority and Policies

The FDIC uses various enforcement powers to protect the deposit insurance funds, punish perpetrators, and deter others from attempting fraud in insured depository institutions. This discussion outlines the FDIC's enforcement action powers and policies.

Statutory Requirements

The statutory authority and requirements for the FDIC to issue certain administrative enforcement actions against individuals are contained in Section 8 of the FDI Act.[4] The FDIC exercises supervisory authority over institution-affiliated parties (IAPs) at insured institutions for which it is the primary Federal regulator. An IAP includes a director, officer, employee, or controlling shareholder of or agent for the institution as well as an independent contractor (such as an attorney, appraiser, or accountant) who knowingly or recklessly engages in a violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that caused or is likely to cause more than a minimal financial loss to or a significant adverse effect on the insured depository institution.

Removal/Prohibition Authority

The FDIC's removal and prohibition authority is found in Section 8(e)(1) of the FDI Act. An order issued under this Section removes an individual from office if he or she is currently an IAP at a state nonmember bank, and it prohibits that individual from holding office in or participating in any manner in the affairs of any insured depository institution. This prohibition also applies to any insured credit union, Farm Credit Bank, Federal depository institution regulatory agency, Federal Housing Finance Board, and any Federal Home Loan Bank. This remedy has been interpreted to impose an industry-wide ban designed to protect the banking industry. To issue an Order against an individual, the FDIC must establish three separate grounds: misconduct, effect of the misconduct, and culpability for the misconduct. Each of these grounds has multiple elements; at least one element of *each* of these three areas must be alleged and proven for a removal/prohibition action to be issued.

Misconduct

Violated any law or regulation, cease-and-desist order that has become final, written agreement, or condition imposed in writing by a Federal banking agency in connection with the granting of any application or other request by the institution;

Engaged or participated in an unsafe or unsound banking practice; or

Committed or engaged in any act, omission, or practice that constitutes a breach of fiduciary duty.

Effect

Institution has suffered or will probably suffer financial loss or other damage;

Interests of the institution's depositors have been or could be prejudiced; or

Individual received financial gain or other benefit.

Culpability

The individual exhibited personal dishonesty; or

The individual exhibited a willful or continuing disregard for the safety or soundness of the institution.

Civil Money Penalty Authority

The FDIC's authority to assess CMPs is found in Section 8(i)(2) of the FDI Act. A CMP removes the incentive for financial gain from an individual's misconduct. This punishes the particular offense and deters similar abuses by the individual being penalized and, by the public nature of the action, deters abuses by others in the banking industry. CMPs are divided into three tiers with increasingly higher penalties for more egregious misconduct.

[4] 12 U.S.C. § 1818.

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Tier 1 CMPs may be imposed for violations of law, regulation, final order, condition imposed in writing, or written agreement. A penalty of not more than $6,500 per day may be assessed for each day the violation continues.

Tier 2 CMPs may be imposed for any Tier 1 violation, engaging in an unsafe or unsound practice, or breach of fiduciary duty, whereby the violation, practice, or breach presents a pattern of misconduct, causes or is likely to cause more than a minimal loss to the institution, or results in personal gain. A penalty of not more than $32,500 per day may be assessed for each day the violation continues.

Tier 3 CMPs may be imposed for violations, practices, or breaches for which Tier 1 or 2 penalties may be assessed where the respondent knowingly or recklessly causes substantial loss to the institution or realizes substantial personal gain. A penalty of not more than $1,250,000 may be assessed for each day the violation continues.

The FDI Act requires the FDIC to consider four mitigating factors in determining the appropriateness of a penalty—the size of the financial resources and good faith of the person charged; the gravity of the violation; the history of previous violations; and such other matters as justice may require.

Restitution Authority

The FDIC, under Section 8(b)(6)(A) of the FDI Act, may issue a Cease and Desist Order requiring an IAP to make restitution if the IAP was unjustly enriched or the violation or practice involved a reckless disregard for the law, applicable regulations, or prior order of the appropriate Federal banking agency. When the statutory criteria are met, the FDIC will consider pursuing restitution and will regularly encourage the respondent to make voluntary restitution to the bank. If restitution is appropriate but the respondent cannot pay both restitution and CMPs, FDIC policy generally favors having the respondent pay restitution to the institution. In some cases, restitution may not be sought if the respondent has already made restitution or likely will be ordered to do so through criminal proceedings, the institution recovered its loss through a blanket bond claim, the loss to the institution is deemed inconsequential in relation to its financial resources, or the respondent's financial condition precludes the ability to make restitution.

Issuance of Enforcement Actions

Enforcement actions issued by the FDIC may be either consensual or contested by the respondent. The FDIC attempts to obtain consent agreements to the issuance of enforcement orders, as a stipulated action saves the FDIC and the respondent the cost and time of litigating a contested case. In a stipulated case, the respondent agrees to the issuance of an order, and the FDIC issues a final, enforceable Order of Removal and/or Prohibition from Further Participation, Order to Pay, and/or Order for Restitution.

If the respondent chooses to contest an action, the FDIC issues a Notice of Intention to Remove and/or Prohibit from Further Participation (and notices related to CMPs and/or restitution, as appropriate), which details the FDIC's case and provides notice of a hearing to be held before an Administrative Law Judge (ALJ). The respondent's failure to answer the Notice within 20 days or failure to appear (either in person or by duly authorized counsel) at a scheduled hearing constitutes a default, and the FDIC may petition the ALJ to issue a default judgment. After receiving the ALJ's recommended decision, the FDIC Board of Directors may then issue a final order(s) against the respondent. In a CMP proceeding, the failure to timely request a hearing results in the Notice becoming a final and unappealable Order.

Scott S. Patterson
Review Examiner

Zachary S. Nienus
Financial Analyst

Fair Lending Implications of Credit Scoring Systems

During the past decade, lenders' use of credit scoring systems has increased significantly, and examiners routinely consider the role of credit scores in lending decisions. The comparative analysis portion of a fair lending examination includes an interview to determine the criteria the lender considered in the decision point (underwriting, pricing, etc.) selected for review.[1] This interview frequently reveals that a credit score was one of the criteria. At this point, examiners can determine how to proceed by consulting the *Interagency Fair Lending Examination Procedures*.[2] However, examiners must synthesize information from several sections of the Procedures and the appendixes.

This article gives examiners the tools they will need to navigate this situation. It provides an overview of credit scoring systems, analyzes why the use of credit scores has proliferated, and explains how their use is considered as part of a fair lending examination. It then recommends a concise conceptual framework for proceeding with a fair lending examination when a credit score is one of the criteria considered by the lender.

An Overview of Credit Scoring Systems

A credit scoring system mechanically evaluates creditworthiness on the basis of key attributes of the applicant and aspects of the transaction.[3] A system can be as simple as a form the loan officer completes by hand that assigns points to particular attributes, or as complex as an artificial intelligence-based neural network with a continuous feedback loop that adjusts the weighting coefficients and the cutoff score. A credit scoring system can be the only factor considered in making the credit decision, or the lender may combine a credit score with other criteria.[4]

Two types of credit scores exist—bureau scores and custom scores. A bureau score considers only the information on an individual's credit report and is generated by a consumer reporting agency. The largest three consumer reporting agencies are Experian, Equifax, and TransUnion. A lender pays the consumer reporting agency an additional fee to obtain the score at the time it obtains a copy of the credit report. An "acceptable" score varies with the lender's appetite for risk; however, an acceptable score usually falls around 600.

A custom score (sometimes referred to as an application score) is generated by the lender from a scoring system either developed by the lender or purchased from a vendor. A custom score usually considers the information on the applicant's credit report, selected information about the applicant, and characteristics of the credit transaction. Examples of commonly considered applicant information are type of residence, length of time at

[1]FDIC-regulated institutions are subject to two Federal statutes that prohibit discrimination in lending. The Equal Credit Opportunity Act (ECOA) covers all credit transactions. It prohibits discrimination on nine bases—race, color, religion, sex, national origin, age, marital status, receipt of public assistance, and the exercise of a right under the Consumer Credit Protection Act. The regulation that implements ECOA is 12 C.F.R., Part 202 (Regulation B). The Fair Housing Act covers residential real estate-related credit transactions. It prohibits discrimination on seven bases—race, color, religion, sex, national origin, handicap, and familial status. The regulation that implements the Fair Housing Act is 24 C.F.R., Part 100.

[2]Interagency Fair Lending Examination Procedures, www.fdic.gov/consumers/community/fairlend.pdf

[3]12 C.F.R. 202.2(p)(1).

[4]Official Staff Interpretations at Paragraph 202.6(b)(2), Comment 5.

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current residence, type of employment, length of time in current employment, and income. Typically, eight to ten variables are considered in a custom scorecard. Many custom scoring systems are scaled so that an acceptable score will be around 200, again depending on the lender's risk appetite. The scaling of custom credit scoring systems varies considerably among vendors and lenders. Some lenders blend an applicant's bureau score and a custom score in making a credit decision.

The Use of Credit Scoring Systems Has Increased Considerably

The accuracy and cost of credit scoring systems have benefited substantially from technological advances in automated data processing and improvements in statistical methodologies. Many lenders have found that credit scoring systems are cutting the time and administrative costs of making credit decisions, as well as improving the consistency of the decisions within their organizations. As a result:

- More lenders are using credit scoring systems.
- Lenders are applying credit scoring systems to more credit products.
- Lenders are using credit scoring systems in additional aspects of credit transactions, such as pricing and account administration.
- Lenders are using multiple systems in a single credit product.[5]

The increased use of credit scoring systems has implications for examiners as they conduct fair lending examinations.

The Role of Credit Scoring Systems in a Fair Lending Examination

A fair lending examination attempts to detect either overt discrimination or disparate treatment on a prohibited basis. Examiners select a focal point based on the risk that discrimination may be occurring, determine the criteria the lender considers in making the credit decision, evaluate the criteria and procedures for overt discrimination, and compare how the criteria are applied to a selected prohibited basis group with how they are applied to an appropriate control group. For example, the treatment of Hispanic applicants may be compared with the treatment of non-Hispanic whites.[6]

The use of a fairly developed and applied credit scoring system can reduce the possibility of unlawful discrimination by helping to ensure consistency and uniformity and minimizing individual judgment and discretion. However, a credit scoring system is not a panacea, and in certain circumstances, it can even be the source of fair lending violations.

