Fourth Quarter 2006 / Volume 11 Issue 2

SRC Insights

Federal Reserve Bank of Philadelphia

SPECIAL EXPANDED YEAR-END ISSUE

Check 21 and Check Fraud Prevention: Are They Mutually Exclusive?

by Mary G. Sacchetti, Supervising Examiner

The Check Clearing for the 21st Century Act, commonly known as "Check 21," was signed into law on October 28, 2003, and became effective one year later on October 28, 2004. The purpose of the legislation was to modernize and enhance the efficiency of the check payments system by making check truncation and electronic exchanges possible through the use of a "substitute check," more commonly known as an image-replacement document (IRD). The use of IRDs for payment in lieu of an original paper check was designed to shorten the processing time and possibly create faster availability of funds by eliminating many of the costs and risks associated with physically transporting checks. The new legislation only required paying banks to have the capability to accept and process IRDs as if they were paper checks rather than enforced the use of the other features of Check 21, such as requiring banks to create IRDs or to accept checks electronically.

The Check 21 Environment

Early adopters of Check 21 tended to be the banks of first deposit that would find immediate advantage in collecting checks faster than traditional physical methods. These "sending" institutions included banks of all sizes intent on improving their float times and reducing their transportation costs. Recent data provided by the Electronic Check Clearing House Organization highlight the increasing rate at which financial institutions have adopted the new processing environment within the past year. The volume of checks collected under Check 21 rules increased from

continued on page 16

SRC Insights is published quarterly and is distributed to institutions supervised by the Federal Reserve Bank of Philadelphia. The current and prior issues of *SRC Insights* are available at the Federal Reserve Bank of Philadelphia's website at www.philadelphiafed.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone (215-574-3769), or by e-mail (joanne.branigan@phil.frb.org). Please address all correspondence to: Joanne Branigan, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

Editor....................Joanne Branigan
Associate Editor........... Katrina Beck
Designer.................Dianne Hallowell

FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

The Credit Cycle

by Michael E. Collins, Senior Vice President

Credit cycles reflect changes in both loan quantity and loan quality. Credit cycles often occur in tandem with business cycles, which are related to fluctuations in the overall output of goods and services. In recent decades, credit cycles have followed the business cycle fairly closely, although this is not always the case. The current credit cycle includes new factors that were not part of past cycles, such as new products and market entrants, advances in technology, deeper capital markets, and continued advances in risk-based pricing. It remains to be seen how these factors will influence the credit cycle going forward.

Credit cycles are an inherent part of banking due in large part to the way banks compete for borrowers. The U.S. economy is entering a period in which economic activity is expected to moderate. During upturns in the credit cycle, riskier borrowers get credit, while collateralized loans—driven by competition—decrease along with other loan covenants. Financial institutions are challenged to recognize that as memories of past credit cycle downturns fade, loan officers may become desensitized to the impact of credit problems and may be more willing to lend to high-risk borrowers.

One way to measure a credit cycle is by noting changes in the supply of and the demand for credit. The demand for credit has been strong in the last few years, coinciding with a period of historically low interest rates and extraordinary mortgage lending activity. And the supply of credit has kept up with the demand, proven by strong market competition during this time.

Another way to measure a credit cycle is by examining the quality of credit. Credit quality is often described in terms of delinquency rates and charge-off rates, in addition to other metrics. Credit quality has been very strong over the last several years, as indicated by a stable nonperforming assets ratio, low net charge-off ratio, and strong reserve coverage of nonaccrual loans.

However, examiners continue to see evidence of easing of underwriting standards as financial institutions continue to stretch for loan volume and yield. Price concessions and more liberal repayment terms and loan covenants have been documented by examiners. On the contrary, during downturns in the credit cycle when nonperforming loans are rising, only banks' best customers get credit. Competition and margin pressure and the desire to drive profitability may be incenting loan officers to increase loan growth at the expense of future loan quality.

There is empirical evidence of more lenient credit standards during boom periods, both in terms of screening borrowers and underwriting and collateral requirements. Bank supervisors and bankers have evidence to suggest that bank lending mistakes are more prevalent in good times when both borrowers and lenders are overconfident about the ability to repay.

Policymakers must balance the focus on prudent risk management while avoiding unintentional consequences such as creating a credit crunch.

Because of the recent extended period of strong credit quality, growing loan demand, and fierce competition, it is not surprising that there is speculation about when there will be a change in the credit cycle and what the impact of that change will be.

Let's take a closer look at a few specific lending areas to gain some insight into current credit conditions. Commercial and industrial lending (C&I) is closely tied to the performance of the business sector. C&I credit quality has continuously improved over the last several years, and C&I loan demand has been steady, while underwriting standards have weakened and loan terms have eased. These trends are not unusual at this stage of the credit cycle. In fact, the Federal Reserve System's *October 2006 Senior Loan Officer Opinion Survey on Lending Practices* stated that strong competition (from nonblank market participants, in particular) is the main driver of the continued easing of C&I loan terms.[1]

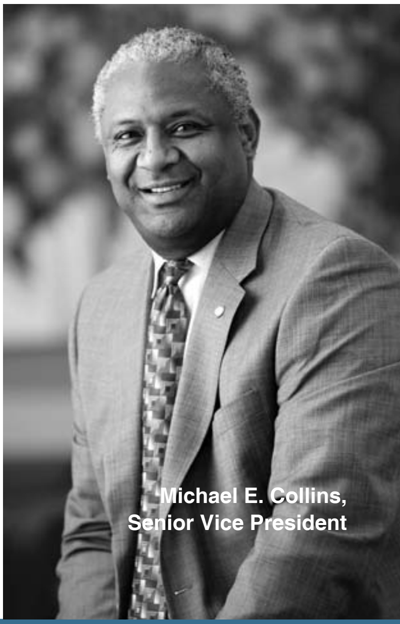
Commercial real estate (CRE) lending has received much attention from the regulators as CRE concentrations have reached historic levels. Bank supervisors have focused on CRE because it is typically a highly volatile asset class and CRE was a key factor in the credit problems of the late 1980s and early 1990s. Generally, CRE underwriting has improved over the last 15 years or so, but concentrations of CRE loans as a percentage of capital have continued to grow.

Of particular concern is that CRE lending has grown significantly in the last few years in the community banking sector. In previous credit cycles, large financial institutions typically had the most exposure to CRE loans. At financial institutions with assets between $100 million and $1 billion, average CRE concentrations are approximately 300 percent compared to about 150 percent at the bottom of the last CRE credit cycle in the late 1980s and early 1990s. Consequently, concern has been raised, and proposed guidance has been issued on CRE concentration and risk management practices, which aggregates previously issued guidance with an increased emphasis on portfolio management, strong risk management practices, and CRE concentration monitoring.

Policymakers must balance the focus on prudent risk manage-

continued on page 20

[1] The Federal Reserve System's *October 2006 Senior Loan Officer Opinion Survey on Bank Lending Practices* is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/SnLoanSurvey/200610/default.htm>.



Michael E. Collins, Senior Vice President

Influenza and the Financial Services Industry: A Case Study of the 1918 Spanish Flu

by Andrew Kish, Banking and Economic Analyst; Timothy Mochan, Intern; and Todd Vermilyea, Assistant Vice President

There has been a great deal of discussion and media attention recently surrounding avian influenza, commonly referred to as bird flu. Some of the discussion has been useful and has led to concrete steps that could mitigate the effects of a pandemic should one occur. For example, the U.S. government has budgeted $3.8 billion for pandemic influenza preparedness for the year 2006 alone.[1]

Also, on March 15, 2006, the Board of Governors of the Federal Reserve System, in conjunction with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), issued an interagency advisory on Influenza Pandemic Preparedness.[2] The supervisory letter is intended to raise awareness regarding the threat of pandemic influenza and also to alert financial institutions of the need to address this threat in their crisis response and contingency strategies.

However, some cataclysmic media accounts of the possible consequences of a pandemic may leave the public unduly fearful. Irrational fear, including a lack of public confidence in the financial system, could have potentially disastrous effects. This article presents a historical analysis of the deadly Spanish flu of 1918 and its effect on the U.S. economy and, particularly, the financial services industry. While the possibility of avian influenza becoming a human pandemic is still uncertain, a historical analysis of the 1918 flu can shed light on how the U.S. handled a serious crisis in the past. In addition to providing a historical account, the facts in this article may be useful in countering any irrational fear and bolstering confidence in the financial services industry should a pandemic occur in the future.

