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Stress Testing: A Risk Management Tool for Commercial Real Estate Loan Concentrations

by James Adams, Supervising Examiner, and Sharon Wells, Assistant Examiner

In December 2006, the Federal Reserve issued SR Letter 07-1: *Interagency Guidance on Concentrations in Commercial Real Estate* (guidance) to "remind institutions that strong risk management practices and appropriate levels of capital are important elements of a sound commercial real estate (CRE) lending program."[1] The guidance was issued in response to concerns surrounding the changing real estate environment and the increase in CRE lending activities over the last five years. Institutions that are actively involved in CRE lending should regularly assess the CRE portfolio to identify potential concentrations and ensure that risk management practices are in line with the size and complexity of the CRE portfolio.

This is the first part of a three-part series on stress testing and sensitivity analysis, which will both be referred to as stress testing for the purpose of this article. There are several elements in a risk management framework that identify, monitor, and control CRE concentration risk, and this part outlines the basics of stress testing and its benefits as a risk management tool. The second part in the series, to be published in the third quarter issue of *SRC Insights*, will address specific stress testing programs for unique portions of the CRE portfolio. The third and final part in the series will provide tips for developing a strong management oversight and contingency planning program and will be available in the fourth quarter issue of *SRC Insights*.

[1] SR Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate*, is available on the Board of Governors' website at: <www.federalreserve.gov/boarddocs/srletters/2007/SR0701.html>.

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FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

Subprime Lending: Lessons Learned and the Regulatory Response

by Michael E. Collins, Senior Vice President

A confluence of factors has led to the recent financial turmoil and significant strain in the U.S. financial markets, involving material subprime-related write-offs exceeding $232 billion (and counting) at financial institutions globally.[1] Currently, there is ongoing concern about counterparty risk, a lack of confidence in rating agencies, and significant financial pain for millions of consumers facing a cascade of foreclosures.

This quarter's expanded "Supervision Spotlight" will provide a brief perspective on the origin of the subprime mortgage problem, which has evolved into this financial crisis, encompassing falling U.S. house prices, rising delinquencies and foreclosures, and severe strains in capital markets. The private and public response to current conditions and ways to move forward that promote market discipline complemented by effective regulation will also be discussed.

Although financial crises often seem to happen overnight, they usually have long roots. Our financial services sector has enjoyed a long period of growth. Our sector's share of corporate profits, for example, grew from an average of 10 percent in the early 1980s to 40 percent in 2007, while the share of stockholder value grew from about 6 percent to 19 percent during that same period.[2] In the last decade, growth was spurred by an expanded use of leverage, a substantial increase in risk taking, a shift away from sound credit fundamentals, and the widespread adoption of financial innovation.

While rising defaults in the subprime housing markets clearly played an important role in the current crisis, they were just one piece of a complex interaction of factors involving market forces. The consumer protection infrastructure, private-sector risk management, financial disclosure, and supervision and regulation have all lagged behind rapid innovation and changing business models. With financial innovation, the benefits are often immediately apparent, while the potential problems can remain hidden until stressed conditions force them to surface. Innovation, misaligned incentives, and the accelerated revenue growth

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[1] Onaran, Yalman, "Subprime Losses Reach $232 Billion With UBS, Deutsche: Table," available online at: <www.bloomberg.com/apps/news?pid=20601208&sid=an2o_RDeA.9A&refer=finance>.
[2] "The Financial System: What Went Wrong," *The Economist*, March 22, 2008.

associated with new products can frequently overwhelm sound governance and risk management until obvious adjustments are needed.

The cracks in the façade began to show up in late 2006 as the housing market cooled and subprime borrowers began to default in larger-than-anticipated numbers. The subsequent meltdown of the U.S. subprime mortgage market led to widespread financial instability, evidenced by a severe credit crunch, a dramatic repricing of risk, a drop in valuations of structured credit products, and a severe retraction in liquidity.

The private-sector response to the recent financial turmoil has varied considerably by organization, reflecting broad dispersion in risk management capabilities. Some financial institutions have moved promptly to repair their balance sheets and secure funding, while others have curtailed dividend payments. Those that have fared better overall to date generally had stronger risk management practices in place, including a process to capture cross-disciplinary risks firmwide and the appropriate communication channels to ensure that aggregate risk information flowed up the management chain in a timely manner.

