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Understanding Reputational Risk: Identify, Measure, and Mitigate the Risk

by William J. Brown, Enforcement Specialist

While building and maintaining a solid reputation is important for all types of organizations, it is especially important for financial institutions. It could be argued that protecting a financial institution's reputation is the most significant risk management challenge that boards of directors face today.

Last month, in the midst of the global credit crisis partly caused by the U.S. subprime mortgage meltdown, Northern Rock, Britain's fifth largest mortgage lender, had to be bailed out by the British central bank, the Bank of England. The institution began as a small local lender in early 2001, but grew excessively in 2005 and through early 2007, primarily by relying on wholesale markets rather than retail deposits. Northern Rock bundled its loans together and packaged them into bonds that it sold to investors around the world; however, as liquidity dried up this past summer in the U.S. and across the globe, it spelled disaster for Northern Rock. When news leaked out that Northern Rock had approached the Bank of England to obtain emergency funding, customers reportedly withdrew £2 billion in one day. Britain's first bank run in 140 years occurred despite the bank's solvency, the nation's strong economy, low interest rates, and low inflation. Northern Rock became a victim of reputational risk.

Reputational risk is regarded as the greatest threat to a company's market value, according to a study by Price-

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FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

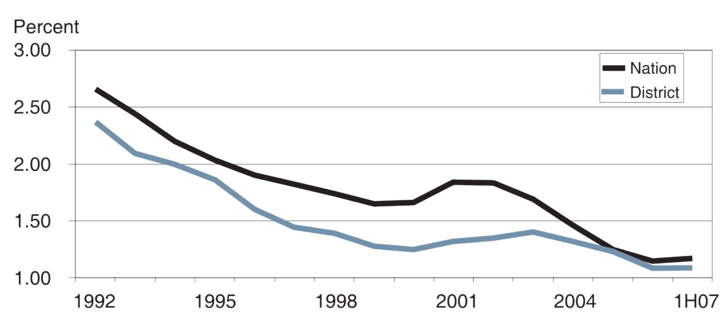
Trends in Provisions for Loan and Lease Losses

by Michael E. Collins, Senior Vice President

The allowance for loan and lease losses (ALLL) is a valuation account estimate for uncollectible loans and leases. Banking organizations use current income, through the provision for loan and lease losses, to fund this account. The ALLL is one of the most significant estimates in a banking organization's financial statements and regulatory reports. Banking organizations are required to develop, maintain, and document a comprehensive, systematic, and consistently applied methodology for estimating the ALLL in accordance with generally accepted accounting principles (GAAP) and supervisory guidance. The downturn in the current credit cycle places additional emphasis on the ALLL in a banking organization's ability to weather changing credit conditions.

For a number of reasons, in recent years banking organizations have consistently been provisioning less for loan and lease losses. Accounting transparency rules, for example, strive to eliminate the practice of including unsupported amounts in the reserve to account for uncertainty and to smooth earnings. While current ALLL guidance permits the practice of including amounts in the allowance that are unallocated, these amounts must reflect an estimate of probable losses, determined in accordance with GAAP, and must be supported properly. Another factor contributing to the trend in lower provisions is the improved risk management models many banking organizations have implemented.

Allowance to Total Loans



District excludes credit card banks and HSBC

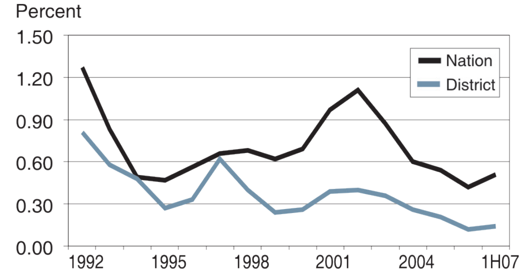
At the same time, earnings pressures resulting from intense competition and challenging yield curve conditions have encouraged banks to look for ways to boost income while keeping expenses low. To support higher income, some banks have adopted a strategy of maintaining lean provisions for loan and lease losses. The financial performance of banks that employed this approach would have benefited during the long stretch of exceptionally sound asset quality from which the industry is now emerging.

In the Third District, the allowance for loan and lease loss coverage of total loans has hovered at historic lows for the past several years, mirroring the national trend. While asset quality remains sound, there is evidence of deterioration, albeit from historically low levels, as nonperforming assets for the nation and the Third District rise. At the national level, for example, nonperforming assets reached .63 percent of total loans and other real estate owned in the second quarter of 2007, the highest level since the third quarter of 2004, but still well below the peakof 3.7 percent in 1990. During this same period, over 80 percent of insured commercial banks increased provisions, and total provisions jumped 25 percent in anticipation of higher loan losses. These data support the view that banking organizations are increasing their provisions in response to worsening credit conditions and the housing downturn.

In comparison, less than half of the commercial banks in the Third District increased provisions in the second quarter of 2007, and the majority of those that did so increased provisions modestly. The remaining banks either decreased or maintained the same level of provisions from the previous quarter. Third District commercial banks also reported a relatively low aggregate net charge-off rate of .17 percent in the second quarter, a marked contrast to loan losses for the industry, which measured .53 percent, up from .48 percent in the first quarter.

These differences may reflect the fact that Third District banks are more insulated from the negative effects of the subprime mortgage crisis or evidence a more conservative lending strategy, or they may suggest more balanced regional economic conditions. This could also signal that some Third District banks may be lagging the industry in acknowledging problem loans or adjusting loss estimates based on current economic and industry conditions. Bank examiners have observed that community bankers, in particular, have been slower in past credit cycles to identify problem loans and recognize losses than larger banks.

Net Charge-offs



District excludes credit card banks and HSBC

As credit conditions deteriorate, however, there is more potential for credit problems to emerge. An appropriate ALLL that is reflective of the current risk exposure in a bank's loan portfolio is especially critical during cyclical downturns when the potential for credit losses is greater and capital becomes more expensive. Bolstering provisions too late in a credit cycle can magnify the impact on a bank's income and capital if loan quality deteriorates more quickly than a bank anticipates.[1] Banks with low ALLL coverage of nonperforming loans and leases and rising delinquencies are the most vulnerable.