Disparate treatment can occur at three stages in the use of a custom credit scoring system:

- *Data development and input:* For example, a lender credits white applicants with the length of time they have worked in the same field but credits Hispanic applicants only with the length of time they have worked for their present employer. Or, a lender credits white applicants with secondary income (such as bonuses, overtime, or commissions)

[5]Many lenders segment the applicant population by applicant characteristics, channels through which the application was received, or both. For example, a lender may have one system for applicants with nothing worse than a 30-day late on their credit report and a different system for applicants with more serious derogatory information. Or, a lender may have one system for automobile loan applications received directly from the borrower and a different system for automobile loan applications received indirectly through an auto dealer.

[6]See footnote 2.

but credits Hispanic applicants only with base salary. In either example, because discriminatory data are input into the system, the system will produce a discriminatory result.

- *Within the credit scoring system:* The system could include a prohibited basis as one of the variables, or, if not a prohibited basis itself, a factor that is so highly correlated with a prohibited basis that it serves as a proxy for the basis. (As discussed later in this article, in certain circumstances age can be considered in a credit scoring system.) A variable that considers the geographic area in which an applicant lives should be carefully scrutinized to determine if the geographic distinctions are so highly correlated with a prohibited basis that they serve as a proxy for that basis. In 2001, the Department of Justice (DOJ) settled a case against Associates National Bank in which the bank required a higher cutoff score for applicants who applied on Spanish-language applications than it required of applicants who applied on English-language applications.[7] DOJ treated the Spanish-language application as a proxy for ethnicity.[8]
- *Discretionary overrides:* The more discretion bank staff is permitted in overriding a credit scoring system, and the greater the number of staff with override authority, the greater the risk that the discretion will be exercised discriminatorily. Discretionary overrides fall into two categories. Low-side overrides are decisions to approve an applicant whose credit score falls below the cutoff score, and high-side overrides are decisions to deny an applicant whose credit score exceeds the cutoff score. The two types of overrides should be independently analyzed to detect an overall pattern of disparate treatment. This type of violation is illustrated by a settlement agreement between DOJ and Deposit Guaranty National Bank in 1999. The bank used a custom scorecard to underwrite applications for home improvement loans, but gave broad discretion to loan officers to override the credit scoring system. The pattern of overrides showed that white applicants were significantly more likely than black applicants to be approved with a credit score below the cutoff, and black applicants were significantly more likely than white applicants to be denied with a credit score above the cutoff.[9]

How should a fair lending examination be conducted once an examiner learns that a credit score is one of the criteria used in making a credit decision? Initially, the examiner should determine if the credit score is a bureau score or a custom score. If it is a bureau score, the examiner does not need to obtain more information about the scoring system. The comparative analysis should focus on the pattern of overrides and the lender's consideration of other criteria unrelated to the system. It is rare for a bureau score to be the only criterion considered in making a credit decision.

However, if the credit score is a custom score, the examiner should obtain a list

[7]United States v. Associates National Bank (D. Del.), www.usdoj.gov/crt/housing/caselist.htm#lending.

[8]The opportunity for overt discrimination or disparate treatment to occur does not exist in the first two stages if the lender uses a bureau score, because (1) the lender does not develop or input the data and (2) we can confirm from publicly available information that bureau scores do not consider any prohibited basis, including age, or any variable that could be considered a proxy for a prohibited basis.

[9]United States v. Deposit Guaranty National Bank (N.D. Miss.). www.usdoj.gov/crt/housing/caselist.htm#lending.

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of the variables considered by the system and determine if the scoring system is split into multiple cards on the basis of age. If a prohibited basis other than age, or a possible proxy for a prohibited basis other than age, is contained in the variables, the examiner should report this information to his or her manager as soon as possible. Addressing the overt discrimination issue will consume significant resources; therefore, the examiner should also consult with the manager about whether to continue with the planned comparative analysis.

As mentioned previously, ***age is the only prohibited basis that legally can be considered in a credit scoring system***. Age is not a prohibited basis under the Fair Housing Act, and the Equal Credit Opportunity Act and Regulation B provide a narrow exception for the consideration of age if the system meets certain requirements.

It is preferable from a risk management standpoint for a lender to validate every credit scoring system used to underwrite or price loans. However, from a compliance standpoint, a credit scoring system does not have to be validated unless it considers age. A credit scoring system can consider age in one of two ways: (1) the system can be split into different scorecards depending on the age of the applicant or (2) age may be directly scored as a variable. Some systems may consider age in both ways. Regulation B requires that all credit scoring systems that consider age be validated. The regulation uses the term "empirically derived, demonstrably and statistically sound."[10] For purposes of this article, we will refer to this term as "valid."

The burden is on the lender to demonstrate that a credit scoring system that considers age is valid for each credit product for which it is being used. An initial validation and periodic revalidations must occur to allow the scoring system to consider age.[11] Generally, a lender must validate a credit scoring system based on data from the institution's own through-the-door applicant population. However, if the lender's data are insufficient for an initial validation, the lender is permitted to obtain a validated scoring system or the data from which to develop a validated system from another lender or lenders for use on an interim basis. A lender must validate and revalidate its system based on its own data when they become available.[12]

Age-Split Systems

The system is treated as considering, but not scoring, age if it is split into only two cards, neither of which contains age as a variable, and one card covers a wide age range that encompasses elderly applicants. (Elderly applicants are applicants 62 years of age or older.)[13] Typically, the younger card in an age-split system is used for applicants under a specific age between 25 and 30. The younger scorecard de-emphasizes certain factors, such as the number of accounts on the applicant's credit history, the age of the oldest account on the applicant's credit history, length of employment, and length of time at present residence, but increases the negative weight of any derogatory information on the credit report. Validation is the only requirement Regulation B imposes on a system that considers, but does not score, age.[14]

[10]12 C.F.R. 202.2(p) and Official Staff Interpretations.

[11]A credit scoring system that considers age must be validated and revalidated even if it is only one of several factors considered in the credit decision. Official Staff Interpretations at Paragraph 202.6(b)(2), Comment 5.

[12]Official Staff Interpretations at Paragraph 202.2(p), Comment 3.

[13]12 C.F.R. 202.2(o).

[14]Official Staff Interpretations at Paragraph 202.6(b)(2), Comment 2.

Conducting a Fair Lending Examination—A Conceptual Framework

1. Determine if the credit score is a bureau score or a custom score.
2. If the credit score is a bureau score, no further information about the system itself need be obtained. Complete the comparative analysis focusing on the pattern of low- and high-side overrides and the application of any other criteria.
3. If the credit score is a custom score:
   a. Obtain a list of the variables considered in the credit scoring system and determine if the system is split on the basis of age.
   b. If a prohibited basis other than age, or a possible proxy for a prohibited basis other than age, is contained in the variables, report this information to your manager as soon as possible.
   c. If age is considered in the system, either through age-split scorecards, direct scoring of age, or both, obtain the lender's documentation on the initial validation and all periodic revalidations, including weighting coefficients, and submit the documentation to the Washington Office for expert review.[15]
   d. Complete the comparative analysis, considering whether there are indications of disparate treatment in either the development and input of the applicant data, the low- and high-side overrides, or both.

The FDIC has regional Fair Lending Examination Specialists available to provide technical assistance to FDIC examiners conducting any aspect of a fair lending examination.

Systems that Score Age

A system is treated as scoring age if age is directly scored as a variable, regardless of whether the system is also age-split, or if elderly applicants are included in a card with a narrow age range in an age-split system. Regulation B imposes a second requirement on scoring systems that score age—the age of an elderly applicant must not be assigned a negative factor or value.[16]

The next steps in the fair lending examination framework flow from these requirements. If a custom scoring system considers age, the examiner should obtain the lender's documentation on the initial validation and all periodic revalidations, including the weighting coefficients. At the FDIC, the documentation is then submitted to the Washington Office through regional management for expert review. The examiner should then complete the comparative analysis considering whether there are indications of disparate treatment in either the development and input of the applicant data, low- and high-side overrides of the system, or both.

In summary, based on an understanding of the different types of credit scoring systems and the Regulation B requirements for scoring systems that consider age, the framework in the shaded box is recommended for conducting a fair lending comparative analysis of credit decisions in which one of the criteria considered is a credit score.

Benefits of Using This Framework

This conceptual framework is recommended as an aid in conducting efficient fair lending examinations that result in correct, legally supportable

[15]This paragraph describes the procedures adopted by the Federal Deposit Insurance Corporation (FDIC). Examiners at other regulatory agencies should consult their agencies' most recent guidance.

[16]A negative factor or value means utilizing a factor, value, or weight that is less favorable than the lender's experience warrants, or is less favorable than the factor, value, or weight assigned to the most favored age group below the age of 62. (12 C.F.R. 202.2(v)).

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conclusions. Applying the framework does the following:

- Assists in focusing the review for overt discrimination and disparate treatment only on those areas in which it possibly exists;
- Ensures that the requirements of Regulation B for validation and treatment of the elderly are considered only for the small minority of credit scoring systems to which they apply;
- Ensures that lenders that choose to use custom credit scoring systems that consider age comply with the rigorous requirements for the narrow exception to the general prohibition against age discrimination; and
- Ensures that validation documentation is reviewed by FDIC staff with the appropriate, highly specialized expertise.

R. Russell Bailey
Senior Fair Lending Specialist

The Changing Landscape of Indirect Automobile Lending

Many traditional aspects of indirect auto lending have changed owing to significant competitive pressures exerted by the captive finance companies (captives) of automobile manufacturers. In response, many banks have loosened underwriting standards and relaxed procedures to become more "borrower friendly" to compete with the financial concessions of competitors. As a result, some banks operating in this highly competitive market with weak controls and lax automobile loan underwriting programs have been adversely affected. Banks with stronger programs remain susceptible to diminishing collateral values as loan terms continue to be extended over longer periods.

