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SRC Insights

Federal Reserve Bank of Philadelphia

CRE Trends and the Re-Emergence of the Troubled Debt Restructuring

by Sharon Wells, Assistant Examiner

Signs of credit quality weakness are beginning to appear in certain CRE sectors. Delinquencies, charge-offs, and ORE levels are rising after a period of relatively benign credit conditions. Banking organizations are tightening lending standards on CRE loans, and many are anticipating CRE loan portfolio deterioration in 2008.[1]

In the Third District, residential construction and land development loans comprise a significant portion of some institutions' loan portfolios. Recently, this loan type has seen significant stress, as single family residential home and condominium sales have slowed and inventory levels have swelled. Market prices in some areas are now declining, creating greater leverage and builder/developer cash flow constraints.

Outside of residential construction, most CRE sectors continue to show stable vacancy rates, good net absorption levels, and supportive rental rates. However, some other CRE sectors may not be immune over the long run, and a gradual weakening in overall CRE conditions could be on the horizon.

As lenders look for economical solutions to minimize credit losses in an unstable environment, loan restructurings may become more prolific, and these restructurings may qualify as troubled debt restructurings (TDRs). This article is the first in a two-part series on TDRs and will focus on defining TDRs and managing the associated risk. Part II will appear in the second quarter issue of *SRC Insights* and will focus on the accounting and regulatory aspect of TDRs.

[1] *The January 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices* is available on the Board of Governors' website at: <www.federalreserve.gov/boardocs/SnLoanSurvey/200801/default.htm>.

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FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

Balancing the Potential Payoffs and Pitfalls of Remote Deposit Capture

by Michael E. Collins, Senior Vice President

A common theme that crops up frequently in my conversations with bankers these days is the challenge of managing intense competition in an increasingly tough operating environment. Lower earnings, worsening credit quality, and a slowing economy are contributing to the difficult conditions that are pressuring banks to look for creative solutions to augment their bottom line. Community and large banks alike are struggling to increase their efficiency and reduce operating costs while meeting their customers' needs and expectations.

Technology has been an important tool that financial industry participants have turned to in the past to enhance their competitive edge. A number of Third District bankers have indicated that continuing to look for technology solutions gives them an advantage over their competitors and helps them to retain or increase their current market share. Currently, many of them are exploring or adopting remote deposit capture, a new technology that is catching on quickly among District banking organizations and the banking industry as a whole.

For those unfamiliar with it, remote deposit capture technology, or RDC, essentially allows a bank's branches or its corporate clients to electronically capture check deposits locally and transmit the images to another main location, such as a bank's head office, for deposit and clearing. There is also emerging interest in the consumer market for RDC. Currently, RDC may be extended to individual "noncorporate" customers through image-enabled ATMs and home scanning equipment. One vendor, Mitek Systems, Inc., has also recently announced plans to offer an RDC product for consumers using camera-equipped mobile phones to create digital images of checks.[1]

The advent of the Check Clearing for the 21st Century Act, or "Check 21," which became effective in late 2004, was the catalyst that introduced RDC technology more broadly to the industry. Additional advances in technology and the creative application of RDC within the banking industry helped further its rapid spread.

[1] Press release, Mitek Systems, Inc., January 22, 2008, available at www.miteksystems.com.

A surge in bank branch expansion may also have contributed to the popularity of RDC and similar technologies. Branch expansion has been increasing for well over a decade now, outpacing industry consolidation, and it is an integral component of some banking organizations' strategies for attracting customers and deposits.[2] RDC allows a banking organization to capitalize on the visibility of maintaining numerous branches while minimizing certain aspects of the associated costs. For example, RDC eliminates the manual preparation of deposits, avoids keying errors, reduces the physical footprint at operations centers and braches, trims transpotation costs, and provides other economies of scale.

Some adopters of RDC have also taken advantage of the technology's potential to increase their client base by reducing or eliminating geographic constraints, while others have boosted customer service through improved funds availability and the extension of deposit deadlines. RDC can also improve efficiency by consolidating customer deposits at the source, which may eliminate multiple accounts and simplify reconciliation. As a result, it's often a bank's corporate customers who are pushing to implement the technology and, thus, are playing a key role in fueling the trend.

New technologies that affect how financial transactions are delivered or that extend such transactions beyond the control of the banking organization or its vendor, in particular, necessitate prudent risk management practices and thoughtful consideration as to how the technology fits into an organization's overall strategic plan.

