First Quarter 2009 / Volume 13 Issue 3

SRC Insights®

Federal Reserve Bank of Philadelphia

Liquidity Risk Management: Are You Prepared?

by Joanne Branigan, Manager

Liquidity is a financial institution's ability to meet its cash and collateral obligations without incurring unacceptable losses. Liquidity risk is the risk to financial condition or safety and soundness that is created when a financial institution cannot meet its contractual obligations, both real and perceived. Under the current market situation, the importance of proper liquidity risk management practices is evident more than ever before. This is the first of a two-part series on liquidity risk management. This article will provide an overview of the elements of financial institution liquidity and sound liquidity risk management. Part two of the series, to be published in the second quarter issue of *SRC Insights*, will focus on liquidity risk measurement and contingency funding plans (CFPs).

Liquidity Management Basics

Liquidity need and liquidity supply are situation-specific—different circumstances will cause a bank's needs to differ. Likewise, the supply of liquidity by creditors or depositors will change given differing situations. Too much liquidity can impact a financial institution's profitability; too little liquidity can result in various negative repercussions resulting from the inability to meet contractual obligations.

The basic elements of liquidity management are as follows:

- Assessing current and expected future needs for funds on an ongoing basis and providing that sufficient funds or access to funds exists in order to meet those needs at the appropriate time
- Providing for an adequate cushion of liquidity to meet unanticipated cash flow needs that may arise from potential adverse circumstances ranging

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FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

Credit Market Stress and the Real Economy

by Michael E. Collins, Executive Vice President

Although some financial markets have exhibited signs of improved functioning, overall, financial market conditions remain strained. Financial institutions have tightened their lending terms and show signs of needing more capital at the same time that volatile stock markets have made raising capital more difficult.

Research shows that economic slowdowns follow closely on the heels of periods of financial crisis. As the health of institutions deteriorates, the cost of borrowing increases. To compensate for rising credit costs in a declining interest rate environment, institutions may adjust pricing for risk, raise the rates for loans, or set a floor and tighten lending standards. As the cost of credit increases and becomes harder to obtain, businesses are more likely to decrease investment spending, negatively affecting economic activity.

Evidence of credit tightening is apparent in the latest Federal Reserve Senior Loan Officer Survey. While bankers have stated that they continue to make loans to creditworthy borrowers, the standard for a creditworthy borrower has shifted, and many banks are constraining the credit offered to consumers and businesses. In many cases, the illiquidity in securitization markets and high-priced deposits are also limiting banks' lending capacity. As the economy contracts, there is also lower demand for credit, as firms see no need to expand.

As credit conditions have tightened for both households and businesses, the lack of credit and capital continues to slow the economy. Analysts are worried that the economy's troubles could trigger a major retrenchment by consumers that will make the current recession, already the longest in a quarter-century, even worse. A decline in household wealth resulting from large drops in equity and housing prices, together with tighter credit conditions, higher unemployment, and deteriorating consumer sentiment, is contributing to a sharp contraction in consumer spending. Consumer spending comprises roughly 70 percent of gross domestic product, or GDP, so the sharp pullback in spending will have an outsize impact on the economy.

As consumers curtail spending, many businesses have turned to practices employed during the Great Depression to conserve resources, such as reducing or freezing salaries and initiating extended plant closures. Ultimately, credit crises like the one we are experiencing now can lead to severe recessions when they block businesses' access to capital long enough to generate widespread corporate failures.

With the migration of the financial turmoil to the real economy, banks will be exposed to a more traditional credit cycle. Recent industry data show declining asset quality and equity prices and weak earnings. The erosion of asset quality that was primarily evident in residential mortgages and construction and development loans is now spreading across all asset classes. Although institutions are increasing their allowance for loan losses, the rise in problem loans is outpacing loan loss provisions.

Defaults, distressed debt, and deleveraging will be evident through 2009, adversely impacting banks. Capital and liquidity will remain strained, and the market for credit derivatives will be tested as more businesses fail. Rising credit costs, restructuring charges, and the poor economy will negatively affect bank earnings, as will declining values and write-downs for mortgage-related assets. In some cases, the rapid deterioration of bank assets is outpacing the government's efforts to provide capital to banking organizations while private capital sources are constrained.

The current financial crisis has required large-scale government intervention to stabilize the financial system. This is not an unusual policy response during severe financial crises. Government intervention typically is based on principles that the intervention should be temporary and should be structured so that taxpayers have upside risk and shareholders have downside risk. In an effort to shore up the financial system, last fall Congress passed the U.S. Treasury's Troubled Asset Relief Program, or TARP. Under the program, injections of new capital into the banking system are designed to moderate the powerful pressures that otherwise would have caused the financial institutions receiving the funds to deleverage by selling assets and pulling back from new lending.

