



# Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

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## SVP Commentary on... Commercial Real Estate Trends

Throughout the history of banking, asset concentrations have been a primary cause of banking problems. In particular, commercial real estate (CRE) has been vulnerable to cyclical downturns, such as those that preceded the banking problems of the late 1980s and early 1990s. Given this profile, banks are expected to monitor real estate market conditions in their lending area to ensure that bank policies continue to be appropriate for the current market conditions.

properties and loans secured by nonfarm residential properties. Moreover, this growth has been primarily in community and regional banks.

The data reveals that commercial real estate lending remains a primary activity of most Third District banks. As evidenced by the growth in commercial real estate lending in the Third District, there is increased potential for concen-

In the Third District, from 2001 to 2004, CRE loans grew 55 percent as total CRE loans outstanding increased from \$18 billion to \$28 billion. CRE as a percentage of tier 1 capital and reserves was equal to 195 percent and 221 percent in 2001 and 2004, respectively. This acceleration is evident both in lending for construction and development, including residential



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# Does Your Financial Institution Understand Its Responsibilities Under the Servicemembers Civil Relief Act?

by Minh T. Do, Assistant Examiner

Failure to comply with the *Servicemembers Civil Relief Act* (Relief Act) has caused a recent increase in media attention.<sup>1</sup> Some nationally prominent institutions, such as Wells Fargo and Citigroup, have received criticism for noncompliance with the Relief Act. In a recent *American Banker* article, it was noted that a Wells Fargo subsidiary violated the Relief Act by initiating foreclosure proceedings against an Army reservist who had been called to active duty.<sup>2</sup> In a *New York Times* article, a Citibank employee refused a Coast Guardsman's request to adjust the interest rate on a credit card retroactive to his enlistment date.<sup>3</sup>

The servicemembers were eligible for protection under the Relief Act. But in both cases, the banking organizations were unaware of their responsibilities under the act, which led to publicized scrutiny. Subsequent corrective action has been taken by both organizations.

This long-standing legislation contains provisions that apply to all

financial institutions, many lenders, debt collectors, and lawyers, but they may lack familiarity with the act. Does your financial institution understand its responsibilities under the *Servicemembers Civil Relief Act*?

Provisions include a limitation on the rate of interest charged, the lawful termination of installment contracts and leases, and a prohibition against foreclosure.

**It represents an updated version of the Soldiers' and Sailors' Civil Relief Act of 1940, and provides clearer guidelines for protecting the rights of servicemembers.**

## What is the Servicemembers Civil Relief Act?

Prompted by the September 11, 2001 terrorist attacks, the *Servicemembers Civil Relief Act* was signed into law on December 19, 2003. It represents an updated version of the *Soldiers' and Sailors' Civil Relief Act of 1940*, and provides clearer guidelines for protecting the rights of servicemembers. This act covers active duty military, as well as reservists and national guard members who are called to active duty. In general, the act requires temporary suspension of specified legal proceedings and certain financial transactions. Banks must understand their responsibilities under this act to minimize credit, legal, and reputational risk.

## What Provisions Affect Banks?

The Relief Act contains specific provisions to protect servicemembers, their spouses, and their dependents.

## Interest Rate Limitation

Under the Relief Act, servicemembers are eligible for an interest rate reduction to 6% on debt obligations incurred prior to military enlistment. Creditors are required to forgive interest in excess of 6%, as opposed to deferment. The 2003 act provides clarity on this provision, because the prior act was too vague. This rate reduction is designed to alleviate the debt burden when active military duty causes a material reduction in a servicemember's family income.

While creditors are obligated to abide by this provision, servicemembers also have responsibilities to invoke their rights under this act. In order to be eligible for protection under the act, servicemembers must show proof of material effect on the legal or financial matter involved. Written notice

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<sup>1</sup> The *Servicemembers Civil Relief Act* is available at <Thomas.loc.gov/cgi-bin/query/z?c108:H.R.100.enr:>.

<sup>2</sup> Todd Davenport, "In Brief: OCC: Follow-Up on Protections for Military," *American Banker*, March 29, 2005, p. 18.