Background on the 1918 Spanish Flu

The so-called Spanish flu swept the world during late 1918 and early 1919. This pandemic infected about one-fourth of the global population, and it is estimated that between 50 and 100 million people lost their lives worldwide.[3] Some of the first reported cases of the deadly influenza actually came from the United States at Fort Riley, Kansas in March 1918, but the illness quickly showed up all over the world.[4] Military personnel incubated and amplified the spreading of the disease due to the constant movement of troops across the Atlantic Ocean and the harsh conditions soldiers endured on the battlefield. The name associated with this pandemic, Spanish flu, was mainly due to wartime censorship and was likely a misnomer. The nations involved in World War I ini-

Photo Courtesy of the National Museum of Health and Medicine, Armed Forces Institute of Pathology, Washington, D.C. (NCP 1603)

[1] United States Congressional Budget Office, *A Potential Influenza Pandemic: An Update on Possible Macroeconomic Effects and Policy Issues*, 2006

[2] SR 06-05, *Influenza Pandemic Preparedness*, is available on the Board of Governors' website at <www.fedweb.frb.gov/fedweb/bsr/srltrs/sr0605.htm>.

[3] "1918 Spanish Flu Timeline," Twoop.com, June 20, 2006, available online at <www.twoop.com/medicine/archives/2005/10/1918_spanish_flu.html>.

[4] Sara Francis Fujimura, "Purple Death: The Great Flu of 1918," *Perspectives in Health*, Vol. 8.3, pp. 28–30, 2003, available online at <www.paho.org/English/DD/PIN/Number18_article5.htm>.

tially suppressed media reports, such as death rates, in an effort to conceal information that could prove valuable to the enemy or could hurt morale. However, uncensored reporters from neutral Spain more accurately reported the deaths from the pandemic, causing people to inaccurately believe the epidemic was more prevalent in Spain than in other countries.

While a new form of influenza strikes annually, the flu of 1918 was especially unique and devastating. A distinctive aspect of the influenza was its disproportionate effect on healthy adults in their prime. During typical epidemics, most of the lives claimed are young children and elderly people, which creates a "U-shaped" death pattern. However, this particular influenza caused a distinct "W-shaped" mortality pattern by also targeting healthy middle-aged men and women with a very high frequency.[5]

In a matter of months, the death toll of the Spanish flu in the U.S. was greater than the number of Americans killed in World War I, World War II, the Korean War, and the Vietnam War combined.

The pandemic struck the U.S. in three waves, with the most horrific and deadly wave beginning in August 1918.[6] The month of October ended up being the deadliest month of the pandemic. Overall, it is suspected that 675,000 Americans lost their lives due to the Spanish flu. In a matter of months, the death toll of the Spanish flu in the U.S. was greater than the number of Americans killed in World War I, World War II, the Korean War, and the Vietnam War combined.[7]

Impact of Spanish Flu on the U.S. Economy

There are very few studies published that analyze the effect the Spanish flu had on the overall U.S. economy, perhaps because it is difficult to find substantial and accurate data from that time period, but also because it is difficult to separate the economic impact of influenza and World War I. Industrial production and the business activity index did dip slightly at the height of the epidemic.[8] Correspondingly, the National Bureau of Economic Research (NBER) cites August 1918 to March 1919 as a period of business contraction in the United States, which coincides with the period in which the epidemic had a stronghold on the U.S.[9] The Congressional Budget Office (CBO) has estimated that a pandemic similar to the 1918 flu would decrease annual U.S. GDP levels by 5% if it happened in today's economy.

Certain industries were hit especially hard, notably places of amusement and life insurance companies. Pennsylvania, along with most other states, issued the mandatory closings of schools, churches, theatres, and places of public assemblage toward the end of the year in 1918. In his book, *America's Forgotten Pandemic*, Alfred Crosby estimates that the closing of Philadelphia theatres, motion picture houses, hotels, and saloons cost the city $2.35 million. Crosby also notes that influenza caused "37 out of 48 life insurance companies in the United States to omit or at least reduce their dividends. The number of death claims made against the Equitable Life Insurance Society of the United States in the week of October 30, 1918, was 745 percent higher than the number made in the equivalent week of 1917."[10]

---

[5] E. Brainerd and Mark V. Siegler, "The Economic Effects of the 1918 Influenza Epidemic," Centre for Economic Policy Research Discussion, February 2003, available online at <www.cepr.org/pubs/dps/DP3791.asp>.

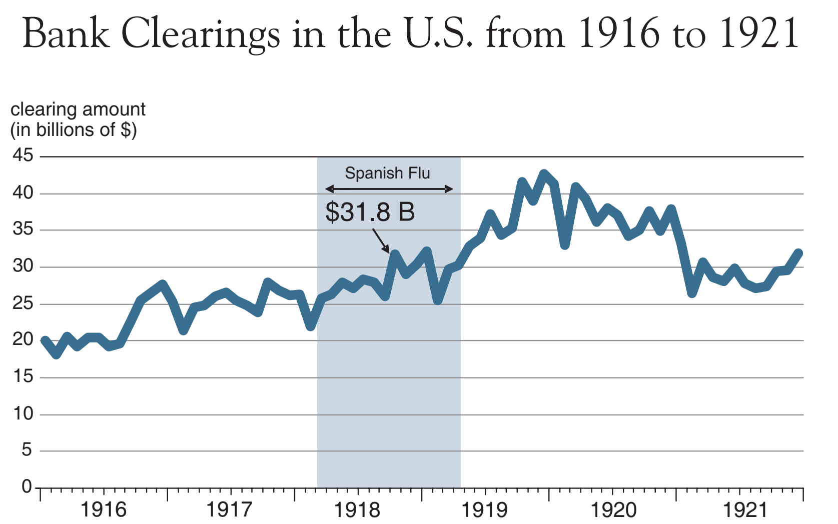
[6] Alfred W. Crosby, *America's Forgotten Pandemic*, 2nd Ed., Cambridge, U.K.: Cambridge University Press, 2003.

[7] See footnote 5.

[8] International Monetary Fund, Avian Flu Working Group, *The Global, Economic, and Financial Impact of an Avian Flu Pandemic and the Role of the IMF*, 2006.

[9] See footnote 5.

[10] See footnote 6.



Source: Compiled from *Dun's Review* from 1916 to 1922
Note: Clearing amounts are monthly totals

Effect of Spanish Flu on the Financial Services Industry

The financial services industry proved resilient in the face of the pandemic. As noted, states throughout the country in 1918 were forced to order many public gathering places to shut down. Banks, however, were generally not required to close. In addition to closing down certain businesses, health officials in many areas staggered opening and closing times for many businesses to minimize crowds and decrease congestion on transportation lines.[11] However, the New York City Board of Health published a resolution on October 6, 1918, in the *New York Times* that affirmed that, "The opening and closing of banks, trust companies, and offices of the United States Government are not affected by the provisions of this order."[12]

Like other industries, sickness of the labor force did impede operations in financial services. An article in the *Wall Street Journal* on October 24, 1918, states that efficiency at the Federal Reserve Bank of New York had been hindered due to 300 cases of influenza out of a workforce of 2,515.[13] Similarly, the pandemic caused the Boston Stock Exchange to close for a day in late September. Nevertheless, most banks and financial markets remained open and continued to function throughout the crisis.

Perhaps most important of all, the payment system functioned normally throughout the crisis. A *New York Times* article dated October 12, 1918, states, "Clearings through the banks continue to be maintained in noteworthy volume at most of the more important centers in the United States, the total this week, according to *Dun's Review*, amounting to $5,662,220,053, an increase over the same week last year of 12.2 per cent."[14] This growth was achieved despite a peak in influenza cases. The graph on this page is an illustration of monthly bank clearing amounts from 1916 to 1921. The graph displays a general upward trend in bank clearings during the course of the pandemic. It also shows that, at $31.8 billion, total bank clearings for October—the deadliest month of the pandemic—equaled the largest amount registered of any month in 1918.

Similarly, most financial markets remained open during the crisis. In fact, stock prices and volumes on the New York Stock Exchange were surprisingly unaffected by the pandemic. By the end of 1918, the Dow Jones Industrial Average was up 10.5 percent for the year and continued its upward climb, experiencing a 30 percent post-war rally in early 1919.[15] The Dow also reached its high for 1918 in mid-October, when the pandemic was at its peak. Furthermore, trading volume on the NYSE showed an upward trend during

---

[11] See footnote 6.

