Fourth Quarter 2010 / Volume 15 Issue 2

SRC Insights

Federal Reserve Bank of Philadelphia

SPECIAL YEAR-END ISSUE

Revisions to Payment System Risk Policy to be Implemented in 2011

by Jay Karlyn, PSR Specialist, and Glenn Fuir, Manager

On September 30, 2010, the Federal Reserve Board (Board) announced that it will implement changes to its Payment System Risk (PSR) policy on March 24, 2011. The changes were approved in late 2008 to reflect the need for Federal Reserve Banks (Reserve Banks) to provide intraday credit to improve intraday liquidity management and payment flows for the banking system while continuing to mitigate credit exposures stemming from daylight overdrafts. The purpose of this article is to serve as a refresher on the administration of payment system risk by the Reserve Banks and to highlight the impacts of upcoming PSR policy changes scheduled to take effect on March 24.

One of the primary objectives of the PSR policy was to implement a program to oversee the use of intraday credit by the Federal Reserve and to define the methodology that Reserve Banks must use to minimize their credit risk exposures. The revised PSR policy allows Reserve Banks to mitigate credit risk by:

- Providing intraday credit to healthy institutions (those that satisfy safety and soundness requirements)
- Establishing limits on the amount of Federal Reserve intraday credit that an institution may use
- Allowing Reserve Banks to place risk controls on account activity to protect themselves from the risk of loss
- Giving institutions incentive to voluntarily pledge collateral to secure daylight overdrafts through a revised fee structure

[1] www.federalreserve.gov/newsevents/press/other/20100930a.htm.
[2] www.federalreserve.gov/newsevents/press/other/20081219a.htm.

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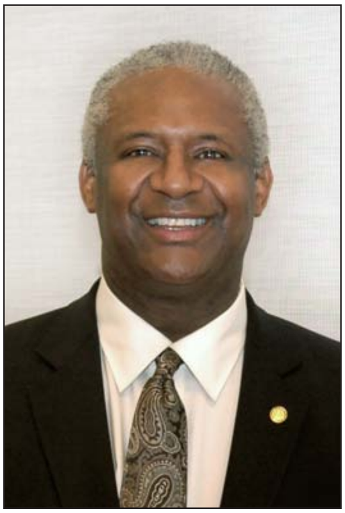
Federal Reserve Bank of Philadelphia

Supervision Spotlight

Improving Bank Supervision

by Michael E. Collins, Executive Vice President



Banking has always been, and will remain, a dynamic and innovative business. In order to effectively regulate a rapidly-changing financial services industry, the basic core mission and broad strategies of supervision and regulation should remain relatively constant, while the policies and practices must continually adapt, evolve, and improve.

The recession and financial crisis provided a period of reflection for businesses and consumers. Gaps and weaknesses in the risk management capabilities of firms and in the supervision and regulatory process became apparent. The legislative response was to enact the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most sweeping regulatory reform since the Great Depression. Supervisory agencies have also been considering the lessons learned, addressing weaknesses, implementing action plans, and undergoing constructive transformation. No supervisory regime was entirely untouched by the crisis.

Supervision and Regulation

It is important to first recognize the distinction between supervision and regulation. Although the terms are often used interchangeably, they are, in fact, two distinct, although complementary, functions. Bank regulation refers to the laws and rules that govern the industry, while bank supervision involves the monitoring, inspection, and examination of banking organizations to assess their condition, risk management capacity, and compliance with relevant laws and regulations. Both are essential to a safe and sound financial system.

Prominent professor Edward Kane describes the ongoing "regulatory dialectic," saying "Regulation is best understood as a dynamic game of action and response, in which either regulators or regulatees may make a move at any time. In this game, regulatees tend to make more moves than regulators do. Moreover, regulatee moves tend to be faster and less predictable, and to have less-transparent consequences than those that regulators make."[1]

The Need to Reform Supervision

The Bank for International Settlements (BIS) captured the crux of the matter in its 2008-2009 annual report: "For all their enduring virtues, markets have failed in some very important ways. It is now apparent that as the financial system has grown and become more complex, it has come to need a more comprehensive set of rules to ensure that it functions smoothly. Ensuring that a decentralized financial system operates safely and efficiently does not simply mean more regulation or more centralization; rather, it means better regulation and better supervision that induce the private sector to improve incentives, risk management and governance."[2]

As Chairman Bernanke indicated, "Even before passage of reform legislation, the Federal Reserve has been overhauling its supervision and regulation of banking organizations and working to strengthen financial market infrastructures and practices. We will be focused and diligent in carrying out our responsibilities under the new law."[3]

Many of the fundamental principles that support prudential oversight proved effective and will remain intact. However, lessons learned have already spurred changes.

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1 Kane, Edward, "Extracting Nontransparent Safety Net Subsidies by Strategically Expanding and Contracting a Financial Institution's Accounting Balance Sheet," *Journal of Financial Services Research*, Vol. 36, Issue 2, December 2009, available online at www2.bc.edu/~kaneeb/Extracting%20 Nontransparent%20Safety%20Net%20Subsidies.pdf.

2 BIS Annual Report 2008/09, available online at www.bis.org/ publ/arpdf/ar2009e7.pdf.

3 Statement by Chairman Ben S. Bernanke, available online at www. federalreserve.gov/newsevents/press/other/20100715a.htm.

Emergence of a "New Normal"

Today's supervision will aim to de-risk the industry by being out in front of emerging risks, monitoring leading indicators excess, and responding promptly in order to eliminate or mitigate potential negative consequences. Determining the optimal timing, approach, and forcefulness of the response still remains a challenge. When weaknesses are identified, supervisors will be more vigilant in requiring corrective action before the weaknesses impact capital.

The "new normal" for supervision is characterized by key enhancements and mandates, including the following:

Defining, learning, and applying new rules and regulations. A regulation that, on its surface, may contribute to the banking system's efficiency and stability can also harbor hidden costs and perverse outcomes if it fails to factor in banks' incentives and reactions. The regulatory agencies are now working to set up balanced, but effective rules around the regulation framework. 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. The majority of the rule-writing phase will be completed over the next 12 to 18 months. Outcomes of this phase will likely shape the practices and performance of the industry for years to come. The Federal Reserve Bank of Philadelphia's well-established program of forums and outreach has helped bankers stay abreast of the latest developments. It also allows an opportunity to directly engage and interact with bankers and to solicit their valuable insights and perspectives on the issues. It is imperative that bankers voice their concerns and opinions during this time.

Macroprudential supervision. The term "macroprudential supervision" refers to the "use of prudential tools with the explicit objective of promoting the stability of the financial system as a whole, not necessarily of the individual institutions within it. Naturally, most of the tools lie with the regulation and supervision of individual institutions. The main challenge is to achieve a better balance in their use, with the aim of successfully marrying the two perspectives."[4] Better insight into correlation, pro-cyclicality, and interdependencies in financial markets is needed. In addition, understanding the risks inherent in new products is necessary, with additional emphasis placed on the role of innovation in a firm's risk appetite and as a key driver of earnings.

