FEDERAL RESERVE BANK OF PHILADELPHIA

SRC INSIGHTS

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SVP Commentary on…

Credit Risk in Today's Economy

by Michael E. Collins

At recent Bankers' Forums, we have discussed a wide range of topics, including financial modernization, interest rate risk, electronic banking, and integrated IT supervision. After lengthy discussions on these emerging issues, an attendee at one Forum questioned whether the Federal Reserve was still concerned with credit risk, since credit risk has not been a specific agenda topic for a number of years. I would like to take this opportunity to assure bankers in the Third District that, yes, the Federal Reserve is still concerned with credit risk. We at the Federal Reserve still view credit risk to be at the core of a financial institution's risk management processes. Here's why…

The length of the current U.S. economic expansion continues to set records with the passage of every month. While most economists remain optimistic and forecast continued growth, a number of sectors, such as health care and manufacturing, appear to be slowing and/or experiencing difficulty. In addition, technology is having a much wider impact on many older industries than is easily understood, and higher energy prices are beginning to cause problems. In the coming months, significantly higher energy bills could be the event that triggers a sharp drop in consumer confidence. All of these factors might be an early indicator of a broader slowing of the economy than many currently believe.

On a national scale, adverse classifications of syndicated bank loans (Shared National Credits, or SNC) increased in 2000 for the second consecutive year. The SNC program, established in 1977, is designed to provide efficient and consistent review and classification of any loan or loan commitment of $20 million or more that is shared by three or more supervised institutions. In 2000, the SNC Program covered 9,848 credits to 5,844 borrowers totaling nearly $2 trillion in drawn and undrawn loan commitments. Of the total, examiners adversely classified $63 billion, or 3.3 percent, because of default or other significant credit concerns. This compares to classification levels of 2.0 percent in 1999 and 1.3 percent in 1998. While classified SNC loans remain low relative to the peak of 10 percent in 1991, the trend is troubling. Of more concern,

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A Regulatory Perspective on FHC Consolidated Supervision

by Joanne Branigan, CPA, Assistant Examiner and Glenn Fuir, CPA, CFA, Senior Examiner

With the passage of the Gramm-Leach-Bliley Act (GLB) in November 1999, a qualifying bank holding company (BHC) can elect to become a financial holding company (FHC). A financial holding company can participate in an expanded array of permissible activities. These activities, as further enumerated in §225.86 of Regulation Y, might include:

- Underwriting and dealing in securities
- Serving as an insurance agent and underwriter
- Acting as a futures commission merchant
- Engaging in merchant banking activities
- Conducting other activities determined by the Board of Governors of the Federal Reserve System and the Secretary of the Treasury to be financial in nature
- Conducting other activities that the Board of Governors finds to be complementary to a financial activity and do not pose a threat to the safety and soundness of depository institution subsidiaries

This expansion of activities adds a degree of organizational complexity to these financial entities. Under GLB, the Federal Reserve has supervisory responsibility for BHCs, including BHCs that operate as FHCs. In August 2000, the Federal Reserve issued SR 00-13 *Framework for Holding Company Supervision* that discusses the Federal Reserve System's approach to FHC supervision.*

The Federal Reserve's authority over FHCs is defined as "consolidated" supervision, concentrating on a centralized approach to analyzing the organization. The goal of consolidated supervision is to identify and evaluate the major risks of the diversified organization to determine how those risks might impact the safety and soundness of the entity's depository institution subsidiaries. Accordingly, consolidated supervision is not intended to be like traditional bank supervision or to replace functional regulators. The Federal Reserve System intends to establish a balanced strategy of protecting the banking subsidiaries of increasingly complex FHC organizations without imposing undue regulatory burden.