[12] "Revise Time Table in Influenza Fight," *New York Times*, October 6, 1918: 1, 8, ProQuest Historical Newspapers.

[13] "Reserve Employees Number 2,515," *Wall Street Journal*, October 24, 1918: 10, ProQuest Historical Newspapers.

[14] "The Condition of Trade," *New York Times*, October 12, 1918: 19, ProQuest Historical Newspapers.

the height of the epidemic. Cooper and Grinder offer three primary reasons why the market was not affected. They suggest press censorship kept investors from knowing the extent of the epidemic, news about the war overwhelmed influenza news, and government officials downplayed the severity of the disease to the public. The lack of immediate public awareness to the pandemic's severity and the impact of World War I are two factors that may have diminished the effects of the pandemic on the financial markets.

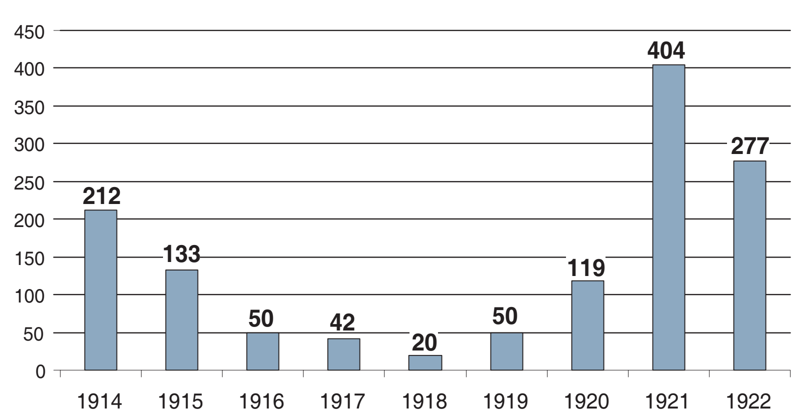
Bond markets also continued to function. A major government bond issuance (the Liberty Loan campaign, in which the Federal Reserve played a major role) raised nearly one billion dollars more than its $6 billion quota during the height of the flu pandemic.[16] Even more notably, the Boston and the Philadelphia Federal Reserve Districts, two cities that were hit extremely hard by influenza, were first and third, respectively, in percentage raised over quota. When referring to the October loan campaign, the secretary of the Treasury at that time stated, "It was the largest flotation of bonds ever made in a single effort anywhere or at anytime."[17]

The level of banking failures in 1918 and 1919 is perhaps the most telling indicator of how the financial services industry fared during the course of the pandemic. The graph below illustrates the number of banking failures by year in the United States as reported by *Dun's Review*. With only 20 bank failures, 1918 had the fewest failures of the nine-year period examined. Additionally, the total amount of liabilities of the banks that failed in 1918 ($5,131,887) is not even half as much as any other single year from 1914 to 1922. These data suggest that the pandemic did not greatly affect the safety and soundness of the banking system. Bank failures also remained low in 1919.

Conclusion

The Spanish flu was the third deadliest pandemic in history, trailing only the plagues of the sixth and fourteenth centuries.[18] At the peak of the influenza, much of the nation's resources were simultaneously being directed toward the war effort in Europe. Under these conditions, the U.S. economy contracted, and GDP dipped. However, the evidence suggests that the payment system and financial services industry weathered the pandemic well. For more information on influenza pandemic preparedness, please see the federal banking agencies' interagency advisory located on the Board of Governors' website at <www.fedweb.frb.gov/fedweb/bsr/srltrs/sr0605.htm>. The advisory also includes a list of websites for locating additional information and resources. ☐

U.S. Banking Failures from 1914 to 1922



Source: Compiled from *Dun's Review* from 1914 to 1923

---

[15] Dan Cooper and Brian Grinder, "The Flu Pandemic, the Flow of Information, and the Financial Markets of 1918," *Financial History*, Vol. 83, 2005, pages 8–11.

[16] "Almost a Billion Over Loan Quota," *Stars and Stripes*, 1.40, November 8, 1918: 3, available online at <http://memory.loc.gov/ammem/index.html>.

[17] See footnote 6

[18] See footnote 8.

Information Security at the Federal Reserve

by Frank P. Mongiello, Manager

Over recent months, there has been a spike in lost and stolen laptops from various business organizations and government agencies in the U.S. Even with heightened awareness and stricter security regulations, the number of these incidents continues to grow, and the Federal Reserve System (Federal Reserve) remains dedicated to ensuring the highest level of information security. This article will outline the information security infrastructure employed by the Federal Reserve to protect its extremely sensitive and confidential information from being compromised.

Section 501b of the Graham-Leach-Bliley Act requires financial institutions to establish appropriate standards for administrative, technical, and physical safeguards for customer records and information. The Federal Reserve employs a comprehensive security program, which is detailed below.

Our information security program begins with employee education. All Federal Reserve employees are required to complete an annual information security awareness session to ensure that they are familiar with all policies and procedures. Security reminders are sent to employees periodically throughout the year in order to remind them of the importance of information security.

All Federal Reserve employees are required to complete an annual information security awareness session to ensure that they are familiar with all policies and procedures.

All software used throughout the Federal Reserve must go through a risk management assessment process. During this process, any potential weaknesses are identified, and necessary mitigating controls are implemented prior to the software being pushed into the production environment. Also, new hardware must go through a similar process to minimize the risk exposure.

While these processes ensure that information is secure at the user and equipment levels, additional processes and technologies are in place for virus protection and unauthorized access prevention. The Federal Reserve has a standard process to classify information for both digital and physical formats, and data must be handled according to their classification. A complex technical security architecture is in place to safeguard Federal Reserve digital assets. All computers are protected with antivirus software, and because all viruses contain a unique signature, the signature file is updated frequently to protect against the latest threats. Finally, an automated process is utilized to distribute the updates to all computers on a weekly basis.

The Federal Reserve also requires that a personal firewall be installed on all laptop computers. A firewall, which acts as a barrier to prevent unauthorized access to a computer or network, can be software, hardware, or a combination of both. Firewalls at the Federal Reserve are "locked down" to ensure that none of the settings can be changed and, most importantly, that they cannot be disabled.

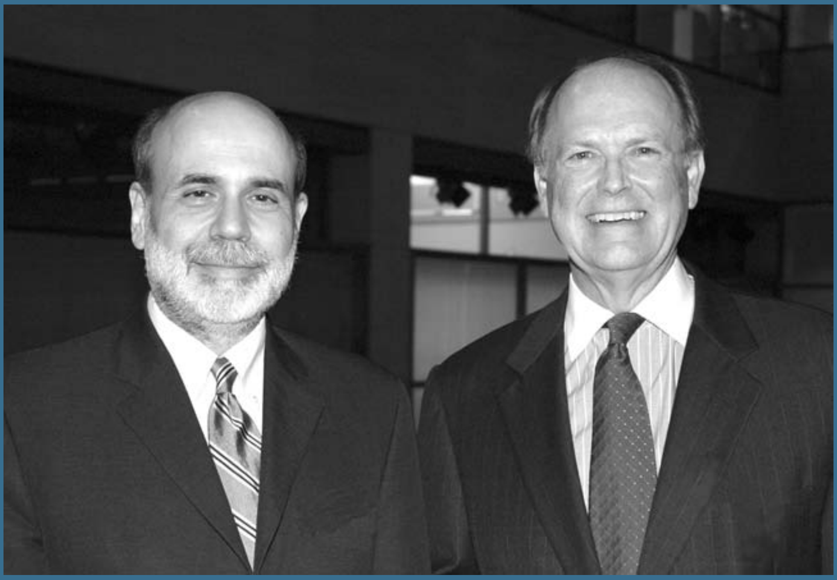
Aside from the threat of stolen property, unauthorized access and hacking are also major threats to data security. To safeguard the data stored on a laptop's hard disk, the Federal Reserve utilizes hard disk encryption, which uses a 256-bit triple DES encryption key, making it virtually impossible for anyone to break in and access data. More importantly, the entire disk is encrypted, so users are ensured that all data saved to the disk are protected. Finally, our hard disk encryption solution uses dual factor authentication to start the operating system and to provide access to the data.

Data transfer and remote access are also sensitive areas in information security. The Federal Reserve currently uses a dual factor authentication process for remote access through a virtual private network (vpn). A vpn is a private, secure network that leverages the public telecommunications network, while securing data only to those with authorized access to the private network. To further increase secure access to its systems, the Federal Reserve is moving to a dual factor authentication process for all users who want to access the operating system and network.

