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Federal Reserve Bank of Philadelphia

SVP Commentary on…

The Federal Reserve Supervisory Process

You know the examiners are coming in a few weeks, but are you fully aware of the process involved with planning and conducting an examination and reporting the examination findings? The supervisory process can appear to be quite complex, and I often receive questions on this subject. Therefore, this commentary will detail the regulatory role and responsibilities of the Federal Reserve to foster understanding of the supervisory process.

The Federal Reserve is required to conduct a full-scope, on-site examination of its insured member banks each 12-month period, with the exception of some smaller institutions meeting certain criteria, which are examined every 18 months. However, the examination authority of the Federal Reserve allows it to examine a member bank as frequently as deemed necessary based on the condition of the bank or as a result of certain triggering events.

After the passage of the Gramm-Leach-Bliley Act, the Federal Reserve decided to continue to perform concurrent examinations for compliance and CRA. The frequency of consumer compliance and CRA examinations is linked to the size of the institution and its compliance and CRA ratings at its most recent examinations.

For institutions with less than $250 million in assets and a compliance rating of 1 or 2, the examination frequency is driven by the most recent CRA rating. An Outstanding CRA rating extends the frequency to five years, while a Satisfactory rating results in a four-year exam frequency. However, an Unsatisfactory or lower compliance rating or a Needs to Improve or lower CRA rating will automatically result in a one-year exam frequency, until the bank has returned to a satisfactory level of performance. Institutions with over $250 million in

continued on page 10

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Credit Risk Guidance for Home Equity Lending

by Stephen Harter, Senior Examiner

In May 2005, interagency regulatory guidance was issued, which outlined sound credit risk management practices for financial institutions involved in home equity lending. For the Federal Reserve, this was issued as SR Letter 05-11.[1] The guidance is a result of the rapid growth in both open-end home equity lines of credit and closed-end home equity loans within the financial services industry.

This growth trend stems from a material rise in residential real estate values, the low interest rate environment, and the favorable tax treatment accorded individuals who mortgage their primary and secondary residences. These reasons have made this form of borrowing an attractive alternative to consumers, and regulatory agencies have found that, in many cases, credit risk management practices for this form of lending have not kept pace with the strong growth trend.

Numerous factors increase the risk associated with this type of lending. These factors include:

- Affordability products, such as interest-only loans and low or no documentation loans, becoming more popular
- Greater use of automated valuation models and other collateral evaluation tools
- Increased acceptance of lower credit scores
- Greater reliance on brokers and other third parties

These risk factors can be mitigated by a robust risk management program that includes fully articulated policies, practices, and procedures that address product development and marketing, underwriting standards, third-party originations, collateral valuation, account and portfolio management, and operations and servicing.

Product Development and Marketing

When developing and marketing home equity loan products, management should establish a review and approval process to ensure compliance with internal policies and all applicable laws and regulations. If possible, risk management personnel should be involved in the product development stage to evaluate the risks. Otherwise, management should evaluate all associated risks, including credit, market, operational, reputational, and legal risks. Furthermore, when home equity products are marketed or closed by a third party, management should review the third party for compliance. There should also be appropriate monitoring tools in place, in-

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[1] SR 05-11, *Interagency Credit Risk Management Guidance for Home Equity Lending*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2005/sr0511.htm>.

cluding effective MIS, to measure ongoing performance of marketing initiatives.

Underwriting Standards
Consistent with regulatory guidance on real estate lending standards,[2] prudent underwriting standards should include an assessment of a borrower's capacity to service the debt. Consideration should be given to a borrower's income and debt levels in addition to the credit score. While credit scores are based on historical performance and may be an indicator of future performance characteristics, a change in the income or debt levels of borrowers may diminish their ability to repay the debt. Furthermore, home equity loans and lines may not have interest rate caps. As a result, a significant rise in interest rates would result in materially higher payments for borrowers and could impair their ability to service the debt.

Third-Party Originations
Financial institutions often use third parties to originate loans, typically brokers or correspondents. It is a common practice for brokers and correspondents to be compensated based on their volume of loan originations. This approach may create an implicit incentive to produce as many loans as possible, regardless of the quality. There should be strong controls in place to ensure the quality of the originations and compliance with all applicable laws and regulations and to help reduce the incidence of fraud.

It is essential for management to perform comprehensive due diligence on third-party originators prior to establishing a relationship. Furthermore, once a relationship has been established, there should be ongoing monitoring to ensure the completeness and accuracy of the information provided by the third parties and to confirm that they are not receiving referral fees or other income contrary to Real Estate Settlement Procedures Act prohibitions.

When developing and marketing home equity loan products, management should establish a review and approval process to ensure compliance with internal policies and all applicable laws and regulations.