Traditionally, Federal regulatory agencies and bank internal loan review departments have relied on a delinquency-based approach to evaluate automobile loan portfolios. This approach has served regulators and bankers well, but recent automobile financing trends may require a more in-depth analysis when loan and collateral values are not correlated, vehicles are financed multiple times, or losses are deferred and embedded in loan balances.

This article discusses how heightened competition, weak underwriting standards, and lax auto lending controls can harm a bank's asset quality, earnings, and capital. Two case studies identify warning signs and highlight best practices that will strengthen automobile lending programs. Consumer compliance risks associated with indirect auto lending are considered, along with controls to mitigate those risks.

Trends in Indirect Auto Lending Structure

Banks develop indirect automobile lending programs by establishing relationships with automobile dealers. Insured financial institutions define the type of borrower and loan they will accept by providing dealers with underwriting and interest rate guidelines. In most cases, a dealership's finance manager gathers credit information from prospective buyers, completes loan applications, and forwards the documents to the bank for approval. Historically, auto financing has been perceived as a low-risk form of lending, with risk spread among a large volume of small-balance, collateralized loans. However, recent instances of weak indirect auto lending programs have indicated insufficient collateral values and marginal to deficient borrower repayment capacity, resulting in substantial financial adversity for the lender.

Anecdotal evidence suggests that increased competition is influencing indirect auto lending programs. Heightened competition has prompted banks to offer lower interest rates, lengthen amortization periods, and scale down payment requirements. In some cases, competition has prompted banks to grant lending authority to the dealer in order to expedite the approval process for loans that fall within bank-approved guidelines. Banks sometimes permit credit arrangements outside underwriting guidelines if the dealer signs a recourse agreement stating that it will repurchase such loans if they become delinquent. Recourse agreements vary, and some expire after a certain period of time has passed or a certain number of payments have been made. Today's indirect automobile lending practices represent unique challenges to bank management and supervisors.

Automobile Finance Market Conditions

In recent years, automobile manufacturers have responded to overproduction by offering special rebate and financing offers to stimulate consumer demand. The manufacturers' primary objective is

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to reduce inventory; pricing and financing are secondary concerns. This goal conflicts with that of other lenders, whose primary goal is to earn a fair return for a limited amount of risk. Manufacturers use their captives to introduce special financing offers. Captives, such as General Motors Acceptance Corporation, Ford Motor Credit, and Toyota Motor Credit, dominate the industry, with 56 percent of the automobile financing market in 2003.[1] Banks, credit unions, and other finance companies comprise the remaining market.

To spur demand, manufacturers have introduced large cash-back rebates, while their captives offered zero- and low-rate, no-money-down financing for longer periods. The Consumer Bankers Association's (CBA) 2004 Automobile Finance Study reflects an annual increase of 6 percent for the average automobile loan balance, while the average amount financed grew to represent 99 percent of invoice for new cars and 96 percent of wholesale value for used cars. To compensate for the larger loan balances, loan amortization periods have lengthened to keep monthly payments low and vehicles affordable. Federal Reserve Bank data show the average new car loan maturity increasing from 53 months to 62.5 months between 1999 and fourth quarter 2003 as more consumers selected a 72-month loan product. An article in the American Banker indicates that the terms of automobile loans are increasing, with some banks offering eight-year loans.[2]

Initial vehicle depreciation rates generally exceed loan amortization rates for credits with lengthy amortization periods. Increased loan balances, low down payment requirements, and lengthy amortization periods create negative equity, a situation in which the loan balance exceeds the vehicle's value. J.D. Power and Associates estimates that approximately 38 percent of new car buyers have negative equity at trade-in, compared to 25 percent two years ago.[3]

Impact on the Banking Industry

Vehicle financing trends reflect a general weakening in overall underwriting standards, leaving automobile loan portfolios increasingly vulnerable to an economic downturn. To date, weaker loan underwriting has not translated into widespread asset quality problems in the banking industry. The relatively low interest rate environment and a healthy economy have contributed to improved automobile loan loss and delinquency rates. According to a Moody's report, the October 2004 auto loan net loss rate fell from 1.22 percent in October 2003 to 0.93 percent in October 2004, and account balances more than 60 days late declined from 0.56 percent to 0.46 percent.[4] The Moody's report also indicated that the net loss rate and delinquency rate had fallen for 17 and 18 consecutive months, respectively, on a year-over-year basis. These positive industry trends reflect the strengthening U.S. economy. However, these trends may mask the actual risk inherent in automobile loan portfolios. The 2004 CBA Automobile Finance Study states that the average net loss per unit increased 10 percent since the prior year, a statistic that may suggest more borrower-friendly underwriting standards at the same time the incidence of negative equity value of collateral is on the rise. The case studies in this article reflect the impact these high charge-off rates can have on an

[1]Deutsche Bank, "U.S. Autos: A Triple Threat," February 20, 2004.

[2]"Driven into Making More Used-Car Loans," *American Banker,* April 15, 2005.

[3]"Owing More on an Auto Than It's Worth as a Trade-In," *New York Times,* March 27, 2004.

[4]Moody's Reports: Prime Auto Net Loss and Delinquency Rates Continue to Improve in October 2004.

institution's capital and earnings, following loan defaults. Rising market interest rates or a general economic downturn could affect marginal borrowers' repayment capacities and may eventually subject the banking industry to increasing losses.

Large cash-back incentives depress used car values, resulting in lower repossession values. At the same time, favorable consumer financing terms may heighten risk and shrink profitability. It has become more difficult for banks to compete safely in a market dominated by captives, which establish lending criteria that are influenced by manufacturing decisions rather than the risk/return trade-off of each financial transaction. In some cases, banks' attempts to remain competitive with captives have resulted in portfolios characterized by lower interest rates, extended loan amortization periods, and weaker borrowers. These underwriting trends suggest that some banks' automobile loan portfolios may require closer internal review and regulatory scrutiny.

Regulatory and Industry Approach to Retail Credit

To evaluate a large volume of small-balance loans efficiently and consistently, the FDIC, the Comptroller of the Currency, the Federal Reserve Board, and the Office of Thrift Supervision adopted the *Uniform Retail Credit Classification and Account Management Policy*.[5] The policy provides general guidance for assessing and adversely classifying retail credit based on delinquency status. Auto loans, considered closed-end credit, that are delinquent for 90 cumulative days are classified Substandard; those at least 120 days delinquent are classified Loss. Examiners are charged with ensuring that banks adhere to this policy, unless repayment will occur regardless of repayment status. Many internal loan reviews have adopted a similar approach. Traditional application of this approach assumes that borrowers initially had adequate repayment capacities or that the collateral values cover loan balances. Closer scrutiny is required when auto loan portfolios have not been underwritten in a traditional fashion. Examiners have the latitude to deviate from the prescribed classification guidelines when historical delinquency and charge-off trends warrant such action. In cases where underwriting standards are weak and present unreasonable credit risk, examiners may also classify entire portfolios or portfolio segments. Similarly, bank management should consider a more in-depth transaction-based review if traditional formulas are not capturing insufficient collateral values or the performance of less financially substantial borrowers.

Case Studies: When Indirect Auto Lending Went Awry

A number of banks have developed heightened risk profiles while attempting to maintain or increase market share in automobile financing. These case studies show the pitfalls banks may face when they compete in this market without appropriate lending policies, procedures, internal controls, and oversight.

Bank A

Bank A opened in the second quarter of Year 1 with an indirect automobile lending program managed by one loan officer. By the end of Year 2, indirect automobile loans represented 58 percent of total assets and 370 percent of Tier 1 capital; the delinquency rate was relatively low at 1.91 percent. Bank A also reported a 0.30 percent return on assets, despite its relatively small size and recent

[5]Federal Financial Institutions Examination Council, Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36903 (June 12, 2000).

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start-up date. Bank A's management attributed early profitability to the indirect automobile loan portfolio's success. However, by the end of Year 3, the bank reported a net loss owing to charge-offs and provisions to the allowance for loan and lease losses (ALLL). In Years 4 and 5, delinquencies, charge-offs, added provisions to the ALLL, and losses from the sale of automobile loans significantly depleted capital. Automobile lending was a part of the bank's strategic plan, but not to the degree depicted in Table 1.

Although the loan policy included a maximum 110 percent loan-to-value ratio, minimum 640 credit score developed by Fair Isaac & Company (FICO), and maximum 60-month maturity limit, the loan officer consistently approved credits outside these guidelines. Examiners also determined that dealer reserves were not properly monitored. The difference between the bank's "buy rate" and the interest rate charged on the loan at the dealership was placed into a dealer reserve and was intended to be distributed to the dealer over the life of each loan. However, in many cases reserves were made available to the dealer after the vehicle had been repossessed. Lack of oversight allowed these loan policy contraventions to occur, and the loan officer was compensated with bonuses tied to the volume of indirect dealer paper generated. Following a random sample of automobile loans, examiners determined that subprime loans comprised 78 percent of the portfolio, and most originated from a single dealership. The board of directors was not aware that the loan policy standards were ignored nor that the bank had developed a subprime loan portfolio.

Inadequate oversight and controls also permitted the loan officer to manipulate delinquency and net loan loss figures through a perverse repossession cycle. Bank A's loan officer and president waived dealer recourse without board approval on several loans in return for the dealership's agreement to store all repossessions at no charge and sell the repossessions for a small commission. During this cycle, the dealer sold repossessions at prices well above market value to borrowers with extremely low FICO scores. In most cases, these sales included thousands of dollars in add-ons (credit life insurance, extended warranties, and Guaranteed Auto Protection insurance) for which the dealer was paid immediately through bank financing. The bank reported a gain on the sale of repossessions, assumed excessive credit risk on bank-financed repossessions, and, for a few months, essentially understated the level of losses and nonperforming assets (i.e., the relatively low 2.86 percent delinquency ratio at the end of Year 3).

