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SRC Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

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IN THIS ISSUE

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SVP Commentary on…

Strategy and Leadership in a Turbulent World

by Michael E. Collins

Recently, I attended the Executive Focus International's (EFI) executive forum on *Strategy and Leadership in a Turbulent World*. The conference themes centered on managing change, coping with chaos, and effective strategic and leadership responses. The timing of this forum was particularly meaningful, since these are extraordinary times for business. Financial services firms that are successful today and will thrive in the future will be those that have effective strategic planning, effective talent planning, and disciplined management processes. Most leaders recognize the importance of strategic planning and disciplined management processes. However, "talent planning"—the process of recruiting high impact people, assessing their potential, developing their talents, and retaining them for the long haul—while recognized, is often not effectively managed.

To cope with rapid change and uncertainity, leaders need to strike a balance between the infusion of outside talent and the development of tenured, high-potential people. This is important because, while living in a time of great

continued on page 6

Trends in Commercial Real Estate

by Eddy Hsiao, Senior Examiner and Vince Poppa, Special Studies Manager

In recent months, many economists and analysts have changed their initial optimistic views on the pace of economic recovery. The popular prediction that the economy would pick up in late 2002 or early 2003 may not come to fruition. Economic reports for various business sectors reflect mixed results and forecasts are embedded with many uncertainties. However, one area where analysts are in agreement is the gloomy outlook for the commercial real estate (CRE) market. This article will show how the regional CRE market compares to that of the nation and how CRE and commercial and industrial (C&I) loan performance measures for Third District banks compare to the national averages.

A survey of real estate trends conducted by the FDIC for the period between January 2002 and June 2002 indicates that the nation's real estate markets continued to deteriorate. The deterioration trends appear in higher vacancy rates, lower market prices, higher rent rate concessions, and a slower pace of sales. The western region was the weakest, specifically in San Francisco, where many institutions have high concentrations of CRE loans. Other markets that reflected over 20 percent vacancy rates included Columbus, Detroit, Dallas/Ft. Worth, Salt Lake City, Las Vegas, Jacksonville, Austin, Baltimore, and Atlanta. While the Philadelphia region has not weakened as much as other regions, it has not been spared entirely.

PHILADELPHIA REGION CRE[1]

Philadelphia Metropolitan Office Market

The Philadelphia metropolitan region consists of nine counties in Pennsylvania, New Jersey, and Delaware, and covers 19 submarkets listed in Table 1. The office market consists of over 118 million square feet of multi-tenant office space in 1,480 buildings.

[1] A significant source of statistical information for this section of the article was CB Richard Ellis Services, Inc & Torto Wheaton Research.

Table 1. Philadelphia Metropolitan Office Submarkets

Submarket	Vacancy Rate (%) Q202	Q102	Under Construction (SF) Q202
Bala Cynwyd	6.7	6.3	0
Conshohocken	25.9	15.1	340,000
Delaware County	13.7	14.0	525,000
Exton/West Chester	24.8	22.1	34,000
Fort Washington	9.9	10.8	75,000
Horsham/Willow Grove	16.4	13.2	50,000
King of Prussia/ Valley Forge	13.2	14.6	407,000
Main Line	13.0	15.3	0
Plymouth Meeting/ Blue Bell	11.5	12.6	96,000
Trevose/I-95	14.0	14.4	224,700
Upper Main Line	11.8	10.0	90,000
Philadelphia Suburbs Subtotal	**14.1**	**13.8**	**1,841,700**
Market West	11.5	10.4	0
Market East	13.4	13.4	0
Independence Hall	10.1	12.0	0
Philadelphia Downtown Subtotal	**11.7**	**11.3**	**0**
Burlington County	5.5	7.1	0
Camden County	9.3	8.7	0
Gloucester County	6.7	8.3	0
South Jersey Subtotal	**7.1**	**7.8**	**0**
Wilmington	16.5	14.0	108,000
Suburban New Castle	6.9	7.0	0
Delaware Subtotal	**10.9**	**10.0**	**108,000**
MARKET TOTAL	12.1	11.8	1,949,700

While some submarkets have reported a decline in office vacancy rates, overall market vacancy continues to rise. The Conshohocken market had the highest increase in the vacancy rate, with vacancies jumping from 15.1 percent at the end of the first quarter to 25.9 percent at the end of the second quarter. The delivery of completed offices may have been a factor in the sharp increase in the vacancy rate. For instance, at the end of the first quarter, there were 685,000 square feet of office space under construction in Conshohocken, with only 340,000 square feet remaining under construction at the end of the second quarter.

Table 2. Office Vacancy Index

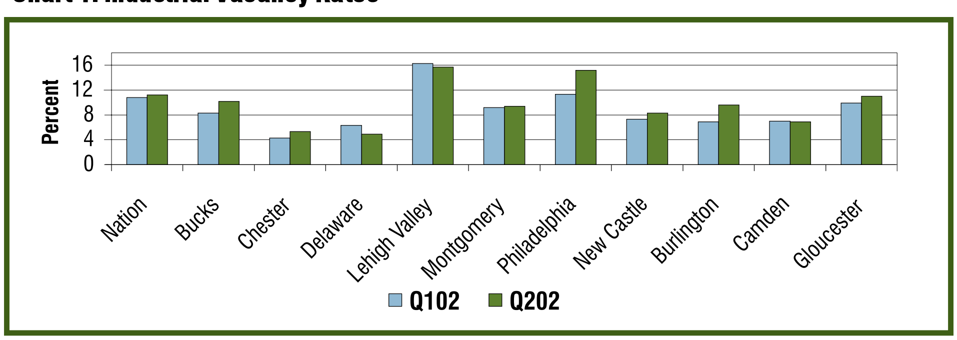
Market	Downtown			Suburban			Metropolitan		
	Q202	Q102	Q201	Q202	Q102	Q201	Q202	Q102	Q201
Philadelphia	11.7	11.3	8.6	14.1	13.8	9.0	13.1	12.7	8.8
Wilmington	17.6	14.0	6.6	7.0	7.0	3.8	11.5	10.0	5.0
Nation	12.1	11.7	8.3	15.9	15.6	11.5	14.6	14.2	10.3

As shown in Table 2, the vacancy indices of the Philadelphia and Wilmington metropolitan and suburban regions compared favorably to those of the nation. However, the vacancy rate for downtown Philadelphia approached the national average of 12.1 percent, and downtown Wilmington's vacancy rate exceeded that of the nation for the second consecutive quarter. The significant increase in vacancy for downtown Wilmington reflects corporate downsizing and relocations. Wilmington has a high level of office employment in the finance, insurance, and real estate sectors. Their problems, coupled with stagnant economic conditions and a depressed stock market, have had a significant negative effect on the office employment in Wilmington. Other than miscellaneous investing and trust business areas, which had positive annual growth, banks, mortgage companies, insurance agents, and securities firms all reported negative employment growth.