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Michael E. Collins, Senior Vice President

[1] Laeven, Luc and Giovanni Majnoni, *Loan Loss Provisioning and Economic Slowdowns: Too Much, Too Late?*, March 14, 2002, available on the World Bank's website at <econ.worldbank.org>.

The Internal Audit Function: Keeping the Foundation Strong

by James W. Corkery, Supervising Examiner

Like most industries, the banking industry is cost-conscious, and, to some bankers, the internal audit function, whether it is housed internally or outsourced to a third party provider, may be viewed as merely a cost center with very little benefit to the institution's bottom line. But when another all-too-familiar headline shouts that fraud has damaged or crippled a company, most bank directors and executives are thankful for their internal audit function.

In April 2003, the regulatory agencies issued a joint policy statement, *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*, that amended a 1997 statement. As stated in the policy:

> "The board of directors and senior management of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility cannot be delegated to others within the institution or to outside parties. An important element in assessing the effectiveness of the internal control system is an internal audit function."[1]

This article seeks to provide a refresher on this statement and to address some areas that directors and senior management should review to ensure effective oversight of their institution's internal audit function.

The 2003 Policy Statement

The amended policy statement was issued to bring supervisory policy in line with the provisions of the Sarbanes-Oxley Act of 2002, as well as pertinent regulations of the U.S. Securities and Exchange Commission (SEC). As a result, banking organizations subject to Section 36 of the Federal Deposit Insurance (FDI) Act—essentially those with $500 million or more in assets—are required to comply with the Sarbanes-Oxley Act prohibition on internal audit outsourcing to their external auditor.[2]

The amended policy statement also indicates that institutions that are not subject to Section 36 of the FDI Act and are not SEC registrants are encouraged not to use their external auditor to perform internal audit services.

The policy statement is divided into four parts:

Part I: The internal audit function. Details key characteristics of the internal audit function and focuses on director and management responsibility for providing an effective system of internal controls and an effective internal audit function. The guidance recommends that institutions consider the placement of the audit function in the management structure to provide directors with confidence that internal audit can perform its duties with impartiality and will not be unduly

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[1] SR Letter 03-5, *Amended Interagency Guidance on the Internal Audit Function and Its Outsourcing*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2003/sr0305.htm>.

[2] For banks under $500 million, see *Interagency Policy Statement on External Audits of Banks with Less Than $500 Million in Total Assets*, issued on November 18, 1999. State member banks should refer to SR Letter 99-33, available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/1999/SR9933.HTM>.

influenced by managers of day-to-day operations. The guidance also expounds on: (1) management, staffing, and audit quality; (2) scope of testing and reviews; (3) communication of audit issues; and (4) contingency planning.

Part II: Internal outsourcing arrangements. Discusses sound practices for the use of third-party outsourcing arrangements. This section provides examples of outsourcing arrangements and then details additional considerations for outsourcing arrangements, including: (1) contracts with vendors, (2) reviewing vendor competence, (3) management oversight, (4) communication of findings, and (5) contingency planning.

Part III: Independence of the independent public accountant. Describes the effect outsourcing arrangements have on the independence of an external auditor who also provides internal audit services to an institution. There are three sections in Part III that outline the applicability of the SEC's auditor independence requirements to public companies, insured depository institutions subject to Section 36 of the FDI Act, and non-public institutions that are not subject to Section 36. Also included is information on the AICPA's independence guidance.

Part IV: Examination guidance. Addresses how examiners assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or by a third party, to determine compliance with the areas defined in the previous three parts. In addition, examiners will generally review audit reports and workpapers on a sample basis to attain a comfort level with the audit function. If the institution is deemed to have a strong audit function and examiners are comfortable relying on the audit coverage in place, it will likely result in a reduced need for examiner transaction testing, which may result in less on-site examination time.

There's More to Audit Than Just Audit Reports

Very often, directors and senior management review significant amounts of information in very detailed reports that can sometimes distract from the big picture. While audit report details are certainly important, especially with regard to high-risk and/or problem areas, directors also need to focus on the administration of the audit function to ensure it remains reliable.

So, what are some of the high level items that directors and senior management should review? Several areas that serve as a foundation for any internal audit function are outlined below. Next to each item is a suggested review interval, but each financial institution should tailor such intervals to suit its own needs and comfort level.

Audit risk assessment (annual). Audit risk assessments should be performed by the audit manager at least annually. The assessment, which encompasses all areas of the organization (also known as an audit universe), serves to focus audit efforts and staffing resources on higher-risk areas more often than lower-risk areas. By establishing an audit frequency, the auditor is able to derive an audit schedule and estimate audit resource requirements.

Risk assessments can vary in complexity, but at a minimum should take into account the internal control environment; prior audit ratings/findings; and changes that have occurred in personnel, controls, or business lines. No matter how complex the risk is, a good

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Risk assessments can vary in complexity, but at a minimum should take into account the internal control environment; prior audit ratings/findings; and changes that have occurred in personnel, controls, or business lines.

Implications of Fair Value Accounting for Financial Institutions

by Jacqueline P. Fenton, Supervising Examiner, CPA

Advocates for fair value accounting believe fair value, which is based on market value, is the most relevant measure for financial reporting. Others, however, believe historical cost, which is more clearly verifiable, provides a more useful measure. So, which is more appropriate? The Federal Reserve's longstanding position on this issue is to ensure that financial institutions follow sound accounting policies and practices. These practices should support enhanced financial disclosures, improve transparency, and provide useful information for decision makers.[1]

In September 2006, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 157, Fair Value Measurements (FAS 157). This standard provides a framework for how companies should measure fair value when they are required to use a fair value measurement for recognition or disclosure purposes under generally accepted accounting principles (GAAP). In February 2007, the FASB issued a Fair Value Option Standard (FAS 159). This standard permits an entity to elect the fair value option on an instrument-by-instrument basis, upon origination or purchase, or after a business combination. The Fair Value Option is intended to address certain problems of a mixed-measurement accounting model and the complexity in current hedge accounting standards.

