Third Quarter 2003

SRC Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

A newsletter published by the Supervision, Regulation & Credit Department for the institutions that it supervises.

Volume 8 Issue 1

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SVP Commentary on…

Balance Sheet Management

Accounting issues, corporate governance, and control of credit costs will remain focal points for financial services firms for the foreseeable future. However, the more immediate focus today is on balance sheet and interest rate risk management.

The current low interest rate environment has affected two primary components of bank balance sheets: mortgage loans on the asset side and money market deposit accounts (MMDAs) and savings accounts on the liability side. Conventional wisdom is that banks tend to benefit from low rates and suffer from high rates because they loan long and borrow short. That has been only partially true during this economic cycle. The low interest rate environment that banks operated under during the past few years initially helped widen spreads. More recently, however, average asset yields have fallen faster than average funding costs, placing pressure on interest margins. The self-imposed restraints in pricing MMDAs and savings deposits, coupled with the lower market rates on residential mortgages, have placed balance sheet management at the forefront of management's challenges.

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Is It Time to Reevaluate Mortgage Products in Your Portfolio?

by Avi Peled, Senior Financial Specialist

Mortgage products have been profitable sources of income for a large number of banks for many years. Banks have gained fees by originating mortgages and interest income by holding mortgages or debt instruments collateralized by mortgages. From 1994 to 2000, mortgage-related assets were about 20 to 21 percent of total commercial bank assets on a national aggregate basis, which is heavily weighted towards the larger banks. However, there were significant increases by year-end 2001, when mortgages were 22.57 percent of total assets, and by year-end 2002, when the percentage was 23.97 percent. Securities collateralized by mortgages as a percent of total assets were in the 7 to 8 percent range from 1994 through 2000. Once again, the last two years have seen significant increases; by year-end 2001, this ratio rose to 9.20 percent and at year-end 2002 to 9.67 percent.

Table 1 shows the growth rates of the components of mortgage loan portfolios from 1995 to 2002. In 2002, all categories, with the exception of junior liens, grew significantly.

Table 1. Growth Rates of Mortgage Loan Portfolios

Year	1st lien	Jr. lien	1 – 4 Family	Multi-Family	Home Equity
1995	10.76	13.49	11.06	11.92	4.68
1996	3.72	13.02	4.77	7.34	7.97
1997	7.85	8.88	7.98	7.98	14.26
1998	7.61	5.80	7.39	3.75	-1.49
1999	10.65	9.40	10.50	22.13	5.82
2000	4.63	23.15	6.86	13.83	24.49
2001	3.35	-3.21	2.44	5.93	20.58
2002	18.97	-15.40	14.47	11.52	37.21

Source: *Commercial Bank Call Reports*

Table 2. Mortgage-Backed Securities Portfolios

Year	Growth Rate		MBS as Percent of	
	Pass-Through	Other MBS	Security Portfolio	Total Assets
1995	5.07	-11.18	40.69	7.60
1996	11.71	-11.00	42.19	7.37
1997	12.51	12.69	44.10	7.62
1998	21.21	24.24	48.07	8.62
1999	-5.12	8.76	43.66	8.16
2000	0.98	-5.20	43.92	7.45
2001	27.51	31.87	53.40	9.20
2002	15.80	6.49	53.29	9.67

Source: *Commercial Bank Call Reports*

Looking at the growth of mortgage-backed securities (MBS) over this period, Table 2 illustrates a large jump in growth rates for MBS in 2001 and a smaller, but still significant, jump in 2002. Concentrations of MBS likewise increased significantly in 2001.

Table 3 shows substantial volatility between appreciation and depreciation of the mortgage-backed investment portion of banks' portfolios. At year-end 2001 and 2002, mortgage-backed securities provided a substantial and increasing part of the appreciation of the total investment portfolio. However, in 1994 and 1999, mortgage-backed securities provided about half the depreciation of the total investment portfolio. Since 1994, there has been a number of years when the MBS part of the investment portfolio provided a significant portion of the total appreciation or depreciation of the investment portfolio across all sizes of banks. In many instances, the percentage appreciation or depreciation of MBS was higher than the percentage of MBS in the investment portfolio. In 1996 and 2000, MBS depreciated while the investment portfolio appreciated, except for banks in the $1 billion to $50 billion asset size category. The con-

Table 3. Percent of Mortgage-Backed Securities Appreciation/Depreciation to Appreciation/Depreciation of the Entire Investment Portfolio, by Total Assets