Table 1

Statistical Trends in Bank A

Key Risk Indicators	Year 1	Year 2	Year 3	Year 4	Year 5
IL/ Total Assets	38.03%	58.39%	44.03%	36.38%	9.00%
IL / Total Capital	147.32%	369.94%	428.71%	1,024.73%	121.55%
% Delinquent IL	0.00%	1.91%	2.86%	20.62%	29.28%
Gross Charge-Offs	0	$12M	$290M	$1,328M	$2,547M
ALLL Provisions	$79M	$130M	$545M	$3,984M	$0
Net Income	($673M)	$110M	($414M)	($4,112M)	($822M)
Total Equity Capital	$6,687M	$6,703M	$6,412M	$2,208M	$1,731M

Note: ALLL = allowance for loan and lease losses; IL = individual loans; M = thousands.

Transaction testing enabled examiners to identify lending practices that deviated significantly from board-approved policies. This finding prompted an extensive credit file review in which examiners found numerous vehicles financed three and four times without documentation to demonstrate sufficient repayment capacity or collateral for these loans. The average bank-financed repossession reflected a 186 percent loan-to-value ratio and a 554 FICO score. Bank A recognized multiple charge-offs on the same vehicles, which likely exceeded the losses that would have been recognized had the bank sold the initial repossessions on a wholesale basis (see Table 2).

Owing to the speed of deterioration in Bank A's auto loan portfolio, examiners conducted migration analyses to establish accurate adverse classification and ALLL levels. Examiners separated bank-financed repossessions from the other auto loans because of their distinctly different default rates. Results from the migration analyses indicated that 29 percent of all bank-financed repossessions deteriorated to a Loss category (repossession or 120 days or more delinquent). More specifically, the bank-financed repossession analysis reflected that 15 percent of current loans, 38 percent of loans delinquent between 30 and 89 days, and 100 percent of loans delinquent between 90 and 119 days migrated to a Loss category. Actual loss history reflected that the bank charged off 41.5 percent of each bank-financed repossession loan balance. The migration analysis on the remaining consumer loan portfolio indicated that 1.31 percent of current loans, 25 percent of loans delinquent between 30 and 89 days, and 80 percent of loans delinquent between 90 and 119 days migrated to a Loss category. The bank's loss history for the remaining indirect auto credits reflected that 25 percent of each loan was charged off upon repossession.

Results from the migration analyses indicated that the formula classifications in the *Uniform Credit Classification and Account Management Policy* guidelines would not accurately reflect the risk in Bank A's auto loans. Examiners used the migration analyses to establish more accurate adverse classification totals that required significant ALLL augmentation. By the time problems were identified and brought to the board of directors' attention, the bank required a significant capital injection to remain viable. Unsuccessful efforts to recapitalize the bank ultimately led to the bank's acquisition by another institution. Shareholders of Bank A never fully recovered their initial investment. Regulators issued various enforcement actions, including a civil money penalty and prohibition against the loan officer from participating in the affairs of any insured financial institution.

Table 2

Examples of Bank A's Bank-Financed Repossessions

Loan Balance	Automobile	NADA Value	Loan-to-Value
$21,412	Vehicle A	$8,250	259%
$18,398	Vehicle B	$8,250	223%
$20,570	Vehicle C	$9,900	208%
$12,469	Vehicle D	$8,800	142%
$20,394	Vehicle E	$7,225	282%
$21,272	Vehicle F	$9,900	215%

Note: NADA = National Automobile Dealers Association.

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Bank B

Bank B is a midsized, well-established bank with experience in indirect automobile lending. Auto loan delinquencies were consistently high, but supervisory concern over delinquencies was mitigated by reported losses that were not extraordinarily high. For a number of years, the bank's indirect automobile loan portfolio ranged between 4 percent and 9 percent of total assets. Despite a moderate portfolio, these loans represented a relatively large portion of Tier 1 capital, ranging from 70 percent to 123 percent between Year 1 and Year 5. Although delinquencies exceeded 10 percent of total indirect automobile loans, the ratio remained relatively constant, and Bank B consistently reported a mediocre return on assets. However, the examiners' file review in Year 5 highlighted a number of problems that resulted in large loan losses, increased provisions to the ALLL, and a declining Tier 1 capital ratio (see Table 3).

Results of examiner transaction testing showed that indirect automobile loans were approved by one officer, and most originated from a single dealership. Many of the indirect automobile loans were to subprime borrowers and were approved with insufficient documentation. In addition, the officer routinely approved credits in excess of 100 percent loan-to-value. As a result, the bank developed a portfolio of high loan-to-value, subprime loans. The problems were compounded by a repossession cycle that included bank-financed repossessions. In several cases, dealer recourse was waived without reason. In other cases, problem loans were rewritten with past-due interest, repairs, and add-on expenses (Guaranteed Auto Protection insurance, extended warranties, and/or credit life insurance) capitalized and added to the bank's exposure.

These accounting and lending practices resulted in understated delinquencies and losses, which prevented a full and timely recognition of the problems. Lax underwriting and excessive loan-to-value ratios contributed to charge-offs that represented approximately 20 percent of the average auto loan portfolio between Year 1 and Year 5. Bank B did not possess sufficient information technology for examiners or bank management to perform a meaningful migration analysis. Bank B continues to struggle to recover from the adverse effects of the indirect automobile lending program.

Lessons Learned

Competition for automobile finance products is intense, requiring vigilance from bankers and regulators when portfolios are significant in relation to a bank's capital and earnings. The problems associated with Banks A and B were identified only after examiners performed transac-

Table 3

Statistical Trends in Bank B

Key Risk Indicators	Year 1	Year 2	Year 3	Year 4	Year 5
IL / Total Assets	8.63%	8.53%	7.80%	5.55%	4.42%
IL / Total Capital	122.72%	107.83%	95.59%	84.99%	70.37%
Delinquent IL	10.51%	10.45%	10.51%	10.33%	11.89%
Tier 1 Capital	8.12%	7.92%	7.86%	5.93%	5.50%
Gross Charge-Offs	$304M	$358M	$534M	$333M	$2,157M
ALLL Provisions	$350M	$350M	$519M	$250M	$2,768M

Note: ALLL = allowance for loan and lease losses; IL = individual loans; M = thousands.

tion testing and reviewed credit files. These case studies show that automobile lending is not the conventional collateral-based product it was in the past, but now places increased emphasis on borrowers' repayment capacity, timely internal identification of potential problem loans, and closely monitored underwriting policies that prevent undesirable loans from being extended. The basic tenet of strong oversight is a comprehensive automobile lending policy. Examiners must determine bank management's tolerance for risk and validate that underwriting practices comply with policy guidelines. Examiners and bank management should monitor and address any deviations from approved policies, watch for spikes in portfolio growth or delinquency levels, and ensure that adequate independent loan reviews and audits are performed. Lessons learned from the case studies indicate that the following steps should be taken to provide effective regulatory and bank management oversight:

- Compare auto lending trends to strategic plans for consistency, including growth rates, risk levels, and anticipated rates of return on that risk.
- Ensure automobile lending policies establish specific underwriting guidelines that encompass credit scores, debt-to-income ratios, interest rates, amortization periods, loan-to-value ratios, diversification standards, and concentration limits (from a single dealer).
- Determine that the control structure provides sufficient oversight in the lending decision process.
- Verify that auto loans are adequately covered in independent loan reviews and scopes of internal/external audits.
- Ensure collection procedures and the repossession process are independent of any bank personnel involved in originating that credit.
- Verify that potential loss evaluation methods have some relation to the behavior of the portfolio.
- Validate that lending practices conform to approved policies through a sampling of files if the auto loan portfolio is significant in relation to capital.
- Ensure bank-financed repossessions are identified and tracked.
- Determine whether management has waived any dealer recourse agreements.
- Verify that information technology systems are used effectively to create a database capable of capturing a number of variables (credit scores, dealers originating the paper, debt-coverage ratios, bank-financed repossessions, and vehicle identification numbers).

Compliance Considerations of Indirect Auto Lending Programs

Indirect automobile lending can also expose insured institutions to compliance risks, particularly related to fair lending and unfair and deceptive practices. It is critical to determine whether a bank is considered a creditor and whether an agency relationship exists with the dealer. A "creditor" is defined by Section 202.2(l) of Regulation B.[6] There can be multiple creditors in a single credit transaction. In indirect automobile lending there are usually at least two: the bank and the dealer.

[6]12 C.F.R. Section 202.2(l) (2005). See also 12 C.F.R. Part 202, Supplement I, Official Staff Interpretation for Regulation B, 2(l): "The term creditor includes all persons participating in the credit decision. This may include an assignee or a potential purchaser of the obligation who influences the credit decision by indicating whether or not it will purchase the obligation if the transaction is consummated."

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A bank buying dealer paper (i.e., loans that have already been made) that did not influence and was not involved in the credit decision in any manner is not considered a creditor under Regulation B. However, a bank that either influenced or was involved in the credit decision is considered a creditor and is subject to all fair lending regulations. It is also essential to determine the nature of the relationship between a bank and an auto dealer. Banks are directly responsible for any discriminatory pricing or other discriminatory decisions made by a dealer acting as an agent of the bank.

If no agency relationship exists, a bank could still be responsible for a dealer's discriminatory practices if it continued to participate in the transactions from the time it either "knew" or "should have known" about the discrimination. Indications that a bank "knew" could come from internal memos, internal or external audits, internal compliance reviews, or statements by bank employees. Indications that a bank "should have known" would normally consist of *either* (1) a pattern of discrimination obvious enough that a reasonable person knowledgeable about fair lending laws would have realized what was going on even without looking for it, *or* (2) a pattern of discrimination obvious enough that a reasonable person knowledgeable about fair lending laws would have realized what was going on if he or she looked for it, *and* there is documentation that the bank looked for it. Banks that play a role in the credit decision process should also ensure that borrowers receive all appropriate disclosures.

Insured institutions also should monitor auto lending programs for any evidence of unfair or deceptive conduct. Such conduct may arise through sales practices as well as through the financing and repossession process. Circumstances that raise red flags in this area include Bank A's practice of financing vehicles in amounts that exceeded their market values and programs that evidence a large volume of first payment defaults (i.e., programs in which a significant number of borrowers walk away from transactions when they begin to appreciate what is truly involved).

Compliance examiners and officers should follow up on any concerns raised during the safety and soundness examination process—for example, if an institution's practices do not adhere to established policies. Issues relating to internal control weaknesses, lack of segregation of duties, and loans made outside approved policies could prompt an expanded review into compliance-related areas.