Extensions of regulatory authority. Having proper authority is a prerequisite for conducting thorough and effective supervision. This aspect has been largely strengthened through the legislative process. For example, the Dodd-Frank Act addresses "Fed-lite" issues. The provisions will broaden the Federal Reserve's authority to require reports from a BHC and its subsidiaries and to examine the functionally-regulated subsidiaries. It also requires the Federal Reserve to examine each non-"functionally-regulated" subsidiary. This process encompasses the Fed's responsibility and accountability for oversight of systemically-important financial institutions. Tools to unwind systemically-important institutions and crisis-related policy interventions are also required.

Increased availability and effective use of data. Effective bank supervision must be seen by banks as a continuous presence. This is mainly achieved through off-site monitoring, both micro- and macro-prudential in scope. Reliable and timely data becomes crucial to making informed decisions. "Macro-prudential analysis is based on market intelligence and macroeconomic information, and focuses on developments in important asset markets, other financial intermediaries, and macroeconomic developments and potential imbalances."[5] Therefore, supervision staff and examiners must have greater access to a broader array of relevant data sources and analytics.

In light of the recent events, the use of stress testing has gained greater prominence as a key element of effective risk management, which should be employed in both liquidity and capital planning at financial institutions. Stress tests should also be a routine part of assessing real estate risk and other credit risk in the loan portfolio. Stress tests do not require sophisticated models, but should be commensurate with the size, complexity, and risk profile of the institution. It is important to recognize that low-likelihood, highly-adverse situations may be infrequent, but they are not outside the realm of possibility, and management should plan accordingly.

In light of the recent events, the use of stress testing has gained greater prominence as a key element of effective risk management, which should be employed in both liquidity and capital planning at financial institutions.

Greater sharing of information between agencies. The new regulatory structure has been strengthened, but not necessarily simplified. Increased coordination among the agencies will be necessary. National and international regulators and policymakers will be more engaged and coordinated, and future regulatory regimes are likely to evolve around a firm's functions and products rather than by how it is chartered.

More emphasis on incentive compensation. Compensation practices and, specifically, incentive compensation received intense public scrutiny and drew significant criticism during the recent financial crisis. Policymakers and regulators have responded by taking measures to ensure that future compensation

[4] Clement, Piet, "The Term "Macroprudential": Origins and Evolution," available online at www.bis.org/publ/qtrpdf/r_qt1003h.pdf.

[5] "Toward a Framework for Financial Stability," International Monetary Fund, available online at www.imf.org/external/pubs/ft/wefs/toward/index.htm.

practices are managed prudently and discourage excessive risk-taking.

On June 21, 2010, the federal banking regulators (the agencies) issued final interagency guidance (final guidance) on sound incentive compensation practices for banking organizations. The adoption of the final guidance is fully consistent with the agencies' statutory mandate to protect the safety and soundness of banking organizations.

Banking organizations must ensure that their incentive compensation practices properly balance risk and reward. Incentive compensation plans should not promote short-term gains while disregarding longer-term risks, and potential risks should be considered from an enterprisewide perspective.

Developing a stronger "will to act." In their paper "The Making of Good Supervision: Learning to Say No,"[6] Jose Viñals and Jonathan Fiechter identify key elements of good supervision as being intrusive, skeptical, proactive, comprehensive, adaptive, and conclusive. The authors also suggest that the "ability" to supervise, which requires appropriate resources, authority, organization, and constructive working relationships with other agencies, must be complemented by the "will" to act. Supervisors must be willing and empowered to take timely and effective action, to intrude on decision-making, to question common wisdom, and to make unpopular decisions. When a material loss review is conducted after a bank failure, examiners are often criticized for identifying detrimental risks and rising concentrations early, but not acting quickly or forcefully enough to alter the course of events. Taking away the punchbowl is rarely an easy process, even when ultimately it may be in the best interest of all involved. Acting during "good" times, when risk is still building but not necessarily reflected in the performance numbers, is often a source of contention and brings about accusations that examiners are overzealous or are predicting the future outcomes of economic or market activity. There should be reasonable and logical justification for the decision and clear lines of accountability. Examiners must be empowered to make choices and draw conclusions based on a logical and consistent approach and in a manner that is vetted at various levels.

Final Thoughts

Supervision and regulation continue to adapt and improve. A proper balance that limits moral hazard, yet minimizes the risks of being overly burdensome, must be maintained. The lessons learned from the recent crisis will help advance the evolution of supervision, make the overall financial system more resilient, and ultimately benefit all involved. ☐

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6 Viñals, Jose, and Fiechter, Jonathan, "The Making of Good Supervision: Learning to Say No," IMF Staff Position Note, May 18, 2010, available online at www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf.

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Business Combinations Challenges: GAAP Accounting Rules, FDIC-Assisted Acquisitions, & Bargain Purchases

by William Lenney, Regulatory Applications Specialist

During the past few years, business combinations have become increasingly complex due to Generally Accepted Accounting Principles (GAAP) changes, FDIC-assisted acquisitions, and bargain purchases. ASC Topic 805, *Business Combinations* (formerly FAS 141 R), replaced FAS 141, introducing significant changes in the accounting for and reporting of business acquisitions.[1] In addition, during the past few years, FDIC-assisted transactions have increased, and due to their nature, structure, and timing, they have created a large number of bargain purchases.

Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions was established on June 7, 2010. Although the guidance concentrates on bargain purchases, it is also pertinent to business combinations in general. The guidance does not add to or modify existing regulatory reporting requirements issued by the agencies or current accounting requirements under GAAP. This article will discuss some of the supervisory concerns around bargain purchases and business combinations.

What Is a Bargain Purchase?

A bargain purchase takes place when the fair value of acquired net assets in a business combination exceeds the consideration paid by the acquirer. Under current guidance, rather than recognizing this "bargain purchase" value as negative goodwill, companies now record a gain on the income statement. Bargain purchases are raising supervisory considerations related to the reliability of valuations and estimated purchase gains for certain institutions, especially during the period when provisional estimates are recorded.

ASC Topic 805 continued the movement toward the greater use of fair values in financial reporting and increased transparency through expanded disclosures. It changed how business acquisitions are accounted for and impact financial statements at the acquisition date and in subsequent periods. Further, certain changes introduce more volatility into earnings and thus may impact a company's acquisition strategy.

Supervisory Considerations

The movement toward the greater use of fair values in financial reporting for business combinations requires a high level of accounting and fair value measurement expertise. Acquirers should ensure that they have qualified personnel to perform due diligence. Management should establish strong corporate governance and internal controls to ensure compliance with complex accounting requirements and regulatory requirements related to a business combination. Management is encouraged to understand applicable regulatory reporting and supervisory factors, such as fair value, measurement period, and required applications prior to consummating a business combination.

Fair value and measurement period. Due to the significant impact that fair value estimates can have on goodwill, earnings, and capital, management should have the appropriate written fair value measurement policies and procedures to report fair values in accordance with ASC Topic 820, *Fair Value Measurements and Disclosures*. If management does not have the requisite expertise, it should seek an expert opinion.

[1] December 4, 2007, the Financial Accounting Standards Board (FASB) issued ASC Topic 805. The standard became effective for acquisitions consummated on or after the beginning of the first annual reporting period (beginning on or after December 15, 2008).