As of January 13, 2009, the Treasury has invested \$192 billion of the \$250 billion TARP Capital Purchase Program. Institutions appear to be using the money for four general purposes: increased lending, absorbing losses, bolstering capital, and making opportunistic acquisitions. The disbursement of TARP funds has created much controversy, and in 2009, there will be more scrutiny of how funds are being used. It will be increasingly important that institutions receiving capital have some accountability with regard to how they are using these funds, although it is also just as important that the government limit its involvement in the decisions of individual institutions receiving the funds.

The combination of factors associated with this crisis has transformed the structure of the financial services industry. The global nature of the downturn has spurred the intervention of central banks around the world with aggressive and creative responses to restore confidence in financial markets. Policymakers and industry experts are analyzing the contributing factors—lack of transparency, misaligned incentives, rating agencies, excessive leverage, poor risk management, financial innovation, regulatory gaps—in an effort to better understand the root causes of the crisis and fix upon a broad range of solutions, including regulatory reform.

Despite the turbulence we see today, our financial system is likely to emerge stronger and more resilient as a result of the crisis. Banks will return to fundamentals, and businesses and consumers are likely to exhibit less leverage. National and international regulators and policymakers will engage in more coordination, and future regulatory regimes are likely to evolve around a firm's func-

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Michael E. Collins, Executive Vice President

Bank Mergers and Acquisitions Slow with Economy

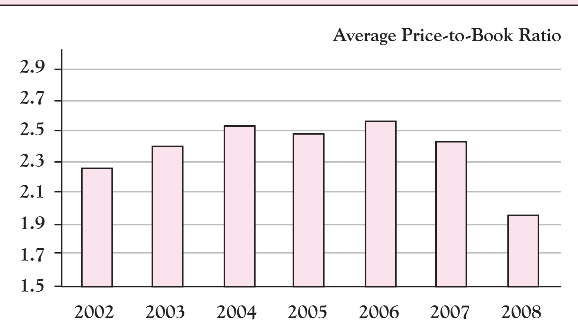
by William Lenney, Regulatory Applications Specialist, and Lauren Jones, Intern

"Factors Affecting Bank Acquisition Valuations," which was published in the first quarter 2008 issue of *SRC Insights*, discussed key factors affecting the bank acquisition valuation trend during the five-year period of January 1, 2002, to December 31, 2006 (2002–2006 analysis). Specifically, it was noted that acquiring banks were paying a significant price-to-book premium for target banks and that by the end of 2006, valuations were at record levels. Over the last two years, economic and financial conditions have deteriorated significantly, and the challenges of the weak housing market, subprime mortgage crisis, a slowing economy, reduced liquidity, and capital issues have led to a decline in the number of bank acquisitions and lower price-to-book premiums paid for target banks. For this article, data from 734 U.S. commercial banks acquired from January 2002 to June 2008 were reviewed to update the 2002–2006 analysis.

Background

The 2002–2006 analysis found that price-to-book premiums paid for acquired institutions were impacted by several factors, including geographic location, core deposit ratios, intrastate acquisitions versus interstate acquisitions, total asset size of the target bank, and the composite CAMELS or RFI/C rating of the acquired institution.[1] The average price-to-book premium peaked at 2.56 in 2006 and declined to 2.43 in 2007. The average during the first six months of 2008 dipped to 1.96 (Figure 1).

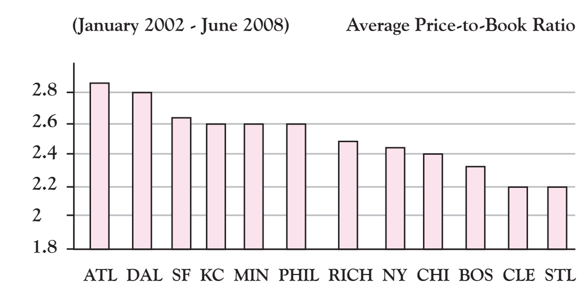
Figure 1: Price-to-Book By Year



The factors from the 2002–2006 analysis were reevaluated using the expanded data period, and the conclusions were consistent. Generally, a higher price-to-book premium was paid for out-of-state target financial institutions in desirable geographic locations with high core deposit ratios and strong composite CAMELS and RFI/C ratings. The total asset size of target financial institutions also had an impact on the acquisition price, as the price-to-book ratio appears to increase with the total asset size of the acquired institution.

During the January 2002–June 2008 period, the average nationwide price-to-book premium paid was 2.45, and the banks acquired within the Federal Reserve's Atlanta District had a 2.75 average price-to-book premium, which was the highest in the U.S., followed by Dallas and San Francisco, respectively (Figure 2).

Figure 2: Price-to-Book vs Federal Reserve District



Locally, institutions acquired in the Third District received a 2.46 average premium during the six and one-half-month time frame, which was consistent with the 2.47 average from the 2002–2006 analysis and could be an indication that the Third District was less affected by current nationwide trends. The largest acquisition in the Third District during the period January 1, 2007–June 30, 2008, was Toronto Dominion Bank Financial Group's purchase of Commerce

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

Bancorp for $9.1 billion in 2008, and the price-to-book premium was 2.91.