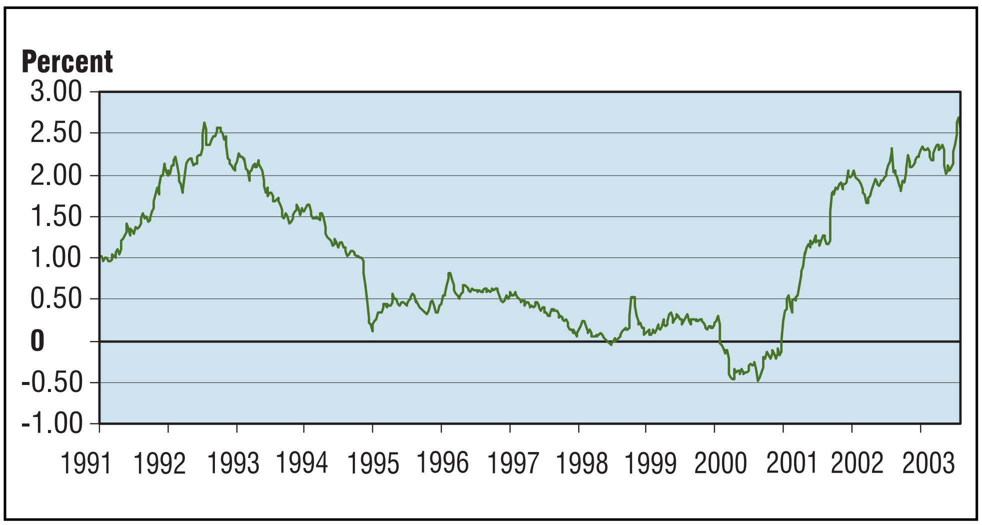
Year	All		Less Than $300 Million		$300 Million - $1 Billion		$1 Billion - $50 Billion		Over $50 Billion	
	% Appr.	% of Port.	% Appr.	% of Port.	% Appr.	% of Port.	% Appr.	% of Port.	% Appr.	% of Port.
1994	48.2 (-)	34.7	37.0 (-)	24.1	49.9 (-)	31.9	65.6 (-)	46.2	43.8 (-)	45.3
1995	20.6 (+)	33.8	4.3 (+)	23.6	10.1 (+)	30.4	24.4 (+)	45.0	81.3 (+)	42.2
1996	-28.9 (*)	35.9	-30.7 (*)	22.9	-15.2 (*)	30.8	8.1 (+)	48.3	-54.8 (*)	45.3
1997	32.8 (+)	40.9	11.2 (+)	22.0	20.2 (+)	31.5	43.2 (+)	47.1	44.9 (+)	53.7
1998	28.6 (+)	43.2	5.7 (+)	23.6	13.3 (+)	33.0	29.9 (+)	49.8	52.9 (+)	54.6
1999	51.4 (-)	39.2	24.1 (-)	21.7	38.0 (-)	31.5	53.5 (-)	49.2	65.7 (-)	45.8
2000	-54.4 (*)	40.4	-22.8 (*)	20.6	-11.8 (*)	29.6	18.4 (+)	47.1	-79.0 (*)	49.0
2001	18.7 (+)	50.4	16.4 (+)	28.3	25.0 (+)	38.8	42.3 (+)	52.0	7.2 (+)	59.4
2002	47.3 (+)	50.4	23.6 (+)	30.1	33.1 (+)	40.0	47.0 (+)	51.7	58.1 (+)	57.2

% Appr: Percent MBS Appreciation/Depreciation of Investment Portfolio Appreciation/ Depreciation
% of Port: Percent MBS amortized value of entire Investment Portfolio amortized value
(*) MBS depreciated, Total Security Portfolio appreciated
(+) Both MBS and Total Security Portfolio appreciated
(-) Both MBS and Total Security Portfolio depreciated

Source: *Commercial Bank Call Reports*

tinual increase in the proportion of MBS in the investment portfolio adds to the concern about the volatility in the change in value of these securities. To put the appreciation/depreciation percentages in context, Table 3 includes columns (labeled % of Port) that contain the percentages that MBS represent of the entire investment portfolio.

Chart 1. Difference between Ten- and Two-Year Treasuries
(Last Difference 2.57% as of 8/6/03)



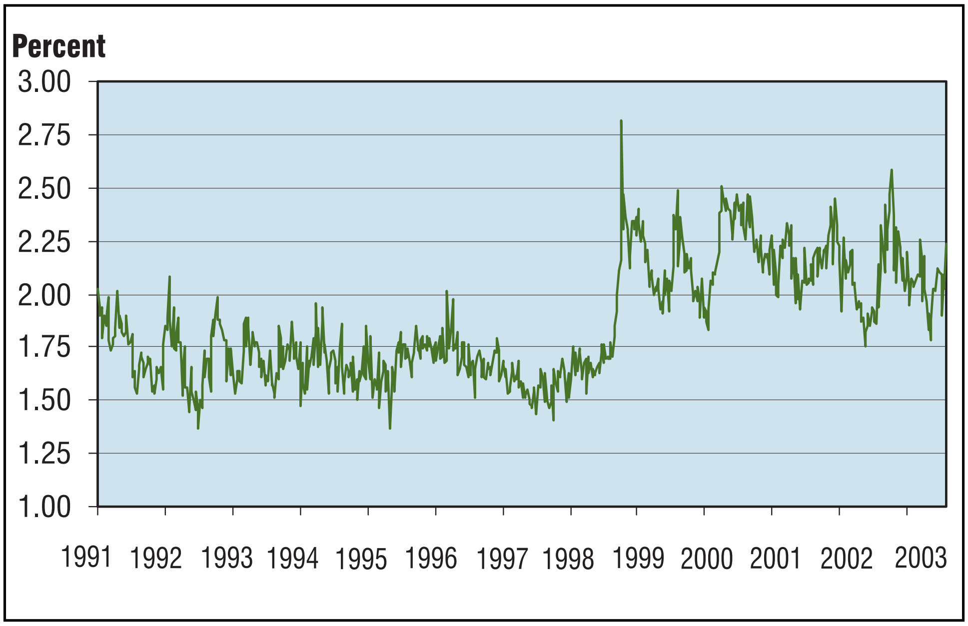
Source: *Federal Reserve Board, H.15 Release*

The Interest Rate Environment and the Shortening of Mortgage Product Durations

Interest rates are now at historic lows when compared to rates over the past 50 years. As the Fed has lowered the Fed Funds and Discount rates on the short end, the yield curve has acquired a very steep shape, as seen by the increasing spread between ten- and two-year treasury notes since 2000 in Chart 1.