Both FAS 157 and 159 are effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. This article summarizes the key provisions of FAS 157 and FAS 159, and it discusses the implications for financial institutions.

FAS 157—Fair Value Measurement

FAS 157 provides for a more common definition of fair value and more consistent, comparable, and improved disclosures. Prior to this statement, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Market participants are defined as buyers and sellers.

To increase consistency and comparability in fair value measures, FAS 157 establishes a three-level hierarchy to prioritize the inputs used in valuation techniques. In measuring fair value for a financial statement item, FAS 157 gives the highest priority, known as Level 1 inputs, to quoted prices in active markets. Examples of Level 1 inputs are actively traded securities.

To increase consistency and comparability in fair value measures, FAS 157 establishes a three-level hierarchy to prioritize the inputs used in valuation techniques.

The second hierarchy is Level 2 inputs, which are directly or indirectly observable. Examples of Level 2 inputs are less frequently traded instruments or pricing models with observable market data. Finally, Level 3 inputs are unobservable inputs such as pricing models using the entity's assumptions. Concerns raised about the reliability of fair value measures based on Level 3 inputs resulted in expanded disclosure requirements, which are addressed later in this article.

The implications of FAS 157 are that current accounting practices will change based on the definition of

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[1] Statements from former Federal Reserve Board Governor Susan Schmidt Bies, November 18, 2004, are available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/speeches/2004/20041118/default.htm>.

fair value, the prescribed methods for measuring fair value, and the expanded disclosure requirements. Some accounting practices that FAS 157 will impact include the following.

Market-based measures. Since the term fair value is intended to mean market-based, FAS 157 gives the highest priority to quoted prices in active markets. However, FAS 157 also permits the use of unobservable inputs for situations for which there is little, if any, market activity. Whether there is significant market activity or not, companies should consider the risk inherent in a particular valuation technique (such as option pricing models) and/or the risk inherent in the inputs to the valuation technique. Accordingly, an adjustment for risk should be included in the fair value measurement, if market participants would include such an adjustment in pricing a specific asset or liability.

Valuing credit risk. FAS 157 clarifies that in measuring the fair value of a liability, a company should take into account the effect of its own credit standing. This practice could possibly create misleading financial results. For example, if a company is performing poorly and its credit quality deteriorates, the company could recognize a gain in the income statement because its liability would be worth less, as the fair value of a liability would decrease as credit quality deteriorates.

Investment blocks. The AICPA permits companies to adjust the fair value of large holdings of securities (blocks) to reflect blockage factors. A blockage factor is a discount applied to the security price to reflect the lack of trading volume in the market. FAS 157 does not allow this. The fair value of a security is equal to the quoted price without any adjustment to reflect the blockage factor.

Restricted securities. Securities where a sale is restricted for a period of less than one year under FAS 115 may not be reduced to reflect the quoted price of an identical but unrestricted security. However, since FAS 157 requires companies to reduce the quoted price of an identical unrestricted security, FAS 157 essentially amends the FAS 115 requirement.

Expanded disclosures. FAS 157 requires disclosures regarding the extent to which companies use fair value to measure assets and liabilities, the methods and assumptions used, and the effect of fair value measures on earnings. Concerns raised about the reliability of fair value measures based on Level 3 inputs resulted in expanded disclosure requirements. For each category of assets or liabilities using Level 3 inputs, a reconciliation of beginning and ending balances, including total gains and losses, is required. Additionally, a company must disclose the amount of total gains and losses attributable to the changes in unrealized gains and losses related to Level 3 input-based assets and liabilities and a description of where those gains and losses are reported in the income statement. This may mean modifying information systems and developing new reports to comply with this requirement.[2]

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[2] “DataLine 2006-25: FASB Standard on Fair Value Measurements: An Overview of the Standard’s Key Provisions and Its Implications,” is available online at <www.cfodirect.pwc.com/CFODirectWeb/Controller.jpf?ContentCode=AALN-6U4398&ContentType=Content>.

The 2007 Revised *Bank Secrecy Act/ Anti-Money Laundering Examination Manual*

by Susan Y. Gonzalo, Examiner

The Federal Financial Institutions Examination Council (FFIEC), in collaboration with the Financial Crimes Enforcement Network (FinCEN), issued the revised *Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual* on August 24, 2007.[1] The Office of Foreign Assets Control (OFAC) collaborated on the revisions to the section that addresses compliance with sanctions enforced by OFAC. This is the second annual update to the manual since its original release in 2005, and this recent version is primarily in response to feedback from the banking industry and examination staff.

The revised manual supersedes the 2006 version and is intended to provide current and consistent guidance to banking organizations for compliance with the BSA and for safeguarding operations from money laundering and terrorist financing. The manual also further clarifies supervisory expectations and incorporates regulatory pronouncements issued since the manual's 2006 revision. Some of the significant updates involve the areas listed below.

Customer Due Diligence

Sufficient information should be obtained at account opening so the bank understands the customer's normal and expected activity and can differentiate between lower-risk and higher-risk customers. Lower-risk customers should be monitored through regular suspicious activity monitoring and customer due diligence processes, while higher-risk customers are subject to enhanced due diligence.

Suspicious Activity Reporting

The discussion on law enforcement inquiries and requests in this section has been enhanced to include guidance on grand jury subpoenas, maintaining accounts, and supporting documentation.