Philadelphia Metropolitan Industrial Market

The Philadelphia metropolitan industrial market consists of approximately 260 million square feet of industrial space in over 1,000 manufacturing and warehouse buildings. As shown in Chart 1, Delaware, Lehigh Valley, and Camden Counties experienced vacancy declines, while the rest of the submarkets experienced increasing vacancy rates. The Lehigh Valley and Philadelphia markets had the highest vacancy rates in the region, at 15.7 percent and 15.2 percent, respectively. The Lehigh Valley market continues to lead the area in new construction despite its high vacancy rate, with 763,820 square feet under construction. The average vacancy rate of 10.7 percent for the region was slightly below the national average of 11.2 percent, but up from the first quarter 2002 level of 9.4 percent.

Chart 1. Industrial Vacancy Rates



A rise in the average lease rate during 2001 exacerbated the increased overall vacancy rate for the Philadelphia region. However, the average lease rate appeared to have dropped slightly in the second quarter in response to higher vacancy rates, with five out of the ten counties reporting a decline in the average lease rate.

CRE AND CREDIT RISK

Regulators are concerned that the increased concentration of CRE loans, combined with deteriorating CRE markets, might lead to heightened credit risk exposures. However, regulators also have noted that the underwriting standards generally are better than in the previous recession, during which the CRE loans took a

continued on page 8

Professional Practices Framework – What In the World…

by John B. Shaffer, Senior Vice President and General Auditor

Enron, WorldCom, K-Mart, governance, enterprise-wide risk assessments, external auditor independence, Arthur Andersen, 2002 Corruption Perception Index, ImClone, restated earnings, managed earnings, 2002 Bribe Payers Index, Tyco International…

An accident waiting to happen. Accidents that did happen! Why are we surprised? Just a few years ago the only term listed above that would have caught the attention of anyone was "managed earnings," followed by a yawn. After all, doesn't every company want to improve earnings quarter after quarter, year after year? Allow me to suggest that that was the warning sign that largely went unheeded. It was just "part of the game" until multiple events went awry.

The cause? It was not just greedy executives and stockholders. It was not just incompetent auditors and accountants. It wasn't just the sense of power among the "movers and shakers." It wasn't just apathy. It wasn't just the "governing bodies" (e.g., SEC, FASB, and others) that were two steps behind the industry. It wasn't any of it, but rather all of it, and then some.

Welcome to a practical and appropriate solution to at least begin to address the problem. Welcome to the internal auditors' world of the *Professional Practices Framework*. In June 1999, The Institute of Internal Auditors (The IIA) approved a new *Professional Practices Framework* (PPF). To quote The IIA, "a framework provides a structural blueprint of how a body of knowledge fits together… it facilitates consistent development, interpretation, and application of concepts, methodologies and techniques useful to a discipline or a profession."

The framework within which internal auditors are challenged to conduct such activities is comprised of four elements:

- Definition of Internal Auditing
- Standards and Ethics (better said, "Ethics and Standards")
- Practice Advisories
- Development and Practice Aids

The foundational piece of the PPF is the **definition of internal auditing**:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

The definition of internal auditing makes a fairly sweeping statement. Internal auditors want to help an organization accomplish its objectives by providing an independent look at virtually anything and everything. The organization's objectives should become Internal Audit's objectives.

Internal Audit: What We Do

- ✔ Assurance Services
- ✔ Consulting Activities
  via disciplined evaluation of
- ✔ Risk Management
- ✔ Control
- ✔ Governance Processes

The **Ethics and Standards** are mandatory, core directives. The first element—the Institute's *Code of Ethics*—is designed to promote an ethical culture. Such a code is necessary for several reasons. First, The IIA is a worldwide organization. Therefore, it is necessary to establish an ethical climate within which all are expected to practice the profession of internal auditing. Second, it is necessary to maintain credibility in all that we do. Third and finally, it is essential to provide behavioral norms upon which both the practitioner and the client can rely.

Internal Auditing…Code of Ethics

- ✔ Integrity
- ✔ Objectivity
- ✔ Confidentiality
- ✔ Competency

To most, such a code is common sense; to all, it is essential. More than any other governing document, adherence to the *Code of Ethics* will determine an individual's success or failure as an internal auditor and the success or failure of the internal audit organization. Although obvious, many have fallen—whether in business or politics—because of inappropriate ethical behavior.

The second element of the mandatory direction is the *Standards for the Professional Practice of Internal Auditing* (Internal Auditing Standards). Like the *Yellow Book*, which directs governmental auditors, and Generally Accepted Auditing Standards (GAAS), which govern the public accounting community, the Internal Auditing Standards are the generic "how to" of the Internal Auditing framework.

The Internal Auditing Standards are divided into Attribute Standards (AS), Performance Standards (PS), and Implementation Standards (IS). There is one set of Attribute Standards and Performance Standards governing all audit activities, and separate Implementation Standards for Assurance Services and Consulting Services. The Attribute, Performance, and Implementation Stan-

continued on page 7

Internal Auditing... *The Internal Auditing Standards*

Attribute Standards (AS)

Purpose, Authority, and Responsibility
- *(IS for Assurance vs. Consulting)*

Independence and Objectivity
- Organizational Independence
  - *(IS for Assurance)*
- Individual Objectivity
- Impairments to Independence or Objectivity
  - *(IS for Assurance vs. Consulting)*

Proficiency and Due Professional Care
- Proficiency
  - *(IS for Assurance vs. Consulting)*
- Due Professional Care
  - *(IS for Assurance vs. Consulting)*
- Continuing Professional Development