New opportunities for fraud are a special concern. In addition to the known avenues of fraud, such as check alteration, counterfeit checks, identity theft, and the like, banking organizations that adopt RDC and similar technologies need to guard against the duplicate presentment of a check either in its physical form or its image. Bank branches and corporate customers that transmit check images to a main processing site should ensure that the transmissions occur over encrypted, secure lines and should follow appropriate policies and procedures to ensure that captured checks are disposed of properly. Prior to implementing RDC for a corporate customer, a banking organization should also be comfortable with the customer's management framework and financial status to minimize the possibility of fraud and misuse.

Banking organizations that are considering implementing RDC or a similar technology would do well to prepare a comprehensive risk assessment that considers the legal and compliance risks, relevant controls, as well as the need for robust employee training and a strong vendor selection and management framework. This list is not inclusive and does not constitute official regulatory guidance.

Banking organizations considering RDC are also advised to consult the *FFIEC Information Technology Examination Handbook*, which is available on the FFIEC's public website at <http://www.ffiec.gov/ffiecinfobase/html_pages/it_01.html>. The handbook provides guidance on IT topics of interest to banking organization, such as the risks and risk management practices applicable to a financial institution's information technology activities, as well as guidance on IT outsourcing, including service provider selection, contract issues, and ongoing monitoring.

In addition, the FFIEC is currently preparing guidance on RDC and a related work program for bank supervisors, which are scheduled to be released by the end of the first quarter of 2008. In the interim, if you have questions about the regulatory implications of RDC or similar technologies, please contact Joe Krencicki (joe.krencicki@phil.frb.org) at (215) 574-6251, Brian Hood (brian.hood@phil.frb.org) at (215) 574-6054, or Bill Wisser(william.t.wisser@phil.frb.org) at (215) 574-7267. □

Michael E. Collins, Senior Vice President

[2] Johnson, Hilary, "Branching Outlook: Cautious, Surgical, But Still Growth Key," *American Banker*, January 15, 2008.

Guidance for Writing Effective SAR Narratives

by Jennifer Salutric, Enforcement Specialist

Tell what happened, tell it well, tell it concisely…William F. Buckley, Jr.

Since 1996, depository institutions—including banks, bank holding companies, and nonbank subsidiaries of bank holding companies—have been required to file Suspicious Activity Reports (SARs) with the Financial Crimes Enforcement Network (FinCEN) when they detect a known or suspected violation of federal law, a suspicious transaction related to money laundering activity, or a violation of the Bank Secrecy Act (BSA). Specifically, a SAR must be filed under the following circumstances:

- Criminal violations involving insider abuse in any dollar amount
- Criminal violations aggregating $5,000 or more where a suspect can be identified
- Criminal violations aggregating $25,000 or more, regardless of a potential suspect
- Transactions aggregating $5,000 or more that may involve potential money laundering or violations of BSA or where the transaction has no business or apparent lawful purpose

The information contained in filings provides SAR users (FinCEN, law enforcement, federal regulators, and intelligence agencies) with valuable data for investigating and combating money laundering, terrorism, terrorist financing, and other financial crimes and identifying patterns and emerging trends in suspicious and criminal activities. However, the increasing volume of SARs (the number filed by depository institutions soared from 62,388 in 1996 to 567,000 in 2006) presents a challenge for users who must review the reports but have limited resources to dedicate to that process. Therefore, it is imperative that depository institutions submit SARs that are complete, accurate, and timely so the users can extract the most useful information efficiently. Depository institutions can improve the utility of SARs by composing clear, concise, and thorough narratives in Part V of the SAR form, Suspicious Activity Information Explanation/Description.

Given the importance of the narrative, the purpose of this article is to provide guidance on how to write effective SAR narratives.[1] The process for writing the narrative can be divided into two steps: compiling the information and formatting the relevant information in a cohesive manner.

Compiling Information for the Narrative

To the fullest extent possible, the preparer of the SAR should gather all information necessary to answer the following five essential questions, which comprise the basis of the SAR narrative.

1. **Who** is conducting the suspicious activity? Fully describe and identify all suspects with respect to their occupation, position, or title within the business and the nature of the business. Explain the relationship amongst the suspects, and provide any other identification numbers, addresses, and aliases not reported elsewhere on the SAR form.

2. **What** instruments or mechanisms were used to facilitate the suspicious activity? Fully describe these instruments, which may include, but are not limited to, wire transfers, letters of credit, correspondent accounts, structuring, shell companies, bonds/notes, stocks, mutual funds, insurance policies, travelers checks, bank drafts, money or-

[1] More information on BSA forms and filing requirements is available on the FinCEN website at: <www.fincen.gov/reg_bsaforms.html>.

ders, credit/debit cards, stored value cards, and/or digital currency business services.