If a Suspicious Activity Report (SAR) is filed after receipt of a grand jury subpoena, the confidential nature of grand jury proceedings precludes the bank from referring to the receipt or existence of the subpoena in the SAR. Only the facts supporting the suspicious activity finding should be identified by the bank.

When a law enforcement agency requests an institution to keep a certain account open regardless of suspicious or potential criminal activity related to the account, the bank should ask the agency to put the request in writing and state the purpose and duration of the request. However, the bank has the ultimate decision to maintain or close the account in accordance with its own internal guidelines.

Banks are required to provide all SAR supporting documentation when requested by FinCEN or an appropriate law enforcement or supervisory agency even in the absence of legal process (e.g., subpoena). The revised manual contains a list of examples of appropriate law enforcement agencies.

Foreign Correspondent Account Recordkeeping and Due Diligence

The updated section provides newly-issued enhanced due diligence requirements for foreign correspondent accounts established or maintained for certain foreign banks.

Office of Foreign Assets Control (OFAC)

This section clarifies the guidance regarding the OFAC

[1] The five federal banking agencies that are members of the FFIEC are the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The State Liaison Committee, which includes representatives appointed by the Conference of State Bank Supervisors, the American Council of State Savings Supervisors, and the National Association of State Credit Union Supervisors, is also a member of the FFIEC.

screening responsibilities of originating depository financial institutions (ODFI) and receiving depository financial institutions (RDFI) with respect to automatic clearinghouse (ACH) transactions. The ACH section of the manual also incorporates these revisions.

Correspondent Accounts (Foreign)
The revised manual presents additional guidance on specific procedures the bank should undertake to mitigate the risks associated with foreign correspondent accounts.

Electronic Banking
A new discussion regarding Remote Deposit Capture (RDC) has been added to the electronic banking section. RDC provides a bank customer the convenience of remotely depositing checks into a bank account, but it is a potentially high-risk electronic delivery system. The revised manual presents the risk factors and examples of risk mitigation strategies associated with RDC.

Privately-Owned Automated Teller Machines (ATMs)
Privately-owned ATMs and Independent Sales Organizations (ISOs) are particularly exposed to money laundering and fraud. Due diligence regarding these entities poses various challenges. The revised manual adds a discussion on the particular challenge posed when ISOs sell ATMs to or subcontract with third- and fourth-level companies, referred to as sub-ISOs, and the sponsoring bank is unaware of their existence. The due diligence of the ISO should include, among other risk mitigation processes, obtaining information from the ISO on its sub-ISO arrangements, such as the number and location of the ATMs, transaction and dollar volumes, and source of replenishment currency.

Trade Finance Activities
This enhanced section lists activities considered trade financing, clarifies regulatory expectations, and expands the discussion of risk mitigation and monitoring practices, such as OFAC screening and documentation review. Since trade finance is largely document-based, it is exposed to documentary fraud and a heightened risk of money laundering, terrorist financing, or the circumvention of OFAC sanctions or other restrictions.

Nonbank Financial Institutions
The expanded discussion on providing banking services to money services businesses (MSBs) includes sections on regulatory expectations, MSB risk assessment and risk mitigation, and due diligence expectations for opening and maintaining accounts for MSBs. Banks are not expected to serve as the de facto regulator of MSBs and will not be held responsible for the MSB's BSA/AML program. However, depending on the level of perceived risk and the size and complexity of the MSB, banks may review the MSB's BSA/AML program as part of their enhanced due diligence procedures.

Banks are not expected to serve as the de facto regulator of MSBs and will not be held responsible for the MSB's BSA/AML program.

Appendix F: Money Laundering and Terrorist Financing "Red Flags"
The appendix has been expanded with more examples of red flags for ACH transactions, lending activity, trade finance, shell company activity, and other unusual or suspicious customer activity.

Appendix R: Enforcement Guidance
This new appendix sets forth the *Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements* issued on July 19, 2007. The guidance presents the circumstances in which an agency will issue a cease and desist order and other enforcement actions for BSA compliance program failures and for violations of other BSA requirements. The policy statement was issued to promote consistency among the agencies in enforcing BSA/AML requirements and to promote transparency of the standards to the banking industry.

Index
In the 2007 revision, a detailed index of various subjects has been added at the end of the manual to aid in information search and retrieval.

Conclusion
How are financial institutions affected by these recent revisions? The 2007 revisions became effective as of September 1, 2007. As with prior versions, the "revised manual does not set new standards; instead, it is a compilation of existing regulatory requirements, supervisory expectations, and sound practices in the BSA/AML area."[2] The following minimum requirements for an effective BSA/AML compliance program have not changed:

- A system of internal controls to ensure ongoing compliance
- Independent testing of BSA/AML compliance
- Designation of an individual or individuals to be responsible for managing BSA compliance
- Training of appropriate personnel

In addition, the BSA/AML compliance program should include a Customer Identification Program (CIP).

To promote consistency, the manual includes procedures that will be used by examiners for carrying out BSA/AML and OFAC examinations. A complete copy of the revised manual is posted on FFIEC's website at <www.ffiec.gov/bsa_aml_infobase/default.htm>.☐

[2] SR Letter 07-15, *Release of the Revised Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2007/SR0715.htm>.

Trends in Provisions for Loan and Lease Losses *...continued from page 3*

Examiners evaluate the appropriateness of the ALLL based on an assessment of the credit quality of the loan portfolio, the effectiveness of the bank's loan review function, and a review of other credit-related processes and controls. As examiners assess these areas, they look for red flags that could signal an inappropriate ALLL, such as basing the ALLL on budgeted amounts, target statistics, or ratios without relevant supporting documentation, or applying an overall adjustment to bring the ALLL to a predetermined percentage of loans.

Examiners also consider whether overall adjustments to the ALLL are directionally consistent. For example, if a number of qualitative or environmental factors are changing, such as regional unemployment rates, consumer confidence levels, or housing sector indices, in most cases, examiners would expect to see a corresponding adjustment to the ALLL.