Quality Assurance and Improvement Program
- Quality Program Assessments
  - Internal Assessments
  - External Assessments
- Reporting on the Quality Program
- Use of "Conducted in Accordance with the Standards"
- Disclosure of Noncompliance

Performance Standards (PS)

Managing the Internal Audit Activity
- Planning
  - *(IS for Assurance vs. Consulting)*
- Communication and Approval
- Resource Management
- Policies and Procedures
- Coordination
- Reporting to the Board & Senior Management

Nature of Work
- Risk Management
  - *(IS for Assurance vs. Consulting)*

Performance Standards (cont'd)
- Control
  - *(IS for Assurance vs. Consulting)*
- Governance
  - *(IS for Assurance vs. Consulting)*

Engagement Planning
- Planning Considerations
  - *(IS for Consulting)*
- Engagement Objectives
  - *(IS for Assurance vs. Consulting)*
- Engagement Scope
  - *(IS for Assurance vs. Consulting)*
- Engagement Resource Allocation
- Engagement Work Program
  - *(IS for Assurance vs. Consulting)*

Performing the Engagement
- Identifying Information
- Analysis and Evaluation
- Recording Information
  - *(IS for Assurance vs. Consulting)*
- Engagement Supervision

Communicating Results
- Criteria for Communicating
  - *(IS for Assurance vs. Consulting)*
- Quality of Communications
  - Errors and Omissions
- Engagement Disclosure of Noncompliance with *The Standards*
- Disseminating Results
  - *(IS for Assurance vs. Consulting)*

Monitoring Progress
- *(IS for Assurance vs. Consulting)*

Management's Acceptance of Risk

"Strategy and Leadership" continued from page 1

change, we frequently lose sight of the things that have not changed.[1]

In our lives and organizations, we seek stability at the same time we demand change, growth, and innovation. This is the paradox that must be managed. All firms are managing change and transitions because the new game now begins before the old one ends. However, one lesson learned in the last decade is that you cannot manage change without managing continuity. Today's leaders are challenged to preserve the organizational culture that has made them successful while at the same time energizing it with new people who bring new ideas, fresh ways of thinking, creative friction, and best practices. This often means keeping the core company growing and addressing disruptive innovation, while simultaneously running the business.

How have businesses performed throughout the last decade? By some accounts, the metrics from the last decade show superior economic and corporate performance. We have seen the longest U.S. economic expansion in history, material productivity gains, strong employment, and significant advances in computational capability and information technology. By other measures, however, company performance has declined. We have experienced an Internet and telecom meltdown, the failure of firms previously celebrated, weak core industry profits, and an inability of firms to sustain pricing. These factors have created a cycle where companies pursue a single best way to compete, imitate each other, and pursue strategies based on cost cutting, mergers and acquisitions, accounting gimmicks, layoffs, and restructurings.

Strategy and leadership in a turbulent world needs to stay grounded with a central goal—the creation of economic value. Throughout the 1990s, shareholder value, not economic value, became the goal, and management ran companies to increase share price. While shareholder value is a desirable outcome, it should not guide a firm's strategy.

Strategy is the creation of a unique and valuable position involving various sets of activities.[2] As the banking industry emerges from a mild recession, now is a good time for organizations to rethink their core strategy, with a focus on sustained return over a business cycle.

A firm understanding of industry structure is critical to strategic planning. Leaders need to know what is driving profitability in the industry to best position their company for success among the competition. This requires a sound analysis of revenue and cost factors to ensure management knows how their business makes money. This sounds overly simplistic, but often due to environmental and industry change, the standards for business and value propositions constantly shift. Every time the competitive landscape in banking changes, the industry evolves.

It is also important to understand structure at the firm level. Internal structural responses to change are often complicated by the fact that rapid change increasingly requires integrated processes and flexible networks, particularly for knowledge workers in a distributed system. Leaders must acknowledge that structure, by its nature, divides, while people integrate. Consequently, firms must establish core processes that integrate people's efforts across structural boundaries. For banking organizations, this will be essential to implement enterprise-wide risk management practices. Management must be everywhere in a networked organization to ensure alignment.

When management is armed with a firm grasp of the fundamentals, their strategy should deliver a unique and sustainable value proposition. Sustaining a competitive position requires trade-offs. In today's competitive markets, it is generally not effective to be a jack of all trades and a

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[1] This concept was the first of ten half-truths of management discussed by Henry Mintzberg, Cleghorn Professor of Management, McGill University, Montreal, Quebec, Canada, at the EFI executive forum on *Strategy and Leadership in a Turbulent World.*

[2] This concept was discussed more fully by Michael Porter, Institute for Strategy and Competitiveness, Harvard Business School, at the EFI executive forum on *Strategy and Leadership in a Turbulent World.*

master of none. We have seen recent business models in banking that attempted to focus on the financial supermarket or on being a niche player. Choosing the right strategy is key. However, executing the chosen strategy is equally important. No strategy can be executed successfully unless it is simple, clear, and actionable. As a banking organization identifies the strategy that will result in the right value proposition, it will need to develop fast feedback loops to respond promptly to change.

In a stable market, a firm can differentiate itself by focusing on quality. However, today's market place is not stable enough to demand perfect products. Financial services companies will need to become agile, capturing the upside while avoiding the downside. Success today is less sustainable, and strategies die faster and are replicated faster. Consequently, banking organizations will need to be resilient and manage strategic transformation in a way that is not overly detrimental to the organization.

So, what does all of this say about leadership? Leaders have to set clear strategies and goals, and execute them effectively. Given the pace of change, practices may have to be based more on principles under which people are expected to act as opposed to specific procedures. Leaders must set compelling visions not only through logic, data, and cognitive means, but also through connecting with people on a human level. Leaders will need to display absolute integrity and foster trust and openness to create a new social fabric in organizations. They must train staff on values and principles as well as technical aspects of their jobs. There must be a recognition that accountability comes from how much a person cares about the work, and not just from compensation.

Leadership has always required persistence, tenacity, and the ability to select and motivate the right people. None of this is new. However, the performance of future leaders will likely be measured by a balanced scorecard, and not just by share price and short-term results. ■

"Professional Practices Framework" *continued from page 5*

dards are supported by a comprehensive glossary.