In fulfilling its role as consolidated, or "umbrella," supervisor, the Federal Reserve will focus on the financial strength and stability of the FHC, the organization's consolidated risk management processes, and its overall capital adequacy. Effective, productive relationships with primary regulators and functional regulators will be established to promote information flows, to eliminate duplication of efforts, and to minimize burden. The Federal Reserve will continue to rely on reports issued by primary bank regulators, and will now also look to reports issued by functional regulators of non-bank subsidiaries. In addition, continued reliance on risk-focused supervision and market discipline will be necessary. The Federal Reserve currently employs most of these concepts when supervising BHCs.

The Federal Reserve's FHC supervisory activities can be grouped into three broad categories:

- Information gathering, assessments, and supervisory cooperation
- Ongoing supervision
- Promotion of sound practices and improved disclosure.

As part of the **information gathering** process, the Federal Reserve will seek to develop relationships

*SR 00-13 is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0013.HTM>.

with senior management and boards of directors of FHCs, as well as line of business leaders and critical internal audit and risk management personnel. The Federal Reserve will assess risk management and internal control processes and perform targeted transaction testing on a limited basis to ensure that risk management systems are effective and in compliance with all applicable laws and regulations. Ongoing dialogue with key officials of the organization and timely access to information will be essential in understanding the FHC's risk profile. The information gathering process will also require continued supervisory cooperation, which is the process of sharing information among interested regulatory authorities.

Ongoing supervision encompasses the reporting and examination process, assessment of capital adequacy, monitoring of intra-group exposures, and, where warranted, enforcement action. As part of the *reporting and examination process*, the Federal Reserve will rely to the greatest extent possible on regulatory reports; publicly available information, such as audited financial statements; and specialized reports from primary bank, thrift, and functional regulators.

> The Federal Reserve will rely on regulatory reports, publicly available information, and specialized reports from primary bank, thrift, and functional regulators.

The Federal Reserve will use information obtained from unregulated subsidiaries to assess the financial condition of the FHC as a whole. If necessary, the Federal Reserve will examine an unregulated subsidiary to evaluate its operations and financial condition, and to assess risks that may pose a threat to any depository institution subsidiary of the FHC.

However, the Federal Reserve is precluded from examining a functionally regulated subsidiary unless one of three conditions exists: (i) the subsidiary is engaged in an activity that poses a perceived risk to an affiliated depository institution, (ii) an exam provides information about the FHC's systems for monitoring and controlling the financial and operational risks that threaten the safety and soundness of an affiliated depository institution, or (iii) the subsidiary in question is not in compliance with a federal law within the jurisdiction of the Federal Reserve. Examinations of functionally regulated subsidiaries, when necessary, will be coordinated with the appropriate supervising agency.

Another ongoing supervisory responsibility of the Federal Reserve as consolidated supervisor is to *assess capital adequacy* on a consolidated basis. Part of this assessment entails a review of the FHC's internal capital adequacy assessment, although responsibility for assessing capital adequacy at the subsidiary level will continue to rest with the primary banking regulators and functional regulators. Consequently, the Federal Reserve will continue to rely on these assessments when analyzing capital adequacy at the consolidated level.

The Federal Reserve will also *monitor intra-group exposures and risk concentrations* for potential adverse effect on depository institution subsidiaries. Specifically, the Federal Reserve will focus on the FHC's monitoring and control of intra-group exposures such as servicing agreements, derivatives and payment systems exposures, and group-wide risk concentrations.

The Federal Reserve has the authority to take *enforcement action* against an FHC and its nonbank subsidiaries, although resolution of issues involving only the functionally regulated subsidiaries remains with the appropriate functional regulator. Nevertheless, the Federal Reserve may take enforcement action against a functionally regulated subsidiary to ensure compliance with federal laws under its specific jurisdiction.