For more information on developing an appropriate ALLL methodology, banking organizations are encouraged to review current supervisory and GAAP guidance. In addition, the Federal Reserve has developed an ALLL job aid for examiners that lists all relevant current guidance and provides other pertinent information, such as common ALLL-related terminology, the steps examiners take when evaluating the ALLL and the methodology, a flow chart of the interaction between FAS 114 (loss estimation for individual impaired loans) and FAS 5 (loss estimation for homogeneous pools of loans), inappropriate loan loss estimation practices, and other relevant information.

While the job aid does not constitute official policy and is not a substitute for management judgment and analysis, banking institutions may find it useful, in particular, to understand how examiners evaluate a bank's ALLL methodology. If you have any ALLL-related questions or would like to obtain a copy of the Federal Reserve's ALLL job aid, please contact Eddy Hsiao (eddy.hsiao@phil.frb.org) at (215) 574-3772 or William Lenney (william.lenney@phil.frb.org) at (215) 574-6074. ☐

Understanding Reputational Risk: Identify, Measure, and Mitigate the Risk ...continued from page 1

waterhouseCoopers and the Economist Intelligence Unit.[1] Reputational risk also overtook credit risk last year as the most pressing issue facing bank audit committees, according to an annual survey released on February 27, 2007, by Ernst & Young, one of the Big Four accounting firms.[2] This article will discuss reputational risk, its implications for financial institutions, and how bank supervisors assess management's ability to measure and monitor the risk.

What is Reputational Risk?

The Federal Reserve System's *Commercial Bank Examination Manual* defines reputational risk as "the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation or revenue reductions."[3] Reputational risk is one of the Federal Reserve System's categories of safety and soundness and fiduciary risk (credit, market, liquidity, operational, legal, and reputational) and one of three categories of compliance risk (operational, legal, and reputational). While it is a defined risk, reputational risk is often difficult to identify and quantify.

> Reputational risk is one of the Federal Reserve System's categories of safety and soundness and fiduciary risk and one of three categories of compliance risk.

Interpreting Reputational Risk

Assessing reputational risk is not an objective process, but rather it is a subjective assessment that could reflect a number of different factors. "Reputational risk is the starting point of all risks…if you have no reputation, you have no business."[4] Reputation can be interpreted as a market or public perception of management and the financial stability of an institution by its major stakeholders. Stakeholders can include its customers, shareholders, and the board of directors. The media could also have a perception, either good or bad, of an organization.

Reputation is and could be perceived as an intangible asset, synonymous with goodwill, but it is more difficult to measure and quantify. Consistently strong earnings, a trustworthy board of directors and senior management, loyal and content branch employees, and a strong customer base are just a few examples of positive factors that contribute to a bank's good reputation.

The rewards can be great for an institution that has an excellent reputation. Establishing a strong reputation provides a competitive advantage over an organization's counterparts. A good reputation strengthens a company's market position and increases shareholder value. It can even help attract top talent and assist in employee retention. In short, reputation is a prized asset, but it is one of the most difficult to protect.

How Can Reputation Be Tarnished?

Just as reputation can be built and preserved over time, it can also be destroyed quickly. We are all too

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[1] "Financial Institutions See Reputational Risk As The Greatest Threat," August 24, 2004, available online at <www.continuitycentral.com/news01427.htm>.

[2] "Poll: Reputation Top Risk at Bank Audit Committees," *American Banker*, February 27, 2007.

[3] See Section 1000.1 of the Federal Reserve System's *Commercial Bank Examination Manual*, November 2006, available online at <www.federalreserve.gov/boarddocs/supmanual/cbem/200705/1000.pdf>.

[4] McDowall, Bob, "Reputational Risk," *The Register*, May 22, 2006, available online at <www.theregister.co.uk/2006/05/22/reputational_risk/>.

familiar with the scandals that affected financial institutions such as Riggs, Bank of New York, and PNC. These organizations maintained a strong corporate and public image, but their brand values were eroded due to well-publicized missteps. And, as mentioned earlier, Northern Rock's franchise value tumbled as its share price plummeted by 50 percent over a few days in the midst of a global credit crisis.

In the banking industry, a reputable financial institution may encounter various issues that could significantly harm or even destroy its brand name in a short period of time. For example, noncompliance with and violations of laws could lead to issuance of civil money penalties and/or formal enforcement actions, which would be published in the local or national media and could ultimately tarnish the institution's image.

The public can also mistakenly interpret certain data, affecting its view of an institution. For example, in the compliance area, an institution's HMDA (Home Mortgage Disclosure Act) data and CRA (Community Reinvestment Act) ratings are publicly available on the Internet. Also, interpretation of an institution's lending practices can be gleaned from its HMDA data, while an institution's CRA rating (outstanding, satisfactory, needs to improve, and substantial noncompliance) can be easily obtained online.

Data security breaches in the bank's computer system, which houses sensitive financial data of hundreds of thousands of customers, or an unethical board member who leaks confidential information to a family member just days prior to a major announcement of a company acquisition are examples of events that could have an adverse effect on a bank's reputation.

BSA-related reputational risks remain high: How would the public and the markets react to a financial institution that is found to be a haven for terrorist financing or is laundering millions of dollars from illegal activities?

Other factors like bad customer service or costly lawsuits and litigation could all bring an organization's reputation spiraling downward. So, how can a financial institution prevent its reputation from being damaged or tainted?

Mitigating and Managing Reputational Risk

Preserving a strong reputation revolves around effectively communicating and building solid relationships. Communication between a bank and its stakeholders can be the foundation for a strong reputation. Timely and accurate financial reports, informative newsletters, and excellent customer service are important tools for reinforcing a bank's credibility and obtaining the trust of its stakeholders.

> Preserving a strong reputation revolves around effectively communicating and building solid relationships. Communication between a bank and its stakeholders can be the foundation for a strong reputation.