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period ends as soon as the acquirer either receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

Business combination applications. The acquiring institution must submit the appropriate application to its primary regulator and any appropriate state regulator for approval prior to consummating the transaction. The acquirer should submit one pro forma balance sheet with two sets of pro forma capital calculations when the business combination results in a bargain purchase. The first set of pro forma calculations should include the increase in capital due to the bargain purchase, while the second set should exclude any estimated gain from the proposed business combination and any bargain purchase gains from prior business combinations still within the measurement period.

The acquiring institution must submit the appropriate application to its primary regulator and any appropriate state regulator for approval prior to consummating the transaction.

Since there may be concerns about the quality and composition of capital for a bargain purchase during the measurement period, conditions may be imposed in regulatory approvals, such as excess capital requirements, dividend limitations, independent audits or agreed-upon procedures requirements, independent valuations, and legal lending limits.

FDIC-assisted transactions. FDIC-assisted transactions have extremely short time frames for bidding and closing acquisitions, while important information about the failing bank, such as examination ratings, board minutes, employee information, and employment contracts, may not be available to the prospective acquirer. The due diligence review is limited to 2 ½ to 3 days and is usually performed by four to six individuals. The acquiring institution should carefully read the purchase and assumption agreement. On April 1, 2010, the FDIC lowered its loss-sharing coverage for purchases and assumptions from 95 to 80 percent, so the risk of losses has increased for an acquiring institution.

GAAP accounting. ASC Topic 805 has changed many well-established business combination accounting practices and significantly impacts how acquisition transactions are reflected in the financial statements. It affects the allowance for loan and lease losses (ALLL), capital, regulatory capital, goodwill, acquisition-related expenses, and earnings.

ASC Topic 805 requires that receivables, including loans, acquired in a business combination be recorded at fair value. Separate valuation allowances are not recognized on assets that are recorded at fair value as of the acquisition date. The determined fair value of the acquired loans and leases, as defined in ASC Topic 820, become the new book value, which is the basis to assess future reserve requirements. It is important to note that some acquiring institutions have found that the elimination of the ALLL for the loans at the acquired institution has a negative impact on the total risk-based capital of the newly combined entity, since the ALLL is a component of tier 2 capital.

Subsequent to the measurement period, a loan loss reserve should be established for these loans in accordance with existing ALLL guidance. Additional analysis, such as historical and peer group, may be required to determine the effect of acquisition-related loans on the historical loss rates, coverage ratios, and allowance ratios. Institutions may need to implement new systems to segregate acquisition-related loans from the originated portfolio.

The acquirer shall account for transaction or acquisition-related costs (e.g., finder's fees, advisory, legal, accounting, valuation, or other professional or consulting fees) as expenses, which differs from the treatment under previous GAAP. The acquirer would defer these costs under previous GAAP by adding them to the purchase price, which typically increased recorded goodwill. The expensing of transaction costs under ASC Topic 805 reduces an acquirer's earnings and capital, as the expenses are recognized.

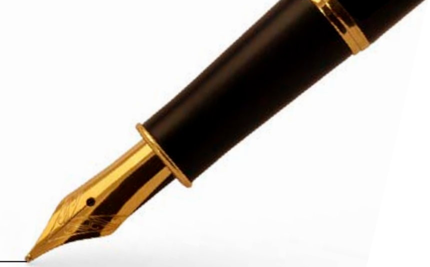
Conclusion

ASC Topic 805 affects how companies negotiate and structure transactions, model financial projections of the acquisition, and communicate to stakeholders. For more information, *Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions* is available online at www.federalreserve.gov/boarddocs/srletters/2010/sr1012.htm.

Business combinations during times of uncertainty and volatility can be extremely challenging, but rewarding in the long run for an astute acquirer. Novelist Louisa May Alcott once said "I am not afraid of storms, for I am learning to sail my ship." Before embarking on an acquisition, prospective acquirers should realize that there is a steep learning curve, and that it is challenging to navigate through the complexities of GAAP accounting, FDIC-assisted acquisitions, and bargain purchases. ☐

From The

Examiner’s Desk



Qualitative Factors and the Allowance for Loan and Lease Losses in Community Banks

Sharon Wells, Examiner, and Trevor Gaskins, CPA, Assistant Examiner

This is the first of two articles associated with the analysis of the Allowance for the Allowance for Loan and Lease Losses (ALLL). This article discusses improving the analysis of qualitative factors under ASC 450-20 (formerly FAS 5). Based on a variety of observations made by examiners, this article identifies some areas of weakness and also discusses suggested measures and “best practices” outlined within regulatory guidance to help financial institutions further develop their methodologies. During early 2011, we will expand our discussion of the ALLL to include a refresher on impairment analysis and the ASC 310-10-35 *Accounting by Creditors for Impairment of a Loan* portion of the ALLL (formerly FAS 114).

Current regulatory guidance under SR 01-17, *Interagency Policy Statement on the Allowance for Loan and Leases* (the guidance), requires that the ALLL methodology must estimate credit losses on groups of loans with similar risk characteristics (homogeneous pools) in accordance with Generally Accepted Accounting Principles (GAAP) under ASC 450-20, *Accounting for Contingencies*. This is accomplished through the use of qualitative, or “environmental,” factors.

Environmental factors are used to reflect changes in the collectability of the portfolio not captured by the historical loss data. These factors augment actual loss experience and help to estimate the probability of loss with in a loan portfolio based upon emerging or inherent risk trends.

Mechanically, the process typically begins with an institution identifying and applying historical net charge-off rates to homogeneous loan pools based upon actual experience. This is the base point on which an institution then applies environmental factors that would likely cause estimated losses to be different from the historical loss experience. This is normally applied as an “adjustment” to the historical loss rate pursuant to the requirements outlined in the *Commercial Bank Examination Manual* under Section 2070.1, Allowance for Loan and Lease Losses, “Measurement of Estimated Credit Losses.”

This portion of the ALLL methodology can be challenging. Some challenges that have been observed in Portfolio Segmentation, Selection of Specific Environmental Factors are as follows:

Portfolio Segmentation:

- Portfolio segmentation into “homogeneous” pools is often less granular than needed. This limits the ability to capture the unique behavioral characteristics that vary the degree of inherent risk or increase the likelihood of loss.
- Materiality is measured by a loan portfolio’s contribution to total assets, not its relevance to risk-based capital.

Selection of Specific Environmental Factors:

- Environmental factors are not well supported and documented.
- Environmental factors selected to adjust historical loss rates are often limited or are broadly or too narrowly applied.

- Environmental factors are premised upon highly intuitive, subjective "opinion"-based factors or limited strictly to suggested guidance examples.
- The same environmental factors are applied across all portfolio sectors regardless of their specific influence (or lack thereof) on the portfolio.
- Documentation supporting the relevancy of each environmental factor is sometimes weak.
- Concentrations are applied only for the commercial real estate (CRE) sector (because it is the subject of the guidance under SR 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate*).

Assigning Quantitative Values

- Support for values is not documented or based upon comprehensive analysis. Values used to make the adjustment to historical losses are often not well correlated to the "risk."
- Factors are aggregated, and a single flat environmental factor value is applied across all loan pools. Values for environmental factors may not vary based upon the unique risks inherent to each loan pool.
- "Caps," or limits, on values assigned to factors are sometimes applied based upon risk severity (low, medium, high) that does not allow for rising trends over time, i.e., risk continues to increase, but the assigned value has been maximized and cannot be increased due to the "cap."
- Values for qualitative factors are assigned and then weighted, imposing an additional "cap."
- Use of "negative values" and values for one loan pool are netted off of values for factors affecting another pool.
- Assume that the sum of all qualitative factors must equal 100 percent or 1.