Preparers also should explain briefly and clearly **how** the suspicious activity was conducted, documenting the method used to initiate the transaction, such as the Internet, phone, mail, ATM, and couriers. When describing the flow of funds, include the source of funds and the use, destination, or beneficiary of the funds. Identify all account numbers at financial institutions affected by the suspicious activity and, if possible, the account numbers held at other financial institutions involved, along with the institutions' names and locations.

3. **When** did the suspicious activity take place? Record the date when the suspicious activity was first noticed and the timeframe in which it occurred. To better track the flow of funds, list the individual dates and the amounts of each transaction in chronological order rather than just the aggregate amount of all transactions.

4. **Where** did the suspicious activity occur? If multiple offices of a single institution were involved in the suspicious activity, provide the addresses of these locations. If the activity or transaction involved a foreign jurisdiction, provide the name of the jurisdiction and the name and address of any financial institutions involved, with any corresponding account numbers, if possible.

5. **Why** is the activity considered suspicious? Explain why the activity is unusual for the customer, considering the types of products and services offered by the institution and the typical activities of similar customers. The following is a sample, not a comprehensive list, of common patterns of suspicious activity:

- A lack of evidence of legitimate business activity, or any business operations at all, undertaken by many of the parties involved in the transactions
- Transactions that are not commensurate with the stated business type and/or that are unusual and unexpected in comparison with the volumes of similar businesses
- Unusually large numbers and/or volumes of wire transfers and/or repetitive wire transfer patterns
- Unusually complex series of transactions indicative of layering activity involving multiple accounts, banks, parties, or jurisdictions
- Bulk cash and monetary instrument transactions
- Transactions seemingly designed or attempting to avoid reporting and recordkeeping requirements
- Transactions being conducted in bursts of activities within a short period of time, especially in previously dormant accounts
- Beneficiaries maintaining accounts at foreign banks that have been subjects of previous SAR filings
- Parties and businesses that do not meet the standards of routinely initiated due diligence and anti-money laundering oversight programs

Formatting the Narrative

Do not insert tables or other pre-formatted templates in the narrative because the conversion process used by the IRS Detroit Computing Center does not convert them properly, and the information becomes indecipherable. Also, do not submit any supporting documentation with the SAR form, because such documents are not entered into the database, thus making any reference to them meaningless. If possible, perform a second review of the SAR to ensure accuracy and completeness. In particular, verify that the suspicious activity described in the narrative matches the activity indicated in Part III of the SAR form, Suspicious Activity Information.

The following outline may be used as a guide for composing a more effective SAR narrative.

I. Introduction

This section can include:

- A brief description of the institution filing the report and its primary business
- The purpose of the SAR, including a general description of the known or alleged violation or activ-

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Factors Affecting Bank Acquisition Valuations

by William Lenney, Applications Analyst, and Lauren Jones, Intern

Bank acquisition prices increased steadily during the five-year period of 2002 through 2006. Expansion by acquisition was common throughout this period, as banking organizations generally believed that it was better to enter a new market by purchasing an existing bank than by building a branch network from the ground up. Acquiring banks paid a significant price-to-book premium for target banks, and by the end of 2006, valuations were at record levels. This article will discuss some of the key factors affecting the bank acquisition valuation trend during this five-year period.

To analyze the trend, data from 565 U.S. commercial banks acquired from January 1, 2002, to December 31, 2006, were reviewed, including data related to geographic location, composite CAMELS and RFI/C ratings, core deposit ratios, intrastate acquisitions versus interstate acquisitions, and the asset size of the target institution. The performance of the S&P 500 over this five-year period was also factored into the analysis. The average price-to-book premium for the 565 commercial banks acquired during this time period was 2.47, while the average price-to-book premium for the entire U.S. was 2.26 in 2002 and climbed to 2.56 in 2006.

Overall, it was expected that target institutions with high core deposit ratios and composite CAMELS and RFI/C ratings of strong or satisfactory would receive the highest price-to-book premiums, and that interstate acquisitions would command higher price-to-book premiums due to acquiring banks' willingness to expand boundaries and develop new customer bases. It also was expected that price-to-book premiums would increase as the S&P 500 index rose and also as the total asset size of the target institution rose. The analysis confirmed these hypotheses.

Geographic Location

There is a prevalent belief that the most important factor in real estate is location, location, location. Geographic location also appears to be important in banking, and it had a significant impact on price-to-book premiums during the five-year period. In general, banks in the areas with the strongest real estate markets and population growth had a higher price-to-book premium. The banks acquired within the Federal Reserve's Atlanta District had a 2.75 average price-to book premium, which was the highest average in the U.S., followed by Dallas and San Francisco, respectively (Fig. 1). The state of Nevada had the highest average price-to-book premium at 3.08, followed by Florida at 2.95.