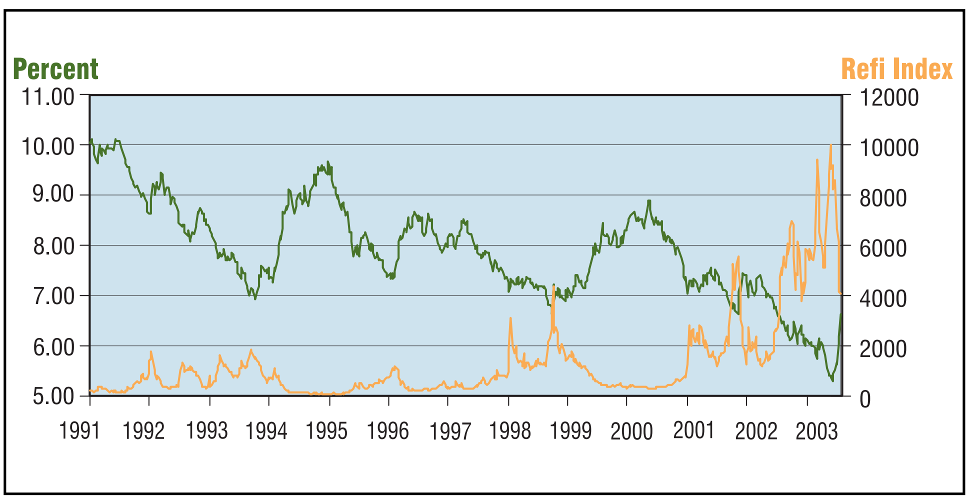
With the continuing falling interest rate environment, until recently the long end of the yield curve also declined. However, mortgage rates have held up better than Treasuries. Chart 2 shows a distinct change, starting in 1999, in the spread between 30-year Fannie Mae mortgage rates and 10-year Treasuries. As the probability of acceleration in the refinancing rate increased, the price of the prepayment option on mortgage products increased for banks, as did the risk.

Chart 2. Difference between 30-Year FNMA Mortgage and 10-Year Treasury
(Last Difference 2.24% as of 7/30/03)



Sources: *Treasury rates from Federal Reserve Board, H.15 Release*
Mortgage rates from Mortgage Bankers Association of America

Chart 3. MBA Refinancing Index
FRM 30-Year Effective Interest Rate
(Last MBA Refi Index 4047.5 and FRM 30-Year Rate 6.64% as of 7/30/03)



Sources: *Mortgage Bankers Association of America*

Chart 3 shows that starting around mid-year 2001, the lowering of longer term rates (in green) meant an extraordinary jump in refinancing volume (in orange) that caused the average duration of mortgage products to plummet and the coupon on new mortgages to decline.

Chasing Yield?

Table 4 illustrates the decline in core deposits as a percentage of assets over the last eleven years, although rapid growth in 2001 and 2002 reversed the steady decline. In 2001, core deposits grew almost twice as fast as assets, but some of this growth was due to commercial banks' acquiring other types of depository institutions' deposits. MMDA and other savings accounts in 2001 and 2002 grew faster than core deposits overall. As a percent of total deposits, MMDA and other savings accounts jumped in the past two years, while time deposits, particularly those under $100,000, declined.

Deposits have flowed to banks as a safe haven from the declining stock market and unease over the poorly performing economy. However, the fact that MMDA and other savings accounts, as a percent of total deposits, grew so substantially over the past two years compared to time deposits may suggest that these new nontransactional elements of core deposits are mostly "parked funds," rather than long term funding. The economic situation has made it harder for banks to find good commercial and industrial lending opportunities. Therefore, many banks have deployed the additional funds in investment securities, particularly mortgage-backed securities, or mortgage loans. However, as interest rates continued to decline and refinancings accelerated, most investors in mortgages or mortgage-backed securities had to reinvest in lower coupon mortgages or securities.

The exceptionally low short-term rates have presented many banks with a pricing challenge on interest-bearing deposit accounts. Many banks are reluctant to lower interest rates on interest-bearing accounts any closer to zero. This reluctance, coupled with refinancings of loans and reinvestment of securities at lower rates, has caused net interest margins to decline at the same time that many banks have experienced credit

Table 4. Growth in and Extent of Core Deposits

Year	Growth				Percent of Assets		Percent of Deposits		
	Core Deposits	MMDA	Other Savings	Total Assets	Core Deposits	MMDA & Sav.	MMDA & Sav.	TD < $100M	TD > $100M
1992	—	—	—	—	62.33	21.33	31.02	25.92	9.34
1993	1.45	0.26	8.72	5.54	59.92	20.93	32.02	24.22	8.33
1994	-0.14	-6.19	-1.94	8.15	55.33	18.49	30.39	25.45	9.05
1995	3.83	11.14	-2.64	7.48	53.45	18.12	30.42	26.99	10.29
1996	4.26	17.75	7.80	6.04	52.54	19.46	32.71	26.12	11.71
1997	4.14	16.13	6.49	8.93	50.23	20.12	34.74	25.54	13.24
1998	6.94	21.98	10.93	8.17	49.66	21.97	38.29	23.89	13.46
1999	0.07	4.79	10.06	5.16	47.26	22.26	40.06	23.24	14.94
2000	6.21	14.37	0.42	8.04	46.46	22.59	40.61	23.06	16.48
2001	9.69	21.98	14.44	4.62	48.71	25.84	45.22	19.82	14.76
2002	7.32	18.80	17.41	6.87	48.91	28.62	50.04	17.53	14.48

Source: *Commercial Bank Call Reports*

quality problems in their loan portfolios. The temptation is to recoup the margin shortfall by buying longer duration assets, assets of lower credit quality, and assets with riskier options. Some investors have combined some of these strategies by purchasing lower quality mortgages or mortgage-backed securities that tend to have longer durations (lower prepayment speeds) than conventional mortgages.

What is Next?

The business press and financial analysts generally appear to be forecasting a period of stable interest rates at their current low levels, followed by a gradual rise in rates as the economy achieves a sustained recovery.

What if the forecasts are wrong? Could the U.S. have a rapid recovery, a surge in economic demand and production, signs of inflation, and rapidly rising interest rates instead? Could all those investors with expectations of slow interest rate rises rush for the exit at once? Would they suffer significant losses? Table 5 on page 6 shows periods of increasing rates in the 10-Year Constant Maturity Treasury and the FHLMC Contract Rate on Commitments for Conventional 30-Year Mortgages. Interest rates, including rates on mortgages, have risen rapidly in the past and there is no reason to suppose they could not do so again in the future. Chart 4 on page 6 shows that some of the rapid interest rate increases were preceded by flat or gradual declining trends.