Portfolio Segmentation

Lack of adequate portfolio segmentation, over-use of subjective and unsupported variables, and a lack of understanding of unique inherent risk characteristics within various loan pools may lead to an underfunded ALLL. Therefore, institutions seeking a more thoughtful evaluation of estimated losses should consider the following when developing a comprehensive ALLL methodology.

Portfolio segmentation is one of the key elements to a sufficient ALLL methodology under the regulatory guidance. Under the guidance, "management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans." In general, many Third District state member banks segment their portfolios into very broad categories, which typically mirror major segments highlighted within the call report.

Lack of adequate portfolio segmentation, over-use of subjective and unsupported variables, and a lack of understanding of unique inherent risk characteristics within various loan pools may lead to an underfunded ALLL.

Broad grouping of loan types may be appropriate for some institutions depending upon the breadth (or lack) of product offerings. However, for institutions with extensive lending capabilities, this approach may obscure underlying risk behaviors that are driving risk within the loan portfolio. These behaviors can become diluted when aggregation occurs. The extent of additional segmentation depends on the size of the institution and the nature, scope, and risk of its lending activities (e.g., new products, significant changes to underwriting, origination in new markets, etc.). In general, the more highly developed an institution's management information systems (MIS) and data mining capabilities, the more accurately risk identification will be for ALLL purposes.

For example, institutions may want to consider other loan pools, such as:

- Loans in certain poorly-performing markets or geographies where a concentration exists
- Subordinate loan positions (i.e., junior lien positions for commercial portfolios, etc.)
- Unsecured loans
- Open-ended construction loans
- Asset-based loans (ABLs)
- Bridge loans or swing loans
- Unpermitted and not yet zoning-approved land and development loans (dirt loans)
- Mezzanine loans
- Agricultural loans
- Non-recourse loans
- Floor-plan loans
- Out-of-market loans
- Purchased loan participations
- Loans underwritten during a certain time period (where weak or lax practices may have existed)
- Home equity loans
- Loans where repayment/collateral is subject to completion risk

Suggested Environmental Factors

The guidance provides several examples of fundamental environmental factors that an institution should consider, as represented below. Presented as an expanded reinforcement of the guidance, Exhibit I (found on the following page) suggests other common risk or loss drivers that could be considered when evaluating inherent risk that may drive losses in a loan portfolio. Best practice would be to prepare an institution-specific and customized risk assessment of each portfolio sector based upon the unique characteristics and loss drivers of that loan portfolio. One example would be to evaluate the underlying causes of loss each time a loss is recorded and maintain that intelligence for ongoing monitoring and review. Migration analysis for certain sectors, portfolios, pools, etc. may also help to identify issues sooner rather than later. This information could be analyzed to determine whether it justifies an adjustment to historical loss rates for ALLL purposes.

Environmental Factors and Values

No matter what factors management chooses to emphasize in the ALLL analysis, management must support the actual values for environmental factors that affect historical loss rates. Management must account for and document its inputs for determining these values and must have policies and procedures for executing a change in these values.

To illustrate how broadly institutions are assigning values for qualitative factors, the authors reviewed a number of ALLL methodologies for Third District Institutions. No reviewed institution expanded qualitative factors outside those highlighted in the guidance. In addition, some determined that some factors did not even apply, even though, for items such as concentrations, the organization actually had high exposure risk in certain concentrated sectors.

Certainly, management must ensure that assigned values for estimated loss are appropriate, and that the cause and effect of these drivers can be tracked over time and changed depending upon circumstances and trends. If the process is too random or subjective, or if the changes in values do not keep pace with the impact of increased risk, then institutions will find the ALLL to be inadequate and potentially directionally inconsistent. This can result in regulatory criticism as well and may ultimately result in supervisory requirements for increased capital levels, potential limitations on dividends, or other enforcement actions to ensure the safety and soundness of an institution.

Recent Accounting Developments

At the time of the writing of this article, the Financial Accounting Standards Board (FASB) has proposed amendments to disclosures under ASC 450. The proposed amendments seek to broaden financial statement reporting regarding the types of contingencies required to be disclosed. In addition, the proposed amendments increase qualitative and quantitative descriptions of those contingencies within the notes of the financial statements, specifically surrounding loss contingencies related to litigation proceedings. While the possibility exists that this proposal may en-

Exhibit I

Factors	Drivers
Lending Policies and Procedures	• Changes in lending policies and procedures • Changes in underwriting standards and collection • Charge-off and recovery practices • Increased speculative lending • Increased lending in high-risk products or markets • Origination of loans with marginal debt coverage ratios (DCRs) • High loan-to-value (LTV) ratios • Increased granting of unsecured lending • Subprime lending • Preponderance of loans approved with exceptions • Loans to high-risk industries not normally permitted by policy • High degree of loan documentation waivers, deficiencies, or an abundance of matured loans (refinance risk) • Financial statement exceptions or originations without them
Business Conditions	• Economic factors (national, local behavior, or both, if applicable) • Should consider a variety of drivers, such as inflation, consumer price index (CPI), interest rate environment, housing starts, bankruptcy rates, producer price index (PPI), etc. • Should reflect distinctions among geographies (material) • Industry/Sector trends (manufacturing, investment real estate, hospitality, etc.) • Regional business closings
Loan Profiles and Volume	• Use supportable proxies for new loan products for which actual historical loss experience or risk profiles are not available • Consider infrastructure issues with rapidly-growing portfolios • Consider effect of newly-introduced innovative product types with little risk behavior history causing risk in the “unknown” • Premiums should be incorporated for high-volume, high-risk areas vs. “bread-and-butter” lending • High level of participation risk (one step removed or “agent” risk) • Impact of loans subject to maturity or refinance risk
Lending Staff	• Economics on turnover rates and loss of expertise • Absence of qualified staff for workout activities • Training issues • General lending experience and experience in assigned lending sector • Length of employment with the organization
Problem Loan Trends	• Volume and severity of past due, adversely-classified, or criticized loans • Foreclosure rates • Level of troubled debt restructurings and modifications

Continued on the following page...

Loan Review Quality	• Depth and breadth of scope and penetration. Problem loans included? Loss passes review? Selective sample of passes? All portfolios? All lenders? • Changes in scoping • Quality • Experience of team • Staffing levels • Degree to which staff detects documentation deficiencies and exceptions • Findings on consistency or inconsistency in assignment of risk ratings
Collateral	• Lack of collateral/unsecured status • Type of collateral (trade assets, intangibles, etc.) or lack thereof • Declining valuation environment • Trend of other factors that affect collateral protection (occupancy, environmental considerations, rent rate declines, number of loans with outstanding taxes – inability to track taxes, documentation deficiencies and unperfected interests, poor collateral administration program, etc.)
Credit Concentrations	• Not just limited to commercial real estate • Measured by the impact to capital, not as a percentage of total assets • Diverse analysis—loan types, borrower concentrations, geographic emphasis, sector emphasis, etc.
Competition, Law, and Regulation	• Impact from ratings agencies • Impact of public enforcement actions • General regulatory environment from agency oversight • Regulatory environment on certain loan sectors (new environmental laws, healthcare reform, etc.) • Degree of risk-taking prompted by competitive pressure • Participation risk – participant squabbles, legal action, etc.

hance the disclosures related to qualitative factors, the current version under consideration does not appear to have a material impact on financial accounting and reporting of estimated loan and lease losses and related disclosures.