Over the last year and a half, the FRB Minneapolis District's ranking changed from twelfth highest to fifth, as the six deals occurring in its District during 2007 and 2008 had a 3.19 average price-to-book premium, which was a significant increase from its 1.98 average for 2002–2006. During the January 1, 2007–June 30, 2008, time period, the highest priced deal in the U.S. occurred in the FRB Minneapolis District, with Merchants Financial Group Inc. acquiring Jerema Inc. for 4.62 times its book value. The FRB Richmond and FRB Minneapolis Districts were the only Districts whose 2008 acquisitions averaged a higher price-to-book premium than their 2002–2006 average.

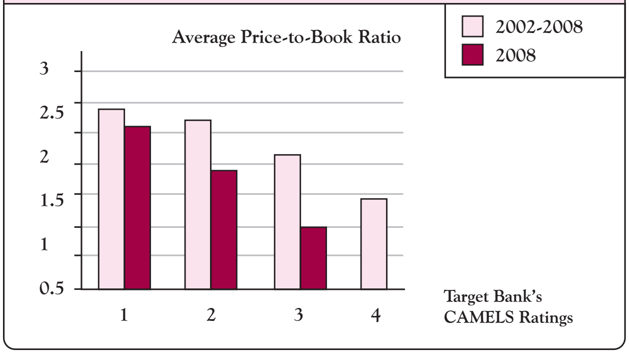
2008 Acquisitions and Mergers

The number of acquisitions during the first half of 2008 slowed significantly to 24, compared to 84 deals during the same period in 2007. The average price-to-book premium was 1.96 in the first half of 2008, which was a significant drop from the 2.46 average from 2002 to 2007. The slowing economy, weak housing market, declining stock market, and uncertainty in financial stocks have depressed bank valuations.

In theory, financial institutions that have 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. Thus, examination and inspection ratings should positively impact the price-to-book premiums paid. This fact was evident in the 2002–2006 analysis and again proved to be the case with the recent data.

The average price-to-book premiums paid during the January 1, 2002–June 30, 2008, time period for 1- and 2-rated banks were 2.59 and 2.45, respectively, and for 3- and 4-rated banks were 2.05 and 1.54, respectively (Figure 3). In comparison, in the first half of 2008, the average price-to-book premiums paid for targets dropped significantly for 2- and 3-rated banks; however, 1-rated banks did not decline as much. The 1- and 2-rated targets' values declined to 2.39 and 1.87, respectively, while 3-rated banks had a 1.23 average (Figure 3).[2]

Figure 3: Change in Price-to-Book Ratio vs CAMELS Ratings



Conclusion

Deterioration in economic and financial conditions has led to a decline in the number of bank acquisitions and lower price-to-book premiums paid for target banks. Multiple factors influence the price-to-book premium paid for financial institution acquisitions. Acquiring institutions still appear willing to pay a higher price-to-book premium for out-of-state targets in desirable geographic locations with high core deposit ratios and strong composite CAMELS and RFI/C ratings.

As Harry Truman once said, "A pessimist is one who makes difficulties of his opportunities, and an optimist is one who makes opportunities of his difficulties." Although these times are challenging, there may be great opportunities for acquiring institutions. ☐

[2] No 4-rated bank holding companies or banks were acquired during the first two quarters of 2008.

from high-probability/low-severity events that occur in daily operations to low-probability/high-severity events that occur less frequently, but that could significantly affect a financial institution's safety and soundness
- Striking an appropriate balance between the benefits of providing for adequate liquidity to mitigate potential adverse events and the cost of that liquidity from various types of liabilities, transactions, and service fees

Liquidity is dynamic and changes according to events both at a bank and in the market. Some events may be planned or can be expected, while others occur unexpectedly. Changes in interest rates; economic conditions; and operational, reputational, legal, and credit risk exposure can all impact a financial institution's liquidity profile and heighten risk.

Types of liquidity risk include the following:
- **Mismatch Risk**—The risk that there will be insufficient cash to meet obligations in the normal course of business due to ineffective matching of cash inflows and outflows
- **Market Liquidity Risk**—The risk that market constraints will affect the conversion of assets into cash or hinder access to sources of funds
- **Contingent Liquidity Risk**—The risk resulting from unexpected events

A financial institution must understand that its liquidity position is constantly changing and that it must employ sound liquidity risk management in order to respond to all events to remain safe and sound and manage profitability effectively.

Elements of Sound Liquidity Risk Management

Liquidity risk management serves to prospectively assess the need for funds to meet contractual obligations and ensures the availability of cash or collateral to fulfill those needs at the appropriate time by coordinating all sources of funds available to the financial institution. In general, sound liquidity risk management calls for financial institutions to have: 1) effective corporate governance over the management of liquidity risk, including active involvement by the board of directors and senior management, and 2) a liquidity risk management process that is adequate for the size, complexity, and business activities of the financial institution.