Mortgage and mortgage-backed securities that now have relatively short durations will see duration extension, probably significant.

It is fairly certain that interest rates will rise sooner or later as the economy revives. At that time, it is also likely that refinancings will slow significantly. Mortgages and mortgage-backed securities that now have relatively short durations will see duration extension, probably significant. What will be the value of these low coupon debt instruments in higher rate environments? As the stock market resumes trend growth, what will happen to all those deposits that banks have received over the past few years? How much of those new core deposits are actually core deposits that will remain in banks? Deciding on the 'duration' of non-maturity deposits for ALM models is difficult enough in normal times. In the current low interest rate environment with so many new "core deposits," the decision becomes even more difficult and even more important. Counting on low-cost core deposits to fund low-coupon mortgage products in a rising-interest rate, recovering economy may involve considerable risks.

Conclusion

ALM committees, CFOs, treasurers,

Table 5. Periods of Increasing Rates for 10-Year CMT and 30-Year Conventional Mortgages

Type	Start	Low	End	High	Total Basis Pt Increase	Months in Cycle	Annualized Basis Pt Increase
Treasury	12/1976	6.87	03/1980	12.75	588	39	181
Mortgage	02/1977	8.67	04/1980	16.33	766	38	242
Treasury	06/1980	9.78	09/1981	15.32	554	15	443
Mortgage	07/1980	12.19	10/1981	18.45	626	15	501
Treasury	05/1983	10.38	06/1984	13.56	318	13	294
Mortgage	05/1983	12.63	07/1984	14.67	204	14	175
Treasury	03/1987	7.25	10/1987	9.52	227	7	389
Mortgage	03/1987	9.04	10/1987	11.26	222	7	381
Treasury	10/1993	5.33	11/1994	7.96	263	13	243
Mortgage	10/1993	6.83	12/1994	9.20	237	14	203
Treasury	10/1998	4.53	01/2000	6.66	213	15	170
Mortgage	10/1998	6.74	05/2000	8.52	178	19	112

Source: *Federal Reserve Board, H.15 Release*

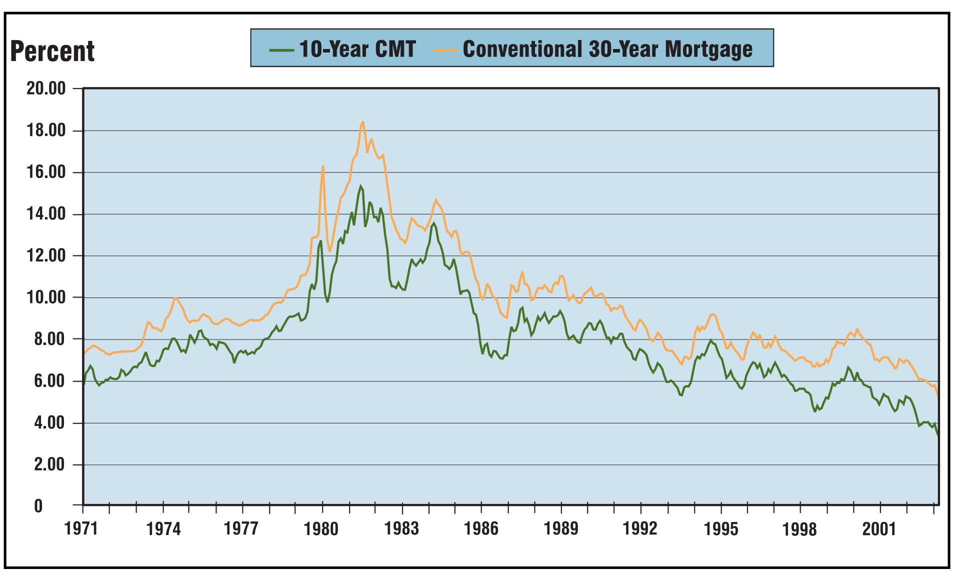
investment officers, CEOs, presidents, and Boards of Directors always should be reevaluating their institutions' ALM profiles and the interest rate risks inherent in their balance sheets. However, this may be a particularly good time to consider how portfolios would perform as interest rates rise, using different scenarios to capture the speed at which rates rise. Bank management should be able to answer questions such as the following:

- Are the risks caused by duration extension in mortgages and mortgage-backed securities adequately quantified?
- Are there plans and strategies for different interest rate scenarios?
- Are exit plans for riskier strategies in place and viable in a rapidly changing market?

In times of heightened uncertainty, long-term profitability and earnings stability may be found in the relative safety of a more duration-neutral balance sheet, with strong credit quality and less embedded options risk. Pursuing yield strategies is likely to be riskier. Some banks that have already taken this more conservative approach probably have lost some profits as interest rates continued to decline. However, their long term profitability may be higher by taking action when they did instead of trying to time the market.

This article should not be construed as advocating a specific course of action concerning ALM, investment, and lending strategies. The only certainty is the lack of certainty about the timing of future interest rate movements. Understanding the risks embedded in investment and loan portfolios and funding will provide bankers the best insurance against surprises.

Chart 4. 10-year CMT and 30-Year Conventional Mortgage Rates



Source: *Federal Reserve Board, H.15 Release*

Regulation W: Its Application to Internal Corporate Reorganization Transactions

by William L. Gaunt, Assistant Vice President

The Board of Governor's new Regulation W, *Transactions Between Member Banks and Their Affiliates* (codified at 12 CFR Part 223), became effective on April 1, 2003.[1] Regulation W implements sections 23A and 23B of the *Federal Reserve Act* and provides a comprehensive reference tool for complying with the statute. Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net (i.e., lower cost insured deposits, the payments system, and the discount window).