<sup>3</sup> Diana B. Henriques, "A Law Gets Lost; Creditors Press Troops Despite Relief Act," *The New York Times*, March 28, 2005, Sec. A, p. 1, col. 3.

# Federal Reserve Board's Final Rule on Trust Preferred Securities

by Eddy Hsiao, Supervising Examiner

The Federal Reserve Board issued a press release on March 1, 2005 announcing the adoption of the highly anticipated final ruling on trust preferred securities (TPS).<sup>1</sup> The new rule, which became effective on April 11, 2005, amended the risk-based capital standards for bank holding companies. As expected, the Board will continue to allow tier 1 capital treatment for TPS. However, stricter quantitative limits and qualitative standards have been imposed. Bank holding companies (BHCs) have a five-year transition period, ending March 31, 2009, to adopt the quantitative limits.

The key differences between the new rule and the old rule are summarized in the accompanying table. In addition, a chart reflecting the regulatory report line items on the FR Y-9C, FR Y-9LP, and FR Y-11 is included on page 4 as a reference.<sup>2</sup>

The Federal Reserve Bank of Philadelphia will monitor each Third

<sup>1</sup> The press release on the final rule is available on the Board of Governors' web site at <[www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/default.htm](http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/default.htm)>.

<sup>2</sup> The instructions for regulatory reporting of TPS and the associated debt are outlined in SR Letter 03-13, *Instructions for Reporting Trust Preferred Securities on Schedule HC-R of the FR Y-9C*, which is available on the Board of Governors' web site at <[www.federalreserve.gov/boarddocs/srletters/2003/sr0313.htm](http://www.federalreserve.gov/boarddocs/srletters/2003/sr0313.htm)>.

## Summary of Key Changes

Key Changes	Old Rule	New Rule
Notification Requirement	Issuers <b>should</b> consult with the Fed on the capital impact before issuance of TPS	Issuers <b>must</b> consult with the Fed on the capital implication before issuance
Dividends Deferral Notification Period	No specific minimum notification period	No sooner than 15 business days prior to the payment day
Call Option for Tier 1 Capital Qualification	One of the key features for tier 1 capital qualification	Call option requirement has been eliminated
Core Capital Elements (CCE)	<ol style="list-style-type: none"> <li>1) common stock</li> <li>2) noncumulative perpetual</li> <li>3) cumulative perpetual</li> <li>4) minority interest</li> </ol>	Same as old rule, but minority interest is further divided into three classes and qualifying cumulative preferred stock and others are categorized into <b>restricted core capital elements*</b>
Deduction of Goodwill from the Calculation of the 25% or 15% of CCE	Not deducted	Goodwill, net of the related deferred tax liabilities, must be deducted for the calculation
15% Limit for Internationally-Active Companies	Suggested or encouraged but not required for internationally-active companies	Mandatory for BHCs that are internationally-active (e.g., BHCs required to follow Basel II)
Sublimits	Amount in excess of the 25% limit is aggregated with other allowable tier 2 capital, which is limited to 100% of tier 1 capital	Excess amount is aggregated with term subordinated debt, limited-life preferred stock, and Class C minority interest, which is further limited to 50% of tier 1 capital
Amortization or Discount in the Last Five Years Before Maturity	No amortization; the allowable portion of TPS is included in tier 1 capital over the life of the instrument	In the last five years, TPS is moved from tier 1 to tier 2 capital and subject to 20% annual amortization

\*Restricted core capital elements, which are limited to 25% of the sum of all core capital elements, include qualifying cumulative perpetual preferred stock, Class B minority interest, Class C minority interest, and **qualifying TPS**.