Board and senior management oversight. Senior management should establish and the board of directors should approve limits and guidelines on the nature and amount of liquidity risk the financial institution is willing to assume. Such limits and guidelines and the level of supporting detail should be appropriate to the size, complexity, and financial condition of the organization and be consistent with the financial institution's overall approach and strategies for measuring and managing liquidity.

Role of the board of directors—The board should understand and guide the strategic direction of liquidity risk management. These responsibilities include the following:

- Understanding the nature of the financial institution's liquidity risks
- Maintaining a general strategy for managing liquidity risk
- Understanding and approving liquidity risk management policies
- Establishing acceptable risk tolerances
- Establishing executive-level lines of authority and responsibility for managing liquidity risk
- Understanding and periodically reviewing the financial institution's CFP
- Understanding the liquidity risk profile of important subsidiaries and affiliates and their potential impact on the overall liquidity of the financial institution

Role of senior management—Senior management should ensure that liquidity risk management strategies, policies, and procedures are adequate for the size and complexity of the financial institution. Management should ensure that policies and procedures are appropriately executed on both a long-term and day-to-day basis. Management should also oversee the design and implementation of an appropriate risk measurement system and standards, a comprehensive liquidity risk reporting and monitoring process, an appropriate CFP, and effective internal controls and review processes.

Senior management should periodically review the organization's liquidity risk management strategies, policies, and procedures and its CFP to ensure that they all remain appropriate and sound. Management should also coordinate the financial institution's liquidity risk management with its efforts for disaster, contingency, and strategic planning, as well as with its business and risk management objectives, strategies, and tactics.

The risk management process. The elements of a sound liquidity risk management process include the following:

- Comprehensive management strategies, policies, procedures, and limits that are appropriately designed, implemented, and monitored
- Adequate liquidity and liquidity risk measurement systems
- Appropriate management information systems that provide for reports throughout the corporate governance structure
- Comprehensive CFPs for addressing potential adverse liquidity circumstances and emergency cash flow needs
- Adequate internal controls that include the involvement of internal audit in the periodic review of compliance with established policies, procedures, and limits

A financial institution's strategies for managing its liquidity and liquidity risk exposure are largely reflected in the policies, procedures, and limits imposed upon the liquidity management process. This includes the plans and courses of actions identified for dealing with the potential for temporary, intermediate-term, and long-term liquidity disruptions. Policies and procedures for managing liquidity and liquidity risk should:

- Identify the objectives of the financial institution's liquidity management and its expected and preferred reliance on various sources of funds to meet liquidity needs under alternative scenarios
- Delineate clear lines of responsibility and accountability over liquidity risk management and management decisionmaking
- Specify quantitative limits and guidelines that define the acceptable level of risk for the financial institution
- Identify the frequency and methods used to measure and monitor liquidity risk
- Define the specific procedures and approvals necessary for exceptions to policies, limits, and authorizations

All liquidity risk policies, procedures, and limits should be reviewed periodically and revised as needed.

Sound liquidity risk management begins with appropriate policies, procedures, guidelines, and limits and effective board and senior management oversight. An institution's liquidity risk management is a critical piece for its ongoing safety and soundness. Part II in this series will discuss liquidity risk measurement, CFPs, and adequate internal controls. If you have any questions on liquidity management and liquidity risk management, please contact Avi Peled (avi.peled@phil.frb.org) at (215) 574-6268 or Andrea Anastasio (andrea.anastasio@phil.frb.org) at (215) 574-6524. □

Emerging Issues Regarding Trust Preferred Securities

by Jennifer Salutric, Surveillance Specialist, and Joseph Willcox, Manager

On October 21, 1996, the Federal Reserve Board approved—with limitations—bank holding companies (BHCs) to include certain cumulative preferred stock instruments in tier 1 capital. These instruments, commonly called trust preferred securities, or TPS, are considered hybrid securities because they contain features of both debt and equity. TPS provide bank holding companies with a means to raise capital for regulatory purposes and deduct the interest payments on the corresponding subordinated debt for tax purposes. Such advantages have made TPS a very popular vehicle for raising capital throughout the past decade, and the advent of pooling and private placements of TPS has opened this market to smaller community BHCs. This article will examine the capital treatment effective as of March 2009 and discuss emerging supervisory and other related issues.

A Recent History of TPS

As of December 31, 2008, almost 1,400 bank holding companies had approximately $148.8 billion in outstanding TPS,[1] compared to 110 BHCs with $31.0 billion outstanding in 1999.[2] As of year-end 2008, 30 of the 101 BHCs in the Third District had outstanding TPS, with a value of $1.2 billion.

The growth in TPS coincided with a period of economic expansion and record earnings for the banking industry from 2000 through 2006. During this time, BHCs used the proceeds from TPS to fund mergers and acquisitions, make capital contributions to subsidiary banks to support growth, repurchase common stock, and reduce the overall cost of capital.

TPS have proven to be an effective way to bolster a BHC's capital position when financial performance is strong. If a BHC or its subsidiary bank's financial condition (particularly, its capital levels) deteriorates, however, the limitations on including TPS for regulatory capital purposes and the restrictive covenants in the debentures could further exacerbate the institution's financial problems and raise concerns.