Collateral Valuation
Increased competition, cost pressures, and advancements in technology have resulted in an increase in the use of streamlined appraisal and collateral valuation processes. Given the current underwriting environment, which allows for higher loan to value (LTV), the need for strong collateral valuation policies and procedures is especially important. Policies and procedures should be in compliance with the regulatory agencies' appraisal regulations[3] and *Interagency Appraisal Evaluation Guidelines*.[4]

Management should establish collateral valuation methodologies commensurate with the risk profile of both the individual loan and the loan portfolio, ensure that expected collateral values are not communicated to the appraiser, and require sufficient documentation to support a collateral value. If several different valuation tools are used for the same property, management should establish a policy for selecting the most reliable method, rather than the highest value.

When automated valuation models (AVMs) are used to support evaluations or appraisals, management should have a clear understanding of how the model works and periodically validate any uncertainty in the model. The validation's analysis, assumptions, and conclusions should be adequately documented. The validation process should also include back-testing of a representative sample of the valuations against market data of actual sales, when sufficient information is available.

continued on page 15

[2] In 1992, the agencies adopted uniform rules on real estate lending standards and issued the *Interagency Guidelines for Real Estate Lending Policies* at 12 CFR Part 208.51 and Appendix C to Regulation H.

[3] 12 CFR 208 subpart E and 12 CFR 225 subpart G.

[4] SR 94-55, *Interagency Appraisal and Evaluation Guidelines*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/1994/sr9455.htm>.

Is Your Financial Institution Vulnerable to Occupational Fraud?

by Mary G. Sacchetti, Supervising Examiner

Read any recent newspaper, and you'll likely conclude that corporate crime is a major area of concern in today's society—so much so that the Sarbanes-Oxley Act of 2002 was enacted to combat fraud committed by corporate insiders by requiring improved corporate accountability and responsibility, as well as fraud detection and prevention practices. Internal fraud, also known as occupational fraud and abuse, isn't limited to the executives making the headlines with their high-profile corporate scandals. Rather, occupational fraud involves a vast range of unethical behavior by all levels of employees and executives that could result in significant costs to the defrauded organization. By definition, occupational fraud is "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."[1]

At this time, no single agency is responsible for obtaining and measuring comprehensive fraud-related information; therefore, the true effects and costs of occupational fraud and abuse are hard to quantify. Further complicating the effort to evaluate the effects of fraud is the fact that many frauds remain undiscovered, and those that do get detected often go unreported. Estimates provided by the Association of Certified Fraud Examiners (ACFE) project the cost of fraud to equal approximately 6 percent of the U.S. gross domestic product, or more than $660 billion in annual fraud losses in 2003.[2] A defrauded organization may also experience additional costs related to a tarnished reputation, as well as be exposed to ongoing governmental scrutiny or potential criminal or civil penalties.

The ACFE Report

In 1996, the ACFE conducted the largest privately funded study at that time on occupational fraud, culminating in the *Report to the Nation on Occupational Fraud and Abuse*. The ACFE updated and expanded its original report in 2002 and again in 2004 (2004 report), with the ACFE claiming that the 2004 report represents the "most comprehensive examination of the effects of occupational fraud and abuse to date."[3] The statistics generated from the study portray the results of 508 cases of occupational fraud investigated by seasoned certified fraud examiners (CFEs) and reflect over $761 million in losses. Since there are no government statistics published on the costs and details of occupational fraud, this article will use the information generated in the 2004 report as a point of reference.

All illegal schemes identified in the occupational fraud cases in the 2004 report were classified in one of the following categories:

- Asset misappropriation, which involves the theft or misuse of any company asset for personal gain (e.g., cash larceny, fraudulent disbursement schemes, stealing inventory)
- Fraudulent financial statements
- Corruption, instances where individuals use their influence in a business transaction to gain some benefit for themselves or another person (e.g., kickbacks)

Although misappropriation of assets accounted for 90 percent of the cases, it proved to be the least expensive of the three categories, with median losses estimated at $93,000 per case. Conversely, fraudulent financial statements represented approximately 8 percent of all frauds within the study but were the most expensive, with reported median losses of $1 million per case.

Other facts highlighted in the 2004 report include:

- Most occupational fraudsters are first-time offenders.
- Small businesses proved to be the most vulnerable to occupational fraud and abuse and suffered dis-

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[1] Joseph T. Wells, *Occupational Fraud and Abuse*, Austin, Texas: Obsidian Publishing Company, Inc., 1997, page 3.

[2] The Association of Certified Fraud Examiners *2004, Report to the Nation on Occupational Fraud and Abuse*, <www.cfenet.com/pdfs/2004RttN.pdf>, page 11.

[3] See the ACFE's report, page 11.

proportionately large losses.

- The average fraud scheme lasted 18 months before it was detected.
- The size of the loss caused by occupational fraud is directly related to the position of the perpetrator.
- Banking organizations accounted for 11.1 percent of the fraud cases, with median losses of $101,000.

Occupational Fraud Motives

Experts offer various theories as to why trusted employees commit fraud against their employers. However, criminologists assert there is no simple explanation, since the decision to commit fraud is attributed to many complex sociological factors. One theory, developed in the 1950s by criminologist Donald R. Cressey, is referred to as the "fraud triangle" since it revolves around the notion that three factors contribute to committing fraud.[4] See box top right.