The third category of supervisory activities discussed in SR 00-13 is **promotion of sound practices and improved disclosures.** This process might involve meetings with FHC management to discuss important issues and emerging risks, or meetings with primary bank,

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Introducing the Role of Consumer Compliance Liaison

by Connie Wallgren, Team Manager

In addition to repealing core provisions of the Glass-Steagall Act and the Bank Holding Company Act, the Gramm-Leach-Bliley Act also dramatically impacts the CRA examination frequency schedule for institutions with assets of less than $250 million (small banks). The Board of Governors of the Federal Reserve System determined that the Federal Reserve would continue to conduct simultaneous consumer compliance and CRA examinations in small banks. Accordingly, a small bank with a Generally Strong or better compliance rating will be examined (i) every four years if it has a Satisfactory CRA rating or (ii) every five years if it has an Outstanding CRA rating. This change was discussed more fully in "Reducing the Burden: New CRA and Compliance Examination Frequency for Small Banks" in the Third Quarter 2000 issue of *SRC Insights*.

While reducing regulatory burden, the change in frequency from three years to either four or five years poses an interesting challenge from a supervisory standpoint. Specifically, how can a regulator adhere to this new examination schedule, while at the same time ensure that the overall compliance posture of state member banks remains sound?

In "Reducing the Burden," we described the off-site monitoring procedures that the Federal Reserve System has adopted as a way of assessing a bank's compliance posture between examinations while not increasing regulatory burden. In addition to these mid-point monitoring procedures, the Consumer Compliance/CRA Examinations Unit of the Federal Reserve Bank of Philadelphia (CC/CRA Unit) has created the role of Consumer Compliance Liaison (CCL).

The CCL program is designed to allow the CC/CRA Unit to regularly assess a small bank's compliance risk profile, without increasing the burden to the institution. This program is similar to the off-site monitoring currently performed in the safety and soundness area. Accordingly, a CCL's responsibilities will include:

- Serving as the primary communication link between the compliance officer at the state member bank and the CC/CRA Unit
- Preparing a quarterly update of the institution's compliance risk profile
- Reviewing the bank's website on a quarterly basis (if applicable)
- Conducting the mid-point monitoring review, consistent with System guidelines
- Ascertaining the institution's compliance strengths and weaknesses, and using this knowledge to refine the focus of the CC/CRA Unit's outreach program

The off-site monitoring activities will place a negligible burden, if any, on the institution, and the benefits of enhanced communication could be significant. Accordingly, although large banks are not subject to the change in examination frequency, examiners will also serve as CCLs for state member banks with over $250 million in assets. However, large banks would not be subject to the formal mid-point monitoring review that is required for small banks with extended compliance examination cycles.

In the near future, CC/CRA examiners will begin to contact the state member banks to introduce themselves and further explain the CCL program. Once the CCL program is underway, feedback from our state member banks will be welcomed.

If you have any questions or comments about the new CCL program or any topic related to the consumer compliance or CRA examination processes, please contact Connie Wallgren, Team Manager at (215) 574-6217 (connie.wallgren@phil.frb.org). ■

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however, is the fact that examiners downgraded from internal risk rating levels almost 50% more loans during this year's SNC review. This disparity between regulatory and internal risk perceptions is troubling, particularly because bankers were warned that the banking regulators were more concerned about credit quality and that examiners would be taking a much tougher stance this year.

On a local level, deterioration in credit quality is generally not evident in the delinquencies or nonaccruals in Third District community banks. However, the asset quality rating was downgraded at almost 20 percent of the Third District commercial banks examined during the first three quarters of 2000, while asset quality was upgraded at only 10 percent of the examined banks.

Both examiners and bankers have observed that the time over which a loan deteriorates appears to be shorter, and loan loss reserves and provisions often do not keep up. In addition, community bankers tend to be slower in identifying and accounting for weaker credits, since relationship managers, underwriters, credit administration specialists, and even loan workout or collection specialists all require very distinct skills, which may not be economically feasible to maintain at a community bank. Accordingly, since they tend to be longer-term holders of credit risk, community banks need to be particularly vigilant to identify early signs of individual and portfolio credit deterioration.

