FEDERAL RESERVE BANK OF PHILADELPHIA

SRC INSIGHTS

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SVP Commentary on…

The Successful Rollover to 2000

by Michael E. Collins

After millions of hours of planning, coding, and testing, and after hours of sleepless waiting and watching on December 31, 1999, the rollover into the Year 2000 was as much a cause for celebration for what did not happen as for what did happen. From an information technology perspective, the rollover thankfully was a nonevent, with only a few minor glitches worldwide. I believe that much of the credit goes to the management and staff of each financial institution who worked diligently over a four-year period to ensure that their institution's information systems could recognize the Year 2000. At the risk of appearing to pat ourselves on the back, I would like to briefly look back at some of the events leading up to the rollover, and discuss how these activities turned what some predicted would be a worldwide catastrophe into a celebration.

On July 3, 1996, the Federal Reserve issued the first of many SR letters addressing what came to be known as Y2K. In this SR letter, each Reserve Bank was directed to ensure during all information system examinations of financial institutions and independent service providers that the necessary steps were being conducted to evaluate the status of Year 2000 action plans. The Federal Reserve Bank of Philadelphia began performing Y2K reviews during the summer of 1997. From the outset, we took a stringent stance on what we considered "satisfactory." While the percentage of Third District institutions that received less-than-satisfactory ratings was higher than the national average in 1997, the ratings caused bank management in the District to become more aggressive in implementing remediation and contingency plans. Consequently, Third District institutions were better prepared and fared well in subsequent examinations.

In developing the Year 2000 supervisory program, the federal banking regulators realized that maintaining public confidence was perhaps the most critical element of a successful rollover. Consequently, in early 1998, the agencies began to issue supervisory guidance on the impact of Y2K on customers,

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Using Self-Evaluations To Streamline The Fair Lending Examination

by Eddie L. Valentine, Supervising Examiner

In 1999, the Federal Reserve began examining banks for fair lending compliance utilizing the risk-based fair lending examination procedures approved by the Federal Financial Institution Examination Council (FFIEC). These procedures provide clear guidance to financial institutions about the methods used to examine for compliance with federal fair lending laws and regulations, as well as how an examination can be streamlined if an institution's compliance program meets certain criteria. This article will address the proactive measures a financial institution can implement to streamline its fair lending examination.

> Regulators expect all financial institutions to perform some form of self-evaluation.

Financial institutions can perform their own fair lending self-evaluation.

If a financial institution's self-evaluation is performed in accordance with regulatory guidelines, it can substitute for a large portion of the examiners' fair lending analysis. Fair lending self-evaluations consist of comparative analyses of loan applicants for disparate treatment in both underwriting and terms and conditions offered. Unlike self-tests using credit shoppers, self-evaluations are not protected from disclosure. There is no penalty for not sharing the outcome of a self-evaluation; however, financial institutions lose the opportunity for a streamlined fair lending examination by declining to inform examiners of the results.

Why would a financial institution perform a self-evaluation?

Most importantly, as noted in the Fair Lending Interagency Policy Statement, regulators expect all financial institutions, regardless of size, to perform some form of self-evaluation. However, even without this requirement, institutions would derive benefits from performing self-evaluations. For example, the self-evaluation will reveal whether fair lending training and procedures are effective. It may also uncover areas of weakness or potential violations prior to the onset of an examination. Finally, if examiners can use the results of the self-evaluation as evidence of fair lending compliance, they will use a significantly reduced on-site scope and the sample size of files reviewed will be decreased significantly.

Who is responsible for performing self-evaluations?

Responsibility to perform self-evaluations can rest with the compliance unit, internal audit, or an external consultant, whether under contract or under the auspices of the financial institution's legal counsel. Naturally, institutions could also use any combination of the aforementioned sources.

How will the examiners determine if the self-evaluation meets regulatory guidelines?

Examiners will look at three areas when determining if the self-evaluation meets regulatory guidelines: the scope and timing, the methodology, and the accuracy of the data.

Scope and Timing

Examiners will analyze the scope and timing of the institution's self-evaluation by posing two questions:

> Did the self-evaluation cover transactions occurring no longer than two years prior to the current examination date?
>
> Did the self-evaluation cover the same focal points (high-risk products, markets, or prohibited basis groups) selected for the planned examination?