Another theory, developed in the 1980s by Dr. Steven Albrecht, involves the notion of a "fraud scale."[5] This theory suggests that three factors contribute to fraud: a situational pressure (similar to Cressey's financial pressure), a perceived opportunity to commit and conceal the misconduct, and the level of personal integrity. According to Albrecht, disgruntled employees and executives are more likely to "right the scales" or commit occupational fraud when situational pressures and perceived opportunities are high and personal integrity is low.

A study conducted by Richard Hollinger and John Clark in the 1980s concluded that employees were motivated to commit fraudulent acts because of their dissatisfaction with their jobs or conditions at work.[6] Perceived injustices such as inadequate compensation, unfair treatment, or an elitist attitude by management, among other factors, prompted employees to commit criminal acts.

While all three theories differ somewhat, all tend to revolve around the notion that occupational fraud is a combination of motive and opportunity. As such, it is essential for an organization to assess its risk of becoming a victim of fraud by analyzing its workplace environment, company practices, and internal controls for both motivating conditions and weaknesses that may create opportunities for fraud. By doing so, the organization will be in a better position to implement appropriate antifraud programs.

Fraud Triangle

The first leg of the triangle represents private or nonshareable financial pressures or needs perceived by the employee, such as gambling debts or living beyond one's means. The second leg represents the employee's perceived opportunity to commit the fraud due to factors such as poor organizational ethics, weak internal controls, or the failure of the firm to discipline fraud perpetrators. The final leg represents the ability of the employee to rationalize the crime as either noncriminal or justified. Cressey maintained that the impetus to commit the fraud is attributed primarily to the employee's financial pressures, yet the opportunity and rationalization to commit the crime must be present as well.

Detecting Fraud

The 2004 report cites the following statistics concerning the most effective means for detecting fraud:

Detection Method	2004 Report	2002 Report
Tip	39.6%	43.0%
Internal Audit	23.8%	18.6%
By Accident	21.3%	18.8%
Internal Controls	18.4%	15.4%
External Audit	10.9%	11.5%
Notified by Police	0.9%	1.7%

Note: The detection methods total over 100 percent because multiple methods contributed to the detection of some frauds.

In both the 2002 and 2004 reports, the "anonymous tip" was considered the most prevalent method of detecting fraud. This information bodes well for the effectiveness of section 301 of the Sarbanes-Oxley Act, which requires audit committees of publicly traded companies to establish procedures for confidential,

[4] See Joseph T. Wells's book, page 11.

[5] See Joseph T. Wells's book, page 11.

[6] See Joseph T. Wells's book, page 25.

anonymous submissions by employees concerning questionable accounting or auditing matters.[7]

The 2004 report also noted that organizations that maintained confidential hotlines incurred median losses that were approximately 50 percent less than those organizations without such reporting mechanisms. To further improve the effectiveness of confidential hotlines, the ACFE recommends expanding hotlines to include access by third parties, such as vendors and customers. Other experts recommend staffing fraud hotlines with professionally trained interviewers to ensure that essential information is gathered to investigate the allegation.[8]

Internal audit was responsible for detecting fraud in almost 24 percent of the cases in the 2004 report, rendering it the second leading method. According to the ACFE, defrauded organizations with internal audit or internal audit departments suffered significantly fewer median losses than organizations without such departments.

Fraud discovered by accident was the third most effective method for detecting fraud, followed by internal controls and external audit. Perhaps the mandates of section 404 of the Sarbanes-Oxley Act and the AICPA's Statement on Auditing Standard No. 99, *Consideration of Fraud in a Financial Statement Audit*, will increase the effectiveness of internal controls and external audits in detecting frauds in the future.

Preventing Fraud

According to the experts, "The most cost-effective way to deal with fraud is to prevent it."[9] The ACFE noted that once a fraud has been detected, it is unlikely that an organization will recover its losses. As such, the costs of fraud can be mitigated by the implementation of an effective fraud risk program designed to include rules and controls to prevent, detect, and deter fraud. In the box to the right are some of the more common factors that fraud experts recommend be incorporated into an antifraud program.

With increasing financial pressures facing today's employees due to rising interest rates, energy costs, and real estate prices, senior management should remain vigilant for warning signs concerning any motivating financial factors or internal problems within its organization that may prompt fraudulent behavior. While motivated perpetrators may succeed in some instances, heightened awareness and the implementation of internal safeguards will go far in protecting your organization from fraud by limiting the opportunity for other dishonest employees to commit a crime.