## Regulatory Report Line Items Affected by TPS Transactions

Transaction	Y-9LP	Y-11	Y9-C
BHC Invests in Common Stock of the Trust	<b>PI-A-PartIII-3</b> (Payment for investment in subsidiary) <b>PC-A-2a</b> (Investment in nonbank subsidiary) <b>PC-5</b> (Investment in subsidiaries)	<b>IS-A-3</b> (Sale of common stock) <b>BS-18a</b> (Stock)	<b>HC-8</b> (Investment in unconsolidated subsidiary) <b>HC-R-42</b> (All other assets)
Trust Issues TPS	NA	<b>IS-A-3</b> (Sale of perpetual preferred stock) <b>BS-18a</b> (Stock)	NA
BHC Issues Debt to the Trust	<b>PI-A-PartIII-5</b> (Proceeds from issuance of long-term debt) <b>PC-18b</b> (Balance due to nonbank subsidiary) <b>PC-B-5b</b> (Borrowings by the parent from nonbank) <b>PC-B-16</b> (Note payable to subsidiary that issued TPS)	<b>BS-9 &amp; BS-M8a</b> (Balance due from related institution/BHC)	<b>HC-19b</b> (Payable to unconsolidated trust issuing TPS) <b>HC-R-6b</b> (Qualifying TPS) <b>HC-R-16</b> (Other tier 2 capital components), for the excessive amount
BHC Pays/Accrues Interest	<b>PI-2d</b> (Other expenses) <b>PI-M4</b> (Interest expense paid to special purpose subsidiaries that issued TPS)	<b>IS-1b</b> (Interest income from related organization) <b>BS-9</b> (Balance due from related organization) <b>BS-M8a</b> (Balance due from BHC)	<b>HI, 2e</b> (Other interest expense)
Trust Pays Dividends	NA	<b>IS-A-4</b> (Dividend declared) <b>BS-14</b> (Other liabilities) if not yet paid <b>BS-M11a</b> Expenses accrued and unpaid	NA

District BHC's TPS level using the stricter limits during the transition period. BHCs need to have adequate plans in place to address any potential significant impact to their regulatory capital positions once the new limits

are applied.

If you have questions regarding the capital treatment or the reporting of TPS, please contact Vince Poppa, Supervising Examiner (vince.

poppa@phil.frb.org) at (215) 574-6492 or Eddy Hsiao, Supervising Examiner (eddy.hsiao@phil.frb.org) at (215) 574-3772. ■

## Stay Informed! Read the Second Quarter Supervision and Regulation Letters

- SR 05-8** *Interagency Interpretive Guidance on the Provision of Banking Services to Money Services Businesses Operating in the United States*
- SR 05-9** *Frequently Asked Questions Relating to Customer Identification Program Rules*
- SR 05-10** *Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans*
- SR 05-11** *Interagency Credit Risk Management Guidance for Home Equity Lending*

The SR Letters are available at

< <http://www.federalreserve.gov/boarddocs/srletters/2005/>>

# Interagency Guidance on the Provision Of Banking Services to Money Service Businesses

by William J. Brown, Senior Examiner

On April 26, 2005, interagency guidance on providing banking services to money service businesses (MSBs) was issued jointly by the Financial Crimes Enforcement Network (FinCEN), the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the National Credit Union Administration, and the Office of Thrift Supervision. For the Federal Reserve, this guidance was issued as SR Letter 05-8.<sup>1</sup> Regulators define MSBs as currency dealers or exchangers; check cashers; issuers, sellers or redeemers of traveler's checks, money orders, or stored value; money transmitters; and the United States Postal Service (subject to certain exclusions).<sup>2</sup>

The guidance addresses the need for banking organizations to assess the risks associated with conducting business with an MSB. It is expected that banking organizations that open and maintain accounts for MSBs will apply the same *Bank Secrecy Act* (BSA) requirements that they do with all account holders, on a risk-assessed basis. The guidance states that

banking organizations will not have to conduct further due diligence on MSB customers if they complete five specific procedures with satisfactory

failed to register with FinCEN or failed to obtain a license under applicable state law. The guidance states that a banking organization should

**The guidance addresses the need for banking organizations to assess the risks associated with conducting business with an MSB.**

results. Whether banks will need to perform additional due diligence on a customer will be based on the level of risk posed by the individual customer.

At a minimum banking organizations must:

- Apply their own Customer Identification Program to MSB accounts.
- Confirm that MSB customers are registered with FinCEN, if registration is required.
- Confirm an MSB's compliance with state or local licensing requirements.
- Confirm the MSB's status as an agent, if applicable.
- Conduct a basic BSA risk assessment to assess how much risk the account poses and whether more due diligence is needed.