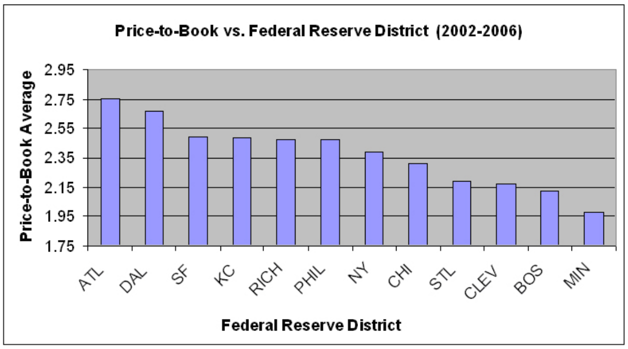

Figure 1

Locally, institutions acquired in the Third District received a 2.47 average price-to-book premium during the five-year period. The largest acquisition in the Third District was Bank of America Corp.'s purchase of MBNA Corp. for $35 billion in 2005, and the price-to-book premium was 2.51. The largest acquisition in the nation during this time period was JP Morgan Chase & Co.'s acquisition of Bank One for $58 billion in 2004, and the price-to-book premium was 2.56.

CAMELS and RFI/C Ratings

In theory, financial institutions that have a solid overall performance should expect to receive a higher price-to-book premium, as solid overall performance commonly results in composite CAMELS or RFI/C ratings of strong or satisfactory; therefore, examination and inspection ratings should impact the price-to-book premium paid. The data analysis confirmed that the composite CAMELS or RFI/C rating of the acquired institution had a significant impact on the price-to-book premium paid.[1]

The average price-to-book premiums paid for 1- and 2-rated banks were 2.56 and 2.49, respectively. The average price-to-book premiums paid for 3- and 4-rated banks were 2.08 and 1.62, respectively (Fig. 2). A strong or satisfactory composite rating would commonly indicate that a bank is generating a higher rate of return on average assets; is well capitalized with sound asset quality and liquidity; and, therefore, may be considered more desirable and possibly easier to integrate into the acquiring organization.

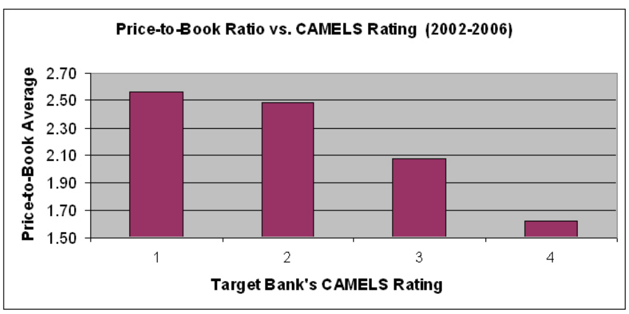

Figure 2

Core Deposit Ratio

A target bank's ratio of core deposits to total assets had a strong impact on the price-to-book premium. Target banks with core deposit ratios exceeding 40 percent received a 3.5 average price-to-book premium, while those with a core deposit ratio less than 10 percent had a 1.52 average (Fig. 3). Acquiring organizations appear to be willing to pay a higher price for targets with high core deposit ratios, which typically is a good indicator of a strong customer base and may result in greater operating stability and lower risk.

[1] The composite CAMELS rating is used for banks in our study, whereas the composite RFI/C rating is used for bank holding companies.

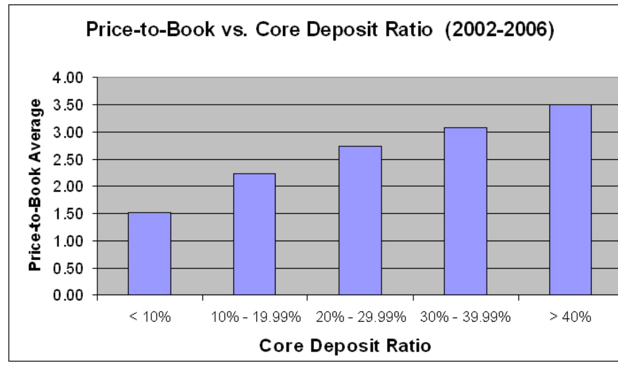

Figure 3

Intrastate vs. Interstate Acquisitions

Acquiring organizations appear to be willing to pay a higher price for out-of-state target financial institutions. During the 2002–2006 time period, 38.7 percent of all bank acquisitions were interstate acquisitions. These interstate transactions had a 10.1 percent higher price-to-book premium than intrastate transactions. Interstate targets received a 2.62 price-to-book premium on average versus 2.38 received by intrastate targets. One of the reasons for the higher premium for interstate transactions is that footprint expansion of marketing boundaries and development of a new customer base may help to offset acquisition costs.