If you have any questions regarding this article, you may contact Supervising Examiner Mary G. Sacchetti (mary.sacchetti@phil.frb.org) at (215) 574-3848. □

Common Factors to be Incorporated into an Antifraud Program

- Institute a hotline
- Set a moral and ethical tone at the top
- Develop a code of conduct and confirmation process
- Institute continuous fraud awareness training designed to deter unethical conduct and influence an employee's responsibility to report fraud
- Create a positive workplace environment
- Create a culture of honesty
- Establish realistic performance goals and reward systems
- Hire and promote appropriate employees
- Perform background checks and credit histories on new recruits or promotions to positions of trust
- Exhibit fair and balanced discipline for fraudulent behavior
- Identify and measure fraud risks
- Implement and monitor internal controls
- Maintain a strong and independent audit committee
- Hire effective internal auditors
- Contract independent external auditors
- Evaluate antifraud processes and controls, and develop an appropriate oversight process
- Determine who will investigate a reported incident and how
- Use case management and technology tools
- Emphasize cross-group collaboration
- Put fraud prevention at the forefront of a successful business strategy

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[7] See the ACFE's report, page 18.

[8] "Best Practices for Ethics Hotlines," *The White Paper*, Volume 18, Number 1, page 40.

[9] See the ACFE's report, page iv.

Foreign Currency Conversion Fees and the Credit Card Industry

by Frederick W. Stakelbeck, Jr., Training and Development Coordinator

American consumers traveling abroad are increasing their use of electronic payment instruments to conduct business transactions in foreign countries. Credit and debit cards are frequently used by U.S. citizens when visiting foreign countries to initiate point-of-sale (POS) transactions and to access cash at ATM locations worldwide. Eager to experience the convenience of electronic payments, consumers are leaving cash and traveler's checks behind and discovering the benefits of credit and debit cards when paying for hotel rooms, rental cars, and meals.

This increase in international electronic transaction activity has been accompanied by what are known as foreign currency conversion fees, which are assessed by the credit card associations and their member banks for the use of payment cards[1] abroad. This fee is a charge passed on to a cardholder by the associations and their card issuing member banks for converting a purchase made in a foreign currency into U.S. dollars. Traditionally, the associations have charged 1 percent, or $1 for every $100 transaction, to convert a foreign currency. Sensing an opportunity for sustained revenue as a result of renewed interest in business and personal global travel, a growing number of banks have begun to charge their own separate foreign currency conversion fee. This has confused many cardholders and raised important disclosure questions that may require regulatory action.

When a cardholder makes a purchase abroad, the foreign merchant requests payment in the foreign currency, while the domestic card issuer pays Visa or MasterCard in U.S. currency. Visa and MasterCard set the foreign exchange rates for performing this conversion, charging credit card issuers a wholesale rate plus 1 percent. For their part, the associations vigorously defend charging a 1 percent foreign currency conversion fee for transactions, stating they have a responsibility for exchanging money and should be compensated for any risk taken in the clearing and settlement process. This issue raises an important question: If Visa and MasterCard actually make the currency exchange and incur the transaction risk, why are banks charging a separate fee?

Over time, member banks realized that they too could charge their own separate "second-tier fee" in addition to the fee charged by the associations. Today, this additional bank fee usually falls between 1 percent and 3 percent of the purchase price of an item charged. In the case of ATM users, an additional surcharge is often applied for cash withdrawals. For example, by using a credit card to withdraw cash at an ATM in Italy, a cardholder may incur a Visa or MasterCard fee of 1 percent, a card issuer fee of 1 percent to 3 percent, and a flat ATM surcharge of an additional $5 to $10 for a $100 cash withdrawal.

The Issue of Fee Disclosures

The most sweeping issue related to cardholder fees today is a lack of voluntary disclosure and transparency of cardholder fee information by payment card issuers. In a meeting with bankers in May 2005, Acting Comptroller of the Currency Julie Williams criticized bank credit card disclosures, indicating that they should be easier for consumers to understand and that consumers should have input into their development. "I hope the committee [U.S. Senate Committee on Banking, Housing, and Urban Affairs] will use the opportunity not to simply criticize the current state of credit card disclosures, but begin a re-examination of the processes of developing, designing, implement-

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[1] A payment card is defined as a financial tool, such as a credit, debit, or charge card, that allows consumers to make purchases online, over the phone, or in person at merchant locations throughout the world.

ing, overseeing, and evaluating consumer disclosures for financial products and services," Williams said.[2] Some members of Congress have threatened credit card companies with tough action if they fail to respond to consumer complaints regarding fees and rates. Senator Elizabeth Dole noted, "We must continue to require that credit card companies provide full disclosure regarding fees, interest rates, minimum payments, and privacy statements."[3]

Fee information is often embedded into the original charge, making the fee almost indistinguishable on the cardholder's monthly credit card billing statement.

In the case of foreign currency conversion fees, fee information is often embedded into the original charge, making the fee almost indistinguishable on the cardholder's monthly credit card billing statement. Problems also arise when the fee is omitted from the POS credit card receipt provided by the merchant to the cardholder. Consequently, this lack of disclosure leaves the cardholder confused about the overseas charges he or she made weeks ago. Making matters worse, subsequent inquiries made by the cardholder to his or her issuer's customer service center often fail to provide the cardholder with a clear understanding of the fees charged. Issuer disclosure practices, the role of the associations in assessing a separate fee, issuer billing statement structure, and consumers' rights as cardholders are issues that are generally questioned.