The market for TPS has essentially dried up during 2008 due to disruptions in the credit markets. As concerns escalate regarding the financial condition of the banking system in general and, specifically, the capability of the issuing entities to service payments, the ability of financial institutions to access capital markets through this vehicle has been severely constrained. Currently, only larger organizations find market acceptance of their issues—and, only then, at a prohibitive cost. The market for pooled TPS or trust preferred collateralized debt obligations (CDOs) is also unreceptive, thus eliminating an option for raising capital for most community banks. According to SNL, only 48 issuances of TPS totaling $19.2 billion were completed in 2008 compared to 210 deals valued at $40.5 billion in 2007.[3]

Adverse economic and market conditions have resulted in rating downgrades of TPS and significant valuation declines for these securities. For instance, on February 10, 2009, Standard and Poor's Ratings Services lowered its ratings on 35 tranches from 14

[1] Data for 2007 obtained from the *Consolidated Financial Statements for Bank Holding Companies* (FR Y-9C) and *Parent Company Only Financial Statements for Large Bank Holding Companies* (FR-Y9LP).

[2] Eveson, Todd H., and Schram, John F., "Bank Holding Company Trust Preferred Securities: Recent Developments," *North Carolina Banking Institute*, Vol. 11, 2007, available online at <studentorgs.law.unc.edu/documents/ncbank/volume11/evesonschramm.pdf>.

[3] Stoval, Nathan, "SNL 2008 League Tables: Most Capital Raising Done Inside the Beltway," SNLi, January 16, 2009.

U.S. trust preferred CDOs. These downgrades reflect fears that institutions issuing TPS may be more likely to defer interest payments as the current economic crisis continues.[4]

Impact on Capital

TPS are considered restricted core elements of capital and may be included in tier 1 or tier 2 capital subject to certain limitations. Due to a rule change, the calculation for the restricted core elements considers goodwill as of the first quarter of 2009. More importantly, as the equity capital position deteriorates, the amount of TPS that qualifies for inclusion in regulatory capital declines, accelerating the ratio's downward trend. This is particularly troublesome for organizations that have made acquisitions and have a significant amount of goodwill.

Tier 1 capital. Effective March 31, 2009, the aggregate amount of restricted core capital elements that may be included in the tier 1 capital of a banking organization must not exceed 25 percent of the sum of all core capital elements, including restricted core capital elements, net of goodwill, less any associated deferred tax liability. In other words, the aggregate amount of restricted core capital elements is limited to one-third (33%) of the sum of core capital elements, excluding restricted core capital elements, net of goodwill, less any associated deferred tax liability.

> TPS are considered restricted core elements of capital and may be included in tier 1 or tier 2 capital subject to certain limitations.

Tier 2 capital. TPS-restricted core capital elements, including TPS in excess of the limit for tier 1, generally may be included in tier 2 capital. Beginning March 31, 2009, the aggregate amount of restricted core capital elements, term subordinated debt, and limited life preferred stock that may be included in tier 2 capital is limited to 50% of tier 1 capital.

Supervisory Issues

For regulators and bank supervisors, the most serious concern is that, as the capital position deteriorates, the amount of TPS that can be considered capital also decreases. Many institutions strengthen their capital position and fund their expansion through the issuance of TPS, so they face serious consequences if that balance sheet suddenly unwinds. Regulatory action may restrict dividends from the bank to the parent in order to protect the depository, thus creating liquidity consequences at the parent, which needs to service the TPS.

Understanding relevant documents. The issuance of TPS involves numerous legal documents and contracts, including the prospectus, the indentures, and the declaration of trust. It is imperative that management and counsel understand the terms of each document, as the definitions and specifics can vary. Failure to fully understand and comply with all of the provisions can present significant risk and result in costly consequences to the organization.

Generally, TPS have been issued during times of favorable economic and banking conditions. Therefore, the documents may have only been reviewed in light of the institution's condition at the time, without considering the repercussions of future issues.

Rank of junior subordinated debentures. The debentures issued in conjunction with the TPS rank pari passu, or equally, with all other junior subordinated debentures issued or to be issued by the BHC and are unsecured and rank subordinate and junior in right of payment to all senior indebtedness.

The pari passu provision requires a BHC to make the interest payments on these subordinated notes if the BHC makes an interest payment on any other debt that ranks the same or that is junior in interest to these debentures. In other words, the BHC cannot pick an order of payment that subordinates senior debt to junior debt.

[4] Hussain Atif, "S&P Lowers 35 Tranches from 14 US Trust Preferred CDO Transactions," SNLi, February 11, 2009.

Notification requirements. The notification requirements may vary among the issues when there are multiple debentures.

Deferral Notice—One of the key elements that qualifies TPS as tier 1 capital is the right to defer payments of interest on the debentures by extending the interest payment period at any time and from time to time during the term of the debentures, for up to five consecutive years. However, if the request to defer these payments is not provided to the trustee within the designated time frame, the BHC will be legally obligated to pay the interest on the debentures.