Total Asset Size

The total asset size of target financial institutions had an impact on the acquisition price, and the price-to-book ratio appears to increase with the total asset size of the institution. Institutions with total assets of less than 100 million received a 2.21 average price-to-book premium. Institutions with total assets of less than 1 billion received a 2.49 average price-to-book premium, while those with total assets exceeding 1 billion received a 2.57 premium on average. Acquirers may be able to achieve economies of scale more quickly by acquiring several mid-sized institutions instead of purchasing a large number of small institu-

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For Your Information: Trust Preferred Securities Review Process

Recently, many banking organizations have contacted this Reserve Bank to obtain an understanding of the review process for issuing and redeeming trust preferred securities (TPS). The following is an outline of the current process.

Banking organizations are required to consult with the Federal Reserve on capital implications before issuing or redeeming TPS.[1] Requests in the Third District should be submitted at least 10 business days before the issuance or redemption to the following:

William L. Gaunt
Assistant Vice President
Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, PA 19106

TPS Issuances
To provide for timely reviews, request letters should include specific information. This includes the purpose of the issuance, source of cash to service the subordinated debt, and pro forma financial statements, including capital projections and regulatory capital ratios.

In addition, in order to qualify for tier 1 capital, TPS must allow a minimum deferral period of 20 consecutive quarters for the payment of dividends, and the subordinated debt must have a minimum maturity of 30 years. The inclusion of these two qualifying criteria in the TPS issuance should also be noted in the request letter.

TPS Redemptions
Redemption requests need to include the purpose for redemption and the source of cash. The TPS should have been outstanding for a minimum of five years, and the banking organization should provide pro forma financial statements, including capital projections and regulatory capital ratios, for the proposed redemption.

When the review is complete, an acknowledgment letter is issued. It should be noted that the Reserve Bank's review is not meant to replace the banking organization's consultation with legal counsel.

For questions regarding TPS, please contact Applications Analyst William Lenney (william.lenney@phil.frb.org) at (215) 574-6074. ☐

[1] Appendix A to Part 225, Federal Reserve System final rule, *Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/attachment.pdf>.

Enforcement Unit Purpose and Practices

In addition to its primary responsibility of drafting and issuing supervisory actions, the Enforcement Unit also plays a key role in fulfilling the broader mission of Supervision, Regulation and Credit. Detailed descriptions of the unit's various roles and responsibilities, definitions of the different types of supervisory actions, and an explanation of the process for issuing supervisory actions are included in the publication *Enforcement Unit Purpose and Practices*, which is now available online at <www.philadelphiafed.org/publications/supervision-and-regulation/>. ☐

Consumer Compliance Outlook

Compliance Corner is now a Separate Publication: Consumer Compliance Outlook

In the second quarter of 2008, look for the inaugural issue of Consumer Compliance Outlook, a brand new Federal Reserve System publication dedicated to consumer compliance issues. This expanded publication will include articles written by senior level supervisory staff from across the Federal Reserve System. Consumer Compliance Outlook will have a national perspective and will include features such as:

- In-depth articles on consumer compliance topics
- On the Docket: current court cases
- Compliance Alerts
- On the Calendar: upcoming conferences and events
- Resource links to websites related to consumer issues
- View from Washington

If you are a current subscriber to SRC Insights and Compliance Corner, you will automatically receive Consumer Compliance Outlook.

CRE Trends and the Re-Emergence of the Troubled Debt Restructuring *...continued from page 1*

TDRs Defined

The term *troubled debt restructuring* was first introduced with Statement of Financial Accounting Standard 15 (FAS 15) in 1977. FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FAS 114, *Accounting by Creditors for Impairment of a Loan*, defines the activities which constitute a TDR and the prescribed accounting and disclosure requirements. If consistent with prudent lending principles and supervisory guidance, TDRs can improve a bank's collection prospects and assist financially-challenged borrowers.