Consumer groups argue that the credit card associations and their member credit card banks have failed to provide consumer disclosures in compliance with the provisions of Regulation Z, *Truth in Lending Act*, and are also in violation of the Sherman Anti-Trust Act. The Truth in Lending Act (TILA), which is implemented by Regulation Z, was enacted in 1968 in response to rapid growth in the consumer credit industry. It requires the disclosure of certain credit terms for the purpose of allowing consumers to compare available credit terms and to protect consumers from the uninformed use of credit. Section 226.5 of Regulation Z, *Credit and Charge Card Applications and Solicitations*, lists the general disclosure requirements card issuers must follow in connection with card applications and solicitations. With respect to card transactions, the section notes that any transaction charge imposed for the use of the card for purchases should be disclosed to the cardholder. However, foreign currency conversion fees are not specifically included in the list of "other charges" in section 226.5 for open-end credit.

The Sherman Anti-Trust Act states that it is unlawful to monopolize a particular industry or market sector by using illegal methods to secure income. In the case of foreign currency conversion fees and the credit card industry, consumer groups argue that the associations and their member banks have colluded to fix cardholder fees. The associations refute claims of fee collusion under the provisions of the Sherman Anti-Trust Act, stating that they convert currency for their member banks and retain the 1 percent fee in their capacity as a single intermediary. Furthermore, Visa and MasterCard claim that individual banks make their own decisions regarding the nature and scope of cardholder disclosures on applications, solicitations, and billing statements. As a result, the associations can recommend, but not mandate, member banks' compliance with existing federal regulations related to cardholder fee disclosures.

Federal Reserve Action

At the request of the U.S. Senate Committee on Banking, Housing, and Urban Affairs; various consumer protection groups; and individual consumers, the Board of Governors of the Federal Reserve Sys-

continued on page 9

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[2] Hannah Bergman, "In Brief: OCC's Williams on Credit Card Disclosures," *American Banker*, May 13, 2005, available online to subscribers at <www.americanbanker.com/>.

[3] See the article by Hannah Bergman.

Foreign Currency Conversion Fees and the Credit Card Industry *...continued from page 8*

tem published an Advance Notice of Proposed Rulemaking (ANPR) in December 2004 designed to study the issue of open-end credit and possible revisions to Regulation Z.[4] Specifically, the ANPR requested comment on several broad categories, including (i) the format of open-end credit disclosures, (ii) the content of the disclosures, and (iii) protections provided under the regulation.

Many observers in the consumer protection area feel that a review of the regulation's disclosure requirements is long overdue. "The Truth in Lending Act plays an important role, but the disclosures required in credit card lending are not adequate to protect consumers," said Edmund Mierzwinski, consumer program director at the U.S. Public Interest Research Group.[5]

One important question related to credit card fees concerns the classification and labeling of fees as finance charges and other charges and whether they can be improved, since how a fee is classified affects when and how the fee is disclosed under TILA. A finance charge is defined as "any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor, as an incident to or a condition of the extension of credit."[6] These charges include interest, cash advance fees, and balance transfer fees. If the fee is not a finance charge, it is considered an other charge, which may include penalty fees, periodic membership fees, or participation fees. If the fee is neither a finance charge nor an other charge, TILA does not require an initial disclosure. However, if such a fee is charged to the consumer and billed to the account, the fee must be disclosed on the relevant periodic statement just as any other transaction item must be disclosed.[7]

The Federal Reserve System's review will address mortgage lending, home equity lines of credit, and other types of closed-end credit. But the primary focus will be on open-end credit, specifically credit cards, since most of the dissatisfaction with the truth-in-lending laws is related historically to credit card requirements and consumer protections. Federal Reserve Governor Edward Gramlich testified in May 2005 that new rules could be expected next year (2006) on how financial information is disclosed by credit card companies. "Having received public comment, we will use that advice to draft and test new rules," Gramlich said.[8]

Conclusion

The payment cards industry is a global enterprise with significant portfolio growth occurring overseas. To maintain this overseas growth and to compensate for sluggish portfolio growth in the United States, banks are looking for alternative ways to generate revenues within the realm of what is considered acceptable under existing federal banking regulations. The Federal Reserve's review of Regulation Z is timely and should help to ensure that all credit card fees that are charged to consumers are clear and understandable. ☐

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[4] Advance Notice of Proposed Rulemaking, Docket No. R-1217 December 3, 2004, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/press/bcreg/2004/20041203/default.htm>.

[5] Damian Paletta, "Fed Seeks Card Disclosure Comments in Regulation Z Review," *American Banker*, December 28, 2004, available online to subscribers at <www.americanbanker.com/>.

[6] See Federal Reserve Board's ANPR, Docket No. R-1217.