If the answer to either of these questions is "no," then the self-evaluation cannot serve to eliminate examination steps. However, examiners will still analyze the self-evaluation methodology and communicate any concerns or recommendations for improvement to management.

Methodology

In order for an institution's self-evaluation to be used as a reliable measure of fair lending compliance, the methodology employed by the financial institution's analysts should be very similar to that outlined in the fair lending examination procedures.

Examiners will expect to see a comparative file analysis in which treatment of a particular prohibited basis group of applicants is measured and compared to a control group. The comparative analysis for denials and approvals should, as outlined in the examination procedures, focus on the underwriting criteria that resulted in denials of prohibited basis applicants, and determine if the control group applicants were required to meet the same standard.

Examiners will also evaluate the definition of prohibited bases and control groups to determine if the method of identification was accurate and consistent with fair lending laws.

Examiners will review the sample selection process to ascertain if it is similar to techniques outlined in the fair lending examination procedures.

Examiners will review the sample selection process to ascertain if it is similar to techniques outlined in the fair lending examination procedures. For disparate treatment in underwriting, the selection process should focus on marginal applicants. The analysis should also focus on one product; for example, a mortgage applicant cannot be compared to a credit card applicant.

The number of files sampled and reviewed should roughly correspond with the sampling guidance in the procedures. In cases where examiners determine that the institution's sample size is too small, they may still be able to use the institution's data and pull additional files to bring the sample size up to an acceptable level.

Accuracy of Data

The procedures require that examiners sample 10 percent of the denied and approved transactions reviewed in the self-evaluation to verify that relevant information was accurately collected. The examiners will be looking for data used by the underwriters to make the credit decision, as well as details of the assistance provided to the applicant by the underwriter or loan processor during the application process.

The loan file data collected should be similar to the data that would be collected by examiners if they were doing the analysis. This would include basic credit underwriting information such as debt-to-income ratios, length of employment, credit history, loan-to-value ratio, number of trade lines, etc. The examiners will also determine whether all of the credit variables and quality of assistance factors were collected in a systematic and accurate manner.

What happens to the conclusions drawn from the self-evaluation?

If examiners find that the self-evaluation was performed accurately and the conclusions are well supported, they will incorporate the results into the examination report. The report will indicate that the findings are based on verified data from the institution's self-evaluation.

If problems are found with the way that data is collected or important variables are omitted, the examiners cannot rely on the self-evaluation to streamline the examination. However, if some portions of the institution's self-evaluation methodology are deemed reliable, examiners may still be able to use the data gathered by the institution and incorporate it into their analysis. For example, if the self-evaluation compared applicants without taking into account the reasons for denial, the examiners could still use the credit data culled from the files, but

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Commercial Loan Underwriting: Balancing Competitive Pressures and Prudent Practices

by David F. Fomunyam, Supervising Examiner

Despite the continuing economic expansion, commercial bank credit underwriting standards have come under increased scrutiny in recent years. Surveys of bankers, supervisors, and industry groups confirmed that banks were easing their underwriting standards for commercial loans from 1995 to 1998, primarily due to competition. During 1999, the banking industry responded to regulatory urgings by gradually tightening underwriting standards, as confirmed by subsequent surveys. The purpose of this article is to discuss some of the reasons for the easing in underwriting standards, the Federal Reserve's supervisory concern and guidance on this topic, and the potential impact on asset quality from the easing of commercial credit underwriting standards.

> Many commercial lenders have not experienced an economic downturn or worked on a problem loan portfolio.

Reasons for laxity in underwriting standards

The primary reasons for the recent easing of credit underwriting standards are increased competition, coupled with relatively inexperienced lenders operating in a strong economy. Competition for prime commercial loans among banks and other financial service providers is intense. This competition has compressed net interest margins, as the effect of tighter loan pricing is exacerbated by higher funding costs. To maintain profitability, banks are accommodating less creditworthy borrowers and lowering their underwriting standards to meet projected performance goals.