Management or legal counsel must coordinate the notices so that they comply with the requirements of each individual debenture. Due to the pari passu provisions, failure to provide notice on any one of the debentures within the set time frame will legally require the BHC to make the interest payments on all of the debentures.

When an FHC is placed under a 4(m) Agreement due to the capital position of its subsidiary bank, it must submit an acceptable capital restoration plan to the Federal Reserve.

Events of Default—Within a designated period of time, the BHC shall inform the trustee of any event of default, as defined in the indenture.

Restrictions during the deferral period. Typically, during the deferral or extension period, the BHC is not permitted to declare or pay any dividends or distributions on—or redeem, purchase, acquire, or make a liquidation payment with respect to—any of its capital stock. In addition, it is not permitted to make any payment of principal, interest, or premium, if any, or repay, repurchase, or redeem any debt securities that rank pari passu with or junior in right of payment to the debentures. Nor is it permitted to make any guarantee payments if such guarantee ranks pari passu with or junior in right of payment to the debentures.

It is critical that a BHC's management that is considering acquiring a bank which has deferred interest payments understand the implications of this provision since the successor will also be held to the provisions of the indenture.

Source of strength enforcement actions. If it is necessary to put a BHC under an enforcement action to ensure that it can and will act as a source of financial and managerial strength for its bank subsidiaries, it may be appropriate to include a provision specifically addressing TPS, since dividends from the subsidiary bank often fund the interest payments. A troubled bank may not be in a position to pay dividends to its parent. A commonly used provision to enforce the source of strength doctrine is that the BHC cannot make any interest payments on the subordinated debentures related to the TPS without the prior written approval of the Reserve Bank, thereby preserving cash at the holding company level. The provision usually requires the BHC to submit pro forma financial information depicting the dividend's effect on the organization and the subsidiary bank for consideration in the Reserve Bank's decision process.

4(m) capital. BHCs that meet the criteria can elect to become financial holding companies (FHCs) and use the expanded banking powers given them under the Gramm-Leach-Bliley Act. When an FHC is placed under a 4(m) Agreement due to the capital position of its subsidiary bank, it must submit an acceptable capital restoration plan to the Federal Reserve. This plan must detail the specific actions that the parent company will take to restore the subsidiary bank to a "well-capitalized" condition. If the FHC has TPS, the plan should address the option to defer interest payments, explain the conditions under which this would occur, and provide pro forma financial statements that show the impact of deferring or not deferring the interest payments, as appropriate.

Other-Than-Temporary Impairment (OTTI)

Given the interrelated ownership of a financial institution's TPS by another banking organization, the underlying stability and strength of the issuing bank must be considered when assessing the risk associated with holding a security which is currently in the deferral phase of dividend payment. Given the extensive issuance of TPS over the past 10 years and the present danger for bank failures, the potential exists for many of these securities to default permanently.

In its report entitled "Continued Credit Concerns Face U.S. Bank TruPS CDOs," dated September 9, 2008, Fitch observed $1.7 billion in TPS defaults, deferrals, and credit risk sales across 38 banks since September 2007.[5] This amount represents 5.1 percent of the outstanding TPS issued by banks. In comparison, in the seven years prior to September 2007, only $258.5 million in TPS defaults, deferrals, and credit risk sales across 11 banks was observed. Many issues remain, including creating uniform criteria for OTTI and for the recognition and valuation of securities that meet the evolving standards.

Future Accounting Landscape

Besides TPS offerings, the SPE is the vehicle of choice to remove assets from the parent's balance sheet and, under different names such as SIVs and QSPEs, is used for the entire range of securitizations, including mortgages and credit cards. The Financial Accounting Standards Board (FASB) recently proposed changes to FAS 140 and FIN 46(R), which significantly affect the "originate to distribute" model and would require all SPEs to be subject to consolidation review.

The proposed qualitative assessment in FIN 46(R) would make consolidation more likely, since the party with the power to make decisions for the SPE and the ability to benefit from the SPE is the primary beneficiary and must consolidate SPE. In other words, the SPE would no longer be a stand-alone, off-balance sheet (true sale) entity, but would be consolidated onto the parent's books for accounting purposes.

Conclusion

Significant issues surrounding the issuance of trust preferred securities have evolved that were not present as little as two years ago. It is clearly a market in transition, and, as such, the associated risks must be managed prudently. ☐

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[5] www.fitchratings.com

Supervision Spotlight on: Credit Market Stress and the Real Economy *...continued from page 3*

tions and products rather than by how it is chartered. A key objective as reforms are implemented will be to ensure that the regime allows for innovation—an important engine for growth—while employing a prudent and flexible regulatory system. This approach suggests an emphasis on a mix of government and private responses to reform.