FAS 15 defines a TDR as a restructuring of a debt when a "creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that would not otherwise be considered." According to FAS 15, "whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. The creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it."[2]

In short, TDRs are compromises ("concessions") that lenders make to improve collectibility or reduce losses on problem loans. These concessions emanate from a borrower's deteriorating financial condition, which in turn prompts the lender to focus on achieving the maximum recovery. Typically, TDRs result from a borrower's inability to repay or meet the contractual obligations under the loan. This predominantly occurs because of cash flow difficulties arising from events such as: the loss of a key contract; unanticipated slow-downs in absorption rates; unanticipated or excessive costs like legal fees or R&D; and, in some cases, poor management.

TDRs are required to be supported by a formal written agreement and can be used to either fully or partially satisfy a loan. FAS 15 identifies the following restructuring activities, which qualify as TDRs:

1. Asset transfers, including those that result from foreclosures or repossessions. Assets typically include cash and equivalents, accounts receivable or inventory, fixed assets or other tangible assets, or real estate assets.

2. The granting of equity interests, unless existing loan terms allowed conversion of the debt into an equity interest. Equity interests include common or preferred stock, warrants or other equity positions, or even material representation on a board of directors.

3. Modification of loan terms, such as:
   a. Reducing the interest rate for the life of the loan
   b. Extending the maturity dates at an interest rate lower than the current market rate for new debt with similar risk
   c. Reducing the amount of the loan below the original contracted amount (principal reduction)
   d. Reducing accrued interest
   e. Adding contingent payment provisions based on prospective events (i.e., cash flow recapture provisions or DCR or profitability hurdles)
   f. Substituting or adding a new borrower or guarantor

4. A combination of all of the above.

The most common type of TDR is the "modification of terms." Granting of equity interests in a TDR is less common due to restrictions within Regulations H and Y, which limit state member banks and bank holding companies from retaining equity positions in nonaffiliated companies.

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[2] Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, June 1977 and No. 114, *Accounting by Creditors for Impairment of a Loan*, May 1993, are available online at: <www.fasb.org>.

It is important to recognize that not all debt restructuring is considered “troubled.” Loan renewals or extensions at interest rates that are equal to the current interest rate or a market rate of interest are not considered renegotiated debt. The factor that ultimately defines a “troubled” situation is a deterioration in financial condition or cash flow. Typically, a borrower that qualifies for a TDR is unable to refinance the debt with another institution at a rate of interest that it can afford to pay, if at all.

Credit Risk Management

Management should apply prudent lending standards and develop policies and procedures to address TDRs as part of its credit risk management program. Ideally, TDRs should occur infrequently and should serve predominantly to protect the bank’s investment. Prudent risk management activities associated with TDRs are: written policies and procedures, management oversight, monitoring and reporting, and loan review and audit.

TDRs also require strict quality controls in loan administration and operations to ensure compliance with the modified terms of the loan.

Policies and Procedures. As part of a comprehensive risk management program, management should develop policies and procedures for TDRs to ensure that loans are properly identified, monitored, accounted for, and controlled. Policies and procedures should complement the provisions set forth in FAS 15, as well as Statements 5, 114, and 118. Banks are encouraged to establish policies that provide a framework of limits for concessions and that establish approval authorities for the final granting of concessions. Policies and procedures will depend on the institutional profile and the magnitude of problem loan levels and high-risk activities inherent in the portfolio.

Management Oversight. TDRs should be identified and monitored closely by management. When resources are available, an institution may assign a loan categorized as a TDR to someone independent of the relationship management function, such as a designated workout officer. In other instances, where a borrower has a good chance of returning to financial health, the loan may remain with the relationship manager. Regardless of the day-to-day management structure, executive management and the board of directors should routinely review reports highlighting the level and trend of TDRs, performance updates, action plans, and loan review reports. It is also good practice for the board of directors, or committee thereof, to approve all concessions offered as part of a TDR, especially if TDRs become increasingly common or represent a significant level of exposure.[3]

Monitoring and Reporting. The development of systems to track problem loans and TDR activities provides management with valuable information to make strategic decisions and manage risk. Furthermore, management should clearly assign responsibility for monitoring and maintaining the tracking system for TDRs. Because borrowers whose loans are subject to TDRs are typically adversely rated or considered high risk, bank managers are encouraged to develop individual action plans that set objectives and timeframes and monitor each borrower’s progress after the debt is restructured. TDRs also require strict quality controls in loan administration and operations to ensure compliance with the modified terms of the loan. In addition to payment monitoring, ticklers should be implemented to ensure that collateral remains protected. Ticklers that monitor real estate tax payments, insurance coverage, UCC filings, escrows, and other pledged assets like securities are essential components of a strong portfolio management system.

