FEDERAL RESERVE BANK OF PHILADELPHIA

SRC INSIGHTS

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SVP Observations

by Michael E. Collins

The clock continues to inexorably march toward January 1, 2000, a date when many predict dire consequences for most computers and computer-based applications. Although it affects computers, the Year 2000 problem is much more than a technology issue; it is an enterprise-wide challenge. The Federal Reserve has been issuing guidance on preparing financial institutions for the new millenium since mid-1996, when SR 96-16, *Interagency Statement on The Effect of Year 2000 on Computer Systems,* was issued. Since then, the Federal Reserve, FFIEC, and the other federal regulatory agencies have issued both joint and individual guidance on Year 2000 (Y2K) supervision programs. All of the Federal Reserve's guidance, together with links to other Y2K sites, can be found on the Board of Governor's web site at 'www.bog.frb.fed.us/y2k/'.

For the most part, supervisory guidance has focused on detailing the agencies' expectations of bank senior management and the board of directors concerning business-wide Y2K risks. These risks include those posed by vendors, business partners, counter parties, and major loan customers. The Year 2000 problem requires an extensive project planning process to ensure that management addresses all business critical issues in a timely and prudent manner. Management must allocate sufficient human and financial resources to the project and should develop and monitor contingency plans for use if Year 2000 corrective efforts do not materialize as expected.

By this point in time, all institutions are in the midst of auditing and updating their systems for Y2K compliance. Many of the financial institutions in the Third District have outsourced their information technology management to third party service providers. This does not, however, absolve them of responsibility related to Y2K preparation. Bank management must be actively involved in their servicer's Y2K preparations, and should appoint a committee headed by a senior officer to conduct due diligence on the servicer's or provider's preparedness. Merely accepting the third party's word that they are Y2K compliance is not adequate. Examiners will be looking for specific test plans related to Y2K compliance during upcoming exams and inspections.

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What's Happening in Credit and Risk Management?

by Gerard A. Callanan, Vice President

In July of 1997 the Federal Reserve Bank of Philadelphia merged its Regulatory Accounting unit with its Credit Discount function to form a new unit titled Credit and Risk Management (C&RM). This unit is part of the Supervision, Regulation, and Credit (SRC) department and is headed by Gerard Callanan, Vice President, who can be reached at (215) 574-6133. As expected, forming this new unit has resulted in a number of benefits, including improved monitoring and counseling of depository institutions regarding daylight and overnight account overdrafts and enhanced service and responsiveness when depository institutions face account management difficulties. Over the past year, this unit has been working on numerous projects that affect the financial institutions in the Third District.

Interstate Branch Banking

Over the past several months, the Federal Reserve has been preparing for the 1998 move to interstate branch banking (ISBB). Effective January 1998, the Federal Reserve implemented a new account structure to support the account management and information needs of depository institutions in the new interstate branching environment. Under this structure, the Federal Reserve provides separately chartered depository institutions with one master account and the option of establishing sub-accounts. Sub-accounts can be used to segregate transaction information according to certain criteria, such as geographic region or type of transaction. All current multiple account relationships for depository institutions operating under a single charter must be phased out by year-end 1998, unless they are required by regulation (e.g., U.S. branches and agencies of foreign banks).

Standardized Operating Circulars

As part of the ISBB effort, the Federal Reserve standardized the operating circulars that the Districts use to set forth processing requirements for such services as check clearing, funds transfer, ACH, and discount window borrowing. In October 1997, the Federal Reserve issued new binders to all depository institutions containing a set of the new, standard operating circulars. One requirement of the new circulars is that new account and lending agreements must be executed for depository institutions to retain their account and discount window borrowing privileges with the Federal Reserve. Through the efforts of C&RM staff, by the end of February the Federal Reserve Bank of Philadelphia had received back over 95 percent of the newly executed account and borrowing agreements. If your institution has not yet filed these new agreements and you would like to retain or begin an account or borrowing relationship with the Federal Reserve Bank of Philadelphia, contact Dennis Chapman, Manager of C&RM, at (215) 574-6596 or Bernie Beck, Director of Credit Operations, at (215) 574-6467 for more information.

C&RM ISBB STAR CLAS

What do these acronyms have in common?
Read about SRC's newest business unit to learn more...