Thus far we have briefly discussed the definition of internal auditing, the *Code of Ethics*, and the Internal Auditing Standards. There remains two additional pieces of the PPF—Practice Advisories and Development and Practice Aids.

Adherence to the **Practice Advisories**, while not mandatory, is strongly recommended. These advisories add specificity to the somewhat generic Internal Audit Standards, are directly linked to specific Standards, and often help to interpret and apply the Standards. In addition, the Practice Advisories represent "best practices" as endorsed by The IIA. Some Practice Advisories are applicable to all internal audit environments while others are applicable to specific industries or geographic areas. All are subject to a formal review process before they are issued.

The fourth element of the PPF is **Development and Practice Aids**. Fundamentally, this category includes research studies, seminars, conferences, books, and other products that relate to internal auditing. All can help to implement the guidance offered in the *Code of Ethics*, Internal Audit Standards, and Practice Advisories.

Where to Find Help!

The volume of guidance available to assist internal auditors and their organizations might appear overwhelming. However, The IIA has organized its guidance in an easy-to-use format on its web site.[1] On The IIA web site, you can find pages that clearly describe each standard and provide links to clarifying Practice Advisories and Development and Practice Aids.

In this format, it becomes clear that the PPF offers a comprehensive approach to guide the profession and provides all internal auditing practitioners with the tools necessary to do their job efficiently and, more importantly, effectively! Perhaps if all professions in the business world had such a comprehensive framework and followed it rigorously, many of the accidents waiting to happen…wouldn't.

If an individual wants to be considered a professional, he or she must conduct themselves accordingly,

continued on page 14

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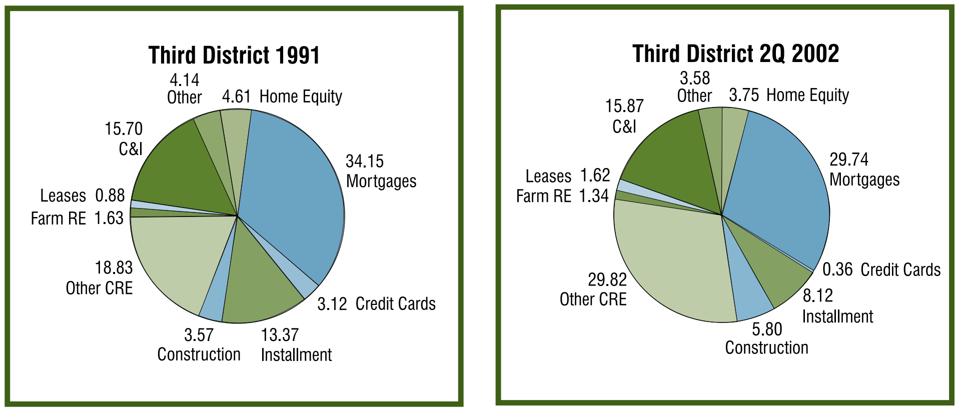
[1] See The IIA's web site at <www.theiia.org> and the *Professional Practices Framework* at <www.theiia.org/ecm/guidance.cfm?doc_id=124>.

“Commercial Real Estate” *continued from page 3*

Chart 2. Loan Mix - Third District



heavy blow. Nonetheless, many de novo institutions have unseasoned loan portfolios and staff who may not have experienced adverse economic conditions.

Concerns about credit risk at Third District banks are not as high as at banks elsewhere in the nation, because the declining CRE market conditions in the District do not appear to be as severe. Many Third District banks are requiring personal guarantees for CRE credit, and most bankers still feel more comfortable making CRE loans than C&I loans, which historically have had greater inherent loss exposures.

PORTFOLIO COMPOSITION

Charts 2 and 3 depict the loan mixes for the Third District and the nation in 1991, at the height of the last recession, and in the second quarter of 2002. Third District loan compositions exclude special purpose banks (i.e., credit card banks), subsidiary banks of out-of-district bank holding companies, and banks that merged out of the District since 1991, thus providing a truer picture of the changes in the loan composition.

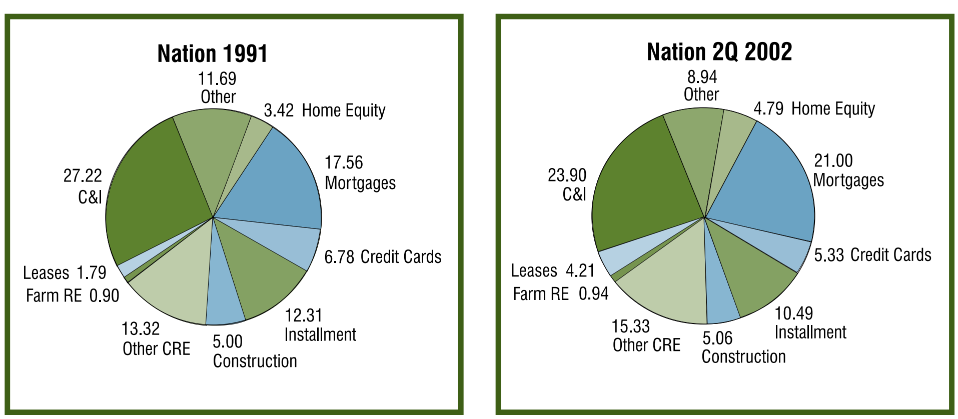
As shown in Chart 2, Third District mortgage loans represented 34.2 percent of the portfolio in 1991, but only 29.7 percent today. The major reason for the decline is that management now sells mortgage loans in the secondary market more quickly than in the past, especially during the recent refinancing booms. Installment loans have declined similarly, falling from 13.4 percent to 8.1 percent of total loans. In contrast, CRE, including construction loans, grew from 22.4 percent to 35.6 percent during this period, and the CRE portfolio now exceeds the residential mortgage loan portfolio.

For the nation, the shift in loan portfolio composition, as shown in Chart 3, is not as pronounced, since only a small change took place since 1991. CRE, including construction loans, grew modestly from 18.3 percent of total loans at the end of 1991 to 20.4 percent at the end of the second quarter 2002. Although the percentage of C&I loans declined from 27.2 percent to 23.9 percent during this period, they still comprise the largest loan component. Compared to the nation, the Third District appears to have a lower credit risk profile, with a larger portion of its loan portfolio secured.