Summary

Development of well-supported and appropriate environmental factors for homogenous loan pools when determining the ALLL requires 1) meaningful and thoughtful consideration of all of the environmental factors to which a particular portfolio is currently vulnerable, 2) the ability to segment the loan portfolio into pools that behave similarly under certain economic conditions, 3) the development of supportable values for all environmental factors, and 4) the ability to fully understand the fundamental behaviors and underlying risk of each portfolio sector.

If you would like additional information or have questions about ASC 450-20 and the ALLL, please contact Sharon D. Wells (sharon.wells@phil.frb.org) at (215) 574-2548 or Trevor Gaskins (trevor.gaskins@phil.frb.org) at (215) 574-6093. Third District institutions are also encouraged to contact their assigned portfolio manager with related institution-specific questions or concerns as they pertain to this subject matter. □

Potential Money Laundering Threats in the Third District

by H. Robert Tillman, Special Advisor[1]

During the past two years, the economy has weakened many banks and businesses across the country. While such banks and businesses in the Third District are increasing their efforts to strengthen their financial condition in a still-weak economy, the individuals and criminals trying to take advantage of these weaknesses are also increasing their efforts. Anti-money laundering compliance and protecting against vulnerabilities are still critical components to keeping banks safe and sound. This article explores some of the potential money laundering threats that exist in the Third District.

The Third District covers the state of Delaware, southern New Jersey, and eastern Pennsylvania and includes several areas that are designated as High Intensity Financial Crime Areas (HIFCAs) or High Intensity Drug Trafficking Areas (HIDTAs).[2] In New Jersey, all 26 counties are designated as HIFCAs. In addition, the city of Camden in Camden County, New Jersey, and Chester, Delaware, and Philadelphia Counties in Pennsylvania are designated as HIDTAS.

During the past decade, the Third District has experienced growth in business startups and expansions, particularly in cities where the population has grown.

During the past decade, the Third District has experienced growth in business startups and expansions, particularly in cities where the population has grown. Even during the recession, the Third District attracted several casinos, and gambling-related activities are no longer limited to Atlantic City, New Jersey. The Pennsylvania casino industry is growing rapidly; 10 casinos are already operating in Pennsylvania, with several more scheduled to open. Millions of consumers are projected to patronize the Pennsylvania casinos, generating over $3 billion per year in gross revenue. This makes Pennsylvania the third largest casino market in the United States[3] out of the 40 states that currently permit casinos.[4]

While these new casinos create jobs and help stimulate the economy, they also bring potential fraud and money laundering-related activities to the Third District. A breakdown of Suspicious Activity Reports (SARs) filed by states/territories indicates that New Jersey casinos filed the highest number of SAR-Cs (26 percent), while Nevada ranked second (18 percent).[5] In the most recent analytical study on the gambling industry, U.S. Treasury Financial Crime Enforcement Network (FinCEN) staff identified 40,409 SAR-Cs filed by casinos and card clubs from January 1, 2004, through December 31, 2008. These SAR-Cs reported an aggregate of over $900 million in suspicious activity. The last year of the review, 2008, reflects the highest percentage of SAR-Cs filed (28 percent), and the percentage of the total dollar amount was nearly 28 percent—more than twice that in 2004.[6]

Forty percent of the total SAR-Cs provided suspicious activity amounts between $10,001 and $50,000 per person. Thirty percent of the sampled narratives reported patrons conducting a series of transactions that involved minimal or no casino play. Specific examples include:

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1 Christine Astillero, Analyst, contributed research to this article.

2 White House Office of National Drug Control Policy, available online at www.whitehousedrugpolicy.gov/hidta/index.html.

3 Pennsylvania Tourism website: www.visitpacasinos.com (November 5, 2010).

4 Charles Steele, FinCEN Deputy Director, U.S. House Committee on Ways and Means Testimony, May 19, 2010, p. 5.

5 Steele testimony, p. 6.

6 Steele testimony, p. 6.

- Cashing out chips when the casino had no record of the individuals having bought or played with chips.
- Buying chips with cash, casino credit, credit card advances, wired funds, or funds withdrawn from safekeeping accounts, but playing minimally or not playing at all. The subjects then cashed out the chips or left the casino with unredeemed chips.
- Receiving wired funds from a depository institution into an individual's casino front money account and then requesting that the funds be wired to another bank account without playing.
- Frequently depositing money orders or casino checks from other casinos into front money accounts, buying in and playing minimally or not playing, and then cashing out through issuance of a casino check.
- Converting currency into redeemable cash tickets by feeding bills (usually $20s) into slot machine bill acceptors and then printing out TITO tickets and cashing out the tickets,[7] typically for large denomination bills.[8]

A small percentage of frauds against a casino were also reported. For example, patrons cashed out or attempted to cash out stolen, forged, or altered checks, as well as counterfeited $20 and $100 bills. Fraud through checks consisted of payments on markers typically with personal checks that were returned unpaid to a casino due to insufficient funds or accounts closed at depository institutions.

The suspicious activity associated with the growth in gambling activities in the Third District adds to an existing high level of suspicious activities reported by banks since 1996. According to the last FinCEN study of SARs filed by depositories, all three states in the Third District are among the top 10 states for the highest number of SARs filed from 1996–2009. Delaware ranks fifth, behind California, New York, Texas, and Florida. New Jersey ranks seventh and Pennsylvania ninth. In 2009, the activities reported the most in Delaware included check-kiting, check card fraud, check fraud, and identity theft. In New Jersey, the activities reported the most included structuring, check fraud, mortgage loan fraud, and counterfeit checks. In Pennsylvania, they included structuring, check fraud, counterfeit checks, and false statements.[9]

The Third District also includes a diverse combination of business activity, ranging from cash-intensive small retailers and nonprofits, gas stations with quick stops, and small farms to some of the largest firms and brokerages in the country executing large wire transfers daily. According to the July 2010 Financial Action Task Force (FATF) Report, "Terrorist organisations also derive funding from a variety of criminal activities ranging in scale and sophistication from low-level crime to involvement in serious organized crime."[10]

The FATF Report mentioned that a 2009 FATF Strategic Surveillance Survey showed the most commonly identified sources as: financial crime[11] (particularly fraud); trafficking in narcotics, cigarettes, weapons, human beings, or diamonds; and petty crime. The survey reported that "Terrorist organisations raise funds through legitimate and illicit activities but more commonly through a mixture of both" and noted "fund raising/donation, charities and non-profit organisations (NPOs) and small cash-intensive businesses as the most prevalent legitimate sources."[12]

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7 Slot machines or video lottery terminals allow customers to play on credits from bills, tickets, or coins. The machines only dispense tickets and not coins. The Ticket in/Ticket Out (TITO) tickets, which can have any stated monetary value, can be inserted into an electronic gambling device that has the TITO function and can be played in such a device or cashed out with a cashier or at a kiosk.