This layered approach provides the highest level of information security, and it is enacted throughout the Federal Reserve. Our infrastructure begins with a comprehensive information security program that specifies policies, procedures, and user awareness. A complex technical security architecture comprised of hardware and software—and combined with secure data transfer—broadens our efforts to preserve the confidentiality of the sensitive information we process and manage daily. □

Chairman Ben Bernanke Visits the Federal Reserve Bank of Philadelphia

Federal Reserve Chairman Ben Bernanke visited the Federal Reserve Bank of Philadelphia on October 18 and 19, 2006. While here, Chairman Bernanke attended a meeting of the board of directors, toured Check Operations and Cash, and met with local banking and business leaders at a reception held in his honor. Chairman Bernanke, who assumed leadership of the Federal Reserve this past February, has close ties to the Philadelphia region. He was a professor of economics at Princeton University and was also a visiting scholar here at the Philadelphia Fed.



Federal Reserve Chairman Ben Bernanke (left) and Philadelphia Federal Reserve President Charles Plosser (right) at the Philadephia Fed in October.

Article originally published in the Friday File*, a weekly publication for Federal Reserve Bank of Philadelphia employees published by Public Affairs.*

Interagency Guidance on Appraisals, Revisions to the USPAP, and Implications for Banks

by James W. Corkery, Supervising Examiner, and David F. Fomunyam, Supervising Examiner

Acquisition and review of a professionally-prepared appraisal is fundamental to the sound underwriting of real estate loans. Title XI of the Financial Institutions Reform and Recovery and Enforcement Act (FIRREA) of 1989 requires that federal financial and public policy interests in real estate-related transactions be protected by requiring real estate appraisals utilized in connection with federally-related transactions to be performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated.[1]

FIRREA also promulgated that each federal banking agency prescribe appropriate standards for the performance of real estate appraisals in connection with federally-related transactions. Since the enactment of FIRREA, the federal banking agencies (the agencies) have been working to ensure that banks develop effective, independent real estate appraisal programs.

[1] The federal banking agencies' appraisal regulations define a federally-related transaction as any real esate-related financial transaction that an agency or any regulated institution engages in or contracts for and that requires the services of an appraiser. See OCC: 12 CFR 34, C; FRB: 12 CRF 225.61-67; FDIC 12 CFR 323; OTS: 12 CFR 564; and NCUA: 12 CFR 722.

This article will provide an overview of current supervisory guidance pertaining to real estate appraisals. In addition, since FIRREA recognizes the Appraisal Standards Board's (ASB) Uniform Standards of Professional Appraisal Practice (USPAP) as the generally accepted appraisal standard, recent revisions to the USPAP and its implication for banks will also be discussed.

Overview of Interagency Appraisal Guidelines

In September 1992, the agencies issued interagency guidance to address supervisory matters related to real estate appraisals and to clarify the development of prudent appraisal programs. In June 1994, that guidance was superseded by new interagency guidance,[2] which addressed amendments to the agencies' real estate appraisal regulations.[3] The new guidance, which provides more detail for each of the points listed below, notes that an effective real estate appraisal program should:

- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals
- Provide for the independence of the person performing appraisals
- Identify the appropriate appraisal for various lending transactions
- Provide for the receipt of the appraisal report in a timely manner to facilitate the underwriting decision
- Assess the validity of existing appraisals to support subsequent transactions

[2] 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>.

[3] FRB: 12 CFR 225.61-67 (Regulation Y, subpart G) and 12 CFR 208.18 (Regulation H); OCC: 12 CFR part 34, subpart C; FDIC: 12 CFR 323; and OTS: 12 CFR part 564.

- Establish criteria for obtaining appraisals for transactions that are otherwise exempt from the agencies' appraisal regulations
- Establish internal controls that promote compliance with these program standards

Additional guidance was provided in a second interagency statement issued on October 28, 2003, which served as a reminder to financial institutions to develop effective, independent real estate appraisal programs for all of their lending functions.[4] This guidance included all real estate-related financial transactions originated or purchased by a financial institution for its own portfolio or to be held for sale.

The 2003 interagency statement also reinforced the need for appraiser independence (with limited exceptions for banks that do not directly engage an appraiser). The statement focused on ensuring independence by safeguarding against internal influence or interference and by fostering effective internal controls so that no single person has sole authority to render credit decisions for loans on which they ordered or reviewed the appraisal.

Regulatory Guidance on 2006 USPAP and the ASB

On June 22, 2006, the agencies put forth an interagency statement to inform financial institutions that significant revisions were made to the USPAP. The 2006 USPAP, effective July 1, 2006, included a new Scope of Work Rule and deleted the Departure Rule and associated terminology. Consequently, financial institutions must ensure that appraisals supporting federally-related transactions adhere to the new USPAP standards and meet the other minimum standards contained in appraisal regulations.

For state member banks, the Board of Governors issued SR Letter 06-9, which incorporated two attachments.[5] The attachments contain the interagency statement and a Q&A document prepared by the ASB to highlight some of the most common questions about the recent changes.

While an appraiser is responsible for establishing the scope of work under the 2006 USPAP, financial institutions are responsible for complying with the agencies' appraisal regulations.

How Has the USPAP Changed?

In adopting the 2006 revisions, the ASB has indicated that the appraisal process has not changed and that the concepts in the Scope of Work Rule are not new to USPAP.[6] Nevertheless, there is greater emphasis on the appraiser's process of problem identification and development of an appropriate scope of work. In essence, the new Scope of Work Rule serves to clarify the standards for the type and extent of research and analysis performed by the appraiser in the appraisal assignment. Since the Scope of Work Rule is now required, the 2006 USPAP deletes the Departure Rule and associated terminology, such as "binding" and "specific" requirements and "complete" and "limited" appraisals.

What Effect Does This Have on Financial Institutions?

As detailed in the June 2006 interagency guidance, while an appraiser is responsible for establishing the scope of work under the 2006 USPAP, financial institutions are responsible for complying with the agen-

continued on page 22

[4] SR 03-18, *Independent Appraisal and Evaluation Functions*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2003/sr0318.htm>.

[5] SR 06-09, *Revisions to the Uniform Standards of Professional Appraisal Practice*, available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2006/sr0609.htm>.

[6] The 2006 USPAP and other ASB documents are available on the Appraisal Foundation website at <www.appraisalfoundation.org/s_appraisal/sec.asp?CID=3&DID=3>.

Net Interest Margin Compression and the Reach for Earnings

by Robert Rell, Supervisory Studies Specialist

The net interest margin (NIM) of most banks has been compressed in recent years. This is largely due to a flatter yield curve and a growing reliance on funding sources that are more sensitive to changes in interest rates. If conditions persist, then NIM compression will continue to dampen near-term earnings prospects. Regulators are concerned about how bankers respond to this added margin pressure. Some may pursue higher yielding, but potentially riskier, lending to compensate, while others could be tempted to relax underwriting standards in order to sustain loan volume or attract new borrowers.

In recent years, bankers have been presented with an exceptionally challenging environment as the yield curve has remained flattened or inverted for a prolonged period.

Yield Curve Influence

Over the last ten years, the banking industry's record profitability and strong return on equity has often overshadowed a declining NIM. In recent years, bankers have been presented with an exceptionally challenging environment as the yield curve has remained flattened or inverted for a prolonged period. As of September 29, 2006, the six-month Treasury rate (5.02 percent) was 25 basis points higher than the 30-year Treasury rate (4.77 percent). While the NIM has shown recent signs of stabilizing, it still remains low by historical standards.

Financial results indicate that small banks have experienced less of an impact from NIM compression. Deposit costs are administrative, as opposed to market-based, and they adjust more gradually, lessening the compression effect typically on small banks that utilize deposits as their main funding source. Large banks tend to have a greater reliance on wholesale funding, and as a result, their margins are more sensitive to changes in interest rates. However, as the flatness of the yield curve persisted, the compression effect became more widespread. For example, between December 2002 and December 2005, NIM declined at nearly two-thirds of the Third District commercial banks, with the greatest changes occurring mainly at large banks, credit card banks, and de novos.

Shift in Funding Sources

Changes in the funding mix have also pressured the NIM. In recent years, loan growth outpaced core deposit growth. Bankers now rely more heavily on more expensive noncore funding sources. Brokered deposits, measured as a percentage of total assets, grew from approximately 1 percent to approximately 3 percent. The use of FHLB advances became commonplace after membership opened to commercial banks in 1989. The level of FHLB borrowings grew from near zero percent in 1990 to around 3 percent in 2005.