Loan Review and Audit. Internal control functions, such as loan review and audit, provide strong independent sources of information regarding the quality of the bank’s loan portfolio and its conformity with accounting and regulatory requirements. The loan review function can provide an independent assessment of TDRs, including the appropriateness of classifying a loan as a TDR, in addition to evaluating the assigned risk rating. If a loan review unit finds that the level or trend of TDRs is high, or that the same loan(s) are being restructured multiple times, systemic problems may be evident. In that case, the observations made by loan review should be referred to the board of directors for review and, possibly, further action.

The audit function should perform a review to ensure that TDRs have been recorded properly in the financial statements, and that the ALLL has been calculated in accordance with FAS 5 and FAS 114. In addition, audit should verify the accuracy of the Call Report with respect to TDRs.

Conclusion

As concerns over credit quality emerge out of a weakening economy, the volume of restructured loans is expected to increase. Troubled debt restructurings can provide an acceptable and more economic alternative to payment demand or foreclosure. For further information regarding the accounting provisions of FAS 15, FAS 114, FAS 5, FAS 118, and the Call Report requirements for TDRs, contact Eddy Hsiao (eddy.hsiao@phil.frb.org) at (215) 574-3772. For further information regarding Third District market trends, contact Bob Rell (bob.rell@phil.frb.org) at (215) 574-4382. ☐

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[3] "Restructured or Renegotiated 'Troubled Debt,'" Loan Portfolio Management, Section 2040.1, *Commercial Bank Examination Manual*, available on the Board of Governors' website at: <www.federalreserve.gov/boarddocs/supmanual/cbem/200710/0710cbem.pdf>.

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ity and a summary of the suspicious patterns that initiated the SAR
- The date of and reason for any SARs previously filed on the suspect or related suspects
- Whether the SAR is associated with the Office of Foreign Assets Control's (OFAC) sanctioned countries or Specially Designated Nationals and Blocked Persons or other government lists for individuals or organizations

II. Body

This section should provide, in chronological order, all pertinent information supporting why the SAR was filed, including the following:

- The key components of the answers to the following questions: Who is conducting the suspicious activity? What instruments were used to facilitate the suspicious activity? When, where, and how did the suspicious activity occur? Why is the activity considered suspicious?
- Any other information not recorded elsewhere on the SAR that could aid investigations
- Any factual observations or incriminating statements made by the suspect

III. Conclusion

The final section can summarize the report and might also include:

- Information about any follow-up actions conducted by the depository institution
- Names and telephone numbers of other contacts at the depository institution, if different from the point of contact indicated in Part IV of the SAR form, Contact for Assistance
- Any additional information or documentation that may be made available to law enforcement
- Names of any law enforcement personnel investigating the complaint who are not already identified in another section of the SAR

The guidance presented above provides depository institutions with a methodology for preparing quality SAR narratives. As stated earlier, incomplete and insufficient SAR narratives waste the valuable time of law enforcement and investigatory resources and hinder investigations. By writing concise, comprehensive, and well-organized narratives, depository institutions provide SAR users with the crucial information they need to conduct investigations into financial crimes and to identify emerging trends and threats.

In addition, improving the quality of SARs can benefit a depository institution directly. By analyzing their SARs internally, a depository institution may also be able to identify any potential operational weakness and better assess its risk profile. Preparing accurate and timely SARs is required by law and is a key requirement of an institution's BSA/AML program. During a BSA/AML examination, examination staff will assess the policies, procedures, processes, and overall compliance with statutory and regulatory requirements for monitoring, detecting, and reporting SARs. Consequently, the systemic failure to file SARs, systemic filing of incomplete or inaccurate SARs, or failure to maintain an adequate BSA/AML compliance program could result in supervisory action against the institution; its board of directors, officers, employees, or agents; or other institution-affiliated parties.

This article focused on just one aspect of the SAR report, the narrative. For additional information regarding SARs, please refer to the following documents produced by FinCEN: *SAR Activity Review, Trends, Tips, and Issues* and *Suspicious Activity Reporting Guidance*, which are both available at <www.fincen.gov/pub_reports.html>, and *Suggestions for Addressing Common Errors Noted in Suspicious Activity Reporting*, which is available at <www.fincen.gov/SAR_Common_Errors_Web_Posting.html>.

For additional information related to BSA/AML, please refer to the *Bank Secrecy Act/Anti-Money Laundering Examination Manual*, available at <www.ffiec.gov/bsa_aml_infobase/default.htm>. □

Factors Affecting Bank Acquisition Valuations

...continued from page 7

tions; therefore, they appear to be willing to pay a higher premium for larger institutions.