[7] See Federal Reserve Board's ANPR, Docket No. R-1217.

[8] Joseph Rebello and Michael Schroeder, "Fed Plans Update of Disclosure Rules for Credit Cards," *Wall Street Journal*, May 18, 2005, page D2.

The Federal Reserve Supervisory Process *…continued from page 1*

assets are examined every two years, with the same one-year frequency requirement for institutions with less than satisfactory compliance or CRA ratings.

For bank holding companies, full-scope inspections are conducted annually for organizations with more than $10 billion in assets. For holding companies under $10 billion in assets, the inspection type and frequency varies depending on asset size, complexity of the organization, and the holding company's rating at its last inspection.

Safety and Soundness Examinations
The supervisory process has four objectives:

- Provide flexible and responsive supervision
- Foster consistency, coordination, and communication among the appropriate supervisors
- Promote the safety and soundness of financial institutions
- Provide a comprehensive assessment of the institution

The supervisory process is designed to be flexible, giving bank supervisors the ability to respond to changes in the condition of the institution or market developments. To minimize regulatory burden, the supervisory process should be collaborative and efficient.

In May 2004, a joint effort of state banking commissioners and senior Federal Reserve and FDIC officials resulted in the creation of recommended practices for joint supervision of state-chartered depository institutions.[1] These practices stress the importance of communication and coordination between state and federal agencies in conducting their supervisory responsibilities.

In evaluating the safety and soundness of a financial institution, assessments of its financial condition and risk management practices are conducted, as well as its compliance with all applicable laws and regulations. A comprehensive assessment of an institution also involves integrating specialty areas, such as information technology systems, trust operations, and consumer compliance, with functional risk assessments and reviews.

Risk-Focused Supervision
In order to keep pace with the rapidly changing banking environment and the risks that result, bank examinations have evolved from reliance on transaction testing in assessing a bank's condition to a risk-focused approach. For institutions deemed to have adequate policies and procedures to identify, measure, monitor, and control their risk exposure, the level of transaction testing will be less than that for institutions where risk management is determined to be lacking.

> A comprehensive assessment of an institution involves integrating specialty areas, such as information technology systems, trust operations, and consumer compliance, with functional risk assessments and reviews.

The Federal Reserve places significant supervisory emphasis on its assessment of an institution's risk management processes. Failure to establish procedures to effectively manage the risks associated with the banking products and services offered and to establish a strong control environment is considered unsafe and unsound conduct.

The risk-focused supervisory process relies on examiner judgment. Examiners determine the level of supervisory activities to be performed based on an institution's size, complexity, and risk profile. More emphasis is placed on those areas posing the greatest level of risk to the institution. To make an informed

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[1]SR 04-12, *Supervision of State-Chartered Banks*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2004/sr0412.htm>.

risk assessment, examiners gain an understanding of an institution's risk profile through a variety of sources. These include previous examination reports, correspondence files, surveillance activities that monitor an institution's ongoing condition and identify outliers in comparison to an appropriate peer group, and other market data.

In addition, examiners conduct meetings with management prior to the commencement of an examination to learn about changes in policy, strategic direction, products and services, and other activities. Examiners then prepare a preliminary risk assessment of the institution and plan their supervisory activities accordingly.

Meetings with management are held during the on-site examination to gather additional information and to provide insight for the assessment of the bank's condition. Examiners also discuss with management any supervisory concerns that arise during the examination and make recommendations for improvement to management when warranted. Frequently, supervisory concerns are resolved during the on-site examination, and there is no need for additional resolution efforts.

For larger, more complex institutions, the supervisory process includes the use of a central point of contact, or CPC, to coordinate the process and to foster ongoing communication with both the institution and other regulators, further promoting effective, efficient supervision of the institution.

Overall Conclusions Regarding Bank Condition
An examination has multiple objectives:

- To reach conclusions regarding the present condition of the bank
- To reach conclusions regarding the future prospects of the bank
- To determine the bank's ability to meet demands in the ordinary course of business or reasonably unusual circumstances
- To determine the bank's adherence to safe and sound banking practices
- To formulate recommended action, when appropriate, based on the examination conclusions
- To communicate the conclusions and any recommendations, both orally and in the examination report

In reaching an overall conclusion about the condition of an institution, examiners use both objective criteria and subjective judgment. The examination process culminates in the assignment of ratings and the issuance of an exam report. This information is for management's use, and the disclosure of supervisory ratings and other confidential supervisory information to third parties is prohibited, except in very limited circumstances. An interagency advisory was issued in February 2005 to remind banking organizations of this prohibition.[2]

The Matters Requiring Board Attention page of the examination report is used to clearly and succinctly detail for the board of directors the most significant issues identified during the examination. Action required on the part of both management and the board of directors is clearly noted. This page is meant to complement the full Report of Examination, which discusses in detail all of the examination findings.