Many Third District bankers say they have been experiencing increased difficulty obtaining and retaining core deposits. Released in early 2006, Grant Thornton's annual survey of bank executives found this to be a common sentiment throughout the industry.[1] The survey found that while almost all bankers (96 percent) identified retaining deposits as critical to their bank's success, only half (51 percent) felt confident in their ability to do so.

Furthermore, the deposit mix has also changed. Between 2000 and 2004, customers typically held their money in MMDA deposits, preferring liquidity to the marginally higher yields offered on certificates of deposit. This changed when the Fed began increasing

---

[1] Grant Thornton's *Thirteenth Annual Survey of Bank Executives* is available online at <www.GrantThornton.com>.

short-term rates in mid-2004. Customer preference has shifted from savings accounts to time deposits as yields have become more meaningful. Many banks now have higher interest expenses on the same underlying deposits.

Looking to the future, there are potential consequences if current conditions persist. Some additional compression is likely to occur if the yield curve remains flat. Smaller banks that have benefited from delays in the re-pricing of core deposits may need to reassess their strategy. As market conditions reach an equilibrium point, some may find it necessary to raise deposit yields in order to prevent attrition.

Banks and other lenders in the region reported that competition for loans continues to be strong and net interest margins remain thin.

Regulatory Concern

Although the current asset quality environment appears relatively benign and charge offs are near historic lows, regulators remain concerned that banks may be turning to higher yielding, but potentially riskier, lending to offset the earnings effects of NIM compression. Stretching for yields and relaxing underwriting standards can lead to poor lending decisions that ultimately translate into credit problems as portfolios mature.

The April 2006 *Beige Book* noted that for the Third District, "Banks and other lenders in the region reported that competition for loans continues to be strong and net interest margins remain thin."[2] For example, there has been sizable and rapid growth in the volume and concentrations of commercial real estate (CRE) loans, a historically volatile asset class. Final interagency guidance that reinforces sound lending principles and emphasizes the need to adjust risk management practices as CRE concentrations increase is expected to be released by year-end.

At the same time, there are signs that underwriting standards are being relaxed. It is apparent from the Federal Reserve's Senior Loan Officer Survey[3] that more lenders are relaxing their underwriting standards on commercial and industrial loans. The number of respondents that were tightening their underwriting standards reached an all-time low in 2005 before improving in recent months. Another indication is that examiners are reporting more frequent concessions to borrowers, lengthened maturities, and fewer loan covenants. As supervisors, we want to ensure that loan to value standards remain high and the number of exceptions does not increase.

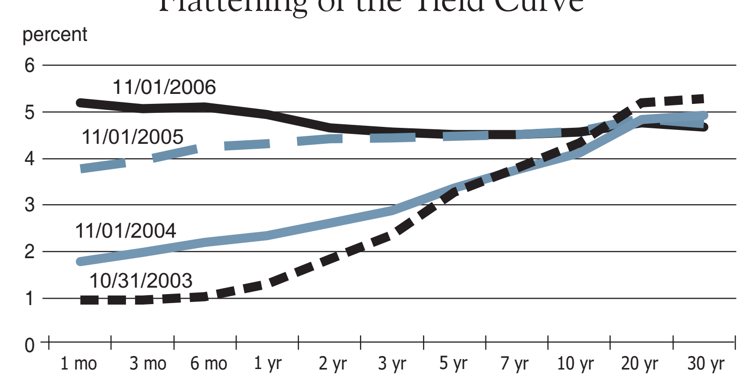
Bankers and regulators face a variety of challenges ahead. A number of potential scenarios could unfold. The supervisory community will monitor how lenders respond to these heightened performance pressures. In the end, sound risk management practices, prudent decision making, and strong internal controls will help ensure the continued stability and prosperity of the industry. ☐

---

[2] The *April 2006 Beige Book—Third District* is available online at <www.federalreserve.gov/Fomc/BeigeBook/2006/20060426/3.htm>.

[3] The Federal Reserve's Senior Loan Officer Survey is available online at <www.federalreserve.gov/boarddocs/snloansurvey>.

Flattening of the Yield Curve



Source: U.S. Department of Treasury

Sarbanes-Oxley's Impact on Nonpublic Organizations

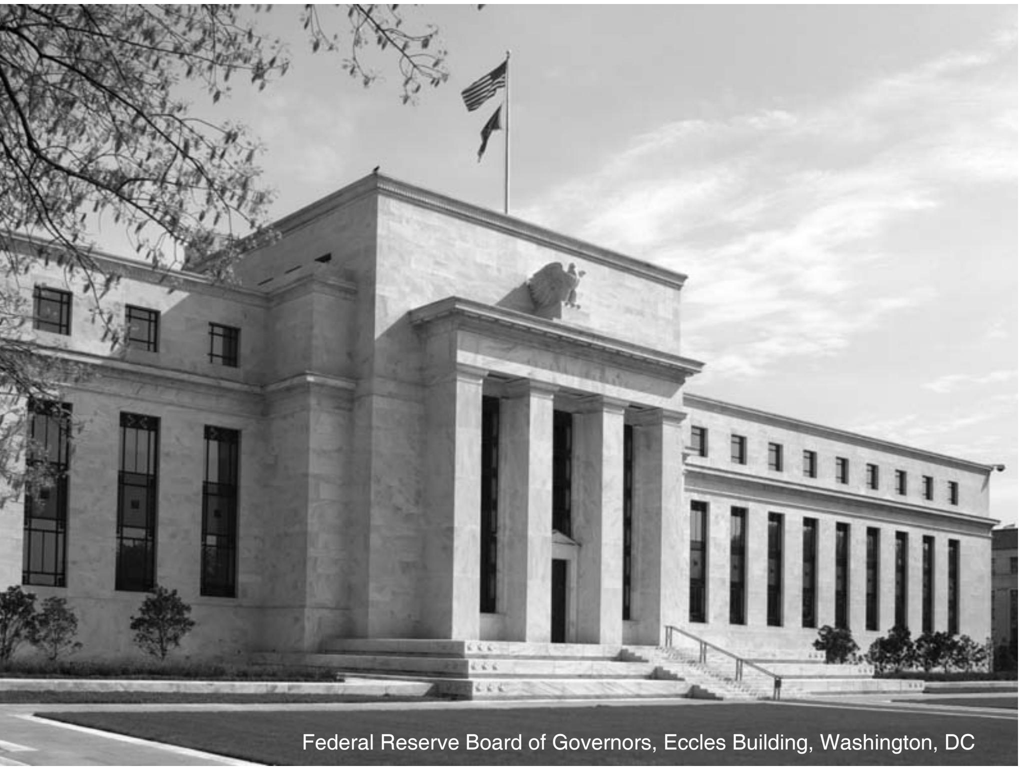
by William Lenney, Applications Analyst

The Sarbanes-Oxley Act of 2002 (SOX) directly impacts publicly-traded companies and companies that meet certain Securities Exchange Commission (SEC) filing requirements. Most private companies, not-for-profit organizations, and government agencies are not required to comply with SOX. However, since the goals of the act include accountability, reliability, and transparency, which are important values for most organizations, some have elected to voluntarily adopt certain provisions of SOX.

The Federal Reserve System (FRS) is one example of such an organization. As the nation's central bank, the FRS has a longstanding commitment to excellence in conducting its activities and fulfilling its principal missions. Earning and maintaining the public's trust and credibility are keys to the FRS's effectiveness as a central bank. The FRS must operate efficiently and effectively, maintaining high standards of internal controls over financial reporting and safeguarding of assets—just as public companies are required to do. The FRS has made a concerted effort to comply with SOX for the benefit of its stakeholders, which include bankers, investors, employees, businesses, and citizens.

In 1997, the FRS adopted the COSO framework for assessing internal controls, and in 1999, the Federal Reserve Act was amended to require an external auditor review of Federal Reserve financial statements. As a member of the FRS, the Federal Reserve Bank of Philadelphia (FRBP) has historically placed great emphasis on strong internal controls. In the past, the annual auditor attestation on the FRBP's internal controls was conducted using the auditing standard of the American Institute of Certified Public Accountants (AICPA)—AT 501: Reporting on an Entity's Internal Control over Financial Reporting.