8 Steele testimony, p. 7.

9 Steele testimony, p. 8.

10 FinCEN, "SAR Activity Review - By The Numbers," Issue 14, June 2010.

11 Consistent with this, a number of mutual evaluation reports showed narcotics trafficking to be the most prevalent criminal activity used to raise terrorist funds. This is followed by fraud, then smuggling and extortion. "Financial Action Task Force Report: Global Money Laundering & Terrorist Financing Threat Assessment," July 2010, p. 8.

12 Consistent with this, charities and NPOs continue to be the leading source of funds as reported in Mutual Evaluation Reports. (FATF Report, p. 9)

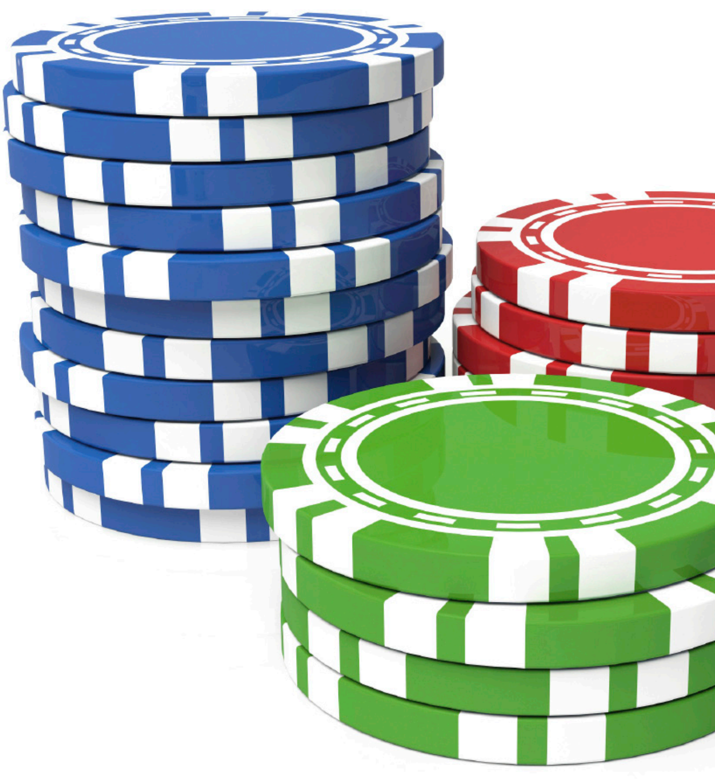
The 2009 survey also showed an increased use of Internet-based systems and new payment methods and abuse of new forms of payment methods, although the adoption of such new or emerging technology by criminals can be seen as increasing in line with the trends in society as a whole. The survey also showed that some jurisdictions have seen new or increasing use of complicated commercial structures and trusts for money laundering.[13]

The Third District has also continued to experience growth in businesses that operate heavily in cash. While a business should not be considered high risk just because it accepts cash, cash intensity is one factor among several that should be considered when assessing risk. These cash businesses include the traditional money service business, such as check cashers and money remitters, along with unregistered money transfer operations. They also include bars, liquor stores, gas stations and mini-marts, amusement parks, water parks, and several children's entertainment centers.

While some of these establishments are subject to small-dollar, high-volume cash transactions, others include higher dollar transactions and allow the purchase of cash equivalents as the method of playing games, purchasing food, and enjoying other amenities. More recently, even agricultural and farmland businesses have been identified as having fraudulent activity, as harvest production and sale numbers can be inflated to hide the receipt of illegal funds that are subsequently deposited into bank accounts. The growth in import/export businesses, prepaid card agents, and the potential for Internet gaming companies (given the increased growth in gaming activity in Pennsylvania) also raise the risk level in the Third District.

Finally, like most metropolitan areas, the economy also influences activity in the Third District. Unemployment is high, and foreclosures have increased. When large numbers of people begin to experience financial difficulty, there is often an increase in the number of fraudulent or illegal activities. Since January 2009, a number of fraudulent or money laundering-related activities have occurred in the Third District. These activities have included drug cartel operatives, an illegal gambling enterprise, a prostitution ring, phishing scams, human trafficking, Ponzi schemes, identity theft, bank fraud, and illegal sports gambling, to name a few. More importantly, some of these activities have occurred in various towns across the entire region, not just the major metropolitan areas like Atlantic City and Philadelphia.

As banks continue to place substantial attention on capital, earnings, and business growth, it is also very important for bank management and the board to pay close attention to BSA/AML compliance. Given potential threats of money laundering and terrorist activity, a thorough risk assessment process, continual suspicious activity monitoring and reporting systems, automated BSA/AML systems, and a strong overall BSA/AML compliance program are a good defense against vulnerability to potential threats. ☐



[13] Examples include complicated commercial structures and trusts involving off-shore entities and front companies, professional advisers, complicit bankers, use of fictitious loans and trade-based money laundering (TBML), and the co-mingling of licit and illicit funds. (FATF Report p. 9)

The Ws of Accounting Standards Update 2010-20 Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses *by Becky Goodwin, Examiner*

The global financial crisis has prompted several regulatory and accounting changes designed to increase clarity, qualify credit quality, and provide for timely recognition of losses. In July 2010, the Financial Accounting Boards Standard (FASB) issued Accounting Standards Update 2010-20 (ASU 2010-20). The update is specifically related to Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses. This article will outline the purpose and requirements of ASU 2010-20.

According to FASB, the purpose of ASU 2010-20 is to provide financial statement users with greater transparency about an entity's allowance for credit losses and the credit quality of its financing receivables. As such, ASU 2010-20 requires affected entities to disclose certain credit quality indicators, such as past due information and modifications to their financing receivables.[1]

Who Is Affected?

ASU 2010-20 applies to both public and nonpublic entities with financing receivables, excluding short-term trade accounts receivable or receivables measured at fair value or at the lower of cost or fair value. The extent of the impact depends on the relative significance of financing receivables to an entity's operations and financial position. It is anticipated that traditional banking-type organizations that currently measure a large number of financing receivables at amortized cost will be affected more than brokers and dealers at securities and investment companies that currently measure most financing receivables at fair value. Additionally, the effect will be less significant for many commercial and industrial entities whose financing receivables are primarily short-term trade accounts receivable.[1]

The definition of financing receivables is as follows: A contractual right to receive money, on demand or on fixed or determinable dates, that is recognized as an asset in the entity's statement of financial position. Thus, examples of financing receivables include 1) loans, 2) trade accounts receivable, 3) notes receivable, 4) credit cards, and 5) lease receivables (other than operating leases) related to a lessor's rights to payment from non-operating leases that must be recognized as assets under the guidance in ASC 840, Leases.[2]

Financing receivables are not 1) debt securities, 2) unconditional promises to give, or 3) acquired beneficial interests or the transferor's beneficial interests in securitized financial assets.[3]

What Are a Financial Institution's Responsibilities?

Disclosures must now be provided to help users of financial statements analyze and evaluate the following:

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1 FASB Accounting Standards Update No. 2010-20, Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses, available online at www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821014426&blobheader=application/pdf.

2 "On The Horizon," Grant Thornton, July 27, 2010, available online at www.grantthornton.com/staticfiles/GTCom/Audit/Assurancepublications/OntheHorizon/2010/OTH_7_27_10.pdf.