This article focuses on a narrow part of Regulation W, but one that often raises questions: the application of Regulation W to holding company internal corporate reorganization transactions.

Background Information

Sections 23A and B and Regulation W achieve their purposes by imposing quantitative and qualitative limits on the ability of a bank to make loans to, or enter into certain other transactions with, an affiliate. Generally, section 23A prohibits a bank from engaging in so-called "covered transactions" with an affiliate unless the bank limits the aggregate amount of such transactions to that particular affiliate to 10 percent of the bank's capital stock and surplus and collateralizes the transactions. Also, section 23A restricts the aggregate amount of all covered transactions between a bank and its affiliates to 20 percent of the bank's capital stock and surplus. Section 23B requires that transactions between a bank and its affiliates be conducted on "arms length" or market terms.

Internal Corporate Reorganizations

From time to time, bank holding companies move various operations from beneath the bank to the bank holding company or from the bank holding company to beneath the bank. Typical transactions involve the transfer within the holding company structure of trust and related investment advisory and administrative activities or mortgage banking operations, generally for strategic or funding reasons. Regulation W establishes some new limits for these transactions and provides several new exemptions for some of the most common transactions structured as internal corporate reorganizations.

Types of Merger and Acquisition Transactions between Banks and their Affiliates

Regulation W includes within the definition of a covered transaction a member bank's purchase of assets from an affiliate and a member bank's purchase of, or investment in, securities issued by an affiliate (see 12 CFR 223.22 and 223.31). In the past, the Board applied these provisions to transactions where a member bank either directly or indirectly acquired an affiliate. The Supplementary Information (SI) issued for Regulation W on November 27, 2002 provides useful guidance on merger and acquisition transactions between a member bank and an affiliate.[2]

The SI to Regulation W notes at Subpart D that, generally, a bank uses one of three methods to acquire an affiliate. The first is a **purchase of assets and assumption of liabilities** by the bank. The Board treats such a transaction as a purchase of assets under section 23A, and the covered transaction amount is equal to the amount of the separate consideration paid by the member bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.

In the second method, the **bank acquires an affiliate by merger.** Mergers between state chartered banks and their affiliates are infrequent because

[1] A link to the full text of Regulation W is available on the Board of Governors' web site at <www.federalreserve.gov/regulations/regref.htm#w>. The press release and the final rule are also available on the Board's web site at <www.federalreserve.gov/boarddocs/press/bcreg/2002/20021127/default.htm>.

[2] The Supplementary Information was provided in the final rule and is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/press/bcreg/2002/20021127/default.htm>.

many state banking codes only permit bank-to-bank mergers. National banks received authority to merge with nonbank affiliates in 2000 and are beginning to exercise that authority.[3] This type of transaction has, in the past, also been treated as a purchase of assets since the transaction is effectively the equivalent of the purchase of assets and assumption of liabilities transaction described above. Again, the covered transaction amount is equal to the amount of the separate consideration paid by the bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.

In effect, Regulation W requires member banks to treat share donations and purchases in the same fashion as if the bank had purchased the assets of the transferred company.

The third method involves the **contribution or sale of a controlling block of the shares of an affiliate to a subsidiary bank**, thereby making the contributed company a subsidiary of the bank and no longer an affiliate of the bank for section 23A purposes. Prior to Regulation W, the Board had treated these types of stock sales or contributions as purchases of assets covered by section 23A if the member bank paid consideration for the shares or if the affiliate whose shares were contributed to the member bank had liabilities to any affiliate of the bank. The SI to Regulation W notes that the Board had adopted this approach because these types of internal reorganizations were frequently driven by a desire to solve funding problems at the transferred affiliate through the bank's resources. Following many such reorganizations, the transferred affiliate's liabilities to the holding company were paid down by bank funds.

Regulation W does not change the treatment of either method one (purchase of assets/assumption of liabilities) or method two (statutory merger) but does introduce different treatment for the third type of transaction. Under Regulation W, the acquisition by a bank of securities issued by an affiliate company is treated as a purchase of assets from an affiliate if *all* of the following criteria are met (see 12 CFR 223.31(a)).

- The securities were issued by a company that was an affiliate before its acquisition by the bank.
- As a result of the transaction, the company becomes an operating subsidiary of the bank.
- The company has liabilities (not just liabilities to an affiliate), or the bank gives cash or any other consideration in exchange for the security.

The regulation further provides that these transactions must be valued for purposes of the covered transaction quantitative limits initially at the greater of the following two formulae (see 12 CFR 223.31(b)).

- The sum of the total amount of consideration given by the member bank in exchange for the security and the total liabilities of the company whose security has been acquired by the member bank, as of the time of the acquisition.
- The total value of all covered transactions (as computed under the regulation) acquired by the member bank as a result of the security acquisition.

Regulation W now places in the valuation calculation "total liabilities," including liabilities to third parties, not just liabilities to affiliates.

In effect, Regulation W requires member banks to treat share donations and purchases in the same fashion as if the bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company plus any separate consideration paid by the bank for the shares.

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[3] See the *American Homeownership and Economic Opportunity Act of 2000*, 114 Stat 2944, Pub L. 106-569 (2000) (codified at 12 U.S.C. Section 215a-2) at <thomas.loc.gov/cgi-bin/query/z?c106:.H.R.5640.enr:>.

"Internal Corporate Reorganization Transactions"

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The ongoing valuation for this type of transaction may be reduced after the initial transfer to reflect certain post restructuring events:[4]

- Amortization or depreciation of the assets of the transferred company, to the extent that such reductions are consistent with GAAP.
- Sales of the assets of the transferred company.