Recessions and financial crises provide a period of reflection for businesses and consumers, and they accelerate implementation of processes and practices that had been considered previously but were postponed. Policymakers are moving from individual responses to problems in the marketplace to more strategic and holistic approaches. While the actions that policymakers and central bankers around the world have taken to date have provided some measure of stability to the financial system, more remains to be done to improve consumer and business confidence in the financial markets. 2009 will be the year that begins to reshape the global financial system, and, for financial institutions, this includes restoring their capital base and their customer trust. ☐

REGULATORY NEWS AND UPDATES

Confidential Supervisory Information Disclosure Rules

On February 28, 2005, the Federal Reserve, OCC, FDIC, and OTS (the agencies) issued an interagency advisory to remind financial institutions about the confidential nature of supervisory ratings and other nonpublic supervisory information. Except in very limited circumstances, financial institutions are prohibited by statute from disclosing their CAMELS rating and other nonpublic supervisory information to nonrelated third parties without written permission from their appropriate federal banking agency. This includes prohibitions on disclosure to insurers underwriting Directors and Officers Liability coverage and disclosure to consultants engaged by the financial institution for any purpose.

Disclosure of confidential supervisory information by financial institutions supervised by the Federal Reserve is addressed in Subpart C of 12 CFR 261, Rules Regarding Availability of Information. This section provides that any supervised financial institution lawfully in possession of confidential supervisory information may disclose such information, or portions thereof, to its directors, officers, and employees and to its parent bank holding company and its directors, officers, and employees. In addition, it may also disclose such information, or portions thereof, to any certified public accountant or legal counsel employed by the supervised financial institution, subject to certain conditions.

Any person who is not included in the class of permissible recipients in 12 CFR 261.20 and who seeks access to confidential supervisory information about a state member bank, a bank or financial holding company, or another entity supervised by the Federal Reserve must file a request for disclosure with the general counsel of the Board of Governors of the Federal Reserve System, following the requirements set forth in 12 CFR 261.22. The other federal banking agencies have similar processes to request disclosure of confidential information about the entities that they supervise. If an examination is conducted jointly with state banking regulators, the report of examination is owned jointly by both regulators. Therefore, written permission to disclose confidential supervisory information must be obtained by the Board as well as the state banking department.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to publicly available information in lieu of disclosing any confidential regulatory information. Institutions supervised by the Federal Reserve Bank of Philadelphia may call the following individuals for additional information on applying the interagency advisory and 12 CFR 261.20.

- Assistant Vice President and Counsel Maryann T. Connelly, (215) 574-6506
- Assistant Vice President Cynthia L. Course, (215) 574-3760

The complete interagency advisory is available in SR Letter 05-4, *Interagency Advisory on the Confidentiality of Nonpublic Supervisory Information*, on the Federal Reserve's website at <www.federalreserve.gov/boarddocs/SRLETTERS/2005/sr0504.htm>. □

Confidential Supervisory Information Disclosure Rules ...continued

Can I Get Confidential Information on the Institution's...?

OK to Disclose to…

- Directors, officers, employees
- Parent BHC directors, officers, employees
- CPA (subject to limitations)
- Legal counsel (subject to limitations)

Check with Appropriate Agency for…

- Consultants
- Insurers
- Creditors
- Shareholders
- Customers
- Rating Agencies
- General Public

Consolidated Supervision of Bank Holding Companies and Foreign Banking Organizations

The Federal Reserve issued guidance in October 2008 to enhance and clarify its consolidated supervision of bank holding companies (BHCs) and the combined operations of foreign banking organizations (FBOs).

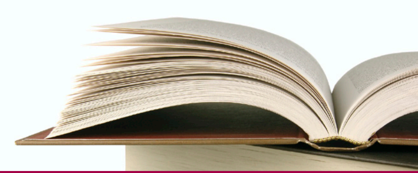
Consolidated supervision, or the supervision of a BHC or FBO on a groupwide basis, allows the Federal Reserve to understand the financial and managerial strengths and risks within a consolidated organization as a whole, thus providing the means to address significant organizational deficiencies before they threaten the safety and soundness of an organization's subsidiary banks.

The recently-issued guidance does not alter the objectives of consolidated supervision, but rather enhances the manner through which supervisors achieve those objectives. The guidance provides for consistent Federal Reserve supervisory practices and assessments across institutions with similar activities and risks. It details expectations for understanding and assessing primary governance and risk controls, material business lines, nonbank operations, and other key risks and activities. The guidance also emphasizes the importance of coordinating with other primary supervisors and functional regulators.