3 Sarno, John; Zelic, Ana; and McKinney, Stephen, "FASB Goes "ALLL"-In, Requires Entities to Show Their Cards: Board Enhances Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses," *Deloitte Heads Up*, Vol. 17, Issue 24, July 22, 2010, available online at www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/AERS/ASC/us_aers_headsup_072210a.pdf.

- The nature of credit risk inherent in the entity's portfolio of financing receivables
- How that risk is analyzed and assessed in determining the allowance for credit losses
- The rationale for changes in determining the adequacy of the allowance for credit losses

Disclosures should be provided on a disaggregated basis or divided into constituent parts for the portfolio segment and class of financing receivable. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. Classes of financing receivables generally are disaggregated or separated from the aggregate portfolio, and the information provided should enable the reader to better understand the characteristic and degree of exposure to credit risk associated with financing receivables.

Disclosures should be provided on a disaggregated basis or divided into constituent parts for the portfolio segment and class of financing receivable.

Specifically, the amendments of ASU 2010-20 require the following additional disclosures about financing receivables:

- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables
- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

Current disclosure requirements have also been amended to require an institution to provide the following on a disaggregated basis:

- A roll-forward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method
- For each disaggregated ending balance in the item above, the related recorded investment in financing receivables
- The nonaccrual status of financing receivables by class of financing receivables
- Impaired financing receivables by class of financing receivables

When Are These Requirements Effective?

The provisions within ASU 2010-20 will become effective for public entities for the interim and annual reporting periods after December 15, 2010. For nonpublic entities, disclosures are effective on or after annual reporting periods ending on or after December 15, 2011. Comparative disclosures for earlier periods are encouraged but not required for earlier periods that ended before adoption.

ASU 2010-20 is available in full at www.fasb.org. For information on accounting issues, please contact Manager Eddy Hsiao (eddy.hsiao@phil.frb.org) at (215)574-3772. ☐

Revisions to Payment System Risk Policy to be Implemented in 2011 ...continued from page 1

Provision of Intraday Credit to Healthy Institutions

A daylight overdraft occurs whenever an institution fails to maintain a sufficient balance in its Federal Reserve account throughout the day to cover payment activities, such as funds transfers, incoming book-entry securities transfers, ACH transactions, and check payments. The Federal Reserve acknowledges the appropriateness of providing a certain level of intraday credit in order to ensure that the payments and securities settlement systems function smoothly. By providing intraday credit or allowing depository institutions (DIs) to incur daylight overdrafts, the Federal Reserve can help avoid payment system gridlock. This has become increasingly important as large dollar transactions are being pushed to later in the day.

Under the revised PSR policy, Reserve Banks will provide intraday credit to healthy depository institutions (DIs) for no fee for daylight overdrafts that are collateralized. Otherwise, institutions that incur uncollateralized daylight overdrafts will be charged 50 basis points. Additionally, the new PSR policy seeks to minimize the impact on institutions that use small amounts of daylight credit; therefore, a biweekly daylight overdraft fee waiver of $150 will take effect.

The revised PSR policy will maintain the utilization of an institution's single-day net debit cap; however, it will now apply to the sum total of both collateralized and uncollateralized daylight overdrafts.

Limits on the Amount of Federal Reserve Intraday Credit

The revised PSR policy will maintain the utilization of an institution's single-day net debit cap; however, it will now apply to the sum total of both collateralized and uncollateralized daylight overdrafts. A net debit cap refers to the maximum allowable daylight overdraft (in dollar terms) that a DI's Federal Reserve account may have at any point in time. The dollar value of a DI's net debit cap is determined by multiplying the DI's risk-based capital by the multiple from its assigned cap category. Six cap categories are defined in the PSR policy: zero, exempt-from-filing, de minimis, average, above average, and high. Aside from the zero cap, daylight overdraft cap levels range from 0.2 times the DI's risk-based capital for an exempt cap (i.e., up to $10 million) to 2.25 times risk-based capital for a high cap.

Under the new PSR policy, the more narrowly defined two-week average cap multiples previously in effect will be eliminated, allowing institutions with average, above average, or high caps to utilize their full daylight overdraft capacity every day. As in the past, in order to qualify for a net debit cap of average, above average, or high, a healthy institution must perform a comprehensive self-assessment covering four separate components: 1) creditworthiness, 2) intraday funds management and controls, 3) customer credit policies and controls, and 4) operating controls and contingency procedures. The self-assessment process requires the institution to evaluate each of the aforementioned components and establish a recommended cap based on the internal assessment. The recommended cap should be reviewed and approved by the DI's board of directors and is subject to review for appropriateness by the Reserve Bank.

If a DI has unusual liquidity pressures or processes high transaction volumes (such as with a mortgage servicing operation), that institution may need to utilize daylight overdraft capacity beyond its established net debit cap. If this occurs, the existing PSR policy allows a DI to apply for "maximum daylight overdraft capacity" (max cap). Justification is required for a max cap, and in this case, the DI would be required to pledge collateral to specifically cover daylight overdraft activity in excess of its net debit cap. Under the new policy, the previous guideline that required institutions to investigate acceptable alternatives to address their increased liquidity needs before considering a max cap will be eliminated, although the process for establishing a max cap will remain the same.

Primary Risk Controls Included in Intraday Credit Policy

On a daily basis, Federal Reserve Banks offer payment services to DI customers and, as a result, may be exposed to risk of loss when they process payments for institutions that hold accounts with them. As previously mentioned, intraday credit is primarily used by depository institutions to cover temporary shortages in their Federal Reserve accounts caused by outgoing Fedwire transfers, incoming book-entry securities transfers, processed checks, and ACH transactions. Whenever a Reserve Bank processes these transactions, it becomes susceptible to a direct risk of loss caused by a depository institution that is unable to eliminate its daylight overdraft position before the end of the business day.

The PSR policy has always enabled Reserve Banks to control credit risk exposures associated with daylight overdrafts in a number of ways. First, institutions must meet safety and soundness requirements, which are usually substantiated through the examination process. Secondly, daylight overdraft caps control the amount of intraday credit an institution may utilize. Moreover, Reserve Banks are permitted to limit their intraday credit risk exposures by implementing other account controls, as necessary. For instance, a Reserve Bank may require a particular DI to prefund certain debit transactions, pledge collateral, or maintain a minimum clearing account balance. Reserve Banks may also impose zero caps on certain institutions and are permitted to reject Fedwire funds transfers, ACH credit originations, or net settlement system transactions that would cause or increase a DI's daylight overdraft position.

As a reminder, it is especially important for individuals who manage an institution's daily cash position to be attentive to payment activities throughout the day and their effects on the Reserve Bank account balance. Institutions that exceed their net debit caps will face restrictions placed on them by Reserve Banks, thereby limiting their flexibility to conduct daily payment operations.