If the newly acquired subsidiary engages in lending activities and the loans are transferred as part of the transaction, the quantitative amount of the covered transaction is reduced as the loans are repaid (see 12 CFR 223.22 (c) (1)). The rule only imposes asset purchase treatment on affiliate share transfers where the company whose shares are being transferred to the bank was an affiliate before the transfer.

The regulation generally exempts qualifying "step transactions" that involve purchases by bank holding companies of companies from third parties when the purchased entity in turn becomes an affiliate and is then, within one business day (or such longer period, up to three months, as may be permitted by the bank's appropriate Federal banking regulator), downstreamed to become a subsidiary of the bank. These transactions are subject to several other restrictions including the safety and soundness requirement and the market terms requirement of section 23B (see 12 CFR 223.31(d) and (e)).

commit to the Board to fully compensate the bank, for a period of two years, for any transferred assets that become low quality assets.

Internal corporate reorganization transactions, while being covered transactions under section 23A, may be exempted by Regulation W from the quantitative 10 percent per affiliate and 20 percent aggregate limits and collateral requirements of section 23A.

Reg W Exemption for Qualifying Internal Reorganizations

Internal corporate reorganization transactions, while being covered transactions under section 23A, may be exempted by Regulation W from the quantitative 10 percent per affiliate and 20 percent aggregate limits and collateral requirements of section 23A. 12 CFR 223.41(d) provides for such an exemption if all five of the following conditions are met.

- The asset purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate.
- The Board of Governors must be provided with contemporaneous notice of the transaction and the bank holding company must
- The bank's board of directors must review and approve the transaction before its consummation.
- The section 23A value of the covered transaction (see discussion of valuation above) must be less than 10 percent of the bank's capital stock and surplus (or up to 25 percent of the bank's capital and surplus with the prior approval of the bank's appropriate Federal banking regulator).
- The bank's holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

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[4] See 12 CFR 223.31(c) for an illustrative example of ongoing valuation.

"Balance Sheet Management"

continued from page 1

Bank supervisors have long stressed the point that funds management represents the core of sound financial planning in banks. A bank's funds management practices, or its processes for managing balance sheet and off-balance sheet investments, will affect both earnings and liquidity, and ultimately capital. The goal of effective funds management is to maximize and maintain the spread between interest earned and paid, while maintaining credit quality, ensuring the bank's ability to pay off liabilities as they mature, and funding asset growth.

A key management challenge is to understand the long-term consequences of today's decisions. On the asset side, there will be pressure to book securities gains to bolster short-term profits as margins continue to compress. However, banks must be careful not to sacrifice higher yielding assets for short-term gains, and effective management of the investment portfolio is critical. As rates rise, consumer spending and borrowing behavior will likely change. In particular, the repricing of the popular variable rate home equity lines of credit will reduce disposable income in a rising rate environment, potentially affecting housing prices and asset quality. On the liability side, weak equity markets in recent years left banking customers with few alternatives for positive returns, fueling MMDA and savings growth at banks. However, depositor behavior will likely change as rates rise, and liquidity and interest rate pressures will increase when depositors shift to other investment vehicles.

As a hedge against margin compression, banking organizations are following several plans of action. First, since net interest income is influenced by the spreads between earning assets and funding sources and by the composition of the balance sheet, some banks are seeking to maintain a respectable net interest margin with prudent loan growth. The article "Is It Time to Reevaluate Mortgage Products in Your Portfolio?" in this issue of *SRC Insights* discusses some of the challenges in this area. Second, some banks are focusing on increasing fee income by introducing new products and/or repricing existing products and services. Finally, some banks are continuing or even starting strong expense management programs.

The appropriate option(s) for a given institution is a management decision, which must include consideration of both short-term and long-term implications. However, I believe that, in the long run, the best hedge against the possibility of prolonged low interest rates or a volatile rate environment is a strong, diversified banking franchise.

Giving 'em "The Right Stuff" to Fight Fraud: An Interview with Michael Collins

Earlier this year, Charles Taylor and Beverly Foster interviewed SRC's Senior Vice President, Michael Collins, on how the Federal Reserve prepares its examination staff to identify fraud. This article appeared as part of a five article group "Focus on Fraud" in the July/August 2003 edition of *The RMA Journal*. Contact RMA at <www.rmahq.org> or at 215-446-4000 for additional information.

Philadelphia Fed Releases 50-State Indexes

The Federal Reserve Bank of Philadelphia is now issuing monthly economic indexes for all 50 states. The Bank's Research Department developed the indexes, which will make it easier to track trends in state economies and analyze state business cycles.

"The indexes will facilitate the study of the impact of national economic forces on individual states. They can also be used to estimate the effect of a state's overall economic activity on the fiscal condition of state and local governments, the level of migration in and out of the state, and other important economic and social issues," said Ted Crone, vice president and economist in the Bank's Research Department.

The indexes are composites of economic data, including nonfarm employment, unemployment rate, average hours worked in manufacturing, and real wages and salaries. They are based on data from 1979 to 2003.

The Bank releases the 50-State Indexes along with the existing series of economic activity indexes for Delaware, New Jersey, and Pennsylvania. However, in addition to the economic activity indexes for the Third District's tri-state area, the Bank's Research Department publishes leading economic indexes for the three states. The leading economic indexes use the economic activity index for each state, as well as various state, regional, and national variables, including initial unemployment claims, housing permits, vendor delivery time from the Bank's *Business Outlook Survey*, and the yield on 10-year Treasury bonds minus the fed funds rate.

The 50-State Indexes are available on the Bank's web site at <www.phil.frb.org/econ/stateindexes>, the economic activity indexes for the tri-state area are available at <www.phil.frb.org/econ/eai/index.html>, and the leading economic indexes for the tri-state area are available at <www.phil.frb.org/econ/lead/index.html>. Documentation on the development of the indexes is available in the working paper 02-7/R *Consistent Economic Indexes for the 50 States* at <www.phil.frb.org/files/wps/2002/wp02-7r.pdf>.