DELINQUENCY TRENDS

Charts 4 through 7 show that the quality of CRE loans, as measured by delinquency and charge-offs, surpasses that of C&I loans and that the quality of both CRE and C&I loans in the District is generally better than nationwide averages. Noncurrent CRE and C&I loans reached record highs at the depth of the recession in 1991. However, the nation’s noncurrent CRE loan level of 8.0 percent

Chart 3. Loan Mix - Nation



was nearly double the C&I loan level of 4.4 percent. CRE loan quality has remained fairly sound since 1997.

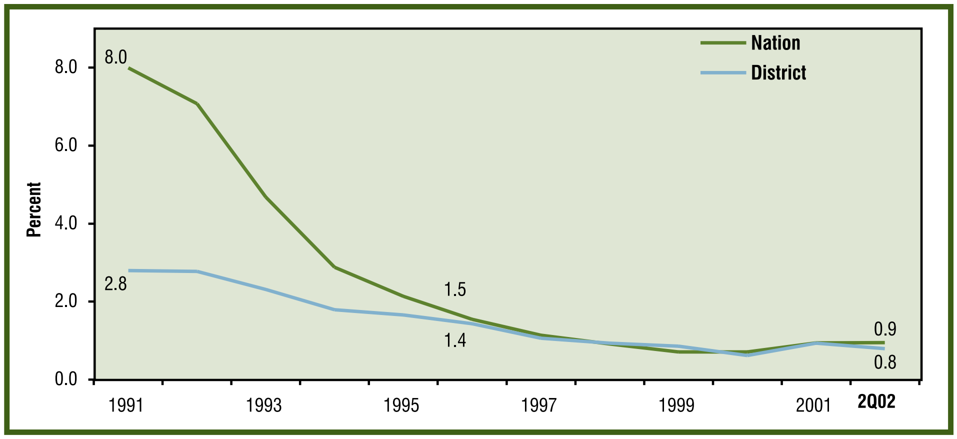
As shown in Chart 4, noncurrent CRE loans in the nation fell dramatically between 1991 and 1995 and continued to decline to a record low of .71 percent in 1999. In 1998, noncurrent CRE loans fell below 1.0 percent of the portfolio and, to date, have not surpassed this level.

For the Third District, the level of noncurrent CRE loans was not as high as the nation's in 1991, only reaching 2.8 percent. The Third District exhibited a gradual improvement in CRE credit quality and reached a record low of .62 percent in 2000. In the second quarter of 2002, the Third District's noncurrent CRE loan level of .79 percent remained below the nation's average of .95 percent.

As noted earlier, some regions within the nation are experiencing problems with CRE and many analysts are concerned with the potential deterioration in CRE credits. However, there are currently no signs of significant deterioration in either the Third District or the nation. Nevertheless, based on the slow economic recovery and the overall increase in vacancy rates, the potential for lower quality in CRE loans exists.

As would be expected, as shown in Chart 5, CRE net charge-offs in both the Third District and the nation followed the same downward trend as noncurrent CRE loans from 1992 to the late 1990s. The CRE charge-off rate has been relatively low since 1996, but has increased modestly in recent quarters.

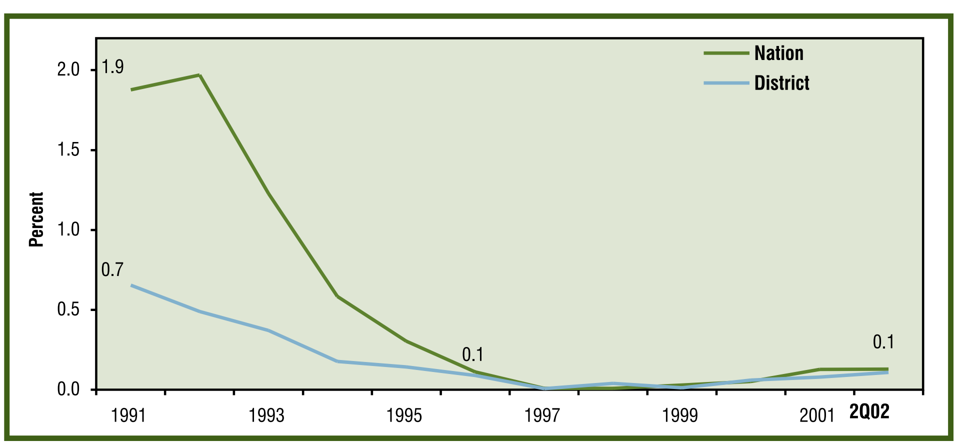
Chart 4. Noncurrent Commercial Real Estate Loans



Although noncurrent C&I loans for the nation reached 4.4 percent in 1991, the Third District was not far behind at 3.6 percent. As shown in Chart 6, the nation's noncurrent C&I loan level improved more rapidly than the District's after the 1991 recession, but it has been rising since 1997. In the last 2 ½ years, nationwide C&I loans have deteriorated considerably, and noncurrent C&I loans represented 2.9 percent of outstandings in the second quarter of 2002, above the 2.0 percent level last seen in 1993.

Growth in noncurrent C&I loans for the nation has slowed somewhat, rising by 26.7 percent for the first six months of 2002, compared to an increase of 35.2 percent in 2001. Most of the growth in noncurrent loans occurred in large banks' C&I loan portfolios. In the last two years, the U.S. financial system has suffered a sharp run-up in corporate bond defaults, business failures, and investor losses. The fallout in the telecom industry, one of the most debt-laden sectors, exacerbated the negative effect on the financial sector. In the past six months, defaults in the telecommunications industry in England, corporate defaults in Argentina, and some major bankruptcies in the U.S. continued to plague the largest U.S. financial institutions. Noncurrent C&I loans to non-U.S. addressees accounted for 84 percent of the increase in noncurrent C&I loans in the first half of this year.

Chart 5. Commercial Real Estate Loan Net Charge-offs



As shown in Chart 6, the Third District's C&I loan performance in recent years has been better than the nationwide average. Third District noncurrent C&I loans were high in the early 1990s and improvement lagged the nation's until 1998. However, since 1998 Third District C&I credit quality has stabilized, while the national average has deteriorated rapidly. Noncurrent C&I loans in the Third District have remained around 1.0 percent since 1998, and were .94 percent in the second quarter 2002.