Conclusion

Competition in the automobile lending market, driven by captive finance companies, has increased significantly in recent years and is not expected to diminish in the near term. The results are thinning collateral and smaller net interest margins. The potential for heightened risk to insured institutions in the compliance and safety and soundness areas can be mitigated only through prudent lending policies and procedures, adequate internal controls, and strong oversight.

James A. Wilson, Jr.
Supervisory Examiner, New York Region

Sandra L. DiChiara
Fair Lending Examination Specialist, New York Region

The authors acknowledge the significant contributions of these individuals:

Edward B. Butler
Senior Examination Specialist, New York Region

Kevin J. Glueckert
Field Supervisor, New York Region

From the Examiner's Desk... Enhancing Examiner Review of Technology Service Providers

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.***

An increasing number of insured institutions are outsourcing software development and maintenance, data processing, and other information technology (IT) services to technology service providers (TSPs); in many cases, these outsourced services are critical to bank and thrift daily operations. Key components of the payments system, including credit card services and automated teller machine (ATM) networks, also are operated and managed by TSPs. Because of the vital role of TSPs in the safe and sound operation of many insured depository institutions, the Federal Financial Institutions Examination Council (FFIEC) has established a process for examining these companies.

This risk-focused examination process considers all available supervisory information in the development of a TSP's risk profile. However, the results of a project conducted by the FDIC suggest that the identification and evaluation of publicly available information sources would benefit the examination planning process. This article provides an overview of the potential risks TSPs pose to insured institutions, describes the current examination approach to reviewing TSPs' services, and offers a framework for incorporating publicly available information into the examination process.

Assessing the Risk Profile of Third Party TSPs

During the past several years, major TSP firms have grown significantly, relying on acquisitions to expand business and product lines and add new ones, with some firms now serving about 2,000 institutions.[1] Aggressive acquisition strategies, while promoting economies of scale, also may pose downside risks for individual TSPs and their clients. For example, a flawed acquisition strategy may weaken the financial condition of the acquirer, or a poorly planned integration could heighten operational or security risk. In addition, the level of concentration risk to bank clients may increase as individual TSPs expand through mergers and acquisitions. Any financial or operational problem these larger firms experience undoubtedly would affect a greater number of clients. Furthermore, the degree of disruption to a single client bank's operations could worsen dramatically, depending on the seriousness of the issues facing the TSP.

Services conducted by TSPs for their bank clients fall within the purview of bank examiners. The Bank Service Company Act grants Federal financial regulators the statutory authority to supervise the activities and records of a bank or thrift—regardless of whether the institution or a third party performs the activities.[2] Bank supervisors recognize the potential risks posed by TSPs to the banking industry and have developed and implemented appropriate examination policies and procedures.

[1]FDIC and FFIEC confidential databases. Many banks contract with multiple TSPs.

[2]Bank Service Company Act (12 U.S.C. 1867).

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The National Examination Program

The FFIEC's national examination program (NEP) examines multi-regional data processing servicers (MDPS) and conducts shared application software reviews (SASR). A TSP is considered for the MDPS program if it processes critical applications, such as general ledger or loan and deposit systems, for a large number of financial institutions with multiple regulators or geographically dispersed data centers. The SASR program uses interagency resources to review major stand-alone and turnkey software packages that involve critical applications used by a significant number of financial institutions.[3] The NEP is based on the concept of ongoing, risk-based supervision. This program identifies those TSPs that warrant examination and develops a supervisory strategy for each company that reflects the level and direction of key risk areas.

As part of the FFIEC's examination program, data about the operations of a TSP are captured on an "Examination Priority Ranking Sheet." The FFIEC uses this information to determine supervisory priorities based on the TSP's business line risks, client base, and the adequacy of internal controls and risk management practices.[4] This ranking sheet provides a framework for examiners to use in assessing the following risk categories: number of clients, previous examination's Uniform Rating System for Information Technology (URSIT) rating, adequacy of oversight of audit reporting provided by client banks, reliability of the technology used by the TSP, and any previously reported problems (see Table 1).[5]

Based on the information collected on this worksheet as well as from other supervisory activities and third party reports, such as external audits, examiners develop an initial TSP risk profile and assign a risk ranking (Higher, Average, or Lower) for each category. These rankings then translate into an examination priority rating of A, B, or C that determines the frequency and scope of on-site examinations and off-site monitoring; the relationships of the risk rankings to the examination priority ratings are shown in Table 2.

Overall, this approach has served examiners well as they plan and scope examinations of TSPs. However, supplementing these programs with research from publicly available sources may enhance examiners' understanding of TSP risk profiles.

The Value of Information from Public Sources

Insight into the financial condition, reputation, and strategic focus of large, publicly traded companies, including TSPs, can be gleaned from an analysis of publicly available information, such as financial statements and Securities and Exchange Commission (SEC) filings, securities analyst and debt rating agency reports, news reports and press releases, consulting firm reports, and company websites.

Large TSPs often have ancillary business lines, and examiners may want to know whether any problems in these other business lines are weakening the parent company's financial health or diverting management's attention. Evaluating the TSP's contribution to parent

[3]Federal Financial Institutions Examination Council, *Information Technology Examination Handbook,* "Supervision of Technology Service Providers," March 2003, pp. 15–22.

[4]Ibid, B-1-3.

[5]The FFIEC agencies use URSIT to assess and rate IT-related risks of financial institutions and TSPs. The primary purpose of the rating system is to identify those entities whose condition or performance of information technology functions requires special supervisory attention. See Federal Financial Institutions Examination Council, *Information Technology Examination Handbook,* "Supervision of Technology Service Providers," March 2003, pp. 5–6.

Table 1

TSP Risk Categories Worksheet[6]

TSP Risk Category				
Factor	**Higher Risk:**	**Average Risk:**	**Lower Risk:**	**NA***
1	Large client base (250 or more supervised financial institutions, or based on other measures, e.g., aggregate client assets affected, transaction volume).	Moderate-sized client base (at least 25 but not more than 249 supervised financial institutions, or based on other measures, e.g., aggregate assets affected, transaction volume).	Small client base (less than 25 supervised financial institutions, or based on other measures, e.g., aggregate client assets affected, transaction volume).	
2	Company rated URSIT 3, 4, or 5 at last examination.	Company rated URSIT 2 at last examination.	Company rated URSIT 1 at last examination.	
3	Client institutions do not provide effective oversight; SAS 70 reports and other audit reviews are not comprehensive.	Client institutions provide limited oversight; SAS 70 reports and audits cover most areas.	Client institutions provide effective oversight; SAS 70 reports and other audit reviews are comprehensive.	
4	Company is using new or untested technology or products. Company is undergoing significant organizational change.	Company is using stable technology and products but implements significant upgrades. Company has minimal organizational changes.	Company is using stable technology and products. Company has stable organizational structure.	
5	Client institutions or their examiners have reported problems or concerns that require supervisory follow-up.	Client institutions or their examiners have reported minimal problems or concerns that require supervisory follow-up.	Client institutions or their examiners have reported no problems or concerns that require supervisory follow-up.	
* If NA briefly explain in comment section below				

company revenues and earnings can provide insight into the TSP's strategic importance.

Supervisory (nonpublic) information, such as risk assessments and auditor findings, reviewed before an examination may provide details about a TSP's risk profile that are not available from public information sources. A review of recent examination findings may help an examiner focus his or her efforts, such as in the case of a TSP that had been criticized for lax security procedures. However, supervisory information alone may not provide a comprehensive picture of the TSP's operations and strategic direction. For example, when examination findings are supplemented with publicly available information about a TSP's recent acquisitions, supervisory concerns may arise about the acquirer's ability to integrate disparate systems and corporate cultures or the potential for management's attention to be diverted from maintaining the highest levels of security.

[6]Ibid, B-2.

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Table 2

Examination Priority Rating Matrix[7]

Agency-in-Charge Recommended Examination Priority: A _____ B _____ C _____ NA* _____

	Business Line Risk Higher	Business Line Risk Average	Business Line Risk Lower
Service Provider Risk Higher	Examination Priority A	Examination Priority A	Examination Priority B
Service Provider Risk Average	Examination Priority A	Examination Priority B	Examination Priority C
Service Provider Risk Lower	Examination Priority B	Examination Priority C	Examination Priority C

*Not Applicable ranking refers to a service provider not warranting interagency examination—not all service providers must be ranked A, B, or C.

A review of public information can broaden an examiner's understanding of the financial condition and operational issues facing a TSP, particularly when the TSP is engaged in business lines outside traditional banking services. For example, the examination may conclude that all of the TSP's bank services lines are well managed and financially viable; yet information gleaned from publicly available sources, such as analysis of acquisitions and divestitures, may show that the bank services line is no longer a strategic priority for the firm, suggesting a potential change in company focus, capital investment, or other factors affecting the company's risk profile. Overall, the analysis of public information, along with a review of examination findings, should strengthen examiners' evaluation of the level and direction of operational or concentration risk facing a TSP's clients.

A Framework for Strengthening the Review of TSPs

The benefits of considering supervisory and publicly available information about a TSP's operations were reinforced through the efforts of a team of technology specialists, financial analysts, and economists at the FDIC. Significant publicly available data about nine of the largest TSPs that provide IT services to banks were gathered, analyzed, and supplemented with data gathered through examinations. As a result of this project, additional off-site analytical tools have been identified that will help examiners assess risks specific to these third-party providers. Going forward, the results of this program suggest that monitoring of public sector data and information about major TSPs by analysts and examiners, using the framework developed through this project, will benefit examiners' understanding of the risk profiles of large TSPs.

Table 3 lists public information sources and search tools that can be used to "mine" these sources. Subscription fees may be required, and examiners may find some or all of these sources available through agency-held licenses.

An analysis of these information sources can help examiners assess a TSP's financial condition, corporate profile, and any pertinent regulatory

[7] Ibid, B-2.