Also, the guidance addresses the issue of filing a suspicious activity report (SAR) on an MSB that has

file a SAR if it becomes aware that a customer is operating in violation of the registration or state licensing requirements.

This guidance will be incorporated into the interagency BSA/Anti-Money Laundering examination procedures that are scheduled to be released in mid-year 2005.

If you have any questions on the guidance for MSBs, please contact your primary 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. You may also contact William J. Brown (william.j.brown@phil.frb.org) at (215) 574-7291. ■

<sup>1</sup> SR 05-8, *Interagency Interpretative Guidance on the Provision of Banking Services to Money Service Businesses Operating in the U.S.*, is available on the Board of Governors' web site at <[www.federalreserve.gov/boarddocs/SRLETTERS/2005/sr0508.htm](http://www.federalreserve.gov/boarddocs/SRLETTERS/2005/sr0508.htm)>.

<sup>2</sup> 31 CFR, Section 103.11(uu).

# COVER STORY

## “Commercial Real Estate Trends” continued from page 1

tration risk. Because the CRE growth trend is expected to continue, banks must actively monitor and effectively manage their concentration risk.

### Real Estate Lending Policies

The *Federal Deposit Insurance Corporation Improvement Act of 1991* (FDICIA) mandated the creation and adoption of uniform regulations for real estate lending standards. These standards are included in the *Interagency Guidelines for Real Estate Lending Policies*, Regulation H, part 208, appendix C (12 CFR 208, appendix C).<sup>1</sup>

The Federal Reserve’s Regulation H requires an institution to establish real estate lending policies that are

At a minimum, CRE lending policies should include the following criteria:

- Clear loan portfolio diversification standards
- Prudent underwriting standards that are clear and measurable
- Effective real estate loan administration procedures
- Sound documentation, approval, and reporting requirements that effectively monitor compliance with the bank’s real estate lending policies
- Regular stress testing of the real estate portfolio

To maintain an effective lending function, the bank’s board of direc-

ment processes should be established that include effective credit review and classification procedures and a methodology for ensuring that the allowance for loan and lease losses (ALLL) is maintained at an adequate level.

### Concentrations of Credit

Real estate lending policies also should include guidelines for diversification of risk within the portfolio. Federal Reserve System examiners consider concentrations of credit generally to consist of direct or indirect extensions of credit and contingent obligations that, when aggregated, exceed 25 percent of the bank’s capital structure (tier 1 capital plus the ALLL). A concentration

**Policies governing a bank’s real estate lending activities must include prudent underwriting standards, strong internal controls, and an effective loan documentation program.**

(1) consistent with safe and sound lending practices, (2) appropriate to the size of the institution and the nature and scope of its operations, and (3) reviewed and approved by the bank’s board of directors at least annually.

tors should establish policies to guide the function. An effective lending policy sets standards, guidelines, and limitations that reflect the bank’s overall mission and business strategy. It should be clearly communicated to both management and lending personnel to ensure adherence to the policy.

Policies governing a bank’s real estate lending activities must include prudent underwriting standards, strong internal controls, and an effective loan documentation program. On an ongoing basis, credit risk manage-

exists when the credit extensions or other obligations possess similar risk characteristics.

In general, loans to related groups of borrowers, loans collateralized by a single security or by securities which have common characteristics, and loans to borrowers that have common characteristics within an industry are considered to be homogenous for risk purposes when determining that a concentration exists.

Examiners expect banking organizations to have in place effective poli-

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<sup>1</sup> *Interagency Guidelines for Real Estate Lending Policies*, Regulation H, Appendix C is available at <[www.federalreserve.gov/boarddocs/srletters/1993/SR9301.htm](http://www.federalreserve.gov/boarddocs/srletters/1993/SR9301.htm)>.

cies, systems, and internal controls to monitor and manage concentration risk. The bank's board of directors is responsible for establishing appropriate risk parameters and for measuring exposure, as well as for evaluating the methods used by management to control and manage concentration risk. To effectively manage the risk, it is important to identify key characteristics that will define a concentration.