Collateral and Revised Fee Structure

The revised PSR policy introduces voluntary collateralization of daylight credit. Collateralizing daylight overdrafts benefits both Reserve Banks and DIs. Collateral mitigates the credit risk Reserve Banks incur by extending daylight credit, and it allows DIs to eliminate or minimize the fee paid for daylight credit. The collateral acceptance criteria and margins applicable for daylight credit purposes are the same as those currently used for the discount window.[3]

The revised PSR policy introduces major changes to daylight overdraft pricing, as follows:[4]

- A zero fee will apply to collateralized daylight overdrafts for institutions with regular access to the discount window.
- A 50 basis point fee will apply to uncollateralized daylight overdrafts for institutions with regular access to the discount window.
- A 150 basis point penalty fee will be assessed for daylight overdrafts incurred by institutions that do not have regular access to the discount window and are not eligible for intraday credit (also referred to as penalty fee institutions).

[3] Collateral Guidelines and a listing of the most commonly pledged asset types are available at http://www.frbdiscountwindow.org/collateralhome.cfm.

[4] Source:www.frbdiscountwindow.org/psrfaqs.cfm?hdrID=22&dtlID=59

- A fee waiver of $150 (per reserve maintenance period) will be subtracted from an institution's gross fees, excluding institutions subject to the penalty fee.

In the fee calculation, the value of unencumbered collateral pledged to the Reserve Banks (i.e., collateral not supporting discount window loans) will reduce negative account balances to determine the institution's uncollateralized overdraft position. This represents a change from the existing policy because collateral is not currently considered in the determination of daylight overdraft amounts. Furthermore, individual daylight overdraft fees incurred during a reserve maintenance period will be added together and reduced by the $150 fee waiver.

Comparison of Overdraft Charges under the Existing Policy vs. the Revised Policy

Total Assets $1,000,000,000 **Risk-based capital** $50,000,000

Note: All $ values in the table are stated in thousands

Col 1	Col 2	Col 3	Col 4	Col 5	Col 6	Col 7 = Col 4 x Col 5	Col 8 = Col 4 x Col 6
Time of Day	FRB Account Balance	Available Collateral	Overdraft Duration (in minutes)	Overdraft	Uncollateralized Overdraft	Overdraft x Overdraft Duration	Uncollateralized Overdraft x Overdraft Duration
2:00 PM	$50,000	$35,000	0	$0	$0	-	-
2:10 PM	$2,000	$35,000	0	$0	$0	-	-
2:30 PM	($75,000)	$35,000	30	($75,000)	($40,000)	2,250,000	1,200,000
3:00 PM	($80,000)	$35,000	60	($80,000)	($45,000)	4,800,000	2,700,000
4:00 PM	($60,000)	$35,000	4	($60,000)	($25,000)	240,000	100,000
4:04 PM	$4,000	$35,000	0	$0	$0	-	-
Sum of end-of-minute overdraft exposures for one day						**7,290,000**	**4,000,000**

		Existing Policy	Revised Policy
(1) Effective daily rate for overdrafts		0.36%	0.50%
(2) Average Overdraft *(under exisiting vs. revised policy)*	Sum of overdrafts for one day / 1,291 mins per processing day	$5,646,785	$3,098,373
(3) Gross Overdraft Charge	(1) x (2) x (21.5/24 hrs)/360 days	$50.82	$38.42
(4) Value of the deductible	Based on 10% of risk-based capital and a 10 hour business day RBC x 10% x (1) x (10/24 hrs)/360 days	$20.83	n/a
(5) Daily overdraft charge		$29.99	$38.42
(6) Gross overdraft charge for the maintenance period		$299.88	$384.20
(6) Value of fee waiver*		n/a	-$150.00
(7) Overdraft charge for the maintenance period**		$299.88	$234.20

**Under existing policy, the fee waiver will be applied only if the total overdraft charge for the maintenance period is less than $25.*

**Assuming similar daylight overdraft activity for each day of the reserve maintenance period (generally 10 business days), resulting in the two-week daylight overdraft charge shown.

See the illustrative Comparison of Overdraft Charges table for a more detailed view of the impact of the policy changes.

In this table, the DI would incur a lower overdraft charge for the maintenance period under the revised PSR policy due to a reduced average overdraft balance (net of the applied collateral) and due to the $150 fee waiver. If, in the example shown, all overdraft balances had been collateralized, then no fees would have been charged to the DI's account under the revised policy.

Final Thoughts

The impending PSR policy changes addressed in this article represent a strategic change for the Federal Reserve Board. As in the past, Reserve Banks will continue to provide institutions with the needed flexibility to manage payment flows in the banking system while simultaneously mitigating credit risk exposures emanating from daylight overdrafts. However beginning on March 24, 2011, healthy institutions seeking to reduce daylight overdraft charges will be permitted to voluntarily apply unencumbered collateral against negative balances incurred during each processing day.

For more information on the revised PSR policy, please contact PSR Specialist Jay Karlyn (jay.karlyn@phil.frb.org) at (215) 574-6216. Frequently Asked Questions are available on the Federal Reserve Bank Discount Window & Payment System Risk Website at www.frbdiscountwindow.org/psrhome.cfm. ☐

Summary of Key PSR Policy Changes, effective March 24, 2011

	Existing Policy	Revised Policy
Collateral	Required for problem institutions and institutions with max caps only. Collateral eligibility and margins same as discount window.	Additional provision that explicitly applies collateral pledged by healthy institutions to daylight overdrafts in their Reserve Bank accounts
Fee for collateralized daylight overdrafts	36 basis points	Zero fee
Fee for uncollateralized daylight overdrafts	36 basis points	50 basis points
Deductible	10 percent of an institution's capital measure	Deductible is eliminated. Replaced by zero fee for collateralized daylight overdrafts and increased fee waiver.
Fee waiver	Up to $25 biweekly if total charges are less than or equal to $25	$150 biweekly
Net debit cap	Two-week average limit and higher single-day limit	Two-week average limit is eliminated; adjusted policy for single-day limit
Max cap	Additional collateralized capacity above net debit cap for self-assessed institutions	Streamlined process for certain FBOs up to a limit; minor changes for all institutions
Penalty fee for ineligible institutions	136 bps	150 bps

SUPERVISION AND REGULATION LETTERS ISSUED IN 2010

SR 10-16	Interagency Appraisal and Evaluation Guidelines
SR 10-15	Classification Requirements for Certain Cross-Border Facilities
SR 10-14	Implementation of Registration Requirements for Federal Mortgage Loan Originators
SR 10-13	Interagency Supervisory Guidance for Institutions Affected by the Deepwater Horizon Oil Spill
SR 10-12	Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions
SR 10-11	Interagency Examination Procedures for Reviewing Compliance with the Unlawful Internet Gambling Enforcement Act of 2006
SR 10-10	Interagency Guidance on Correspondent Concentration Risk Cross
SR 10-9	Release of the Revised Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual
SR 10-8	Suspicious Activity Report Filing Requirements for Banking Organizations Supervised by the Federal Reserve
SR 10-7	Comments to the Basel Committee on Banking Supervision Regarding Proposals to Strengthen the Resiliency of the Banking Sector
SR 10-6	Interagency Policy Statement on Funding and Liquidity Risk Management
SR 10-5	Interagency Guidance on Obtaining and Retaining Beneficial Ownership Information
SR 10-4	Clarification of the Risk Weight for Claims on or Guaranteed by the Federal Deposit Insurance Corporation
SR 10-3	FFIEC Retail Payment Systems Booklet
SR 10-2	Interagency Statement on Meeting the Needs of Creditworthy Small Business Borrowers
SR 10-1	Interagency Advisory on Interest Rate Risk

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

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