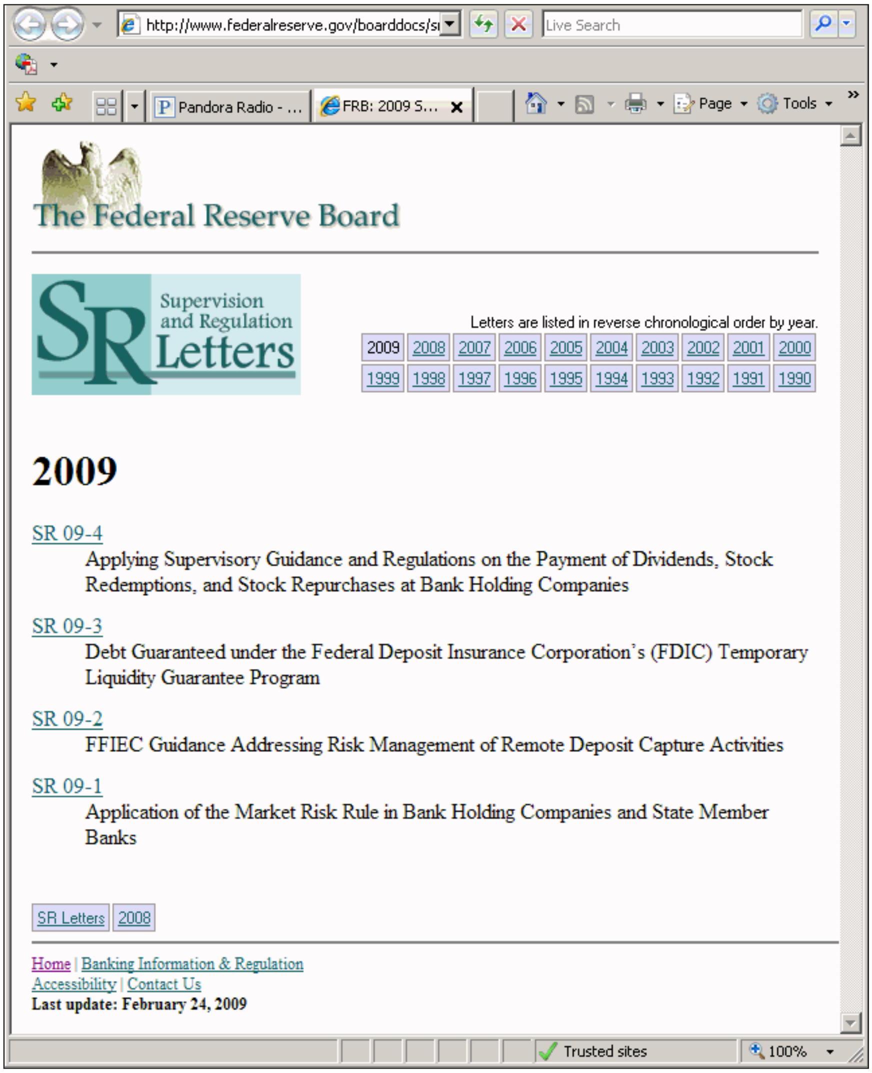
Although the development of the guidance predates the current market turbulence, the guidance's focus on corporate governance, capital adequacy, funding and liquidity risk management, and the supervision of material nonbank subsidiaries should help make the financial system more resilient.

For more information, go to: <www.federalreserve.gov/boarddocs/srletters/2008/SR0809.htm>. □

KEEP INFORMED!



Supervision and Regulation Letters for Financial Institutions Issued First Quarter 2009



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

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Who To Call

Your institution may need to contact an officer, manager, or staff member in the Supervision, Regulation, and Credit Department, but you may not know whom to contact. The following list should help you find the correct contact person to call. Financial institutions that have an appointed central point of contact should generally contact that individual directly. **Contact names appearing in bold are the primary contacts for their areas.**

Community, Regional, and Global Supervision

William W. Lang, SVP	574-7225
Elisabeth V. Levins, AVP	574-3438
Stephen J. Harter, Manager	**574-4385**
Jacqueline Fenton, Manager	**574-7267**
Eric A. Sonnheim, AVP	574-4116
Glenn A. Fuir, Manager	**574-7286**
Adina A. Himes, Manager	**574-6443**
H. Robert Tillman, Special Advisor	574-4141

Capital Markets

William W. Lang, SVP	574-7225
Elisabeth V. Levins, AVP	574-3438
Avi Peled, Manager	**574-6268**

Consumer Compliance & CRA Examinations

William W. Lang, SVP	574-7225
Constance H. Wallgren, AVP	574-6217
Robin P. Myers, Manager	**574-4182**
David A. Center, Manager	**574-34**57

Consumer Complaints

Federal Reserve Consumer Help Center	888-851-1920

Regulations Assistance

Regulations Assistance Line	**574-6568**

Enforcement

A. Reed Raymond, VP	574-6483
Cynthia L. Course, AVP	**574-3760**
Joe Willcox, Manager	**574-4327**

Regulatory Applications

A. Reed Raymond, VP	574-6483
William L. Gaunt, AVP	574-6167
James D. DePowell, Manager	**574-4153**

Retail Risk Analysis

Christopher C. Henderson, Retail Risk Officer	**574-4139**

Discount Window and Reserve Analysis

Vish P. Viswanathan, VP	574-6403
Gail L. Todd, Credit Officer	**574-3886**

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OF PHILADELPHIA

Supervision, Regulation and Credit Department
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Philadelphia, PA 19106

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