Firms whose senior managements were heavily engaged in this process and set the tone for risk tolerance by enforcing controls and actively working to understand and mitigate material risks also have had significantly better outcomes to date. These firms tended to have risk management functions that worked independently and had sufficient authority within the organization. Many organizations are also considering how their compensation and incentives are structured and whether they provide the appropriate balance between short-term gain and long-term outcomes that are in the best interest of the organization.[3]

Policymakers are working to develop an appropriate response that strikes the right balance between consumer protection, regulation, supervision, and market discipline to restore order to and confidence in our financial system.

[3] Senior Supervisors Group, "Observations on Risk Management Practices During the Recent Market Turbulence," March 6, 2008, is available online at <www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf

There are typically three phases in resolving significant financial crises. Initially, there is a containment phase designed to address and contain problems in the financial markets, such as central bank intervention to alleviate interbank liquidity strains. A second step centers on loss recognition, restructuring, and recapitalization, in which many institutions are currently engaged. Banking supervisors are pushing for rapid write-downs for losses and encouraging banks to bolster capital. A third stage seeks to implement fundamental reforms. This is a long process, but it should ultimately strengthen the financial system and improve the way the system responds to future crises.

To this end, the Treasury Department has released a blueprint for a modernized financial regulatory structure. The ultimate goal of any enhancements will be to reinforce the relationship between consumer protection and market stability while providing the regulatory incentives and infrastructure for robust financial markets in a global economy.

Policymakers, meanwhile, are considering various longer-term fixes to address the root causes of the crisis. The Federal Reserve, for example, is strengthening consumer protection rules, issuing rules on unfair and deceptive practices, promoting more robust liquidity and capital contingency planning, and encouraging enhanced risk management capability.

A key area that will be explored in these discussions is the future form of supervision. Although the terms supervision and regulation 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, in-

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Michael E. Collins,
Senior Vice President

Revisiting SFAS 15: Potential Restructuring Activities and the Re-Emergence of the TDR

by Eddy Hsiao, Manager, and Sharon Wells, Assistant Examiner

Recent evidence obtained during on-site examinations and interim reviews of Call Report data suggests that TDRs are beginning to re-emerge and that there may be some confusion regarding their treatment under accounting and regulatory reporting requirements. Part I of this two-part *SRC Insights* series discussed the conditions under which a restructured loan is considered a troubled debt restructuring (TDR). This article, part II, provides an overview of the accounting and regulatory reporting requirements specific to TDRs that involve a modification of terms.

Accounting Pronouncements

The accounting for the recognition of TDRs is outlined in Statement of Financial Accounting Standards No. 15 (FAS 15), *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, which was amended by Statement of Financial Accounting Standards No. 114 (FAS 114), *Accounting by Creditors for Impairment of a Loan*.[1] FAS 114 requires a creditor to account for TDRs that involve a modification of terms as impaired assets. Other accounting literature that addresses TDR-related activities (e.g., transferring of assets or the granting of equity interests) includes the following:

- Statement of Financial Accounting Standards No. 144 (FAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*, addresses TDRs involving transfers of other real estate (ORE).
- Statement of Financial Accounting Standards No. 66 (FAS 66), *Accounting for Sales of Real Estate*, provides guidance on the subsequent disposition of ORE.
- Statement of Financial Accounting Standards No. 115 (FAS 115), *Accounting for Certain Investments in Debt and Equity Securities*, addresses TDRs involving transfers of investment securities.
- Statement of Financial Accounting Standards No. 157 (FAS 157), *Fair Value Measurements*, amended certain sections of FAS 15 and addressed TDR activities resulting from the granting of equity interests.
- Statement of Financial Accounting Standards No. 118 (FAS 118), *Accounting by Creditors for Impairment of Loan-Income Recognition and Disclosures*, is an amendment of FASB Statement No. 114, providing guidance on the recognition and reporting of interest income on an impaired loan.

For regulatory reporting purposes, if the loan is collateral-dependent, the measurement for impairment must be based on the fair value of the collateral, less any costs the institution expects to incur to liquidate the collateral.