In a recent presentation at the RMA Annual Conference 2000, David Aloise, of Aloise and Associates, LLC discussed "Bad Loans – Have We Really Learned Lessons from Our Past Mistakes?" In our experience, most financial institutions learned some lessons from the past. Our examiners have seen fewer concentrations of credit, and technology has allowed for significant enhancements in risk management. In addition, in response to recent warnings by federal banking regulators* and industry groups, many financial institutions have decreased their appetite for risk and returned to stronger underwriting standards. However, while many of the lessons that Mr. Aloise identified are self-evident and already might be incorporated in your bank's underwriting practices, they nonetheless bear repeating.

- Projections should not drive the credit decision. Historical performance is far more important in making an underwriting decision.
- Credit analysis must go beyond the financial aspects of the transaction and into operating and industry issues.
- Valuations are not static, and credit analysis should take into account multiple scenarios, both good and bad. Downside analysis must be tied to industry and economic conditions, and not solely based on the borrower's forecast.
- Individual loan management will not protect an institution from inordinate losses. Overall portfolio management, including limits in size, diversification, concentration, and exceptions, are also necessary.
- Excellent credit administration and loan review processes cannot compensate for weak underwriting standards.
- A strong problem loan management function is not an optional or secondary consideration.
- Getting secured and acting early is key to minimizing loss.
- The 4Cs of Management (capacity, character, competence, and cooperativeness) are as critical as the primary source of payment.

*See SR 99-23, *Recent Trends in Bank Lending Standards for Commercial Loans*, at <www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9923.HTM>.

- Cash flow is king! Covenants and structure do not repay a loan.

Although no one knows with certainty what the future might bring, we do know that current warning signals indicate declining credit quality. In addition, event risk—such as a very cold winter coupled with high energy prices, or a significant drop in stock prices—could derail consumer confidence and precipitate an economic downturn and further credit deterioration.

Accordingly, you should expect that examiners will continue to be thorough in their analysis of credit quality and credit administration. Examiners will scrutinize internal risk-rating systems to ensure that they are validated regularly and are used appropriately. They will also ensure that an independent review process is in place, and that the relationship manager does not have sole ownership of the risk-rating process. Aside from the risk rating process, bankers should ensure that lending and review staff understand that timely problem identification can often lessen potential loss.

While no one can predict the future, everyone can prepare for it. To quote William Shakespeare, "To fear the worst oft cures the worst." I encourage you to fear declining credit quality, practice sound credit underwriting, remain vigilant for early signs of deterioration, and aggressively manage those credits that do deteriorate. With these practices, the worst might *not* be yet to come. ■

A Post-GLB Observation: Applications Might Still be Required for Non-Banking Activities

by James D. DePowell, Manager

The Gramm-Leach-Bliley Act (GLB) paved the way for a bank holding company (BHC) to offer its customers a full range of financial services, and it also established a legal and regulatory framework for engaging in expanded powers. Central to this process is a BHC's registration as a Financial Holding Company (FHC). A BHC that meets specified criteria and desires to exercise these expanded powers should elect to become an FHC by following the procedures outlined in SR 00-1, *Procedures to Become a Financial Holding Company and Guidance Regarding the Initial Monitoring of Acquisitions and the Commencement of New Activities by Financial Holding Companies.*[1]

FHC status affords a BHC a simplified post-commencement notification process for non-bank activities previously authorized by Regulation Y and expanded financial-in-nature activities authorized by GLB. A summary of authorized activities is in §225.86 of Regulation Y. An FHC engaging in a new activity or acquiring a company already conducting a new activity must notify the appropriate Federal Reserve Bank within 30 days of commencement or consummation by submitting Form FR Y-6A.[2]

BHCs that do not desire or qualify for FHC status remain subject to the existing regulatory applications

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[1]SR 00-1 is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0001.HTM>.

[2]The FR Y-6A and its instructions is available on the Board of Governors' web site at <http://www.federalreserve.gov/boarddocs/reportforms/default.cfm>.

process for engaging in non-bank activities that are closely related to banking. For a BHC, most of these activities require some level of application or notification. Although the applications process for non-bank activities has been simplified in recent years, it generally is highly desirable for a BHC to receive assistance from professional counsel to ensure that a given activity is both permissible and that the proper notifications or applications are made.