Statistics and Reserve (STAR) System

On January 25, 1998, staff from the C&RM function and the Financial Statistics unit successfully placed the new Statistics & Reserves (STAR) system into production. STAR is used to analyze and process statistical and regulatory data submitted by financial institutions and to manage the reserves held by those institutions. The STAR system replaces the Banking Statistics (STAT) and the Contemporaneous Reserve Requirement (CRR) systems, integrating these two related functions. STAR addresses many of the processing problems that had arisen over the past decade as the financial industry changed in ways unforeseen when the STAT and CRR systems were first designed. STAR also makes more efficient use of the System's centralized computing facilities in Richmond and will facilitate quicker implementation of updates required for monetary policy purposes. If you have any questions concerning reserve requirements under the new STAR system, please contact Dennis Chapman, Manager of C&RM, at (215) 574-6596 or Donna Wilson, Senior Analyst, at (215) 574-6595.

Fedwire Operating Hours

Effective December 8, 1997, the Federal Reserve enhanced its Fedwire service by expanding the standard operating day for online funds transfers to 18 hours, from 12:30 a.m. to 6:30 p.m. Eastern Time, five days a week. Prior to December 8, 1997, Fedwire operated for only 10 hours a day, from 8:30 a.m. to 6:30 p.m. ET. The expanded operating hours only apply to online funds transfers and do not affect the operating hours for book-entry security transfers or offline funds transfers. Participation in the expanded Fedwire operating hours is voluntary. Further, although an institution may choose to originate funds transfers as early as 12:30 a.m. ET, it is not necessary for a receiving institution to be open for business to receive those incoming funds. The Federal Reserve will automatically post the corresponding credit to the receiving institution's reserve account and make the credit available during the operating day. If you have additional questions on the 18 hour Fedwire service, please contact Jeff DePuyt, Coordinator of Wholesale Payments, at (215) 574-6549, or Anthony Scafide, Manager of Wholesale Payments, at (215) 574-6546.

Modifications to Reserve Maintenance

Beginning with the reserve period commencing on July 30, 1998, the System will move from the current system of contemporaneous reserve maintenance for institutions that are weekly reporters to a system under which reserves are maintained on a lagged basis by such institutions. It is expected that the lagged reserve maintenance approach will reduce the estimating burden on our depositories and on the Federal Reserve, and should improve the ability of the Federal Reserve to estimate accurately the need for reserves on a timely basis. It should also help accomplish the objective of ensuring greater effectiveness of the Federal Reserve's open market operations.

Outreach and Education

As part of our outreach program to assist financial institutions regarding regulatory issues and discount window borrowing, C&RM staff have conducted a number workshops over the past few years to answer questions and provide information on reserve account management. Workshops have been held both at the institutions and at the Federal Reserve Bank of Philadelphia. If your institution could benefit from a workshop, please contact Dennis Chapman, Manager of C&RM, at (215) 574-6596.

Upcoming Initiatives

In the upcoming months, C&RM will be pursuing a number of initiatives. One important activity is the implementation of a new Common Loans Automated System (CLAS) which supports the credit discount function. CLAS is a standard PC/LAN based system that will be used by all 12 of the Federal Reserve Districts. CLAS will be installed in Philadelphia during the second quarter of 1998. Also, as ISBB gets into full swing, C&RM staff will be actively working on the consolidation of operating clearing accounts within the Third District into sub-accounts for other Federal Reserve Districts, while converting Third District branch accounts of other Districts to sub-accounts within the Federal Reserve Bank of Philadelphia account structure.

We look forward to maintaining the strong relationship that we have with institutions in the Third District. As always, if you have any questions or concerns, do not hesitate to call us directly. ■

Protecting Your Trading Operations From Fraud

by John V. Heelan, Examining Officer

The issue of fraud in trading activities is receiving increased attention. This is due in part to the expansion of trading activities in complex products and a series of well-publicized trading-related losses at major financial institutions. These recent large losses involving trading impropriety highlighted shortcomings in the front office among marketers, traders, line supervisors and business heads and in back office operations and corporate control areas.

Virtually all trading fraud involves significant failures of management oversight and internal control. A so-called rogue trader or even a rogue trader with a small group of accomplices cannot realistically inflict substantial damage on a financial institution unless several controls are overridden and/or management oversight and supervision are lax. Due to the complexity of trading operations, management and control personnel need to possess in-depth knowledge and strong judgment skills to enable them to understand each new trading product and activity. It is also imperative that management and control personnel exercise a high level of skepticism and perseverance when confronted with situations in the trading area that are not fully explained or that they do not fully understand.