When discussions and normal follow-up procedures have been unsuccessful in resolving supervisory concerns, there may be a need to take further action. Toward that end, the Federal Reserve has a broad range of enforcement powers, which includes both informal and formal actions.

As I discussed in the Second Quarter 2004 issue of *SRC Insights*, informal enforcement actions are used to address less severe supervisory circumstances and include commitments, board resolutions, and memoranda of understanding. The Federal Reserve does not make information about informal enforcement actions available to the public.

Formal actions are used to correct practices considered to be unlawful, unsafe, or unsound. Formal enforcement actions include written agreements, cease-and-desist orders, and civil money penalties, among others. Most formal actions are made public.

By tailoring the supervisory process to focus on an institution's risk profile and management's ability to manage its risk, the process is more cost-effective for regulators and less burdensome to the institutions, resulting in efficient, effective supervision. ☐

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[2] SR 05-4, *Interagency Advisory on the Confidentiality of Nonpublic Supervisory Information*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2005/sr0504.htm>.

Is Your Bank Correctly Reporting Derivative Mortgage Products?

by Andrea Anastasio, Capital Markets Analyst

On May 3, 2005, the Federal Reserve, OCC, FDIC, OTS, and NCUA issued interagency guidance to clarify the accounting and reporting requirements for commitments to originate mortgage loans that will be held for resale and commitments to sell mortgage loans under mandatory delivery and best efforts contracts. The regulators have found that banks may not be correctly reporting these items on their call reports. The Federal Reserve System's guidance was issued as SR letter 05-10.[1]

Commitments to originate mortgage loans that will be held for resale are derivatives, and the fair value of these derivatives must be reported on the balance sheet. The guidance refers to these commitments as derivative loan commitments. All loan sale agreements, including both mandatory delivery and best efforts contracts, must be evaluated under Financial Accounting Standards Board Statement 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), to determine whether they meet the definition of a derivative. The guidance refers to best efforts and mandatory delivery contracts that qualify as derivatives under FAS 133 as forward loan sales commitments. All forward loan sales commitments should be reported at fair value on the balance sheet.

A **derivative loan commitment** is created when a bank makes a mortgage commitment to a customer and it also intends to sell the loan to a third party once the loan is funded. These commitments include, but are not limited to, interest rate lock commitments. A derivative loan commitment is in place from the time the commitment is made until the loan is funded. Once the loan is funded, it is no longer a derivative loan commitment.

Therefore, if at the end of the calendar quarter, a bank has mortgage loans in its pipeline that it intends to sell, the notional amount of the loans should be reported as over-the-counter written options on Schedule RC-L of the call report. Additionally, the fair value of the derivative should be included in other assets or other liabilities on the balance sheet, depending on whether it has a positive (asset) or negative (liability) value at the end of the calendar quarter.

[1]SR 05-10, *Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans,* is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2005/sr0510.htm>.

Derivative Loan Commitments

Item	Call Report Schedule	Line Item
Notional Amount of the Mortgage Loans	Schedule RC-L (Derivatives and Off-Balance-Sheet Items)	12.d.(1), Column A and 14, Column A
Fair Value of the Derivative	Schedule RC-L	15.b.(1) or (2), Column A
	Schedule RC-F (Other Assets) or Schedule RC-G (Other Liabilities)	5.d. or 4.d.

A **mandatory delivery contract** is a loan sale agreement in which an institution commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the institution fails to deliver the mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a pair-off fee to compensate the investor for not following through on the commitment.

Mandatory Delivery Contract

An underlying, i.e., the price the investor will pay for the loans
A notional amount: the committed loan principal amount
Requires little or no initial net investment
Requires or permits net settlement or the equivalent thereof, as the seller is contractually obligated to either deliver mortgage loans or pay a pair-off fee on any shortfall on the delivery of the committed loan principal amount

A **best efforts contract** is a loan sales agreement in which an institution commits to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the borrower closes. Under this type of agreement, the institution is required to pay a pair-off fee only if the loan closes and the bank fails to deliver it to the investor; if the loan does not close, no pair-off fee is required.

Best Efforts Contract

An underlying, i.e., the price the investor will pay the seller for the individual loan
A notional amount: the principal amount of the loan as an exact dollar amount or as a principal range with a determinable maximum amount
Requires little or no initial net investment
Requires or permits net settlement or the equivalent thereof, as the seller is contractually obligated to either deliver the loan to the investor if the loan closes or pay a pair-off fee to compensate the investor if the loan closes and is not delivered

For a mandatory delivery contract or a best efforts contract to qualify as a derivative, it must possess all four of the characteristics noted in the corresponding tables to the left.

If a mandatory delivery contract or best efforts contract meets all four of the criteria, the notional amount should be reported as a forward contract on Schedule RC-L, and the fair value of the derivative should be included in the other assets (positive value) or other liabilities (negative value) on the balance sheet. See the table on the following page for reporting forward loan sales commitments.