To monitor CRE concentration risk, examiners gain an understanding of the bank's internal policies and the systems and controls used to manage and monitor concentration risk. If concentrations exit, examiners will evaluate the bank's ability to effectively manage the risk and, if necessary, to reduce its exposure.

For institutions with high CRE concentration, particularly in CRE lending areas that are considered more risky, such as construction and development lending and other loans

where the principal source of repayment is dependent upon the sale or refinancing of the property, there may be an even higher level of scrutiny.

Examiners evaluate the processes for identification and sound risk management of concentrations ranging from MIS to portfolio management and diversification techniques. Sound practices should encompass pricing strategies with the goal of improving margins, house limits based on objective quantification of risk, and the effective use of capital.

### **CRE Today**

In general, current real estate underwriting and risk management practices are considered to be materially better than in the late 1980s and early 1990s, and there is presently no evidence of emerging systemic problems in the banking sector. With changing economic conditions, significant increases in interest rates and increasing competition create pressure on underwriting standards.

Consequently lenders must remain vigilant.

In particular, we have begun to see some recent deals that could lead to unprofitable or unsustainable pricing, terms concessions, and ultimately lower portfolio quality. At this stage of the credit cycle, market realities may require institutions to compete aggressively on price, but we support being disciplined around the structure of loans.

Based on continued growth in real estate lending, changes in CRE markets, and some evidence of poorly managed concentrations at some institutions, bank supervisors will continue to monitor the activity closely. Supervisors will continue to track the growth in concentrations through surveillance and other early warning indicators and through transaction testing of quality and underwriting at banking organizations with significant core exposures. ■

## **“The Servicemembers Civil Relief Act”** *continued from page 2*

and a copy of military orders are required to verify eligibility for relief and must be delivered to the creditor no later than 180 days after a servicemember's termination or release from service. Given the servicemember's compliance with notification requirements, the creditor must grant the rate reduction retroactive to the date of active duty.

### *Termination of Installment Contracts or Leases*

Another provision of the act ad-

dresses the termination of installment contracts or leases.

Contracts established with a servicemember prior to active duty cannot be terminated by the creditor due to any breach of the contract. Moreover, repossession proceedings may not take place without a court order.

When a residential lease is executed prior to the lessee entering military service, or when the lessee receives

military orders for permanent relocation or deployment of at least 90 days, the servicemember has the right to terminate the lease. The same conditions pertain to the termination of motor vehicle leases when the active duty period is greater than 180 days. In all situations, servicemembers are responsible for providing adequate documentary evidence.

### *Prohibition Against Foreclosure*

The Relief Act also includes guidance on mortgage contracts and oth-



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The views expressed in this newsletter are those of the authors and are not necessarily those of this Reserve Bank or the Federal Reserve System.

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er similar secured obligations. Servicemembers are protected against property foreclosure. This prohibition applies to contracts originated prior to entry into military service and where default occurs during the period of military service or within 90 days thereafter. Mortgage companies and other lenders are required to obtain a court order prior to any foreclosure activity.

### **The Importance of Compliance**

Heightened awareness of the Relief Act is needed in the financial services industry. Revisions to the Relief Act were passed to provide clearer guidance on protections available to active-duty military families, whereby financial capacity is diminished due to military service. Bank management should familiarize themselves with their responsibilities under the Relief Act in order to remain in compliance with the law.

The Office of the Comptroller of the Currency posted an advisory letter on June 18, 2004 that provides information on the provisions of the act that affect banks.<sup>4</sup> This advisory letter, and the recent examples of lenders failing to comply with the Relief Act, evidence the importance in reeducating banks. Ongoing compliance with the Relief Act is necessary to protect the rights of servicemembers while minimizing potential credit, legal, and reputational exposure for banks.

If you have any questions about this article, please contact Assistant Examiner Minh T. Do ([minh.h.do@phil.frb.org](mailto:minh.h.do@phil.frb.org)) at 215-574-6110. ■

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<sup>4</sup> OCC Advisory Letter AL 2004-8 is available at [www.occ.treas.gov/ftp/advisory/2004-8.txt](http://www.occ.treas.gov/ftp/advisory/2004-8.txt).

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