> Sucessful trading fraud generally requires significant failures of management oversight and internal control.

Segregation of Duties

Without question, trading frauds cannot occur without serious deficiencies in internal controls. The most basic and crucial internal control is establishing and maintaining an effective segregation of duties. The lack of adequate segregation of duties played an important role in several of the recent major trading fraud cases. The largest losses appear to stem from the ability of a risk-taker or trader to control essential aspects of the back office. At Daiwa, for example, Mr. Iguchi's ability to control both the accounting for and movement of securities in custody was essential to his hiding the sale of customer securities to cover his trading losses. Similarly, at Barings, Nick Leeson's responsibility for the back office at Barings Futures in Singapore allowed him to book his trading losses in an error account and create reports to conceal these losses from the Singapore futures exchange, the regulators, and the bank's head office management in the U.K.

In some situations, the organization chart may not be a meaningful barometer to assess the adequacy of segregation of duties in a trading operation. At Kidder Peabody, for example, Joe Jett, the head of the government strips trading desk, was widely viewed as far more knowledgeable than the back office people, even by the back office personnel themselves. Consequently, back office and other control staff deferred to his wishes even when they had questions or did not understand his explanations, which in effect negated what appeared to be adequate segregation of duties. Another example of de facto lack of segregation between front and back offices occurs when risk-takers, such as traders, mark-to-market either the bank's or customer's positions. This type of control breakdown compromises the integrity of any trading operation.

Other Controls

While lack of segregation of duties is probably the most common internal control breakdown in the trading area, inattention to other types of control plays a role as well. The absence or breakdown of the following basic controls are evident to some extent in the recent major trading fraud cases: periodic reconciliations, limit allocation policies, time stamping, tape recording of trading lines, business line and control staff review of off-market or unusually structured transactions, dual control, and adequate audit trails.

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SVP Observations

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Many financial institutions have one vendor in common—the Federal Reserve itself. The Federal Reserve is almost finished replacing nearly 90 million lines of code for its check clearing, accounting, and cash management systems. However, two applications—Fed Wire and automated clearing house—are relatively new and are already year-2000 ready. In January, the Federal Reserve announced a program to allow banks to test the computers that they use for Fed Wire and automated clearing house transactions. Additional information on the test facility's services will be published in the Federal Register, as it becomes available. You can find a wealth of information on the Federal Reserve's Y2K testing at the Federal Reserve Bank of San Francisco's website at 'www.sf.frb.org/fiservices/cdc/bulletins.html'.

The impact of Y2K compliance on credit risk management affects all financial institutions. Much of the time and effort devoted to Y2K compliance is inward-focused. However, financial institutions must also look outward to assess the impact that noncompliant commercial borrowers may have on the institution's safety and soundness. Year 2000 credit risk is the risk that a commercial borrower will default due to Y2K-related issues. Corporate borrowers who have not considered Y2K issues may experience a disruption in business, resulting in potential financial difficulties that affect their creditworthiness. The impact of Y2K noncompliance could be varied, including reduced cash flow due to Y2K expenditures, business interruption due to Y2K-related problems internally or with a key vendor or supplier, or litigation related to Y2K noncompliance. Financial institutions should develop processes to identify, assess, and control the potential Year 2000 credit risk in their lending and investment portfolios. The federal regulatory agencies have recently provided additional guidance in this area. You can also visit Robert Morris Associates' web page, at 'www.rmahq.org' for their thoughts on Year 2000 loan administration and underwriting guidelines.* Alternatively, you can reference the January 1998 issue of *The Journal of Lending and Credit Risk Management* for Cathy Brown's article "Getting a Grip: Year 2000 Credit Risk."

Congress is becoming more involved in oversight of Year 2000 readiness, from both a domestic and international perspective. As I noted in the last edition of SRC Insights, disturbances overseas have a more rapid and more pronounced impact on the domestic economy than ever before. If just one large institution or corporation is not ready for the Year 2000, the repercussions could be felt throughout the world. Based on the broad scope of these issues, you can anticipate hearing and reading about many Congressional hearings in this area in the future.

Federal Reserve Board Governor Kelly may have summed up Y2K compliance best in a February 11, 1998 speech to the Florida International Bankers Association. Governor Kelly stated that you should "be alert to recognize any danger signs in your own organizations and in your counterparties, customers and borrowers. For those of you involved in underwriting and dealing in securities, solid evidence of Year 2000 readiness should be part of your due diligence. You will know you likely have a problem if you hear that the Year 2000 is 'not an issue for our shop,' or if you hear 'we can handle the Year 2000 within the normal planning process without significant budget implications,' or if you hear that the Year 2000 'is a technical issue that does not require special attention by senior management and directors.' Any of these comments are almost certain to be dead wrong, and probably are tip offs to the presence of dangerous complacency, ignorance, or naivete."