As shown in Chart 7, C&I net charge-offs reached a high for the nation of 1.8 percent in 1991, falling rapidly for the next three years to reach lows of approximately .30 percent between 1994 and 1997. In 1998, C&I losses began to rise again, and annualized C&I losses reached 1.6 percent of outstandings in the second quarter of 2002, close to the record high set in 1991.

C&I losses for the Third District reached a record low of .17 percent in 1996. Although increasing since then, they have remained below .50 percent in the past two years, falling to .34 percent in the first six months of 2002.

Chart 6. Noncurrent Commercial & Industrial Loans

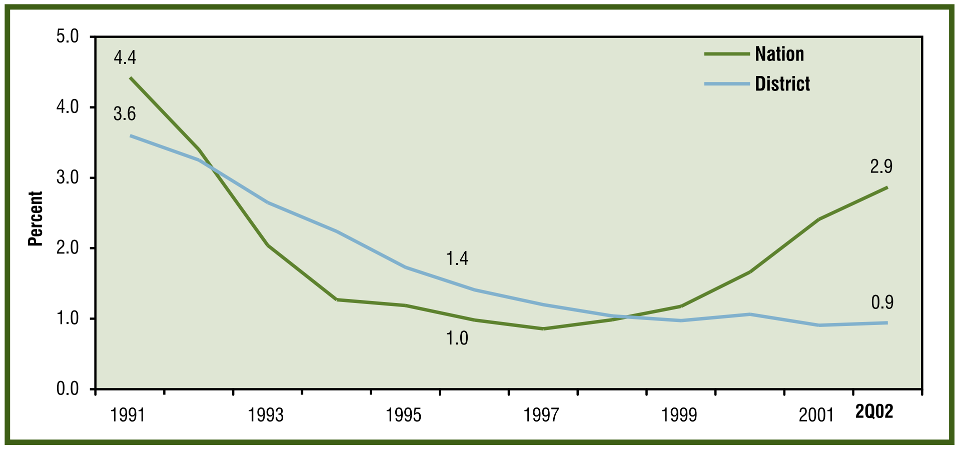
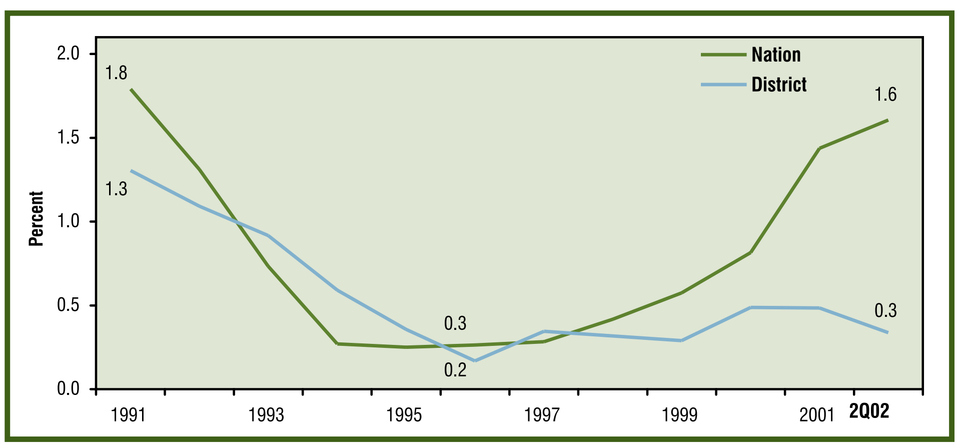


Chart 7. Commercial & Industrial Loan Net Charge-offs



FINAL THOUGHTS

The prospects for commercial real estate loans are mixed, with potential deterioration due to rising vacancy rates and the generally weakened economic condition in the nation. However, the credit risk level for the Third District is not as high as in other parts of the country. The Third District does have a higher concentration of CRE loans than the national average. However, with the exception of a few submarkets, the Philadelphia region does not have the level of office vacancy rates experienced in the West. Bankers in the Third District remain willing to extend CRE loans, due in part to the real estate collateral support in case of liquidation. Consequently, CRE loans continue to outperform C&I loans, the dominant loan category for the nation.

Nonetheless, deterioration in loan quality has started to surface, and examiners have noted some slippage in credit underwriting and appraisal reviews. Given the ever-present economic uncertainty, the influx of bank deposits from the capital markets, and intense competition, it is important for institutions to have proper underwriting standards and adequate risk management processes for CRE lending.

Some areas for close attention are the reasonableness and validity of appraisals and the financial condition of borrowers. In addition, underwriting processes should ensure appropriate monitoring of concentrations and set individual and portfolio limits on speculative construction lending. A future article in *SRC Insights* will review these and other best practices in CRE lending. ■

To Pay or Not to Pay: Section 60 Dividend Calculations

by Salome J. Tinker, CPA

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The views expressed in this article are the author's and do not necessarily represent official positions of the Board of Governors of the Federal Reserve System.

Dividend payments to shareholders play an important role in a society with a free market economy. Prospective shareholders will not invest in a corporation unless they expect to receive an adequate return on their investment. Dividend payments to shareholders typically send a positive statement to shareholders that the company is doing well. An institution that historically pays dividends may make a management decision to pay dividends over its retained net profits during down times, if deemed temporary in nature, as to not send mixed signals to its shareholders. However, as dividend payments reduce capital levels, the capital adequacy of banking organizations is a major concern of the Federal Reserve System and the other banking agencies, which strive to maintain the overall safety and soundness of the banking system.

In order to ensure that dividend payments are reasonable, limitations have been put in place to monitor and control the outflow of capital. Three methods are: the prompt corrective action (PCA) guidelines, which control capital levels from a balance sheet perspective;[1] the section 60 dividend payment limitation, which limits the outflow of capital from the income statement perspective; and the section 56 dividend payment limitation, which establishes restrictions on dividends based on bank's undivided profits.[2] These three methods work in tandem, each playing a key factor in monitoring banks' safety and soundness by ensuring that adequate capital levels are maintained. This article focuses on the computation of the section 60 dividend limitations.