Reputational risk is managed through strong corporate governance. Setting a tone of strong corporate governance starts at the top; an institution's board of directors and senior management should actively support reputational risk awareness by demanding accurate and timely management information.

How should a bank's reputational risk be managed internally? The following are just a few examples of key elements for managing reputational risk:

- Maintaining timely and efficient communications among shareholders, customers, boards of directors, and employees
- Establishing strong enterprise risk management policies and procedures throughout the organization, including an effective anti-fraud program

- Reinforcing a risk management culture by creating awareness at all staff levels
- Instilling ethics throughout the organization by enforcing a code of conduct for the board, management, and staff
- Developing a comprehensive system of internal controls and practices, including those related to computer systems and transactional websites
- Complying with current laws and regulations and enforcing existing policies and procedures
- Implementing independent testing and transactional testing on a regular basis
- Responding promptly and accurately to bank regulators, oversight professionals (such as internal and external auditors), and law enforcement
- Establishing a crisis management team in the event there is a significant action that may trigger a negative impact on the organization

Assessing and Evaluating Reputational Risk

One of the more difficult tasks for examiners is to determine how to assess a financial institution's reputational risk. Examiners complete a risk matrix when conducting full-scope examinations for community and noncomplex institutions. To arrive at a composite risk rating for one of the risk areas, the following criteria are used when assessing risk:[5]

- Level of inherent risk—high, moderate, or low
- Adequacy of risk management—strong, acceptable, or weak
- Trend or direction of risk—decreasing, stable, or increasing

> Examiners will assess whether an institution's expertise is adequate and controls are in place to oversee growth if the institution should engage in riskier products or enter into new business lines.

Many items and areas are considered when assessing the risk rating criteria. For reputational risk, prior to conducting an examination, examiners may review corporate press releases, letters to shareholders, stock message boards, and stock analyst comments to gain an initial indication of reputational risk. Examiners may also consider whether an institution responds to the customer concerns; whether the stock analyst recommends buying or selling and why; and what the shareholders, employees, or general public are saying about the institution.

Examiners analyze the financial statements, review marketing plans and advertising campaigns, and consider whether the institution is growing excessively and what types of risky products and services it is providing, if any. They also consider whether the institution is expanding outside its normal geographical area and is supportive of the community.

While on-site, examiners will talk to both bank employees and management to get a sense for items like corporate ethics, will talk to Human Resources to determine whether a consistent message on the importance of ethics is being conveyed throughout the organization, and will consider whether the institution's risk management practices are strong and commensurate with the size and complexity of the institution. Examiners will assess whether an institution's expertise is

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[5] Refer to Section 1000 (Examination Strategy and Risk-Focused Examinations, pp. 13–15) of the *Commercial Bank Examination Manual*, available online at <www.federalreserve.gov/boarddocs/supmanual/cbem/200705/1000.pdf>. The other regulatory agencies (OCC, FDIC, OTS, and NCUA) provide similar guidance in their respective examination manuals.

adequate and controls are in place to oversee growth if the institution should engage in riskier products or enter into new business lines.

In addition, examiners will determine whether there are violations of consumer law. For example, is the institution involved in unfair or deceptive practices, such as charging excessive interest rates on credit cards, or are there situations where the institution is overcharging its customers for accrued interest on loans? Reimbursing consumers for these charges could be embarrassing and tarnish an institution's reputation. Excessive violations could result in class action suits, civil money penalties, or other regulatory actions. There is also a stigma attached to institutions involved with payday lending, even though that type of lending is not illegal.

In the information technology area, where reputational risk and operational risk go hand in hand, examiners measure board and management oversight from the top down. Is oversight adequate? Are policies and procedures tailored to the institution, rather than boiler-plate? Are there adequate internal controls? Lax oversight and controls leave an institution open to security breaches and employee theft, which again could result in unfavorable media attention and may damage the institution's brand name and reduce the public's confidence in the institution.

Conclusion

Building a financial institution's reputation may take years, but it certainly can be damaged or even destroyed very quickly. Reputational risk exists in a combination of factors that financial institutions face every day. Boards of directors and senior management are responsible for measuring and monitoring reputational risk and therefore must remain vigilant and active in providing the safeguards to prevent loss of reputation. Assessing and managing the risk effectively and properly is a key to a financial institution's continued viability and success. □

Case Study: SunTrust Banks

In 2004, SunTrust Banks, a $180 billion financial institution headquartered in Atlanta, disclosed that due to an accounting oversight, it had to restate its corporate earnings. Because of accounting errors, the bank had overbooked the allowance for loan and lease losses, and therefore underreported earnings, for the first two quarters of 2004 by approximately $22 million. This led to a delay in the release of its third quarter earnings statement.

Within hours, SunTrust issued a press release announcing the accounting irregularities. The release stated that its audit committee, with the assistance of an independent law firm, would begin a review and initiate lines of communication with independent auditors about the errors. In short, the institution addressed the issue immediately, communicating openly with the public and its customers.

Shortly thereafter, market analysts issued their comments concerning SunTrust's press release. One analyst stated that, "It creates a black eye regarding SunTrust's reputation, especially since the firm had a similar problem in late 1998."

Within a month of the press release, the audit committee panel determined that the errors in the loan-loss data related to the auto loan portfolio were higher by approximately $25 million. Loan loss calculation errors and false draft meeting minutes were also uncovered. As a result, three credit administration division members, including the top credit officer, were fired, and a controller was assigned to another division.

Less than two months later, the SEC launched a formal probe of SunTrust's accounting deficiencies and issued subpoenas seeking documents related to the bank's accounting procedures. By the summer of 2006, however, SunTrust was notified by the SEC that its inquiry ended with no enforcement action recommended.