Measuring a TDR Loan for Impairment

When TDRs involve a modification of terms, the loans should be evaluated for impairment in accordance with FAS 114; this includes TDRs for residential mortgages. Impairment measurement for TDRs depends on whether the loan is collateral-dependent. A collateral-dependent loan is defined as a loan where repayment is expected to be provided solely by the underlying collateral.[2] For regulatory reporting purposes, if the loan is collateral-dependent, the measurement for impairment must be based on the fair value of the collateral, less any costs the institution expects to incur to liquidate the collateral. These costs are commonly referred to as "selling costs," such as broker's commissions, legal and title transfer fees, and closing costs.

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

[2] FAS 114, paragraph 13.

If the loan is deemed to be impaired and is not collateral-dependent, impairment is based on the difference between the loan balance and its discounted cash flow or, although less frequently used, observable market price. The effective interest rate utilized in the discounted cash flow method is the original effective interest rate rather than the modified rate granted at restructuring. It should be noted that for a loan with a starter or "teaser" rate that is less than the loan's fully indexed rate, the fully indexed rate should be used.

If the fair value of the collateral, less the selling cost for a collateral-dependent loan, or the calculated present value of a non-collateral-dependent loan is less than the book value of the loan, the difference becomes the amount of impairment, which would be factored into the assessment of the allowance for loan and lease losses. If the amount of impairment is determined to be uncollectible, it should be charged off accordingly. If the fair value, net of selling costs, or the present value, as determined through a discounted cash flow technique, is greater than the book value of the loan, no impairment is recognized.

Accrual or Nonaccrual Status of TDRs

One frequently asked reporting question concerning TDRs is whether a restructured loan classified as a TDR should remain on nonaccrual status. According to the Call Report instructions, a credit that has been formally restructured so as to reasonably ensure repayment and performance, according to its modified terms, need not be maintained on nonaccrual status, provided the restructuring is supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured credit must remain on nonaccrual status.

If a TDR retains its nonaccrual status, an institution should not restore it to accruing status until the borrower can show the ability to comply with the modified terms and has demonstrated a **sustained** period of repayment performance, which typically is a minimum of six months. In some instances, such as when a borrower's financial condition is greatly improved by the signing of a new lease or because of increased sales contracts, a shorter performance period may be acceptable. Institutions are encouraged to evaluate and document the strength and sustainability of these sources of improved cash flow to support the decision to return the loan to accruing status.

Specific regulatory reporting instructions require that loans and leases that are restructured and in compliance with their modified terms be disclosed in Memoranda Item No. 1 under Schedule RC-C (Loans and Leases).

TDRs and Residential Mortgages

A few important issues have arisen regarding the treatment of TDRs involving residential mortgages. The first issue pertains to the impact of waivers of scheduled, contractual rate resets. The question is whether or not allowing a borrower to continue to pay an initial below-market interest rate after a scheduled reset to a higher market rate qualifies as a TDR. The answer is yes. A loan that is modified under this circumstance qualifies as a TDR because a concession is being granted (i.e., lower interest payments than contractually agreed upon, presumably to alleviate debt service requirements and reduce the probability of default), which the bank would not otherwise consider.

Call Reports

Another area of potential confusion regarding TDRs is associated with the disclosure requirements within regulatory reports. Once a loan has been restructured as a TDR, for call reporting purposes it remains a TDR until paid in full. Specific regulatory reporting instructions require that loans and leases that are restructured and in compliance with their modified terms be disclosed in Memoranda Item No. 1 under Schedule RC-C (Loans and Leases). Disclosure may be discontinued in the calendar year following the year in which the restructuring took place if the restructured loan is in compliance with its modified terms

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Stress Testing: A Risk Management Tool for Commercial Real Estate Loan Concentrations *...continued from page 1*

Current Stress Testing Practices

Adoption of portfolio-wide stress testing for CRE portfolios has been slow, and a few factors may be contributing to the issue. The first is that many community banks are still trying to reach or have just reached the point where they are only now able to develop consistent, meaningful, and relevant loan concentration reporting, an important first step in establishing a foundation for stress testing. Many institutions are showing meaningful progress in this area. This may be due to several factors: declining market conditions make stress testing a more relevant management tool, regulatory expectations are becoming more defined and better understood, and information system enhancements are evolving to accommodate data collection requirements.

Institutions should remember that stress testing does not need to utilize sophisticated and expensive models. What is important is whether or not the stress testing program is appropriate for the size, nature, and complexity of the bank's CRE lending activities.