Over the past year, staff at the Federal Reserve Bank of Philadelphia have seen increased use of the BHC structure to engage in non-bank activities. We encourage management and/or counsel of BHCs and FHCs who might be uncertain regarding the proper regulatory protocol to consult with us before making an investment in an entity or directly engaging in a new nonbanking activity.

If you have any questions on the applications process at the Federal Reserve Bank of Philadelphia, please contact Jim DePowell, Applications Manager, at (215) 574-4153 (jim.depowell@phil.frb.org) or Bill Gaunt, AVP, at (215) 574-6167 (william.l.gaunt@phil.frb.org). ■

Coming Attraction: Seminars on the New Privacy Regulations

by Connie Wallgren, Team Manager

Consumer compliance examinations commencing after July 1, 2001 will include an assessment of bank compliance with the new privacy rules as set forth in Regulation P, *Privacy of Consumer Financial Information*. Briefly, the privacy rules require financial institutions to:

- Provide notice to customers about their privacy policies and practices, both at the beginning of a customer relationship and annually thereafter
- Inform their customers of the circumstances under which they may disclose nonpublic personal information about consumers to nonaffiliated third parties
- Provide a convenient opt-out method for consumers to decline having their information disclosed to nonaffiliated third parties

The Gramm-Leach-Bliley Act restored the authority of federal bank regulatory agencies to conduct regular examinations for compliance with the Fair Credit Reporting Act (FCRA) and to write regulations to implement certain provisions of FCRA. Accordingly, in October 2000 the agencies proposed rules to implement the FCRA notice and opt-out provisions governing the sharing of information among affiliates. Comments on the proposed rules were due by December 4, 2000, and are now being considered by the agencies. Once final, these rules will become Regulation V, *Fair Credit Reporting*.

The Consumer Compliance/CRA Examinations Unit plans to conduct seminars on both Regulation P and Regulation V in Philadelphia and at other locations in the Third District before the mandatory compliance date. The seminars will include presentations on the technical provisions of the regulations, as well as an overview of the privacy examination procedures.

Specific information on the dates and locations of the seminars will be available soon. If you have any comments or questions about the privacy seminars, please contact Connie Wallgren, Team Manager at (215) 574-6217 (connie.wallgren@phil.frb.org). ■

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thrift, and functional regulators to explore issues of mutual concern. As part of its effort to promote improved public disclosure, the Federal Reserve will encourage disclosure of group-wide activities, risk exposures, risk management, and intra-group exposures.

FHC supervision presents both challenges and opportunities for the Federal Reserve. Understanding increasingly diverse organizations, their risks, and how those risks might affect banking subsidiaries will provide regulators with many challenges, including the supervision of new financial activities and business lines. However, everyone should benefit from enhanced information flows and more open communication channels between regulators and bankers. In addition, FHC supervision will allow the Federal Reserve to continue to promote sound risk management practices and improved public disclosure within the financial service industry.

If you have any questions concerning consolidation supervision of financial holding companies, you should contact your institution's central point of contact at the Federal Reserve Bank of Philadelphia or the examiner-in-charge of the examination or inspection. ■

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Consumer Compliance Update

Supervisory Implications of Subprime Lending

FEDERAL RESERVE BANK OF PHILADELPHIA

TCB The Checkers Bank

Check it Out: The Checkers Bank is Available to the Public!

As promised in the Second Quarter 2000 issue of *SRC Insights*, the Federal Reserve System recently launched "The Checkers Bank" on its public web site. The Checkers Bank is adapted from an internal Federal Reserve program used to train compliance examiners. The web site intentionally includes violations of federal consumer protection regulations, and is designed to test the user's awareness of consumer regulations and the limits they impose on Internet banking sites.

Check it out at < http://www.federalreserve.gov/tcb/index.html>! ■

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

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