Commercial lenders are challenged daily to book new loans, retain existing customers, and replenish portfolio run-off. To meet these challenges, some banks have resorted to lending to customers or businesses that warrant venture capital financing instead of a traditional commercial loan. To accommodate these types of borrowers, many banks are compromising prudent underwriting standards in areas including collateral, pricing, personal guaranties, and loan covenants.

In February 2000, the current economic expansion set the record as the longest expansion in U.S. history. Consequently, many commercial lenders have not experienced an economic downturn or worked on a problem loan portfolio. Due predominantly to unprecedented economic growth and stable prices, business profits and cash flows, which are important indicators for credit decisions, have been strong. However, many lenders fail to stress test financial projections to ascertain if their borrowers can still perform according to terms under adverse conditions. Furthermore, some commercial borrowers are trying to take advantage of both inexperienced and aggressive lenders by shopping the competition for better conditions, terms, and pricing. It appears that some bank lenders are matching the aggressive counteroffers in many cases, believing that they can hold their ground with other financial service providers.

Federal Reserve concerns and guidance

On June 23, 1998, the Federal Reserve issued SR 98-18, *Lending Standards for Commercial Loans*. In SR 98-18, the Federal Reserve expressed concern that if easing was carried too far, it could undermine a bank's financial health, especially if the economy were to weaken. The SR letter urged banks to resist the tendency to assume that the favorable economic environment would continue indefinitely.

On September 28, 1999 the Federal Reserve issued SR 99-23, *Recent Trends in Bank Lending Stan-*

dards for Commercial Loans. The purpose of this SR letter was to highlight for supervisors, examiners, and bankers the risks of overly aggressive lending practices and the critical actions and control processes necessary to prudently take and manage credit risk. Evidence of departures from historically sound lending practices was observed in several critical areas, as highlighted in the following table. For example, some institutions extended credit based on the expectation that the borrower's strong financial performance would continue indefinitely, or with reliance on overly optimistic views of the borrower's future prospects. In these instances, banks failed to perform meaningful stress tests of the borrower's performance under less than optimal conditions.

SR 99-23 expresses the Federal Reserve's concern that departures from sound lending standards are troubling because of the already evident near-term effect on credit quality. As asset quality deteriorates, the condition of the bank and the banking industry will invariably worsen. SR 99-23 concludes by noting that any trend toward laxity should be reversed to ensure that the banking system remains strong enough to lend to sound borrowers in both good times and in bad.

Observed Activity	Evidence
Undue reliance on optimistic outlooks	"Most likely" scenario depends on continued rapid growth in borrower's revenues Heavy reliance on favorable collateral appraisals Greater willingness to make loans without scheduled amortization prior to maturity Ready willingness to waive violations of covenants or release collateral without a corresponding concession by the borrower
Over-reliance on access to financial markets to satisfy debt	Reliance on public debt or equity offering as the ultimate source of repayment Ambiguous or poorly supported analysis of sources of repayment Measuring leverage against market capitalization as opposed to book equity Extending loans with a risk profile that resembles that of an equity investment
Insufficient consideration of stress testing	Mechanical reliance on threshold financial ratios Failure to consider analysis specific to the borrower, its industry, and its business plan Failure to consider both near-term interest obligations and ultimate principal repayment Failure to stress test for unanticipated changes in costs and revenues, interest rates, capital expenditures, collateral valuation, and product or market developments
Weakening of internal controls	Reduction in resources committed to loan review Reduction in portfolio coverage by loan review staff Reduction in the depth of the review performed on individual loans

Early signs of credit deterioration

Despite the continued strength of the economy, the adverse impact on asset quality from the laxity in credit underwriting standards is beginning to emerge. SR 99-23 provides evidence that the volume of weak or potentially weak loans has increased at some institutions over the past several quarters. Loss rates in domestic commercial and industrial loans (C&I), previously low, rose moderately during the first nine months of 1999. Furthermore, net domestic C&I charge-offs during the same period more than doubled from 1998 levels, while noncurrent domestic C&I loans rose 32 percent. While these increases originate from relatively low levels, these trends are especially troubling considering that generally favorable economic conditions persist. The federal banking regulators remain concerned about the potential affects on loan performance if economic conditions deteriorate and/or there is a sustained rise in interest rates, primarily because of the high level of business and household indebtedness to commercial banks.