Though this newsworthy event cast a negative light on SunTrust's reputation, overall it did not hurt the organization's franchise value. Initially, the market and public perception were critical of the accounting issue, and SunTrust's shares fell 1.12% (less than $1 dollar to $69 per share); however, because the organization's board and senior management were proactive in addressing the issue quickly, the stock price loss (and financial statement gain, in this case) was manageable, and reputational risk was controlled.

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* Gelsi, Steven, "SunTrust Bank Delays Q3 Report," October 11, 2004, available online at <www.marketwatch.com/news/story/suntrust-audit-delays-q3-earnings/story.aspx?guid=%7BBE5794B7%2DEA82%2D4939%2DB55B%2D79E40413BADD%7D>.

The Internal Audit Function: Keeping the Foundation Strong

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auditor will be able to explain and defend the audit risk assessment.

Audit schedule (semiannual). The schedule should be reviewed in the beginning of the year, in conjunction with the audit risk assessment, and again at mid-year, to determine how well the audit schedule is progressing. Conducting a mid-year review will alert directors and senior management to problems in specific areas or with regard to audit staffing and resources (especially if the audit schedule is consistently behind).

Audit ratings and trend analysis (each meeting). Audit ratings, like loan risk ratings, serve to alert audit committee members to the severity of an audit report. An audit rating system (i.e., Excellent, Satisfactory, Needs Improvement, Unsatisfactory) will convey a concise and consistent method for communicating the risk posed by the area audited. The rating system should be appropriately stratified, with descriptions for each rating category, and uniformly applied to all audit reports. Finally, the rating system should be presented to and approved by the board of directors or its audit committee.

Audit ratings, like loan risk ratings, serve to alert audit committee members to the severity of an audit report.

The audit rating system can also be used to track ratings over time, either by specific area or on a broad scale by business line. Similar to loan risk ratings, an audit rating migration analysis can show directors and senior management where specific business lines or operating areas are improving or deteriorating over time.

Exception tracking (each meeting). Often during an audit, items requiring correction are identified. Audit management should include these issues in an exception tracking report that serves to keep the issue open until adequate remediation has occurred. For ease of use, it may be beneficial to have the tracking report color coded by the amount of time items remain outstanding. While there is no standard format, exception tracking reports should include:

- Details on the exception cited in the audit report
- Date the exception was identified
- Person responsible for correcting the exception
- Expected date of correction
- Current status of the exception

Directional Consistency (continuous). Although it is more of a concept than a tangible report, directors and senior management should always be on the lookout to make certain that conclusions are aligned with the analysis performed. They should note the following: risk assessments should be reasonable and well supported, audit schedules should be supported by the risk assessments, audit ratings should take into consideration the severity of findings, and audit conclusions should be aligned properly with audit findings.

Sometimes, examiners will find "directionally inconsistent" patterns with no appropriate explanation. Some examples might include:

- An audit rating drops, but the frequency of audit remains the same (i.e., Needs Improvement audit rating is assigned for a particular area, but that area continues to be on a two-year audit schedule). The frequency is not supported by the rating.
- An audit shows a situation that has gotten worse, but the audit rating does not go down (i.e., an auditor cites numerous exceptions in an audit report, but a Satisfactory rating continues to be assigned). The rating is not supported by the findings.

That's not to say there could not be explanations for inconsistencies, like the examples above, but it is critical that directors and senior management seek clarification when such situations arise.

Summary

Oversight of the internal audit function is a responsibility of the board of directors and senior management and cannot be delegated. Effective oversight helps to ensure that the internal audit function addresses the risks posed by the nature and complexity of current and planned activities. By following the interagency guidance and keeping tabs on several key administrative areas, directors and senior management can help ensure a strong internal audit foundation.

If you have any questions on issues related to internal audit or audit outsourcing arrangements, please contact your primary regulatory agency. For those institutions that are supervised by the Federal Reserve Bank of Philadelphia, please contact Manager Stephen J. Harter (stephen.harter@phil.frb.org) at (215) 574-4385 or Supervising Examiner James W. Corkery (james.w.corkery@phil.frb.org) at (215) 574-6416. □

Implications of Fair Value Accounting for Financial Institutions

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FAS 159—Fair Value Option

FAS 159 includes an option to elect to account for certain assets and liabilities, including stocks, bonds, loans, warranty obligations, and interest rate hedges, at fair value versus historical cost. This is done on an instrument-by-instrument basis, and once an election is made, it is irrevocable.

A transition provision at initial adoption of FAS 159 provides a one-time opportunity, when appropriate, to record changes to fair value directly to the equity section of the financial statements as a cumulative-effect adjustment to beginning retained earnings, with no charges to earnings. Subsequent changes to fair value for elected instruments flow directly to the income statement.

A loophole in FAS 159 resulted in some companies using the one-time transition provision to re-measure all the underwater stocks in their investment portfolio or the expensive loans on their balance sheets (e.g., held to maturity stocks that are underwater, or loans with interest rates much lower than current market rates).[3] Applying FAS 159, the current fair value of the stocks or loans is measured, and any resulting loss is recorded in retained earnings, bypassing the income statement. The stocks or loans are then sold immediately, and replacement assets are purchased and subsequently valued at historical cost, thus indicating that there had been little or no intent to utilize the fair value option going forward.

A loophole in FAS 159 resulted in some companies using the one-time transition provision to re-measure all the underwater stocks in their investment portfolio or the expensive loans on their balance sheets.

While the FASB and the Securities and Exchange Commission did not ban this practice outright, both commented that this practice lacks economic substance, would hide losses from investors, and violates the spirit of FAS 159.

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[3] Leone, Marie, "The FAS 159 Mulligan," is available online at <www.cfo.com/article.cfm/9139916?f=search>.

Implications for Financial Institutions

So how will FAS 157 and FAS 159 impact financial institutions? First, a thorough evaluation of both existing assets and liabilities, as well as those items for which the fair value option is elected, should be performed to understand and comply with the changes in the definition of fair value. Some of those changes include using a fair value that represents an exit price, not an entry price, and using a fair value from the perspective of the market participant, not the company. Other considerations are:

Increased financial statement disclosure requirements. Both statements will require tables indicating the level inputs in the fair value hierarchy and additional disclosures regarding gains and losses.