The second reason stress testing has been slow to be implemented is that guidance specific to an individual institution's needs may be limited. The general "one size fits all" approach is not likely to produce meaningful results and may result in burdensome methodologies that are difficult to implement or are irrelevant. So why stress test? The value of stress testing, when meaningfully applied, is that it:

- Provides a useful tool in diagnosing areas where potential risks may affect the portfolio
- Provides meaningful insight into the durability of a loan portfolio to withstand changes in the internal and external environment
- Develops proactive risk mitigation strategies for the future to protect financial performance and capital adequacy (a bank that finds vulnerabilities to particular risks may use the information to change its policies and strategies)

Where to Begin?

Depending on the risk characteristics of the CRE portfolio, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings. In its most simple form, a "break-even" scenario, would identify the maximum loss rates that a bank could sustain while maintaining its capital levels in accordance with internal policy and regulatory requirements.

On the surface, a low tolerance level may cause management to forgo more detailed stress testing given the severity of this cursory analysis; however, more detailed stress testing may prove to be a very useful diagnostic tool for developing remedial strategies. Conversely, a high tolerance level, at least on the surface, may cause complacency. This may leave management with the impression that there is no need to stress test the portfolio components. Stress testing in this case, however, could provide significant insight into specific vulnerabilities that are diluted during a "broad brush" approach.

Institutions should remember that stress testing does not need to utilize sophisticated and expensive models. What is important is whether or not the stress testing program is appropriate for the size, nature, and complexity of the bank's CRE lending activities. A meaningful stress testing program, at its most basic level, is one that has:

- A foundation (i.e., CRE loan portfolio data) for

modeling that is detailed, accurate, relevant, and able to be updated easily and regularly
- Simulations (or "what ifs?") that are appropriate, meaningful, and relevant to the size and nature of the institution and the markets that it serves
- A process for getting to the "so what?"
- Management oversight and review

Portfolio Concentration Reporting—The Foundation

The same data utilized in developing portfolio concentration reports can be utilized as a foundation for stress testing. These portfolio concentration data can be utilized to:

- Determine which area of the portfolio needs to be tested first
- Determine what data within that sector need to be tested
- Help define appropriate testing scenarios

Determining which area of the portfolio needs to be tested first can be as simple as reviewing the portion of the CRE portfolio with the highest dollar exposure or the segment that is most likely to be affected by current or prospective external factors. A portfolio that is diversified by sector may have geographic concentrations. Interdependencies in sectors may also call for stress testing multiple sections of the CRE portfolio. Regardless, the analysis should focus on the more vulnerable segments of a bank's CRE portfolio, taking into consideration the prevailing market environment and the bank's business strategy.[2]

Raw data inputs for testing will depend on the nature of the sector being tested. Common raw data utilized in stress testing include: loan outstandings, interest rates, interest rate spreads, collateral values, revenues, adjusted gross income (AGI), vacancies, expenses, net operating income (NOI), targeted sales prices, interest reserves, and other types of loan information. Raw data or loan inputs will largely depend on the unique nature of the segment to be tested and the anticipated events and external factors that are of concern. We will discuss the relationship between raw data inputs and specific stress testing scenarios in the second part of this series in more detail.

Regardless of the type of platform used, it is important that it be flexible and able to accommodate changes in information without considerable burden.

Some institutions are able to download pre-coded loan data directly from their loan accounting systems into spreadsheets that can be manipulated manually or through macros. Other institutions choose a more rigorous approach and utilize more comprehensive and integrated stress testing software or programs such as Argus Asset Management, Moody's KMV, etc., particularly when portfolios are larger, more complex, and affected by multiple variables—or where significant interdependencies apply. Other institutions choose to manually input loan data into spreadsheets and work from there. Some institutions, based on their size and systems limitations, may even aggregate individual loan information from loan files or credit write-ups in order to gather information for testing.

Regardless of the type of platform used, it is important that it be flexible and able to accommodate changes in information without considerable burden. Changes in strategic direction, loan growth, market conditions, competitive pressures, demand shifts, economic conditions, and other factors will need to be considered. The model's ability to adapt to these changes is imperative if stress testing is to remain relevant.