From time to time Federal Reserve staff receives questions from examiners on a bank's calculation of its section 60 statutory dividend limitation. Usually the questions pertain to a bank's estimation of allowable dividends available, without Federal Reserve approval, when the dividends are expected to be greater than the net income for the current and/or previous year(s). For state member banks, Regulation H provides for a simplified computation of the section 60 limitation. Regulatory approval is

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[1] Section 208.4 of Regulation H prohibits the payment of dividends when a bank is deemed to be undercapitalized or when the payment of the dividend would make the bank undercapitalized in accordance with the PCA framework. An organization that is undercapitalized in accordance with the PCA framework must cease the payment of dividends for as long as it is deemed to be undercapitalized. PCA guidance is also provided in section 4070, "Dividends," of the *Commercial Bank Examination Manual* (CBEM).

[2] Bank's undivided profits are adjusted for any surplus transferred, with prior regulatory approval, back to undivided profits and the excess, if any, of statutory bad debts over the allowance for loan and lease losses. Dividends paid in excess of the section 56 limitation must receive prior Federal Reserve approval and approval of at least two-thirds of the shares of each class of stock outstanding, pursuant to 12 USC 59. The section 56 computation worksheet is also provided in section 4070.3 of the CBEM.

[3] Section 208.5(2)(c) of Regulation H states, "A member bank may not declare or pay a dividend if the total of all dividends declared during the calendar year, including the proposed dividend, exceeds the sum of the bank's net income (as reportable in the Reports of Condition and Income) during the current calendar year and the retained net income of the prior two calendar years, unless the dividend has been approved by the Board."

Section 208.5(3) of Regulation H states, "In the case of dividends in excess of net income for the year, a bank generally is not required to carry forward negative amounts resulting from such excess. Instead, the bank may attribute the excess to the prior two years, attributing the excess first to the earlier year and then to the immediately preceding year. If the excess is greater than the bank's previously undistributed net income for the preceding two years, prior Federal Reserve approval is required and a negative amount would be carried forward in future dividend computations."

required if the dividend would exceed the bank's retained net income for the current and prior two years or if the dividend would not be made from the bank's undivided profits.[3] This article clarifies the existing Federal Reserve regulations on the payment of dividends by state member banks and provides an additional tool for analyzing whether prior Federal Reserve approval is required.

The dividend computation worksheet is found in the *Commercial Bank Examination Manual* (CBEM), which was revised in 2002.[4] The revision was made in accordance with Regulation H current guidelines, and not based on any new guidance.[5] The purpose of the revision was to clarify the existing guidance and provide examiners with a revised worksheet for assessing whether an institution can pay dividends without prior Federal Reserve approval. The previous computation did not clearly provide for dividend adjustments that were carried back in previous years. As a result, new line items were inserted to clarify that prior year's net income and adjustments should be considered when calculating the current year's retained net profits available for dividend distribution.

The following example illustrates how to determine whether prior Federal Reserve approval is needed for a dividend distribution.[6] Assume XYZ institution has the following earnings and dividend activity for two years:

Year	Net Income	Dividends	Retained Net Profit
1999	11,800,000	7,800,000	4,000,000
2000	11,500,000	9,400,000	2,100,000

In 2001, XYZ net income dropped to $6 million. However, XYZ wanted to declare an $11 million dividend. Under section 60, $6 million of the $11 million dividend would be allowable based on the current year's net income. XYZ must then determine whether the excess $5 million can be paid (or carried back) based on the prior two years retained earnings. Since the guidance states that the institution should carry the excess first to the earlier year and then to the immediately preceding year, the institution carries back $4 million of excess to 1999, thereby depleting all of 1999's retained net profit. XYZ then carries back the remaining $1 million to 2000, leaving $1.1 million in retained earnings that the institution's management could still utilize for dividend payments in 2002. In this scenario, the institution would not need prior Federal Reserve approval to pay this dividend.

The following table summarizes how a bank would determine whether Federal Reserve approval would be needed for this dividend and the amount of retained earnings available from prior years for potential dividends in 2002:

Year	Net Income	Dividends	Retained Net Profit	2001 Carry-back	Adjusted Retained Net Profit
1999	11,800,000	7,800,000	4,000,000	(4,000,000)	-
2000	11,500,000	9,400,000	2,100,000	(1,000,000)	1,100,000
2001	6,000,000	11,000,000	(5,000,000)	5,000,000	-
Total	29,300,000	28,200,000	1,100,000	-	1,100,000

The 2001 section 60 worksheet computation appears on page 13.

Assume that in 2002, XYZ institution reports $3 million in earnings and wants to pay a $4 million dividend. Could the institution pay this dividend without prior Federal Reserve approval?

The following table summarizes how a bank would determine whether Federal Reserve approval would be needed for this dividend and the amount of retained earnings available for potential dividends in 2003 from prior years:

[4] The *Commercial Bank Examination Manual* is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/supmanual/default.htm#cbem>.

[5] In 1990, the Federal Reserve Board amended its regulations on the payment of dividends by state member banks. The objective was to simplify and clarify the computation of certain limitations on the payments of dividends included in 12 USC section 56 and 60. Section 208.5 of Regulation H was later revised in 1998, which provided further clarification on deficits that result from dividends declared in excess of net income. The change was incorporated based on an interpretation made in an OCC letter dated December 22, 1997, and published as Interpretative Letter # 816.

[6] The following dollar amounts in this example are used to illustrate various outcomes for the sake of this article. Occurrences experienced by a bank of this magnitude would be unusual and infrequent in nature.

Year	Net Income	Dividends	Retained Net Profit	2001 Carry-Back	2002 Adjusted Retained Net Profit	2002 Carry-Back	2002 Adjusted Retained Net Profit
2000	11,500,000	9,400,000	2,100,000	(1,000,000)	1,100,000	(1,000,000)	100,000
2001	6,000,000	11,000,000	(5,000,000)	5,000,000	-	-	-
2002	3,000,000	4,000,000	(1,000,000)	-		1,000,000	-
Total	20,500,000	24,400,000	(3,900,000)	4,000,000	1,100,000	0	100,000

At first glance, the answer may appear to be "yes, Federal Reserve approval is required" because XYZ institution paid dividends in excess of retained net profits in 2001. However according to the calculation, XYZ can still pay the $4 million in dividends without prior Federal Reserve approval. The sum of $4,100,00 current and prior year's earnings—$3 million from the current year plus $1.1 million from 2000 retained net profits—is still available for XYZ to distribute. In making the determination, XYZ's management and Federal Reserve examiners should be mindful of the previous two years' calculations and the order in which any adjustments were made. Remember the dividends in excess of retained net profits for 2002 should be first applied to the earlier year, which is 2000. The fact that 2001 had zero retained earnings does not enter the calculation because there were enough profits in 2000 to absorb the excess of dividends over current net income. In addition to the 2002 adjustment made, an additional adjustment was required for retained net profits in 2000.[7] Although XYZ still has a balance of $100,000 in 2000, it could no longer utilize this amount after

[7] If XYZ recorded a net loss of $100,000 in 2002, but wanted to pay dividends of $1,000,000, the $100,000 loss and the $1,000,000 dividend could be carried back to 2000, leaving an adjusted retained net profit balance of $0.