> Regulators remain concerned about the potential affects on loan performance if economic conditions deteriorate.

Conclusion

Based on financial information reported by commercial banks, the commercial banking industry remains healthy, and continues to accommodate the needs of business borrowers. Domestic commercial loans grew 11.8 percent during the year ended September 30, 1999, and accounted for 39 percent of all net new loans booked during the period. However, competitive pressures have affected nearly all facets of the commercial banking business, placing such pressure on profitability that some commercial banks are easing their credit underwriting standards to maintain profit levels. The recent signs of increased credit impairment and losses, particularly in a strong economy, are cause for concern about future trends in commercial credit quality.

If you would like additional information on lending standards for commercial loans, the System's SR letters can be found on the Board of Governor's web site at <www.federalreserve.gov/boarddocs/srletters/>. If you have any questions specifically concerning commercial loan underwriting and credit quality standards, please call your institution's Central Point of Contact at the Federal Reserve Bank of Philadelphia. Alternatively, you may call David F. Fomunyam at (215) 574-4128, or Douglas A. Skinner at (215) 574-4310. ■

SVP Commentary on…

The Successful Rollover to 2000

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and, as the rollover approached, the agencies continued to emphasize the importance of customer communication.

The Federal Reserve System also took several steps to alleviate the fears of consumers, and to mitigate the potential effects of excessive cash withdrawals as the rollover approached. First, in conjunction with its Discount Window responsibilities, the Federal Reserve established the Century Date Change Special Liquidity Facility (SLF), a program for lending to depository institutions from October 1, 1999 through April 7, 2000. The SLF was designed to help ensure that depository institutions would have adequate liquidity to meet any unusual demands in the period around the century date change. Fortunately, Third District institutions have not needed this liquidity, and our Reserve Bank has not made any SLF loans, other than test loans.

Although the Federal Reserve did not anticipate that there would be major or prolonged difficulties accessing cash, we realized that the public may do its own contingency planning by holding extra cash during the rollover period. In order to be prepared for such an occurrence, the Federal Reserve asked the Treasury to print additional currency for contingency purposes. Fortunately, this too was not needed.

The banking industry and the Federal Reserve will reap some lasting benefits from the efforts of the past four years. One of the most positive results of the Y2K supervisory program was the increased awareness of the importance of comprehensive business resumption plans. We believe that financial institutions are now better prepared to understand and deal with technology issues, both on an ongoing and on a contingency basis. Moving forward, financial institutions will be challenged to sustain this heightened sensitivity to business resumption plans so that they can recover quickly and successfully from unforeseen future disruptions. Olaf Schweidler discusses the importance of business resumption plans in his article elsewhere in this edition *SRC Insights*.

Another positive result of this process was the removal of barriers that had grown between lines of business. In preparing for the Year 2000, all business units in a financial institution had to work cooperatively toward a goal with an irrevocable deadline. This removal of barriers should lead to more cross-functional approaches to other important initiatives.

The removal of barriers was also apparent at the supervisory level, as the Federal Reserve adopted procedures to review bank holding companies with multi-chartered bank subsidiaries. During these reviews, we were able to coordinate our resources with those of other regulators, showing that interagency supervision can truly be seamless. We will continue to work closely with our sister regulators to build off this model of supervision in future examinations. Finally, coordination of Year 2000 efforts at the international level may become the model for international communication and coordination between central banks.

Again, I would like to commend all of you for your efforts in making the Year 2000 rollover memorable for the celebrations, and not for the recriminations. I wish all of you health and prosperity and, for your institutions, safe and sound operations in the New Year and beyond.

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Business Resumption Plans: Not Just a Nicety but a Necessity

by Olaf G. Schweidler, Supervising Examiner

As Michael Collins noted in the SVP Commentary elsewhere in this publication, two of the derivative benefits of Y2K are that it forced everyone to take a hard look at how they do business and to develop a plan for business resumption in the face of catastrophe. Unfortunately, the uneventful passage of the rollover weekend does not obviate the need for business resumption plans. Therefore, I would like to take this opportunity to reemphasize the importance of business resumption plans, or "BRPs," in ensuring that businesses continue to operate even when faced with significant adversity.