Development of "What If?" Scenarios

Developing "what if" scenarios is key in stress testing. Management should start by asking two basic questions—what keeps us up at night and

[2] SR Letter 07-01, *Commercial Bank Examination Manual*, May 2007, Section 2103.1, available online at: <www.federalreserve.gov/boarddocs/supmanual/cbem/200710/2000.pdf>.

what do we worry about? Management can begin by stressing only one or two variables and determining how significant the impact could be to individual loans or groups of loans. At the loan level, the question becomes what might cause this borrower's loan to default—tenant loss, absorption rate decline, or cost of construction increases? And while at the portfolio level, the question becomes what might cause many borrowers to default—increasing unemployment, increasing interest rates, or increasing cap rates and vacancy rates—the key is determining what is most appropriate based on the unique characteristics and resources of your institution.

We will discuss stress testing scenarios for specific loan sectors, such as income-producing commercial property, land acquisition and development (LAD), and construction loans, as well as other sectors, in the second part of this series in more detail.

Getting to the "So What?"

Once stress testing is completed and the quantitative results are produced, management needs to analyze the data and draw conclusions, answering the "so what?" question. How could the results of the various stresses employed impact the portfolio, financial performance, competitive position, market, etc.? Based on the results of the stress tests, management will be able to answer questions like: Should capital levels be adjusted? Are more provisions needed to ensure the adequacy of the ALLL? Should more credit enhancements be required going forward to strengthen the portfolio? In general, getting to the "so what?" will enable management to strengthen the strategic decision-making process.

Board and Management Oversight and Review

Regardless of the structure of the stress testing program, no program is effective when it is not fully supported by senior management. Management can emphasize the value of the program in many ways, including:

- Developing a policy for stress testing
- Assigning responsibility (and, ultimately, accountability) for the stress testing program
- Establishing ongoing periodic management reporting requirements
- Utilizing the results as part of the strategic decision-making process
- Developing a contingency plan to mitigate areas of weakness

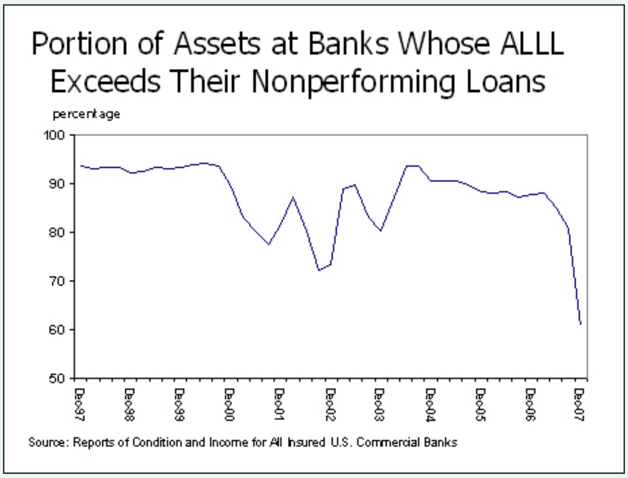
Whatever decisions are made during this process, in the beginning, it is important that management accept the fact that the policies, reporting frequency, data utilization, and contingency planning elements may be somewhat fluid. This will enable management to better understand the portfolio and become more proactively focused on market information retrieval and develop the means and ability to react accordingly. Management must also consider its own unique markets and individual risks. The key is to start somewhere, stick with a program, and be open to what works and what does not.

Suggestions for a strong stress testing oversight program will be included in the last of this three-part series. If you have questions related to stress testing or other CRE risk management inquiries, contact Jim Adams (james.adams@phil.frb.org) at (215) 574-4325 or Sharon Wells (sharon.wells@phil.frb.org) at (215) 574-2548. □

ALLL Update: Current Trends

A fourth quarter 2007 *SRC Insights* article highlighted the importance of the allowance for loan and lease losses (ALLL).[1] Since the banking industry has witnessed further credit quality deterioration in recent months, it seems appropriate to revisit the ALLL topic and provide a brief update on current trends.

Although banks have recently boosted provisions in response to challenging conditions, some key supervisory concerns about the adequacy of ALLL remain. ALLL levels have risen moderately in recent quarters when measured as a percentage of total loans. However, these levels are climbing from a historically low



baseline. In addition, when considered as a ratio of noncurrent loans, a different perspective emerges. The coverage ratio, which indicates the ability of the institution to absorb losses, has continued to decline.