These **forward loan sales commitments** are in place from the time the mortgage commitments are made to customers until the loans are sold to the third party. Therefore, it is possible that the same loan will be included in the total derivative loan commitments (over-the-counter written options) as well as the total forward loan sales commitments (forward contracts).

A fair value that is based on current mortgage interest rates in the market, not on interest rate(s) incorporated in the derivative loan commitment(s), must be assigned to all derivative loan commitments and forward loan sales commitments. There are several methods outlined in the guidance, including valuation techniques based on estimated expected future cash flows, observable prices of other current market transactions, or other source data such as quotations from rate sheets.

When determining the fair value of the derivative, institutions also need to give consideration to the predicted "pull-through" rate, which is the probability that a derivative loan commitment will ultimately result in an originated loan. Institutions are urged to have discussions with their auditors to ensure the integrity of their valuation process.

The guidance also contains additional details and examples that are helpful in clarifying some of the more complicated concepts associated with derivative

Forward Loan Sales Commitments

Item	Call Report Schedule	Line Item
Notional Amount of the Mortgage Loans	Schedule RC-L (Derivatives and Off-Balance-Sheet Items)	12.b., Column A and 14, Column A
Fair Value of the Derivative	Schedule RC-L	15.b.(1) or (2), Column A
	Schedule RC-F (Other Assets) or Schedule RC-G (Other Liabilities)	5.d. or 4.d.

mortgage products. Institutions that sell mortgage loans in the secondary market are encouraged to review the accounting and reporting requirements covered in the guidance to ensure that they are in compliance. Incorrect call report filings are subject to examiner criticism, and failure to comply with GAAP requirements in regulatory reports may be viewed as an unsafe and unsound practice.

If you have any questions about the accounting and reporting for commitments to originate and sell mortgage loans, please contact your institution's central point of contact or assigned manager at the Reserve Bank. ☐

A Fresh Look for *SRC Insights* and *Compliance Corner*

For the tenth anniversary of *SRC Insights* and *Compliance Corner*, we have created an exciting new layout design. While our look is different, we will continue to provide timely and useful information on supervisory, regulatory, and consumer compliance issues.

We would appreciate your feedback on the new design. Please direct any comments and suggestions to Cynthia L. Course (cynthia.course@phil.frb.org) at 215-574-3760.

Credit Risk Guidance for Home Equity Lending *...continued from page 3*

Finally, when tax assessment valuations are used as a basis for the model, the financial institution should validate the correlation between the taxing authority's value and the market value of the collateral.

Account and Portfolio Management

Account management activities should be tailored to the size and risk level of the loans. Because of the nature of some home equity products, such as interest-only and no or low documentation loans, as well as the long-term nature of some loans, management should employ risk management practices to identify high risk accounts and to monitor any change in these accounts. The frequency of these actions should be in line with the risk in the institution's portfolio. Some of the characteristics of effective account management include the following:

- Refresh credit risk scores periodically, and use behavioral scoring and analysis to identify potential problem accounts
- Assess utilization rates and payment patterns, such as borrowers who make only minimum payments over long periods and borrowers who use a home equity line of credit to keep payments current
- Obtain updated information on collateral values as market conditions change

Robust portfolio management practices are necessary to monitor the risk in a home equity lending portfolio. First, management must clearly communicate the loan portfolio objectives, including growth targets, utilization, rate of return hurdles, default and loss expectations, and concentration limits. Management should then measure against these expectations by establishing effective management information systems (MIS) to segment the portfolio and assess key risks.

Effective MIS also includes monitoring for policy and underwriting exceptions and high LTV transactions. All high LTV transactions should be tracked, and aggregate amounts should be reported to the board of directors. There should also be adequate controls in place to manage any high LTV lending.

Ongoing monitoring will enhance overall portfolio management and enable risk mitigation. Based on the results of monitoring, effective risk mitigation techniques could include private mortgage insurance, pool insurance, and securitizations. Finally, interest rate sensitivity testing of a portfolio should also be an important consideration.

Operations and Servicing

Strong processes should also be established for important back-office support functions such as lien perfection and documentation, property tax payments, and loan collections. Credit risk management practices must be in place for these support functions to effectively manage operational risks. Management should have policies and procedures in place to govern problem loan workouts and loss mitigation strategies. However, management should exercise caution to ensure that loss mitigation strategies are not used to defer losses.

Conclusion

Home equity lending is not only an attractive product for consumers, it can also be a profitable business for banks if the risks are managed effectively. If you have any questions about the home equity lending guidance, please contact your institution's central point of contact or assigned manager at the Reserve Bank. You may also contact Stephen Harter (stephen.harter@phil.frb.org) at (215) 574-4385. ☐

Coming Attractions

A new Bank Secrecy Act/Anti-Money Laundering examination manual was issued on June 30, 2005. The fourth quarter issue of *SRC Insights* will focus on Bank Secrecy Act/Anti-Money Laundering (BSA/AML) issues, including a review of any significant updates to the examination manual and current technology for monitoring BSA/AML compliance.

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