The board and senior management should have a good understanding of fair value accounting and consider all of the implications before implementing either standard.

The impact of management's prior assertions. Inconsistencies in financial reporting may result where underwater securities previously classified as held to maturity are marked to fair value and sold.

Establishing proper internal controls. Companies should have in place the proper controls, including policies and procedures for future evaluations; proper ongoing evaluation; possible information system changes; and required documentation.

Required regulatory reporting guidance. Institutions filing their call reports will need to use a new Schedule RC-Q, "Financial Assets and Liabilities Measured at Fair Value." There are also changes to Schedule RC-R, "Regulatory Capital," which removes any income recorded from incorporating any declines in a company's credit rating on liabilities and changes to Schedule RI-E to report the net changes in the fair values of financial instruments accounted for under a fair value option. Currently, the available-for-sale adjustment for banks and savings institutions is excluded for regulatory capital purposes. If fair value is adopted, regulatory capital will be affected by an adjustment to opening retained earnings due to the one-time transition provision.[4]

Loans represent a significant portion of a commercial bank's business activity; however, loans typically do not have market prices. Financial institutions are challenged in how to measure the fair value of loans and loan commitments. Some institutions use fair value as a loan management tool and for communicating information to senior management. Loan management uses include managing credit risk and determining loan pricing.

Since most loan facilities do not have secondary market prices, the fair value must be estimated by the bank. Some institutions use a modeling approach where assumptions are made on default probability and loan facility payments. These assumptions are objective, limit the specificity of information, and require the exercise of judgment in the modeling process. Additional challenges are present when trying to value assets backed by subprime mortgage loans, as this type of asset recently experienced severe price volatility as a result of increased credit risk and reduced liquidity in the marketplace.

The board and senior management should have a good understanding of fair value accounting and consider all of the implications before implementing either standard. For more information on FAS 157 and FAS 159, please refer to the full text of the statements on the Financial Accounting Standards Board's website at <www.fasb.org/>. If you have questions about this article, please contact Supervising Examiner Eddy Hsiao (eddy.hsiao@phil.frb.org at (215) 574-3772. ☐

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[4] "To Fair Value or Not," Crowe Chizek and Company Financial Institutions Update, April 17, 2007, is available online at <www.crowechizek.com/Crowe/Publications/detail.cfm?id=503>.

Regulatory Recap

Supervision and Regulation Letters for Financial Institutions Issued in 2007

SR 07-1	Interagency Guidance on Concentrations in Commercial Real Estate
SR 07-6/CA 07-1	Working with Mortgage Borrowers
SR 07-8	Expanded Examination Cycles for Certain Financial Institutions
SR 07-10	Interagency BSA/AML Enforcement Policy Statement
SR 07-11	The Fair Value Option and the Applicability of the Market Risk Capital Rule
SR 07-12/CA 07-3	Statement on Subprime Mortgage Lending
SR 07-13	Federal Trade Commission (FTC) Request for Comments on the Use of Social Security Numbers (SSNs) Within the Private Sector
SR 07-15	Release of the Revised Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual
SR 07-16/CA 07-4	Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages

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

Other Recent Regulatory Announcements

November 2 , 2007
The Federal Reserve Board approved final rules to implement new risk-based capital requirements in the United States for large, internationally active banking organizations. The Board authorized the staff to publish the final rules in the Federal Register after all of the federal banking agencies have completed their approval processes.

October 31, 2007
The federal financial institution regulatory agencies and the Federal Trade Commission issued final rules on identity theft "red flags" and address discrepancies. The final rules are effective on January 1, 2008. Covered financial institutions and creditors must comply with the rules by November 1, 2008.

September 24, 2007
The Securities and Exchange Commission and Board of Governors of the Federal Reserve System announced the adoption of final joint rules to implement the "broker" exceptions for banks under Section 3(a)(4) of the Securities Exchange Act of 1934. Banks do not have to start complying with the rules until the first day of their fiscal year commencing after September 30, 2008.

September 21, 2007
The federal bank and thrift agencies issued final rules expanding the range of small institutions eligible for an extended 18-month on-site examination cycle.

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

Partnership for Progress

A Program for Minority-Owned and De Novo Institutions

The Key to Growing Strong Communities

The Board of Governors of the Federal Reserve System is proud to offer the Partnership for Progress, a new program for minority-owned institutions (MOIs) and de novo institutions (de novos). Under the leadership of the Federal Reserve Bank of Philadelphia, a nationwide workgroup has developed the program with the following goals:

- To provide guidance to MOIs and de novos
- To address issues that might inhibit the financial and operating performance of MOIs and de novos
- To offer a network of outreach, technical assistance, relationship building, and director training and to enhance the supervisory awareness of unique institution challenges
- To ensure a safe, sound, and accessible banking system aligned with Federal Reserve System objectives

The Minority-Owned Institutions and De Novo Program is made up of three modules relating to the stages of bank development: start-up, transition, and growth.

Module 1: Getting Started—reviews the steps necessary to file a charter or member application and discusses many issues related to the charter process.

Module 2: Managing Transition—is designed for new institutions (typically five years old or younger) that are trying to stabilize in a competitive environment.

Module 3: Growing Shareholder Value—is designed for mature institutions that desire to achieve specific growth targets in a safe and sound manner. Each Federal Reserve District will implement portions of the MOI/De Novo program that are best suited for its member institutions.

These three modules will utilize three types of learning distribution channels to create an enhanced, effective program:

- Face-to-face workshops conducted at selected locations around the country
- Self-paced online learning modules available through a desktop computer
- Website containing additional resources and information

For more information, please visit <www.philadelphiafed.org/src/examinations/moi.cfm>.

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