Remember that this deadline cannot be extended. The time for inaction is past; the time for action is now.

*This website, which is not affiliated with or authorized by the Federal Reserve System, contains information that may be helpful to you. The Federal Reserve, however, has no control over the information contained therein and cannot guarantee its accuracy.

Acquiring ORE – An Accounting Perspective

by Olaf G. Schweidler, CPA and Senior Examiner

This article is the first in a two-part series dealing with real estate acquired in the collection of debt previously contracted, also known as other real estate owned (ORE). This article will address accounting issues related to the acquisition of ORE. We will also review best practices that we have observed during bank examinations in the Third Federal Reserve District. The second article in the series will review accounting for the maintenance and disposal of ORE, including how financing the sale of ORE can affect an institution's treatment of the sale. This article will include a discussion of best practices in these areas.

You may wonder why we are talking about ORE at a time when inflation has been held in check, economic growth has been healthy, and nonaccrual loans and ORE are at relatively low levels throughout the Third District. While there are no immediate signs of concern in this area, events such as the financial crisis in southeast Asia, the flood of sub-prime lending, and the increasing level of bankruptcy filings could become the prelude to a downturn in the economy. Furthermore, despite the absence of any significant economic problems, banks still have to deal with ORE on an occasional basis due to the normal risks associated with the lending process. Therefore, now is as good a time as any to discuss issues related to ORE.

Accounting for the Acquisition of ORE

The acquisition of ORE, whether through foreclosure or deed-in-lieu, is accounted for in accordance with Financial Accounting Statement No. 15, Accounting for Troubled Debt Restructuring (FAS 15). This accounting statement requires that real estate acquired in the satisfaction of debts previously contracted be recorded at the lesser of the fair value of the real estate acquired or the recorded amount of the loan plus the amount of any senior debt to which the property is subject. The loan amount referred to in this statement should include the loan's outstanding principal balance adjusted for any unamortized premium or discount, less any amount previously charged off, plus recorded interest.

The lesser of these two amounts becomes the "recorded amount" of the foreclosed real estate. Moreover, the amount by which the loan balance plus any senior debt exceeds the fair value or "recorded amount" of property acquired is considered a loss and must be charged to the allowance for credit losses at the time of foreclosure.

In instances where an institution acquires a property by deed-in-lieu of foreclosure, the acquisition of real estate should be treated as a loan payment. In this instance, the balance of the loan should be reduced by the fair value of the property. If the fair value of the property is less than the net book value of the loan, a determination must be made as to the collectability of the remaining loan balance. Any uncollectable amounts should be charged off through the allowance for credit losses.

What is Fair Value?

The question often arises as to what constitutes fair value. According to FAS 15, the determination of fair value depends on whether an active market exists for the asset being transferred. Where an active market exists, fair value is the amount that one could reasonably expect to receive from a sale between a willing buyer and seller. For assets where an active market does not exist, the fair value may be determined by discounting any expected cash flow or by using the value of similar assets, if they exist.

For many real estate transactions, fair value is determined by obtaining an appraisal or evaluation. Appraisal and evaluation standards are defined in Subpart G of the Federal Reserve's Regulation Y. This regulation exempts real estate-related transactions involving an existing extension of credit—such as most loan renewals, modifications, workouts, and refinancings—from the previous requirement that a new appraisal must be obtained. This exemption also applies to the acquisition of ORE, since the acquisition results from an existing extension of credit. Therefore, when acquiring ORE, an institution is not required to obtain an appraisal, but is required to obtain an evaluation of the property, regardless of the transaction value. The practice of obtaining appraisals and evaluations for ORE is further described in SR Letter 95-16, *Real Estate Appraisal Requirements for Other Real*

Estate Owned, which can be obtained on the Board of Governors web site at 'www.bog.frb.fed.us'.

In summary, SR 95-16 provides that, if an institution already has a current and valid appraisal or evaluation on a property acquired as ORE, a new appraisal is not required. However, a written analysis performed by an individual with appropriate real estate expertise and market knowledge should be maintained in the loan file. SR 95-16 also identifies factors that should be considered in the evaluation of the property. These factors include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; the current condition of the property; the current zoning of the property; and the environmental risks that exist.