Under SOX, the Public Company Accounting Oversight Board now has authority for issuing audit standards, and in 2004, Auditing Standard No. 2 (AS 2) was implemented. This auditing standard superseded the previous AICPA standard. The AICPA standard is still applicable to nonpublic entities, while AS 2 is required to be used for internal control attestations of public companies. While it is not formally subject to AS 2, which is considered a more rigorous standard, the FRBP has enhanced its internal control processes so that they meet the requirements of AS 2. The level of internal control testing by its external auditor increased substantially in the FRBP's efforts to attain an unqualified opinion on its internal controls under AS 2.


Federal Reserve Board of Governors, Eccles Building, Washington, DC

Other organizations not subject to SOX are taking a similar proactive approach. For example, Drexel University (Drexel), a not-for-profit organization, has identified and documented its critical business processes, as required by Section 404 of SOX.[1] As per Section 301 of SOX, Drexel requires financial literacy for audit committee members and expanded responsibilities for whistle-blowing complaints. In addition, the chief executive officer and chief financial officer certify the financial statements, as required by Section 302 of SOX.

Although Drexel has experienced additional costs due to the increased documentation and additional resources that result from implementing certain elements of SOX, it has also identified significant benefits, including creating potential opportunities for streamlining business operations, educating employees on the importance of strong internal controls, and ensuring that policies and procedures are consistent with business objectives.

> Although SOX compliance should improve corporate governance and lead to fraud reduction, some companies have complained that the cost of compliance is too great.

In general, SOX corporate governance reforms are becoming more widely accepted by nonpublic entities. For example, some are establishing audit committees, increasing their number of independent directors, and adopting conflict of interest policies.[2] SOX is also affecting small private companies that want to go public. For example, Title II of SOX deals with auditor independence. A company preparing to go public must ensure that its CEO, controller, and CFO have not been employed by its audit firm during the 12 months prior to its audit. In addition, it must comply with the limitations on the amount of consulting services performed by its independent auditor.[3]

Entities not subject to SOX should consider the additional costs when determining whether to incorporate SOX requirements into their corporate governance program. Although SOX compliance should improve corporate governance and lead to fraud reduction, some companies have complained that the cost of compliance is too great. A 2005 survey performed by Financial Executives International, a group of 15,000 financial executives, found that public companies were spending an average of \$4.4 million on SOX compliance. Another survey conducted by NASDQ found that public companies with less than \$100 million in revenue were spending an average of 1.3 percent of revenue to comply, while the companies with sales greater than \$5 billion spent an average of 0.3 percent of revenue.[4] In general, larger companies with greater economies of scale cover the increased overhead for compliance with SOX more effectively.

The SEC has taken action to address some of the issues related to SOX compliance, including the high cost. In May, the SEC announced plans to make compliance with SOX Section 404, which deals with internal controls, more efficient and cost effective. The SEC's plans also call for revisions to AS 2. Continuous improvements to SOX implementation and the ongoing evidence of the benefits SOX provides may likely result in more nonpublic entities embracing SOX. ☐

---

[1] James K. Seaman, "What Works Best," *Internal Auditor*, February 2006, available online to subscribers at <www.theiia.org>.

[2] The document "The Impact of Sarbanes-Oxley on Private Companies," September 16, 2004, is available on the Perkins Coie LLC website at <www.perkinscoie.com/content/ren/updates/corp/091604.htm>.

[3] Lynn Stephens and Robert G. Schwartz, "The Chilling Effect of Sarbanes-Oxley: Myth or Reality?," *The CPA Journal*, June 2006, available online at <www.nysscpa.org/cpajournal/2006/606/index.htm>.

[4] Amy Feldman, "Surviving Sarbanes-Oxley," *Inc. Magazine*, September 2005, available online at <www.inc.com/magazine/20050901/surviving-so.html>.

Check 21 and Check Fraud Prevention: Are They Mutually Exclusive? ...continued from page 1

28.1 million images in August 2005 to 283.3 million in August 2006, with the daily average volume increasing from 200,000 to 5.8 million. Within that same time frame, the dollar amount of Check 21 items grew 154.7 percent, increasing from $192 billion to $575 billion.[1]

However, institutions appeared to be less intent upon implementing the receiving aspects of Check 21, since the new operating practices involved making extensive and costly changes to institutions' check processing equipment and procedures. Most banks found that sending electronic files containing imaged checks was relatively easy, as was creating IRDs when necessary. However, most financial institutions also found that receiving and processing these same files as a paying bank were very challenging. Thus, the adoption rate for receiving "image exchange files" by banks as paying banks continues to be far lower than the participation rate for these same banks as banks of first deposit. In the year following the implementation of Check 21, both the send and receive rates were insignificant, with some statistics citing that such checks sent under Check 21 rules represented only 1 to 2 percent of checks processed annually in the United States,with the checks received being even lower.[2] Despite the slow initial adoption of end-to-end processing within the Check 21 environment, payment system experts anticipate that the majority of the largest banks will fully implement the technological standards within the next year.

Approximately 75 percent of all commercial banks incurred losses related to check fraud during 2003, with losses totaling approximately $677 million.

Impediments to the Full Transition to the Check 21 Environment

Despite the probable benefits associated with Check 21, a number of obstacles have impeded the industry's migration to the new processing environment. Rather than elaborate on the wide array of potential challenges, however, this article will focus only on a few. As mentioned above, in order to transition from the practice of processing paper checks to that of processing imaged checks, financial institutions must greatly overhaul their check processing infrastructure and integrate the imaged items into their back office processing and risk management systems. Such actions require significant investments of both time and money at a time when the industry is experiencing a decline in the use of paper checks in favor of alternative forms of electronic payment. According to a 2003 Federal Reserve study of the use of retail payment instruments, the volume of paper checks processed decreased from 42 billion in 2000 to 37 billion in 2003, with U.S. noncash retail payments decreasing from 57 percent to 45 percent during that same time frame.[3] Nevertheless, while the volume of paper checks is expected to continue to decline, experts predict that paper checks will continue to be widely used and will co-exist with electronic checks for years to come.

Another significant impediment relates to the ongoing threat of check fraud that has continued to increase

---

[1] Federal Reserve/ECCHO Communications Work Group, as of August 2006, available online at <www.eccho.com/check_ps.php>.

[2] Peter Lucas, "Checking Up: One Year After Check 21 Was Implemented, New Opportunities in Electronic Check Imaging Are Still Slow to Emerge," *Transaction Trends*, October 2005.

[3] "FRBs Announce Changes to Increase Check Service Efficiency," Financial Services Policy Committee of the Federal Reserve System Press Release, May 31, 2006, available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/press/other/2006/20060531/default.htm>.

in recent years, despite the overall reduction in check volume. According to the results of the 2004 American Bankers Association (ABA) Deposit Account Fraud Survey Report, approximately 75 percent of all commercial banks incurred losses related to check fraud during 2003, with losses totaling approximately $677 million. Moreover, within the past few years, attempted check fraud increased 28 percent, from $4.2 billion during 2000 to $5.5 billion in 2003, with forged checks and counterfeit checks representing 23 percent and 16 percent of check fraud losses in 2003, respectively.[4] Traditionally, financial institutions relied upon the physical security features of a paper check, such as watermarks, microprint, special ultraviolet ink, and others. Unfortunately, these features are rendered useless for verifying the authenticity of check images. Consequently, in an era of increasing check fraud and in a new image-based processing environment, institutions need to develop acceptable alternative methods for detecting fraud without using the original physical check prior to implementing such Check 21 processes.

> The objective of the project was to research the effectiveness of various security features that would function within the proposed imaged-based environment of Check 21.

Taking Advantage of Technology to Combat Check Fraud

Well before the implementation of Check 21 and in anticipation of the aforementioned concerns, the Federal Reserve, along with other federal agencies, financial institutions, industry partners, and technology vendors, acknowledged that new "image-survivable" security features would be necessary to mitigate check fraud in the new processing environment. The Federal Reserve and the U.S. Treasury in particular invested heavily in development projects to pilot selected technologies that could be adapted to the check processing environment, providing new protections for times when the original check is truncated and no longer available for fraud inspection. Several technologies were tested, and some were piloted for a full assessment of the capability to still perform check fraud detection solely from the digital image of a check. This research proved so successful that one technology is now fully deployed on the over 200 million U.S. Treasury checks issued annually.

It became increasingly obvious, however, that check fraud detection at the paying bank still exposed all "upstream" participants in the payment process to risks of check fraud losses. For instance, a merchant might accept a fraudulent check for goods sold and find itself with no recourse. Alternatively, a bank of first deposit might accept a fraudulent check in deposit only to find too late that the check was worthless after money was withdrawn.