Table 3

Sources of Public Information on TSPs
Financial Data for Publicly Traded Companies
Annual reports—information about corporate strategy, potential risks, and financial condition
SEC filings—detail on accounting methods and extraordinary events
Mergent Online—standardized financial results from SEC filings, especially 10-K Annual Report and 8-K Current Report
Yahoo Finance—information on short interests and institutional holdings (http://finance.yahoo.com)
Financial Analysis on Publicly Traded Companies
Thompson Analytics—brokerage house reports
Moody's, Duff & Phelp's, Standard & Poor's—credit reports
Press Reports—may be obtained through online searches of databases available through Factiva, American Banker, ProQuest, Business Source Elite, Lexis/Nexis, and Google. The Stanford Law School Class Action Clearinghouse provides information on class action lawsuits. (http://securities.stanford.edu/info.html)
Company Websites—often feature annual reports and press releases that provide information on acquisitions or changes in corporate structure, current management, location of headquarters and major facilities, product lines, how a company fits into the larger industry, and the results of any analyst conference calls.
IT Consulting Firm Reports—reports issued by firms such as Gartner, TowerGroup, Forrester, and Celent that provide information about the current business environment and IT product quality.

and legal issues more completely and should address the following areas:

Financial analysis focused on revenue growth, revenue growth compared with that of other companies in the industry, income during the past three to seven years, long-term debt ratings, the relationship between long-term debt and shareholders' equity, and profitability.

A ***corporate profile*** of the TSP developed by identifying its business lines and products, supplemental or complementary lines of business, managerial experience related to business lines, areas of financial strength, how recent acquisitions or divestitures relate to the business plan, description of key risk areas, and reputation in the marketplace. Examiners can refer to regulatory filings, analyst reports, the financial press, and company-specific information to develop this profile.

A review of ***legal or regulatory actions*** may identify those that could affect key product lines, the TSP's business viability, or the TSP's banking clients. For example, recent court rulings relating to the major credit card consortia may introduce new competition that could drive down processing fees and hurt earnings. A TSP's inability to meet the internal control deadlines imposed by the Gramm-Leach-Bliley Act could require additional attention during the examination process.

An analysis of ***stock buying and selling patterns*** may provide insight into informed insider or institutional investor opinion about a TSP's financial stability. A review of incidences of insider trading (as reported to the SEC), average short interest, and trends and dramatic changes in stock prices is useful.

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Going Forward...

Review and analysis of public information sources can provide insight into a TSP's strategic direction. Is it likely to be an acquirer or an acquisition target? Types of acquisitions may indicate potential risks or diversification plans. Is any negative press emerging about a particular technology used by a TSP? Combining supervisory information with carefully mined public information will improve the development and maintenance of accurate and meaningful risk profiles. This approach to evaluating TSPs expands the information and data sources available to on-site IT examiners during the pre-examination planning process and strengthens the supervisory response to potential risks posed by these companies.

Douglas W. Akers
Research Assistant, Division of Insurance and Research

Jay W. Golter
Financial Analyst, Division of Insurance and Research

Brian D. Lamm
Senior Financial Analyst, Division of Insurance and Research

Martha Solt
Senior Economist, Division of Insurance and Research

Kathryn M. Weatherby
Examination Specialist, Division of Supervision and Consumer Protection

Accounting News: Other-Than-Temporary Impairment of Investment Securities

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.***

During the past year and a half, the longstanding accounting concept of other-than-temporary impairment of investment securities has drawn renewed attention because of actions by the Financial Accounting Standards Board (FASB) and its Emerging Issues Task Force (EITF). In addition, the federal banking agencies issued a revised *Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts* in June 2004 that incorporated this concept into the Agreement's general debt security classification guidelines. In light of these developments, examiners and bankers should understand the currently applicable accounting guidance on impairment and its relationship to the evaluation of securities portfolios during examinations.

Impairment of Securities

From an accounting standpoint, an "impairment" of a debt or equity security occurs when the fair value of the security is less than its amortized cost basis, i.e., whenever a security has an unrealized loss. In this situation, examiners often refer to the security as being depreciated or under water.

The subject of impairment of securities and the need for an institution to consider its accounting consequences for purposes of reporting in accordance with generally accepted accounting principles (GAAP) dates back more than 50 years.[1] The current source of authoritative guidance on accounting for investment securities, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* as amended (FAS 115), was originally issued in 1993. FAS 115 is perhaps best known for requiring investment securities to be categorized into three categories: held-to-maturity, trading, and available-for-sale. However, it also requires that an institution determine whether a decline in fair value below amortized cost for an individual available-for-sale or held-to-maturity security is other than temporary. If the impairment is judged to be other than temporary, the cost basis of the individual security must be written down to fair value, thereby establishing a new cost basis for the security, and the amount of the write-down must be included in earnings as a realized loss.[2,3] FAS 115 further provides that after such a write-down, "the new cost basis shall not be changed for subsequent recoveries in fair value." A recovery in fair value, both for an available-for-sale security and a held-to-maturity security, should not be recognized in earnings until the security is sold.[4]

[1]See paragraph 9 of Section A of Chapter 3 of Accounting Research Bulletin No. 43, which was issued by the American Institute of Certified Public Accountants (AICPA) in 1953, and its predecessor, Accounting Research Bulletin No. 30, which was issued in 1947.

[2]See paragraph 16 of FAS 115. The impairment provisions of FAS 115 are not applicable to trading securities because they are carried on the balance sheet at fair value with unrealized gains and losses included in earnings.

[3]These FAS 115 provisions on impairment of securities have been incorporated into the instructions for the Reports of Condition and Income (Call Report). See the Glossary entry for "Securities Activities" on page A-72 of the instructions.

[4]After an available-for-sale security has been written down for an other-than-temporary impairment, the new cost basis should be used thereafter to determine the amount of any unrealized holding gains and losses. These gains and losses (provided the losses do not represent further other-than-temporary impairments) should be reported in a separate component of equity capital, i.e., accumulated other comprehensive income.

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As currently defined under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and must be used as the basis for the measurement, if available.[5]

Guidance on Evaluating Impairment in FAS 115

FAS 115 provides only one explicit example of other-than-temporary impairment. Using language that parallels the definition of impairment for a loan in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* FAS 115 states that if it is probable that an institution "will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred." However, FAS 115 also refers to two other sources of literature that should be considered in evaluating impairment:

- Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 59, which has been codified as SAB Topic 5.M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities* (SAB 59); and
- American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (SAS 92).

The impairment guidance in SAB 59 and SAS 92 is discussed below.

Recognizing that FAS 115 provided limited guidance on evaluating impairment, the FASB staff addressed this subject in November 1995 in a FAS 115 implementation guide.[6] In the response to Question 46 of the guide, the FASB staff advised that

> recognition of other-than-temporary impairment also may be required if the decline in a security's value is due to an increase in market interest rates or a change in foreign exchange rates since acquisition. Examples of when a decline in the fair value of a debt security may be other than temporary include situations where the security will be disposed of before it matures or the investment is not realizable.

The FASB staff's response to the next question in the guide deals with the disposal of a security prior to maturity, referencing EITF Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security whose Cost Exceeds Fair Value.* The EITF had discussed this issue earlier in 1995 after the FASB staff had been asked about the accounting treatment for a "specifically identified available-for-sale debt security" that an institution "intends to sell at a loss shortly after the balance sheet date." The FASB staff indicated that, in this situation, if the institution "does not expect the fair value of the security to recover prior to the expected time of sale, a write-down for other-than-temporary impairment should be recognized in earnings in the period in which the decision to sell is made."

The EITF Considers Impairment

Despite the various sources of guidance on impairment of securities, accountants and others expressed concern in 2002

[5]See, for example, paragraph 68 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

[6]*A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers.*

that the accounting literature discussing the concept of other-than-temporary impairment was ambiguous and had led to inconsistent application of this literature. Late that year, the FASB's EITF decided to pursue the development of additional guidance for determining whether certain investments in securities, including held-to-maturity and available-for-sale securities, have incurred an other-than-temporary impairment. In EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1), the EITF first reached a consensus that certain disclosures about securities with impairment should be included in the footnotes to financial statements prepared in accordance with GAAP. Ratified by the FASB Board in November 2003, these new disclosures were first required in annual financial statements as of year-end 2003.

The disclosures required by EITF 03-1 provide quantitative and qualitative information about all held-to-maturity and available-for-sale securities "in an unrealized loss position for which other-than-temporary impairments have not been recognized." For each date for which a balance sheet is presented in the financial statements, an institution must provide a table that shows, for each category of investment security, the aggregate amount of unrealized losses on securities with impairment and the aggregate fair value of these securities. Furthermore, these disclosures must be shown separately for securities "that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer." An example of the format for these quantitative disclosures is shown below. The institution must also provide, in narrative form, sufficient information about the securities with impairment as of the most recent financial statement date to enable "users to understand the quantitative disclosures." In addition, this narrative disclosure must describe the information the institution "considered (both positive and negative) in reaching the conclusion that the impairments are not other than temporary."

In March 2004, the FASB Board ratified the accounting guidance for determining whether certain investment securities have incurred an other-than-temporary impairment on which the EITF had reached a consensus. EITF 03-1 established a three-step process for determining when an investment is impaired,

Investment Securities in an Unrealized Loss Position for Which Other-Than-Temporary Impairments Have Not Been Recognized

	Less than 12 months		12 months or greater		Total	
Description of Securities	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
U.S. Treasury securities	$ x,xxx	$ xx	$ xxx	$ xx	$ x,xxx	$ xx
Mortgage-backed securities issued by government-sponsored enterprises	xxx	xx	xx	x	xxx	xx
Securities issued by states and political subdivisions	xx	x	xx	x	xxx	xx
Corporate bonds	xxx	xx	x	x	xxx	xx
Equity securities with readily determinable fair values	xx	x	xx	x	xx	x
Total	$ x,xxx	$ xxx	$ xxx	$ xx	$ x,xxx	$ xxx

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whether that impairment is other than temporary, and how to measure the impairment loss if the impairment is deemed to be other than temporary. This process was to be applied to individual securities whose fair value had declined below amortized cost.