What Are BRPs?

BRPs are the backbone of an organization's plans to deal with any type of significant business disruption that could result in either tangible or intangible losses. A BRP is, in effect, a business plan for running a process or function under extremely stressful conditions. These plans must be comprehensive, addressing resource centers such as an organization's information systems, telecommunications environment, business partners, facilities, and personnel. In addition to addressing items commonly associated with contingency planning, such as hot sites and off-site storage of data, BRPs should also include protocols addressing issues that range from customer relations to restoration of normal operations.

What Makes A Good BRP?

As with any good business plan, senior management needs to take an active role in the development process. The development of a BRP is not a single task that one person can complete. It is a complex, multifaceted process that requires the support and involvement of the entire organization. Moreover, it will require the knowledge and support of a company's leaders if it is going to be effective and taken seriously by the organization.

A business resumption plan is a complex, multifaceted process that requires the support and involvement of the entire organization.

Another characteristic of a good BRP is that it addresses all of the components or resource centers that make up a business process. Again, these components include items such as information or data, information technology, telecommunications, processes, business relationships, people, and facilities. Too often, businesses only address issues related to core data processing and forget about the processes that feed into the information technology environment.

For example, a bank that derives a large portion of its revenue from leasing may have very detailed plans to address the restoration of payment processing capabilities. However, plans for handling new business during the business interruption may be limited. On the surface, it may appear that one or two days' lost business is not meaningful. However, what is not as apparent is the extent of reputational harm that the company may encounter due to its inability to meet new customers' needs. In today's real-time, online business world where sympathy is a scarce commodity, this could be a very costly oversight if the markets are competitive and new business is driven to competitors.

Effective BRPs are broadly communicated and easy to understand. During a significant business disruption, employees should be implementing the BRP, not reading or trying to interpret it. Staff throughout the organization should receive sufficient training so they understand the importance of the BRP and are able to implement it with minimal oversight.

BRPs also need to be dynamic. The banking industry has undergone dramatic change over the last few years, and it does not appear that the rate of change will slow anytime soon. Consequently, a good BRP must be developed with flexibility in mind, and any new significant business proposal must incorporate BRP elements. Finally, because of the continual improvements and reengineering that occur within established lines of business, BRPs need to be continually reviewed to ensure that they actually address current business processes and functions.

Development Phases of a BRP

The development of a BRP can be broken down into five phases:

Awareness
Risk Assessment
Identification of Recovery Alternatives
Implementation
Validation

In the **Awareness** phase, management should appoint a team to develop the BRP for the organization. Several issues should be considered when choosing members for this team. First, as with any significant strategic undertaking, a member of senior management should champion this activity. In fact, an organization may choose to establish a subcommittee of the Board of Directors to oversee the activities of the team. Team membership should also include sufficient vertical and horizontal representation from within the organization. This will ensure that both critical line functions and strategic functions are represented.

> A member of senior management should champion the Business Resumption Plan.

The second phase in the BRP life cycle is the **Risk Assessment** phase. During this phase, the BRP team will identify and document the risks facing an organization and its various business lines. Once the risks are identified, the team will recommend procedures or processes that could avoid, mitigate, or transfer the impact of significant risks. At this point, management will be able to determine which resources drive the critical business lines or processes. Finally, the risk assessment phase will assist management in quantifying and qualifying the tangible and intangible organizational impact of the loss of significant resources.

In the next phase, **Identification of Recovery Alternatives**, the BRP team will develop recovery strategies and processes based on the criticality of the business line or process. In completing this phase, the team will identify the relationship between the anticipated amount of financial resources spent on completing a recovery over a given time period versus the potential losses arising from a significant disruption. It is important that the team consider intangible as well as tangible losses in this phase. For example, the potential reputational harm that an organization may suffer may be intangible in the short term but is clearly tangible in the longer term.