To that end, the Financial Services Technology Consortium (FSTC), a nonprofit trade association that sponsors and facilitates the development of technolo-

---

[4] Doug Hodge, SVP, JP Morgan Chase Bank, N.A.; Diana Know, Payment Strategies Director, Wachovia Bank; and Woody Tyner, Payment Strategist, BB&T, "Image Survivable Security Features: Proving that Interoperability Works," Presented at the Bank Administration Institute (BAI) Combatting Payments and Check Fraud Conference, Baltimore, Maryland, September 25, 2006.

For More Information...

For additional information on check fraud technology, see Executive Vice President Blake Prichard's article, "Combating Check Fraud: Technology to the Rescue," in the Third Quarter 2002 edition of *SRC Insights* at: <www.philadelphiafed.org/src/srcinsights/srcinsights/q3si3.html>.

gy for the financial services industry, commenced the Interoperable Verification of Check Security Features project in June 2004. The objective of the project was to research the effectiveness of various security features that would function within the proposed imaged-based environment of Check 21.

While some financial institutions independently developed image-survivable security features to operate within the new environment, FSTC's project was unique in that it focused on attaining interoperability among institutions. For this project, interoperability was to be achieved through the use of standards that identify the roles and responsibilities of various constituents as well as communication requirements and message formats needed for financial institutions to verify the imbedded security features on any check. Federal Reserve Bank of Philadelphia Executive Vice President Blake Prichard noted that the "FSTC's proposed national standard was viewed as a major step forward in reducing check fraud."[5]

Furthermore, the FSTC's proposed business practice presents a significant departure from existing check fraud prevention processes used in today's paper-based environment, which typically take place in the back room operations department of the paying bank and rely on the inspection of the physical check. Instead, this process permits the bank of first deposit, or sending bank, to verify the image-survivable security features embedded on the paying bank's imaged check, thus allowing for the detection of the fraudulent item much earlier in the processing cycle. Ultimately, the goal of the process is to enable the bank of first deposit to verify a check's authenticity at the point of presentment, thereby preventing a fraudulent item from actually entering the payments system. Unfortunately, such an endeavor is extremely challenging and complicated to implement since it involves integrating so many variables; as a result, it is realistic to assume that upon initial adoption of this practice, the verification may be performed within the bank of first deposit's back room review. Regardless of which point in the payment process the security features are verified, its attributes provide an advantage, as they allow the item to be validated earlier than in current practices and permit interoperability among institutions. As a result, all involved parties are expected to be better protected from loss.

The goal of the FSTC's proposed business practice is to enable the bank of first deposit to verify a check's authenticity at the point of presentment.

The FSTC's project was completed in March 2006, meaning that effective security features were identified for incorporation into a registry, and core communication and messaging standards were developed to enable a bank of first deposit or its merchant customers to verify the security features of an imaged check to the registry. Currently, the project is awaiting its registry to be sanctioned by the Accredited Standards Committee X9, Inc., a company based in Annapolis, Maryland, that sets imaging standards for the industry. As a testament to the project's significance and quality, the standards committee immediately accepted the project for consideration. In anticipation of formal sanctioning of the registry, the National Clearing House Association (NCHA) established a registry of eight image-survivable security features. According to the NCHA press release dated September 25, 2006, a draft standard for trial use of the registry and the messaging used to access it could be available by early 2007.

Recently, the FSTC indicated that four banks, the Treasury Department, and two technology vendors participated in a Proof of Concept test. The test was conducted to determine the feasibility of the interoperability among the various entities involved in

[5] "FSTC's Pioneering Work Moves Closer to Eliminating Check Fraud in an Imaged Environment," FSTC Press Release, March 15, 2006.

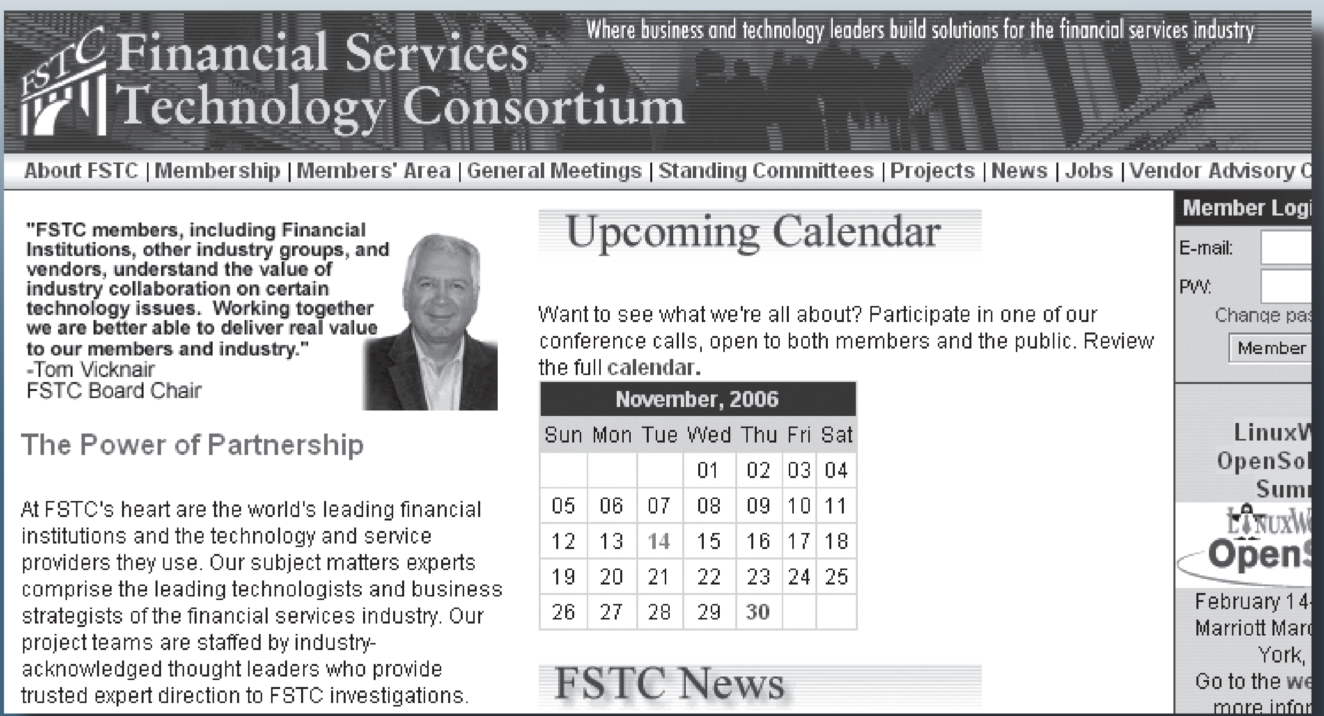
the process, the quality and timeliness of transmitted imaged files, the ability of the central validation entity to verify the security marks and report exceptions to the submitting bank, and the ability of the central validation entity to install and support industry vendor solutions.[6] The FSTC reported that the test yielded generally encouraging results, yet more security marks and vendors are needed in order to truly test operability.

Conclusion

Although the predictions of payment system experts differ concerning the future direction of check fraud and which type of banks will be targeted, one thing is certain: fraud will persist and continue to evolve in this ever-changing environment. While the post-Check 21 environment continues to change, it is essential that industry stakeholders continually reassess their corresponding risk exposures in an effort to reduce the opportunity for fraud and to maintain the integrity of the check processing system. Projects such as the one completed by the FSTC demonstrate that the collaboration of industry stakeholders and the utilization of technology can result in effective anti-fraud processes in this new generation of check processing. ☐

[6] See footnote 4.

For more information on the FSTC's initiatives, visit its website at <www.fstc.org/>.



The Credit Cycle *...continued from page 3*

ment while avoiding unintentional consequences, such as creating a credit crunch. Accordingly, the proposed guidance is not intended to disrupt CRE lending that has been prudently underwritten and well managed. Final guidance is expected to be issued by year-end.

As I mentioned earlier, mortgage lending has reached unprecedented levels in the last few years. For several years, the housing market has been strong, with consumer spending driving the economy. A variety of innovative and nontraditional mortgage products has contributed significantly to the rise in mortgage lending.