Although the accounting guidance in EITF 03-1 was scheduled to take effect September 30, 2004, it has been indefinitely delayed by the FASB. This delay occurred after institutions, in preparation for the implementation of the recognition and measurement provisions of the EITF consensus in mid-2004, raised questions and concerns as to whether conservative interpretations of this guidance by certain accounting firms were consistent with what the EITF and the FASB had intended in EITF 03-1. These concerns were focused primarily on available-for-sale debt securities that are impaired solely due to increases in interest rates or sector spreads in the marketplace.

The FASB staff initially sought to clarify the guidance in EITF 03-1 for such securities through the issuance of a proposed FASB Staff Position in early September 2004. However, as a result of the more than 200 comments received, the FASB indicated in November 2004 that it will instead reconsider the relevant accounting literature on other-than-temporary impairment of debt and equity securities. The time frame for this reconsideration is not clear. In the meantime, the FASB has reminded institutions that hold investment securities that they should continue to apply the existing impairment guidance in FAS 115, including SAB 59 and SAS 92, which are referenced in FAS 115. Additionally, the disclosure requirements of EITF 03-1 remain in effect.[7]

SEC Staff Accounting Bulletin No. 59

The SEC staff originally issued SAB 59 in 1985 to discuss other-than-temporary impairments of "noncurrent marketable equity securities." SAB 59 also notes that "other than temporary" should not be interpreted to mean "permanent" impairment. After the issuance of FAS 115, SAB 59 was updated to encompass "marketable securities classified as either available-for-sale or held-to-maturity." Hence, its coverage expanded to include both debt and equity securities.

SAB 59 notes that the fair value of individual investment securities may decline below cost for various reasons. It states that these declines in value "require further investigation by management," which "should consider all available evidence to evaluate the realizable value of its investment." Numerous factors should "be considered in such an evaluation and their relative significance will vary from case to case." According to SAB 59, the following are "only a few examples of the factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down" to fair value is required:

- The length of the time and the extent to which fair value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events that may influence the

[7]See FASB Staff Position No. EITF 03-1-1 (www.fasb.org/fasb_staff_positions/fsp_eitf03-1-1.pdf). This FASB Staff Position also references one other existing source of impairment guidance, EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). However, excluded from the scope of EITF 99-20 are "beneficial interests in securitized financial assets that (1) are of high credit quality . . . and (2) cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment." EITF 99-20 further states that "determining whether an other-than-temporary impairment of such beneficial interests exists should be based on SAB 59, SAS 92, and the Statement 115 Special Report," i.e., the FAS 115 implementation guide. This article does not address the impairment guidance in EITF 99-20 for those beneficial interests that are within its scope.

operations of the issuer, such as changes in technology that may impair its earnings potential or the discontinuance of a segment of the issuer's business that may affect its future earnings potential; or

- The intent and ability of the institution to retain its investment for a period of time sufficient to allow for any anticipated recovery in fair value.

The SEC staff has elaborated on the process that institutions should follow when determining whether an unrealized loss on an individual security is other than temporary. In this regard, the SEC staff does not believe it is appropriate to employ "bright line or rule of thumb tests" to evaluate impairment. For example, some accountants and institutions have reportedly used such benchmarks as a 20 percent decline in fair value below cost that has lasted more than one year as their definition of other-than-temporary impairment. Although the quantitative disclosures required by EITF 03-1 distinguish between securities that have had unrealized losses for periods of more than and less than one year, this one-year time period is not an automatic line of demarcation for inferring when unrealized losses become other-than-temporary impairments. The SEC staff has noted that an other-than-temporary decline could occur within a short period of time. This would most likely be the case if the issuer of the security has experienced significant credit deterioration, with or without a payment default, or in the event of a planned sale of a depreciated security. By the same token, depending on the facts and circumstances, a decline in fair value that continues for more than one year may be temporary.

When evaluating impairment, the SEC staff has observed the importance of distinguishing between debt securities and equity securities. Consistent with FAS 115, equity securities exclude preferred stock that must be redeemed by the issuer or can be redeemed at the option of the investor. Hence, an investor must look to a sale of an equity security as the way to recover the investment rather than holding the security until its contractual maturity, as would be the case for a debt security. Therefore, the SEC staff has stated that an investor's "ability to hold an equity security indefinitely would not, by itself, allow an investor to avoid an other-than-temporary impairment," which is compatible with the need to consider the near-term, rather than long-term, prospects of the issuer of the equity security.

The SEC expects that institutions will use a systematic methodology to perform their impairment analyses and will fully document all of the factors considered. Moreover, efforts to forecast recoveries in the fair value of individual securities are fraught with uncertainty. In cases where the severity and duration of the unrealized loss on a security increase, the impairment analysis should become more robust and extensive. The longer the forecasted recovery period, the less reliable the estimate of when the fair value of a security will increase up to or beyond its amortized cost. Thus, the SEC envisions that projected recoveries of fair value will be supported by objective evidence.

AICPA Statement on Auditing Standards No. 92

Issued in 2000, SAS 92 provides guidance to auditors in planning and performing auditing procedures with respect to investment securities as well as derivatives and hedging activities. It states that evaluating whether unrealized losses on individual debt and equity securities are other than temporary "often involves estimating the outcome of future events." As a consequence, "judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred" at the date of the finan-

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General Debt Security Classification Guidelines

Type of Security	Classification		
	Substandard	Doubtful	Loss
Investment quality debt securities with "temporary" impairment	—	—	—
Investment quality debt securities with "other-than-temporary" impairment	—	—	Impairment
Sub-investment quality debt securities with "temporary" impairment	Amortized Cost	—	—
Sub-investment quality debt securities with "other-than-temporary" impairment, including defaulted debt securities	Fair Value	—	Impairment

NOTE: Impairment is the amount by which amortized cost exceeds fair value.

cial statements. These factors are both subjective and objective and include "knowledge and experience about past and current events and assumptions about future events."

SAS 92 cites the following as examples of these factors:

- Fair value is significantly below cost and:
  - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - The decline has existed for an extended period of time.
  - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The institution recorded losses from the security subsequent to the end of the reporting period.

Several of these factors correspond to those identified by the SEC staff in SAB 59. In addition, the existence of the final factor as an indicator of an other-than-temporary impairment loss at the date of the financial statements is consistent with the guidance in EITF Topic No. D-44 on the planned sale of a security.

Because management, and not the auditor, is responsible for the preparation of an institution's financial statements and the proper application of generally accepted accounting principles, SAS 92 directs the auditor to evaluate management's impairment assessment process, including the factors management has considered, and the resulting conclusions. Thus, SAS 92 establishes a clear expectation that management will maintain appropriate documentation to support its conclusions.

Examination Considerations

The *Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts,* which the federal banking agencies revised in June 2004, incorporates the other-than-temporary impairment concept.[8] It provides that "[i]f an institution's process for assessing impairment is considered acceptable, examiners may use those assessments in determining

[8]See FDIC Financial Institution Letter (FIL) 70-2004, dated June 15, 2004, which can be accessed at www.fdic.gov/news/news/financial/2004/fil7004.html.

the appropriate classification of declines in fair value below amortized cost on individual debt securities." Although the Uniform Agreement focuses on debt securities, an institution's impairment assessment process must cover both debt securities and any equity securities (not held for trading) in order to satisfy applicable accounting standards. The general debt security classification guidelines set forth in the Uniform Agreement are presented on the previous page.

Thus, each institution's accounting or investment policies should include provisions directing management to evaluate individual securities whose fair value is less than amortized cost at each quarter-end to determine whether any other-than-temporary impairments have been incurred. These evaluations should be documented to show how management has considered the factors enumerated in FAS 115 and its implementation guidance, SAB 59, and SAS 92, and any other relevant factors, in reaching its conclusions concerning the impairment of individual securities.

For institutions with audited financial statements or that otherwise prepare statements in conformity with GAAP, the disclosures required by EITF 03-1 about securities in an unrealized loss position represent a useful tool for examiners. Optimally, these financial statements should be available during pre-examination planning. Otherwise, examiners should obtain the financial statements early in the examination. A review of the required disclosures will provide insight into the quality of an institution's impairment assessment process. If the process appears to be adequate at the most recent year-end, examiners should verify that quarterly evaluations of individual securities in an unrealized loss position are being properly performed. Consistent with the Uniform Agreement, an acceptable impairment assessment process may serve as the basis for any adverse classifications of impairment on individual investment securities in the examination report.

In contrast, at an institution whose policies do not incorporate an impairment assessment process or whose process has not been implemented adequately, examiners should seek management's commitment for appropriate corrective action. When these deficiencies are present, examiners normally should focus their impairment review on those available-for-sale and held-to-maturity securities for which fair value is significantly less than cost. These are case-by-case evaluations based on the facts and circumstances surrounding each investment that require the examiner to exercise judgment.[9] To support a conclusion that an individual security, whether investment quality or sub-investment quality, is other-than-temporarily impaired, an examiner should document the results of his or her consideration of all relevant factors, including those cited above in the accounting literature. This documentation should identify clearly the objective evidence used in the impairment analysis and the sources of this evidence. These findings should be described in the examination report as the basis for assigning a Loss classification to the excess of the cost of the security over its fair value.

Robert F. Storch
Chief Accountant

[9]However, as provided in the Uniform Agreement, an unrealized loss on a debt security for which there has been a payment default will generally be presumed to be an other-than-temporary impairment.