The recovery strategies developed during this phase will fall under one of three possible scenarios: predetermined, prearranged, or redundant. A *predetermined* recovery strategy is the least formal strategy, and assumes that the alternate resources needed to manage a disruption are readily obtainable. Under a *prearranged* recovery strategy, an organization enters into a written contract with an outside party to ensure that a particular resource will be available. A computer hot-site is a prearranged recovery strategy. A *redundant* recovery strategy is the most reliable of all three scenarios, since it requires the organization to obtain an exact duplicate of a specific resource. Redundant strategies are typically used for those specific business lines or processes that are highly dependent on technology and cannot realistically be performed by any other means. Redundant recovery strategies are also the most expensive for an organization to implement.

The fourth phase of the BRP life cycle, the **Implementation** phase, forms the basis for the development and continued maintenance of the BRP document. To be implemented effectively, a BRP should be a user-friendly document. It is critical that these plans be developed and documented so that the individuals who execute them can easily understand their responsibilities.

For ease of implementation, BRP activities are typically divided into several major categories, which could include General Information, Administrative Procedures, Operational Continuity Procedures, Information and Technology Recovery Procedures, and Application Resumption Plans. Unarguably, the BRP should identify the specific actions to be taken by the significant resource centers to recover and restore the critical business lines and processes. However, the plan should also identify the steps necessary to unwind the business resumption activities when no longer required, and to return the resource centers to their original locations.

The last phase of the BRP life cycle is the **Validation** phase. During this phase, management should ensure that all critical employees are trained and tested in the skills necessary to implement the components of the BRP. Management should ensure that the testing is comprehensive and simulates an actual disruption as much as possible. Testing should not focus solely on information systems, but should also include the recovery of manual procedures. Finally, the test results should be reviewed to ensure that all critical business functions are covered.

All critical employees should be trained and tested in the skills necessary to implement the BRP.

Conclusion

The importance of maintaining a current and comprehensive business resumption plan cannot be emphasized enough. As financial institutions increase their reliance on technology to provide customers with more electronic banking alternatives, the level of computer downtime that customers will accept will most likely decrease. Also, as electronic banking receives broader acceptance and becomes a larger part of an organization's business, financial institutions will find that the traditional time buffers provided by non-banking hours will no longer be available to manage short-term disruptions.

If you have any supervisory questions concerning the use of Business Resumption Plans in your organization, please call your institution's Central Point of Contact at the Federal Reserve Bank of Philadelphia. Alternatively, you can call Olaf Schweidler at (215) 574-3434. ■

Using Self-Evaluations To Streamline The Fair Lending Examination

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would have to perform the comparisons focusing on the reasons for denial.

Where can the specific procedures for streamlining the fair lending examination be found?

The entire process for performing a self-evaluation and streamlining a fair lending examination is in the appendix to the fair lending procedures. The procedures and the appendix are attached to the January 5, 1999 FFIEC press release, and can be viewed at <www.ffiec.gov/pr010599.htm>.

If you have any questions regarding fair lending self-evaluations, please contact Connie Wallgren, Consumer Compliance Examinations Manager at (215) 574-6217 or Eddie L. Valentine, Supervising Examiner at (215) 574-3436. ■

www.phil.frb.org

The Federal Reserve Bank of Philadelphia's internet site, <www.phil.frb.org>, recently underwent a major transformation. Visitors to our site will find much more information, and will find it in a better organized format. The Supervision, Regulation, and Credit Department is particularly proud of our section of the website, which can be reached by clicking on "Supervision, Regulation and Credit" on the button bar. Once there, you will find information on nine major areas, such as:

- Who We Are
- Applications
- Regulations
- Examinations & Inspections
- Consumer Compliance & CRA
- Special Studies
- Credit and Risk Management
- Financial Forms
- Related Links

These areas include new information, unique to Philadelphia, as well as links to other established web sites. Then, if you have unanswered questions after visiting our site, you can easily contact many of our officers and staff by clicking on their e-mail address on one of several pages of departmental contacts.

In the next issue of *SRC Insights*, Theresa Willgruber will highlight some of the more useful sections of our website.

NEXT ISSUE

Consumer Compliance Update

Synthetic Collateralized Loan Obligations

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

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