The S&P 500

Price-to-book premiums appear to fluctuate with the performance of the S&P 500. In 2002, the S&P 500 declined by 22.10 percent, bottoming out at 768.63 in October, while the average price-to-book ratio for the year hit a trough at 2.26. In 2003, the S&P 500 increased by 28.68 percent, and the average price-to-book premium increased to 2.41. By the end of 2006, the S&P 500 closed at 1480.30, and the average price-to-book premium reached 2.56.

Ongoing Trends

In 1994 there were 10,450 financial institutions in the U.S., and by July 2007 the number had decreased to 7,357. While the number of financial institutions declined during this time period, total assets increased from $4.01 trillion to $10.1 trillion. Consolidation is expected to continue in the banking industry; however, merger and acquisition activity slowed in 2007, and the issues in the credit markets may have affected the ability of some banking organizations to pursue such opportunities. The nationwide average price-to-premium paid for acquisitions during 2007 (as of November) fell to 2.18, and the number of deals, which peaked at 28 in January for 2007, declined to 12 in October 2007.

Conclusion

Multiple factors influence the price-to-book premium paid for financial institution acquisitions. This information is useful for helping the institution being acquired to better prepare itself for a merger and also for helping to ensure a fair transaction for both parties. As Thomas Jefferson once said, "Never buy what you do not want because it is cheap; it will be dear to you." □

Regulatory Recap - First Quarter 2008
Supervision and Regulation Letters and Other Announcements

SR 08-01/CA 08-01, Communication of Examination/Inspection Findings
Issued January 24, 2008

The Federal Reserve is committed to providing effective communication of examination and inspection findings to ensure that they are written in clear and concise language, prioritized based upon importance, and focused on any significant matters that require attention. To improve the consistency and clarity of written communications, for all inspections commencing on or after April 1, 2008, the Federal Reserve will use standardized terminology to differentiate among:

- Matters Requiring Immediate Attention—Matters arising from the examination/inspection that the Federal Reserve requires a banking organization to address immediately
- Matters Requiring Attention—Matters that are important and that the Federal Reserve expects a banking organization to address over time
- Observations—Matters that are informative, advisory, or that suggest a means of improving performance or management of the operations of the organization

Matters Requiring Immediate Attention and Matters Requiring Attention must be formally communicated to banking organizations in writing through examination or inspection reports or a letter summarizing the results of a target review. Observations may be communicated in writing or conveyed informally.

SR 07-18, FFIEC Guidance on Pandemic Planning
Issued December 12, 2007

The Federal Financial Institutions Examination Council (FFIEC) issued guidance for financial institutions in identifying the continuity planning that should be in place to minimize the potential adverse effects of a pandemic. This guidance expands upon the contents of the *Interagency Advisory on Influenza Pandemic Preparedness* issued in March 2006 (Reference SR Letter 06-5).

SR 07-19, Confidentiality Provisions in Third-Party Agreements
Issued December 13, 2007

The Federal Reserve issued guidance to clarify its expectations regarding confidentiality provisions in agreements between banking organizations and counterparties or other third parties. Banking organizations should also refer to SR 97-17, *Access to Books and Records of Financial Institutions During Examinations and Inspections*.

All SR Letters are available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2007/>.

Announcements

February 28, 2008 – Docket No. OP-1310

The Federal Reserve Board is requesting public comment on a proposed change to the daylight overdraft posting rules under its Payments System Risk (PSR) policy to align the posting times for ACH credit and debit transfers in the payments system. To view the proposed policy change in its entirety, please visit <www.federalreserve.gov/newsevents/press/other/other20080228b1.pdf>.

Comments are requested by June 4, 2008.

February 28, 2008 – Docket No. OP-1309

The Federal Reserve Board is also requesting public comment on proposed changes to its Payments System Risk (PSR) policy that are intended to loosen intraday liquidity constraints and reduce operational risks in financial markets and the payments system. A new strategy for providing intraday credit to depository institutions is proposed that would encourage these institutions to collateralize their daylight overdrafts. The full proposal is available at <www.federalreserve.gov/newsevents/press/other/other20080228a1.pdf>.

Comments are requested by June 4, 2008.

Press releases related to banking and consumer regulatory policy are available on the Board of Governors' website at <www.federalreserve.gov/newsevents/press/bcreg/2007bcreg.htm>.

All comments, identified by Docket No., may be submitted by any of the following methods:

* Board website: <www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>. Follow the instructions for submitting comments.
* Federal eRulemaking Portal: <www.regulations.gov>. Follow the instructions for submitting comments.
* E-mail: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
* Fax: (202) 452-3819 or (202) 452-3102.
* Mail: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

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