Overview of Selected Regulations and Supervisory Guidance

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

Subject	Summary
New Anti-Money-Laundering Guidance on Customer Identification Programs (FIL-34-2005, April 28, 2005)	The Federal banking, thrift and credit union regulatory agencies, the Financial Crimes Enforcement Network, and the Department of Treasury jointly issued additional interpretive guidance, in the form of Frequently Asked Questions, on the application of the "Customer Identification Programs for Banks, Savings Associations, and Credit Unions" regulation.
Guidance and Advisory on Banking Services for Money Services Businesses Operating in the United States (FIL-32-2005 and PR-36-2005, April 26, 2005)	The Federal banking, thrift, and credit union regulatory agencies and the Financial Crimes Enforcement Network (FinCEN) issued interpretive guidance designed to clarify the requirements for, and assist banking organizations in, appropriately assessing and minimizing risks posed by providing banking services to money services businesses. FinCEN also issued a concurrent advisory to money services businesses to emphasize their Bank Secrecy Act regulatory obligations and to notify them of the types of information they will be expected to provide to a banking organization in the course of opening or maintaining account relationships.
Final Technical Amendments to Community Reinvestment Act Regulations (FIL-29-2005, April 20, 2005)	The Federal banking and thrift regulatory agencies adopted the joint interim rule making technical changes to the Community Reinvestment Act (CRA) regulations published for comment in the *Federal Register* on July 8, 2004. The joint final rule took effect March 28, 2005, and conforms the CRA regulations to recent changes in the Standards for Defining Metropolitan and Micropolitan Statistical Areas published by the U.S. Office of Management and Budget, census tracts designated by the U.S. Census Bureau, and the Federal Reserve Board's Regulation C, which implements the Home Mortgage Disclosure Act.
Guidance on the Use of Internal Risk Ratings for Assigning Risk-Based Capital on Exposures to Asset-Backed Commercial Paper (ABCP) Programs (FIL-26-2005, March 31, 2005)	The guidance, issued by the Federal banking and thrift regulatory agencies, generally applies to large banks extending credit enhancements to ABCP programs, explains the qualifying criteria for using an internal risk-rating system for assigning risk-based capital on exposures to ABCP programs, and supplements the "Securitization Capital Rule" (referenced in FIL-99-2001). The guidance provides implementing standards to be used in evaluating whether the bank's internal risk-rating system for ABCP exposures reasonably corresponds to the methodologies used by the ratings agencies in assigning external credit ratings and provides a framework for supervisors to determine the appropriate risk-based capital treatment for unrated direct credit substitutes provided to ABCP programs, using a "weakest link" method.
Answers to Frequently Asked Questions About New HMDA Data (PR-30-2005, March 31, 2005)	The Federal banking, thrift, and credit union regulatory agencies, along with the Department of Housing and Urban Development, released a set of "Answers to Frequently Asked Questions" that addresses the new home loan pricing data disclosed for the first time under the Home Mortgage Disclosure Act (HMDA). The new loan pricing data are intended to advance enforcement of consumer protection and antidiscrimination laws and improve mortgage market efficiency.
Proposed Revision to the Classification System for Commercial Credit Exposures (FIL-22-2005 and PR-28-2005, March 28, 2005)	The Federal banking and thrift regulatory agencies issued proposed guidance that would replace the current commercial loan classification system categories of "special mention," "substandard," and "doubtful" with a two-dimensional framework. The new rating system has one dimension that measures the risk of the borrower defaulting (borrower rating) and a second dimension that focuses on the loss severity the institution would likely incur in the event of the borrower's default (facility rating). Comments are due June 30, 2005.

Subject	Summary
Guidance on Response Programs for Security Breaches (PR-26-2005, March 23, 2005 and FIL-27-2005, April 1, 2005)	The Federal banking and thrift regulatory agencies issued guidance that interprets the agencies' customer information security standards and states that financial institutions should implement a response program to address security breaches involving customer information. The guidance describes the appropriate elements of a response program, including customer notification procedures, and states that a financial institution should notify its primary Federal regulator of a security breach involving sensitive customer information, whether or not the institution notifies its customers.
Proposed Revisions to Community Reinvestment Act Regulations (FIL-21-2005, March 22, 2005)	The Federal banking agencies issued proposed revisions that would raise the threshold for a "small bank" in the Community Reinvestment Act (CRA) regulations from $250 million to under $1 billion in assets, regardless of any holding company size or affiliation. A new "Community Development Test" would be added for banks with at least $250 million and less than $1 billion in assets ("intermediate small banks") that would be separately rated in CRA examinations. The proposal would expand the definition of community development to include activities such as affordable housing in underserved rural areas and designated disaster areas. The proposal also would address the adverse effect of discriminatory or other illegal activities on bank CRA ratings. Comments were due May 10, 2005.
Frequently Asked Questions and Statement on Independent Appraisal and Evaluation Functions (FIL-20-2005, March 22, 2005)	The Federal banking, thrift, and credit union regulatory agencies issued a statement that clarifies and serves as a reminder of the existing standards for independence within the appraisal and real estate lending regulations. This document was developed in response to questions from financial institutions about these regulations, including questions about selecting an appraiser, ordering an appraisal, accepting a transferred appraisal, reviewing appraisals, and evaluation and other appraisal topics.
Revised Payday Lending Examination Guidance (FIL-14-2005, March 1, 2005, and PR-19-2005, March 2, 2005)	The Federal Deposit Insurance Corporation (FDIC) issued revised examination guidance on payday lending programs. The revisions provide more specific guidance to FDIC-supervised institutions to ensure that this high-cost, short-term credit product is not provided repeatedly to customers with longer-term credit needs.
Advisory on Confidentiality of Supervisory Ratings (FIL-13-2005 and PR-18-2005, February 28, 2005)	The Federal banking and thrift regulatory agencies issued an advisory that reminds financial institutions they are prohibited by law from disclosing CAMELS rating and other nonpublic supervisory information without permission from the appropriate Federal banking agency.
Final Guidance on Overdraft Protection Programs (FIL-11-2005 and PR-11-2005, February 18, 2005)	The Federal banking, thrift and credit union regulatory agencies issued final joint guidance to assist insured depository institutions in the disclosure and administration of overdraft protection programs. The guidance details safety and soundness considerations, outlines pertinent Federal regulations, and lists industry best practices.
Recommendations Sought for Reducing Regulatory Burden (FIL-8-2005, February 3, 2005)	The Federal banking and thrift regulatory agencies asked for recommendations on how to reduce the regulatory burden in 28 rules relating to Money Laundering, Safety and Soundness and Securities. Comments were due by May 4, 2005. This was the fourth in a series of requests that are part of the agencies' effort to identify and eliminate regulatory requirements that are outdated, unnecessary, or unduly burdensome pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. For more information, visit www.EGRPRA.gov.

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Subject	Summary
Implementation of Web-Based Central Data Repository for Bank Financial Data (PR-4-2005, January 28, 2005)	The Federal banking agencies announced a new implementation plan for the Central Data Repository (CDR)—an Internet-based system created to modernize and streamline how the agencies collect, validate, manage, and distribute financial data submitted by banks in quarterly Call Reports. While banks will not be required to submit Call Report data to the CDR until October 2005, the agencies plan to make the CDR available for testing by banks and software vendors early this summer.
Video Seminar on Deposit Insurance Coverage for Bank Employees (FIL-1-2005, January 14, 2005)	The video, targeted for bank employees, explains the FDIC's deposit insurance coverage rules and requirements for all account ownership categories.
Disposal of Consumer Information (PR-128-2004, December 21, 2004, and FIL-7-2005, February 2, 2005)	The Federal banking and thrift regulatory agencies issued interagency rules to require financial institutions to adopt measures for properly disposing of consumer information derived from credit reports. These rules, which take effect July 1, 2005, implement Section 216 of the Fair and Accurate Credit Transactions Act of 2003 by amending the *Interagency Guidelines Establishing Standards for Safeguarding Customer Information*.
Study on "Account Hijacking" Identity Theft and Suggestions for Reducing Online Fraud (FIL-132-2004, and PR-125-2004, December 14, 2004)	This FDIC study outlines the problem and suggests steps to reduce online fraud, including upgrading existing password-based single-factor customer authentication to two-factor customer authentication; using scanning software to identify and defend against phishing attacks; strengthening consumer educational programs; and continuing to emphasize information-sharing among the financial services industry, government agencies, and technology providers.
Fair and Accurate Credit Transactions Act Effective Dates (FIL-130-2004, December 13, 2004)	The Fair and Accurate Credit Transactions Act of 2003 (FACT Act) amended the Fair Credit Reporting Act (FCRA) in December 2003 and includes new provisions that impact the credit reporting system and the prevention of identity theft. These provisions will be implemented through regulations and other self-executing provisions, and this letter explains the FDIC's compliance expectations for both.
Guidance for the Purchase and Risk Management of Life Insurance (FIL-127-2004, December 7, 2004)	The Federal banking and thrift regulatory agencies issued a statement that details the risk management practices institutions should use when purchasing and holding bank-owned life insurance (BOLI), including prepurchase analysis, senior management and board oversight, guidance on split-dollar arrangements, and the use of life insurance as security for loans. An appendix describes the types of life insurance commonly purchased and contains a glossary of BOLI-related terms.
Performing Due Diligence When Selecting Computer Software or a Service Provider (FIL-121-2004, November 16, 2004)	This FDIC guidance states that financial institutions are expected to ensure the software or service providers they select comply with provisions of the Bank Secrecy Act, including the USA PATRIOT Act, and other applicable laws and regulations. Management should perform adequate due diligence before commercial off-the-shelf software or vendor-supplied software products are purchased and on an ongoing basis afterward.

Subject	Summary
New Guidance on Evaluating Operations and Wholesale Payment Systems (FIL-119-2004, November 10, 2004)	The Federal Financial Institutions Examination Council (FFIEC) issued booklets with guidance on evaluating financial institutions' technology operations and assessing the risks applicable to wholesale payment systems activities. These two booklets are the last in a series of updates to the *1996 FFIEC Information Systems Examination Handbook*, which is now retired. The entire series of booklets is available at www.ffiec.gov.
Guidance on the Risk Management of Free and Open Source Software (FOSS) (FIL-114-2004, October 21, 2004)	The Federal Financial Institutions Examination Council (FFIEC) issued guidance to help institutions identify and implement appropriate risk management practices when they acquire and use FOSS, which refers to software that users are allowed to run, study, modify, and redistribute without paying a licensing fee. The Federal banking agencies believe the risks associated with using FOSS are not fundamentally different from the risks presented by proprietary or self-developed software.
Consumer Information on Avoiding Overdraft and Bounced-Check Fees (PR-107-2004, October 14, 2004)	The Federal banking, thrift, and credit union regulatory agencies announced the publication of a new consumer resource, *Protecting Yourself from Overdraft and Bounced-Check Fees*. The brochure's key message to consumers is that the best way to avoid overdraft and bounced-check fees is to manage accounts wisely. That means keeping an up-to-date check register, recording all electronic transactions and automatic bill payments, and monitoring account balances carefully.

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