"Internal Corporate Reorganization Transactions"

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Other Types of Affiliate Transfers

There are other types of affiliate transfers in internal corporate reorganizations that require analysis under Regulation W. Among these are the transfer of a subsidiary of a bank to the holding company and transfers of operations between banks.

A transfer of a subsidiary from a bank to the bank's holding company is not a covered transaction under section 23A but is subject to section 23B's market terms requirement. Also, the purchase of loans between affiliated banks, while a covered transaction, is exempt from both the quantitative and collateral requirements of Regulation W (see 12 CFR 223.41(b) and (c)). The transfer or purchase by a bank of part of an affiliate is treated as the purchase of, or an investment in, shares issued by an affiliate (see 12 CFR 223.23). Finally, the purchase of an affiliate that becomes a financial subsidiary of a bank is governed by special valuation rules because, in part, the financial subsidiary is treated as an affiliate of the bank.

Conclusion

Regulation W's exemption for qualifying reorganizations will provide a welcome safe harbor for many of the most common internal reorganization transactions. However, the regulation requires precise analysis when considering holding company internal corporate reorganization transactions.

Depository institutions should direct any questions on the application of sections 23A and 23B and Regulation W to their primary federal banking regulator. Institutions supervised by the Federal Reserve Bank of Philadelphia should direct questions to the examiner-in-charge of an on-going supervisory event, the institution's central point of contact at the Reserve Bank, or an officer or manager in Community, Regional, and Global Supervision or Regulatory Applications. ■

New to Banking? Fingerprints May Be Required

by James D. DePowell, Manager

The *Bank Holding Company Act* and *Change in Bank Control Act* limit the ability of individuals and entities to exert a controlling influence over an insured depository institution without first obtaining approval from the appropriate federal regulator. Approval typically occurs in the context of an application to form, merge, or acquire a bank or bank holding company, or a filing under the *Change in Bank Control Act*. Inherent to the approval process are name checks on individuals who have a significant influence on the policymaking activities of the bank or bank holding company, either by virtue of their management position or through the ability to vote a significant percentage of any class of voting shares.

These name checks include a request for information on the individual from other regulatory and investigative agencies. As announced in SR Letter 03-10, *Enhancement to the Name Check Process Related to Applications Reviewed by the Federal Reserve*, these name checks include an FBI criminal history check.[1] This check assists the Federal Reserve System (the System) in ensuring that proposed shareholders and policymakers have the experience, competence, and integrity to lead a banking organization in a safe and sound manner. In order for the FBI to perform the criminal history check, the System needs to obtain the individual's fingerprints.

The applicability of name checks will vary depending on the type of proposal and other factors unique to each filing.

Accordingly, we are offering the following guidance to Third District institutions and individuals. This guidance should allow you to anticipate a request for fingerprints and initiate them in a manner that will not delay your filing.

Who Must Provide Fingerprints?
The applicability of name checks will vary depending on the type of proposal and other factors unique to each filing. As a result, you should contact Regulatory Applications staff at this Reserve Bank for further clarification on the availability of an exemption.

How are Fingerprints Provided?
A key element in determining the necessity of a background check is the *Interagency Biographical and Financial Report*, Form FR 2081(c). To avoid delays, applicants are encouraged to submit Form 2081(c) prior to the submission of the application. If fingerprints are required, applicants are encouraged to submit them early and may follow either of the following procedures:

- The Federal Reserve Bank of Philadelphia will provide individuals with a fingerprint card, postage paid pre-addressed envelope, and letter of instructions. Individuals should take the card to their local police station or other law enforcement agency, where law enforcement personnel will complete the card and take their fingerprints. The law enforcement agency will mail the completed card in the pre-addressed envelope.
- Individuals may visit the Reserve Bank to have their fingerprints taken via a Live-Scan Terminal and transmitted electronically.

How Do I…

…Get Additional Information?
Additional information on the fingerprinting procedures is available on the following web sites:

- SRC's Regulatory Applications web site at <www.phil.frb.org/src/applications/index.html>

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[1] SR 03-10, *Enhancement to the Name Check Process Related to Applications Reviewed by the Federal Reserve*, is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/SRLETTERS/2003/sr0310.htm>.

FAS 150 and Trust Preferred Securities: The Implications for Regulatory Capital

by Judith M. Lynn, Senior Analyst

The Financial Accounting Standards Board (FASB) issued Statement No. 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* in May 2003.[1] This Statement requires that issuers of specified types of financial instruments with characteristics of *both* liabilities and equity classify these instruments as liabilities (or, in some cases, as assets). Previously, these instruments may have been classified as equity. This statement applies to three types of financial instruments.

- Instruments issued in the form of shares that are mandatorily redeemable
- Instruments requiring the repurchase of the issuer's equity shares by transferring assets
- Instruments that require the issue of a variable number of shares

For public companies, FAS 150 is effective for the first interim period beginning after June 15, 2003. For nonpublic companies, the effective date is December 15, 2003.

Trust preferred securities (TPS) are one of the financial instruments affected by the new reporting requirements. Since 1996, TPS have been a particularly attractive form of funding for bank holding companies because, subject to certain terms and conditions, TPS are considered Tier 1 capital for regulatory purposes and debt for tax purposes. As a result, many institutions in the Third District and across the nation have issued trust preferred securities.

The Implications for Regulatory Capital

So, how does FAS 150 impact bank holding company reporting and capital treatment? As announced on July 2, 2003 in SR Letter 03-13, *Instructions for Reporting Trust Preferred Securities on Schedule HC-R of the FR Y-9C*, one new regulatory reporting requirement became effective for the June 30, 2003 reporting period.[2] Bank holding companies are now required to disclose the amount of trust preferred securities reported as liabilities in their financial statements prepared according to GAAP requirements in the *Notes to the Balance Sheet – Other* section of FR Y-9C filings.