2001 Section 60 Worksheet Computation			
	2001	**2000**	**1999**
Net Income (loss)	$6,000000	$11,500,000	$11,800,000
Deduct:			
• Required transfers to Surplus under state law (generally zero) *or transfers to a fund for the retirement of preferred stock**	$ 0	$ 0	$ 0
• Common/preferred stock dividends declared	$11,000,000	$9,400,000	$7,800,000
Retained net profit available for dividends *before adjustments*	$(5,000,000)	$ 2,100,000	$ 4,000,000
Adjustments for dividends in excess of income (if any)	$5,000,000	$(1,000,000)	$(4,000,000
Retained net profits available after adjustments	$ 0	$ 1,100,000	$ 0
* Wording in *italics* represents the updated changes.			

2002 since the two-year carryback period would have passed. Consequently, Federal Reserve approval would be needed both in 2003 and 2004 if XYZ wanted to pay dividends in excess of net profits because adjusted net profits for 2001 and 2002 are $0.

The section 60 worksheet for 2002 would be calculated as follows:

To reiterate, the changes made to the CBEM did not occur because of any recently issued guidance by the Federal Reserve, but rather to clarify existing guidance. When regulatory approval is required for dividend payments under section 60, institutions should submit the request to the appropriate Reserve Bank for approval. Both examiners and bank management should remember that the section 60 dividend worksheet is a tool that helps examiners assess the safety and soundness of banking institutions and should be used in conjunction with the PCA guidelines and section 56 limitations. ■

2002 Section 60 Worksheet Computation			
	2002	**2001**	**2000**
Net Income (loss)	$ 3,000,000	$ 6,000,000	$11,500,000
Deduct:			
• Required transfers to Surplus under state law (generally zero) *or transfers to a fund for the retirement of preferred stock*	$ 0	$ 0	$ 0
• Common/preferred stock dividends declared	$ 4,000,000	$11,000,000	$ 9,400,000
Retained net profit available for dividends *before adjustments*	$(1,000,000)	$(5,000,000)	$ 2,100,000
Adjustments for dividends in excess of income (if any)	$ 1,000,000	$5,000,000	$(2,000,000)
Retained net profits available after adjustments	$ 0	$ 0	$ 100,000

"Professional Practices Framework" *continued from page 7*

whether as an internal auditor, external auditor, examiner, Treasurer, Chief Financial Officer, Chief Information Officer, Chief Executive Officer, or Board member. The Professional Practices Framework, if followed, will enhance the professionalism of the internal audit community in general and internal audit practitioners as individuals, allowing them to rise above the recent scandals and contribute to the restoration of the investing public's confidence in businesses nationwide. ■

Statement of Financial Accounting Standards No. 147: *Acquisitions of Certain Financial Institutions*

An article in the second quarter 2002 issue of the *SRC Insights*, "In With the New: Accounting for Goodwill and Other Intangible Assets under FAS 142," discussed the accounting for goodwill and other intangible assets under FAS 142. At that time, FASB had issued an Exposure Draft that addressed the continued applicability of FAS 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, which relates to the recognition of intangibles in business combinations involving stock holder-owned financial institutions.

After reviewing public comments and responses to the Exposure Draft and conducting further analysis, FASB concluded that FAS 141 provides sufficient guidance for most business combinations involving stock holder-owned financial institutions and that the specialized industry guidance in FAS 72 and Interpretation 9 would no longer be necessary. Hence, FASB issued FAS 147, *Acquisitions of Certain Financial Institutions*, to amend and supercede FAS 72, FAS 144, and FASB Interpretation No. 9.

Highlights

Except for acquisitions between two or more mutual enterprises that are financial institutions (i.e., mutual savings banks or mutual credit unions), FAS 147 removes acquisitions of financial institutions from the scope of both FAS 72 and Interpretation 9 and requires such acquisitions to be accounted for in accordance with FAS 141 and FAS 142. FAS 72 and Interpretation 9 remain in effect for acquisitions between two or more mutual enterprises until FASB issues additional guidance on the accounting for these transactions.

The excess of the fair value of liabilities over the fair value of tangible and identifiable intangible assets arising from covered acquisitions represents goodwill, which should be accounted for under FAS 142. Thus, the issuance of FAS 147 eliminates unidentifiable intangible assets that were recognized under FAS 72. Previously recognized unidentifiable intangible assets resulting from business combinations should be reclassified to goodwill and tested for impairment in accordance with FAS 142.

FAS 147 also amends FAS 144, *Accounting for the Impairment of Disposal of Long-Lived Assets*, to include long-term customer-relationship intangible assets of financial institutions. These long-lived assets, such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets, are subject to the same impairment test that FAS 144 requires for other long-lived assets that are held and used.

Effective Date

Provisions governing business acquisitions are effective for transactions completed on or after October 1, 2002. The requirements relating to the inclusion of long-term customer-relationship intangible assets in FAS 144 became effective on October 1, 2002. Finally, transition provisions for previously recognized unidentifiable intangible assets are effective on October 1, 2002, with earlier application permitted.

Questions on the application of FAS 147 for financial reporting purposes should be directed to the company's external auditor or other qualified individual. Institutions supervised by the Federal Reserve Bank of Philadelphia that have questions concerning the appropriate application of FAS 141, 142, or 147 for regulatory reporting purposes should contact Eddy Hsiao, Senior Examiner, (Eddy.Hsiao@phil.frb.org) at (215) 574-3772.

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