These products allow borrowers to exchange lower payments during an initial period for higher payments later. Nontraditional mortgage products have also made credit much more available to a greater number of customers who may not otherwise qualify for a similar-size mortgage under traditional terms and underwriting standards. While similar products have been available for many years, the number of institutions offering them has expanded rapidly.

There has been recent evidence at the national level that mortgage delinquencies are on the rise, particularly in geographic markets that have experienced significant home price appreciation over the last several years. In the last few quarters, there has been an increase in delinquencies. In addition, the housing sector has slowed, and certain regional markets have experienced declines in property values.

These nontraditional products are untested across a credit cycle; however, there is anecdotal evidence that delinquencies and foreclosures are rising, particularly in subprime markets affected by higher interest rates and slowing price appreciation. Final guidance to address the risks posed by nontraditional residential mortgages was issued in late September 2006. The final guidance discusses the importance of carefully managing the potential heightened risk levels created by these loans.

Mortgage delinquencies are on the rise, particularly in geographic markets that have experienced significant home price appreciation over the last several years.

Economic conditions over the last several years have supported a period of solid financial performance in the banking industry. However, there is strong evidence that the benign credit environment financial institutions have experienced is changing. Heightened credit risk on bank balance sheets emanating from strong competition and liberal credit policies will increase credit costs going forward and must be managed prudently. In recent years, banks have grown accustomed to spreading risk to investors through various capital markets activities. However, the growing dependence on the transfer of credit risk raises questions about the long-term appetite of investors to fund weaker credits.

Financial institutions must be prudent in managing the risk in their loan portfolios and must strive to be proactive in assessing the effects a change in conditions may have on their portfolio. There is evidence to suggest that the current credit cycle may be shifting, and rising credit costs will present headwinds in 2007. Signs of change include widening spreads on commercial debt issued by noninvestment grade obligors, senior loan officer forecasts that credit conditions will deteriorate in the next 12 months, and rising delinquencies in some retail credit product lines.

So how can banks prepare to weather a downturn in the credit cycle? Some guidelines for management include:

- Establishing and reinforcing a strong loan culture
- Creating a long-term strategic vision and turning away riskier deals when warranted
- Maintaining ongoing awareness of evolving market conditions
- Including credit cycle fluctuation scenarios in the management of both credit exposures and lending policies
- Focusing on portfolio performance and enhanced stress testing

In the future, credit cycles will continue to occur, although the frequency and severity of the cycles will vary depending on contemporary influences. Management must continue to monitor credit cycles and employ risk management techniques to ensure the safety and soundness of their financial institutions. □

Did You Know?
Bank Fraud Working Group Formed

Representatives from the enforcement and legal areas of the Philadelphia region's federal and state bank supervisors, representatives from the FBI and federal and state attorney general offices and Federal Reserve Bank of Philadelphia Bank (FRBP) supervision staff recently met at the Philadelphia Reserve Bank to share information on fraud, both internal and external, that affect Third District institutions.

The meeting was organized by the FRBP as part of its ongoing outreach efforts. The FRBP plans to hold similar meetings going forward to foster ongoing communication among the regulators and between the regulators and members of the federal and state law enforcement communities.

Keep Informed!
Supervision and Regulation Letters for Financial Institutions Issued in 2006

SR 06-4 Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters
SR 06-5 Influenza Pandemic Preparedness
SR 06-9 Revisions to the Uniform Standards of Professional Appraisal Practice
SR 06-11 Release of the Revised Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual
SR 06-12 FFIEC Information Security Booklet
SR 06-13 Questions and Answers Related to Interagency Guidance on Authentication in an Internet Banking Environment
SR 06-15 Interagency Guidance on Nontraditional Mortgage Product Risks

All SR Letters are available at < http://www.federalreserve.gov/boarddocs/srletters/2005/>.

Interagency Guidance on Appraisals, Revisions to the USPAP, and Implications for Banks ...continued from page 11

cies' appraisal regulations. Besides conforming to USPAP, the agencies' appraisal regulations require that appraisals supporting federally-related transactions must:

- Be written and contain sufficient information and analysis to support the financial institution's decision to engage in the transaction
- Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially-leased buildings, non-market lease terms, and tract developments with unsold units
- Be based upon the definition of market value in the regulation
- Be performed by a state-licensed or certified appraiser in accordance with the regulatory requirements

From the appraiser's perspective, these regulatory appraisal requirements are "supplemental standards" to USPAP. If an appraiser knowingly fails to comply with supplemental standards, the appraiser is in violation of the USPAP Ethics Rule.

When ordering appraisals, a financial institution should convey to an appraiser that these supplemental standards remain applicable. The agencies also continue to encourage financial institutions to use engagement letters when ordering appraisals to facilitate communications with the appraiser and to document the expectations of each party to the appraisal assignment. To determine an appraisal's acceptability, a financial institution should review the report to assess the adequacy of the appraiser's scope of work, given the intended use of the appraisal. In accepting an appraisal report, financial institutions must determine that the appraisal report contains sufficient information and analysis to support the credit decision.

Financial institutions are reminded to consider an appraiser's competency for a given appraisal assignment. Further, more institutions should not allow lower cost or reduced delivery time to compromise the determination of an appropriate scope of work for appraisals supporting federally-related transactions.

Bankers can be assured that examiners seek to verify that proper segregation has been established between the appraisal process and the various lending functions

Responsibility, Independence, and the Examiners

The board of directors is ultimately responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal program. To that end, management is responsible for ensuring that the policies are effectively implemented and adequate procedures are employed.

The key word above is independent, which is a crucial element in developing an effective appraisal function. Improperly-prepared appraisals or undue influence by the lending function on the appraisal process could undermine the integrity of the credit underwriting process. Consequently, bankers can be assured that examiners seek to verify that proper segregation has been established between the appraisal process (ordering, preparation, and review of appraisals) and the various lending functions (underwriting, administration, etc.).

Examiners are expected to analyze individual transactions and the related appraisal to determine whether the methods, assumptions, and findings are reasonable and in compliance with the appraisal regulations, supervisory guidelines, and the institution's policies. Examiners will also review the steps taken by an institution to ensure that the individuals who perform appraisals (whether in-house or outsourced) are qualified and not subject to conflicts of interest. Institutions that do not maintain a sound appraisal program or fail to comply with appraisal regulations, supervisory guidance, or policies will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Any deficiencies found will require corrective action.

If you have any questions on issues related to appraisal guidance in general or questions related to the recent revisions to the USPAP, please contact your primary regulatory agency. For those financial institutions that are supervised by the Federal Reserve Bank of Philadelphia, please contact either David F. Fomunyam (david.fomunyam@phil.frb.org) at (215) 574-4128 or James W. Corkery (james.w.corkery@phil.frb.org) at (215) 574-6416. □

FFIEC FAQ Document on Authentication Issued

The Federal Reserve, in conjunction with the other FFIEC banking agencies, has issued an FAQ document related to the 2006 FFIEC guidance entitled *Interagency on Authentication in an Internet Banking Environment*, released in October 2005. Financial institutions will be expected to have achieved conformance with the guidance by year-end 2006. The FAQs are designed to assist financial institutions and their technology service providers in conforming to the guidance by addressing common questions on the scope of the guidance, risk assessments, timing, and other issues.

The FFIEC guidance is available on the Board of Governors' website at www.federalreserve.gov/boarddocs/srletters/2005/SR0519.htm.

The FAQ document is available on the Board of Governors' website at www.federalreserve.gov/boarddocs/srletters/2006/SR0613.htm.

Is Something Missing?

With each issue of *SRC Insights* and *Compliance Corner*, we aim to highlight the supervisory, regulatory, and consumer compliance issues that affect you and your banking institution the most. But we recognize that your institution may be interested in topics that we have not covered, and we want to ensure that your voice is heard. What issues arise in your daily operations? What questions concern you in the course of business? What else would you like to see in an upcoming issue of *SRC Insights* and *Compliance Corner*?

We encourage you to contact us with any topic ideas, concerns, or questions. Please direct any comments and suggestions to Joanne M. Branigan (joanne.branigan@phil.frb.org) at (215) 574-3769.

FEDERAL RESERVE BANK
OF PHILADELPHIA

Supervision, Regulation and Credit Department
Ten Independence Mall
Philadelphia, PA 19106

www.philadelphiafed.org

E-Mail Notification Service

Would you like to read *SRC Insights* and *Compliance Corner* on our website up to three weeks before they are mailed? Sign up for our e-mail notification service today at <www.philadelphiafed.org/phil_mailing_list/dsp_user_login.cfm>.