ORE Acquired in Partial Satisfaction of Debt

When ORE is acquired either through foreclosure or deed-in-lieu in partial satisfaction of debt, the fair value of the property becomes the "recorded amount" of the real estate. The amount of loss, if any, on the transaction is determined by analyzing the borrower's ability to repay the remaining loan balance.

Capitalizing Expenses

A question frequently arises concerning what expenses may be capitalized when an institution acquires real estate as ORE. In general, any amount that an institution expends before the foreclosure for items such as real estate taxes or insurance may be capitalized, provided that the carrying amount of the property will not exceed its fair value. If the addition of these expenses would raise the carrying amount of the property above its fair market value, the excess expense(s) must be recognized immediately, regardless of any legal right to recover these costs from the future sale of the property.

One area that is often misunderstood is the appropriate treatment of legal fees and other direct expenditures related to the acquisition of other real estate. These expenses are not allowed to be capitalized, and must be expensed when incurred. However, while these expenses may not be added to the properties carrying value, this accounting treatment does not preclude the institution from recovering them in a subsequent sale.

Best Practices

During the course of examinations, Federal Reserve examiners have noted several best practices that either aided in the acquisition of ORE or expedited the ultimate disposition of these assets. Some of these practices are listed below.

Know your Environmental Risk. Unforeseen environmental concerns could present significant risks and costs to an institution when real estate is acquired as ORE. The institution should take prudent actions to ensure that any environmental issues are identified before real estate is acquired as ORE. Such actions could include obtaining a Phase I environmental study, if one was not already performed, and visiting the property to determine if any hazardous materials are present.

Develop a Marketing Plan. Given that ORE properties are typically nonearning assets, it is very important for an institution to take proactive steps to dispose of these properties in a timely manner. One way to facilitate this process is to develop a marketing plan even before the property is acquired. This should be relatively easy for most properties since the institution will have obtained relevant information on the property and market place through the evaluation process. Issues to consider during this process include who will be responsible for selling the property; what, if any, improvements should be made to the property; and how long it is expected to take to sell the property.

Monitor and Document Bankruptcy Abuses. The abuse of bankruptcy filings by borrowers can become very frustrating to an institution when it attempts to acquire property through foreclosure. In some cases, an institution is prepared to take a property through foreclosure only to have the borrower file for bankruptcy the day preceding the anticipated foreclosure date. To minimize the impact of abusive bankruptcy filings, an institution should formally track and document borrower actions, submitting a record to the courts if a pattern of abuse is apparent.

Stay tuned for the second article in this series—Maintaining and Disposing of ORE—appearing in the second quarter 1998 edition of SRC Insights. In the meantime, if you have any questions on accounting for the acquisition of ORE, please contact Olaf G. Schweidler at (215) 574-3434 or Cynthia L. Course at (215) 574-3760. ■

Protecting Your Trading Operations...

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Technology and Controls

The proper integration of multi-purpose automated systems is crucial to an effective control environment in the trading area. Information systems have become the backbone of record keeping, report generation, financial analysis, and transaction processing. Any weakness in communication across systems, as well as weakness in any one system, can create breaches in comprehensive control that provide the opportunity for fraud.

The Cumulative Impact

While usually one or two key control breakdowns can be identified as central to a particular fraud, numerous controls had to be breached in order to create large losses in the recent major trading fraud cases. Laxity in designing and executing controls, reticence in questioning unusual transactions or business activities, and slowness to follow up on exceptions was evident in these cases.

Since an internal control process is only as strong as its weakest link, efforts to cut corners, sloppy execution of key control steps, or business practices that simply "evolve" as the business grows can undermine the integrity of the entire control process. In contrast, well designed, carefully observed controls and alert control staff have at times played a major role in early detection of fraud and stemmed the resulting losses. Thus, the quality of the whole control environment can make a difference in the potential severity of a fraud-related loss.

In conclusion, it must be emphasized that the most effective way to protect an operation from trading fraud is to develop an organizational culture which places a high degree of importance on the control environment and an organizational structure which consists of knowledgeable, involved management at all levels and well educated and trained personnel in all support areas. ■

NEXT ISSUE

Maintaining and Disposing of ORE

Inspections of Small Shell Bank Holding Companies

The Year 2000—Time Marches On

Editor.................Cynthia L. Course

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