TPS have been a particularly attractive form of funding for bank holding companies because, subject to certain terms and conditions, TPS are considered Tier 1 capital for regulatory purposes and debt for tax purposes.

At present, there are no other changes to the line items on the FR Y- 9C reports or to the regulatory capital treatment, and financial institutions should continue to follow the current instructions for the reporting of trust preferred securities. For bank holding company reporting, upon consolidation in the financial statements, the parent bank holding company's interest in the trust subsidiary will continue to be reported as "minority interest in consolidated subsidiaries" on the balance sheet. This amount then qualifies for inclusion in Tier 1 capital, up to 25 percent of core capital elements.

What's Next?

Although a number of conceptual issues involving other financial instru-

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[1] FAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, is available on FASB's web site at <www.fasb.org/pdf/fas150.pdf>.

[2] SR 03-13, *Instructions for Reporting Trust Preferred Securities on Schedule HC-R of the FR Y-9C*, is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/SRLETTERS/2003/sr0313.htm>.

ments have not yet been resolved, FASB issued this limited scope statement to provide guidance on the issues that have been decided. Some provisions of FAS 150 are consistent with Concepts Statement No. 6, *Elements of Financial Statements*, which currently defines liabilities as "… probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." However, other provisions will not necessarily appear consistent until FASB revises the definition of liabilities in Concepts Statement No. 6, which is planned for the next phase of the project. This next phase will also include deliberations on complex financial instruments, including puttable shares, convertible bonds, dual-indexed financial instruments, and the possible separation of certain instruments. The Board of Governors will be monitoring these accounting developments as they occur and will provide updated reporting guidance as necessary.

If you have any questions on the reporting of TPS or the implications of FAS 150 on TPS, please contact your primary banking regulator. If you are supervised by the Federal Reserve Bank of Philadelphia, please contact your institution's central point of contact or assigned manager at the Reserve Bank. ■

Money *in* Motion

Come to the brand new exhibition, ***Money in Motion***, where visitors learn about money, banking, and the Federal Reserve System. This permanent exhibition at the Federal Reserve Bank of Philadelphia is **FREE** and employs state-of-the-art presentation technology and interactive displays.

Where else can you learn the story of central banking in the United States, in the city where banking was born? Philadelphia is the home of the first Bank of the United States, and that's why the Philadelphia Fed is eager to tell you about the nation's financial history.

Trace the changes in our national currency from the early 1600s to today. View money from the original 13 colonies. **Examine** a rare $100,000 bill. **Learn** the Fed's role in maintaining national financial stability, especially in the days following 9-11-01.

Explore in-depth our country's monetary policy over the past five decades. Learn what indicators the Fed monitors to predict the economic future. **Delve** into the world of payment and debit cards in the electronic age.

Or, if you can't visit us in person, a virtual tour of ***Money in Motion*** is just a click away at <**www.phil.frb.org/money_in_motion/index.html**>.

New Interagency Guidance on…

The Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management

On July 23, 2003, the federal banking, thrift, and credit union regulatory agencies issued guidance on the appropriate use of the Federal Reserve's new primary credit discount window program in depository institutions' liquidity risk management and contingency planning. This guidance provides background on the Federal Reserve's discount window programs, including new primary and secondary credit programs introduced in January 2003. It also reiterates well-established supervisory policies on sound liquidity contingency planning, and discusses sound practices in using primary credit program borrowings in liquidity contingency plans.

The Press Release and Final Rule are available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/press/bcreg/2003/20030723/default.htm>.

Removal, Suspension, and Debarment of Accountants From Performing Audit Services

On August 8, 2003, the federal bank and thrift regulatory agencies issued final rules governing their authority to take disciplinary actions against independent public accountants and accounting firms that perform audit and attestation services required by section 36 of the *Federal Deposit Insurance Act*. The final rules, which take effect on October 1, 2003, establish procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions with assets of $500 million or more. The rules permit immediate suspensions in limited circumstances.

The rules provide that certain violations of law, negligent conduct, reckless violations of professional standards or lack of qualifications to perform auditing services may be considered good cause to remove, suspend or bar an accountant or firm from providing audit services for banking organizations subject to section 36. Also, the rules prohibit an accountant or accounting firm from performing audit services if the accountant or firm has been removed, suspended, or debarred by one of the agencies, or if the U.S. Securities and Exchange Commission or the Public Company Accounting Oversight Board has taken certain disciplinary action against the accountant or firm.

The Press Release and Final Rule are available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/press/bcreg/2003/20030808/default.htm>.

New to Banking?

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- The Board of Governors' website (SR Letter 03-10) at <www.federalreserve.gov/boarddocs/SRLETTERS/2003/sr0310.htm>

Questions regarding fingerprints or the FBI criminal history check can be answered by the following individuals in the Regulatory Applications Unit:

- William L. Gaunt, AVP (william.l.gaunt@phil.frb.org) at (215) 574-6167

- James D. DePowell, Manager (jim.depowell@phil.frb.org) at (215) 574-4153

…Get a Fingerprint Card?
For a fingerprint card and related materials, please contact:

- Robbin Brown (robbin.brown@phil.frb.org) at (215) 574-3990

- Eric Nichols (eric.nichols@phil.frb.org) at (215) 574-3716

…Make Live-Scan Appointments?
To schedule an appointment to have your fingerprints taken via Live-Scan at the Federal Reserve Bank of Philadelphia, please contact:

- Robbin Brown (robbin.brown @phil.frb.org) at (215) 574-3990

- Eric Nichols (eric.nichols@phil.frb.org) at (215) 574-3716

We appreciate your understanding and support for this additional step in ensuring a safe and sound banking system. ■

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FEDERAL RESERVE BANK
OF PHILADELPHIA

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

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