Fewer commercial banks now have ALLL levels that exceed nonperforming loans. During the past 10 years, the portion of overall industry assets residing at banks whose ALLL exceeds nonperforming loans has dwindled from a peak of nearly 94% to a low of 60% reflected in the December 2007 numbers. Notably, this phenomenon is not unique to large banks, but instead reflects a widespread trend that encompasses regional and community banks as well. The precipitous drop in this ratio at year-end 2007 is particularly noteworthy, as changes in the ALLL level are generally expected to be directionally consistent with changes in the overall risk profile.

The procedure for assessing ALLL is framed by accounting rules. However, given the myriad of potential environmental factors that may be considered, the process of determining ALLL adequacy ultimately involves some degree of inherent subjectivity. Senior management and directors must carefully consider available information and use prudent judgment to select relevant criteria that best depict probable losses at their institution. The process and underlying logic should be documented thoroughly.

Timely and comprehensive data are essential to deriving appropriate ALLL estimates. The analysis should be applied consistently and include dynamic metrics that capture changing economic conditions and regional influences. In addition, it is essential to consider the loan portfolio mix and the inherent risk factors associated with specific loan types. For example, the prolonged housing slowdown stressed residential tract development projects and made that particular commercial real estate sector prone to higher delinquency and loss during the past year.

One key message delivered in the previous article warrants remembering: “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.” In light of the emerging trends, the ALLL methodology has received greater scrutiny from the supervisory community. Examiners are continuing to ensure that the methodology employed at banks is sound and well supported. ☐

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[1] ”Supervison Spotlight...Trends in Provisions for Loan and Lease Losses”, *SRC Insights*, Fourth Quarter 2007, is available online at <www.philadelphiafed.org/src/srcinsights/srcinsights/2007/q4si2_07.html>.

Pandemic Preparation: Is Your Institution Ready?

by Becky Goodwin, Examiner

According to the Center for Public Health Preparedness, 2007 was the most active flu season in many years.[1] As they do each year, influenza virologists will convene this summer to determine the formula for next year's flu vaccine, although the U.S. Centers for Disease Control and Prevention notes that the existing flu vaccine is only effective in fighting one of the three strains of influenza that are currently circulating in the United States.[2] There have been concerns in recent years regarding the possibility of a pandemic, since several pandemics have occurred throughout history, and experts predict that we will experience at least one pandemic outbreak in this century.[3] While there is currently no certain threat of such a pandemic, it is important to institute a pandemic plan and prepare your institution for potential disruptions.

A pandemic is defined as a global disease outbreak, and an influenza pandemic occurs when a new influenza "A" virus emerges—for which there is little or no immunity in the human population—and begins to cause serious illness and to spread easily from person to person.[4] Back in November 2005, the U.S. government issued its National Strategy for Pandemic Influenza to address the potential of a pandemic influenza outbreak.[5] And in February 2008, the Federal Financial Institutions Examination Council (FFIEC) issued its *Interagency Statement on Pandemic Planning*, which identifies the actions that should be taken by financial institutions to lessen the adverse outcome of a pandemic.[6] The statement expands upon the *Interagency Advisory on Influenza Pandemic Preparedness* issued in March 2006, wherein FFIEC agencies, in a joint effort, reminded financial institutions of the importance of addressing pandemics within their business continuity plans.[7]

How Is Pandemic Planning Different from Business Continuity Planning?

Business continuity planning is based on the various degrees of difficulty caused by the potential outcome of natural and technical disasters, as well as deliberately harmful acts. Traditional business continuity planning develops responses suitable for disasters limited in duration and intensity. Most incidents that would prompt the activation of a business continuity plan would be confined to a particular region, physical structure, or network of related data or transmission devices. The severity of such incidents can be successfully minimized through effective recovery efforts.

Pandemics, on the other hand, pose distinctive challenges for financial institutions. Unlike natural and technical disasters, the duration and overall impact of a pandemic are unpredictable. The very nature of operating in a global economy heightens the possibility of effects involving a wide geographical area and an unknown duration, as pandemics generally occur in multiple waves, each lasting two to three months. In addition, unlike other disasters, a pandemic outbreak would likely have an enormous impact on staffing levels for prolonged periods of time. While no organization is protected from the inauspicious effects of a pandemic, financial institutions must plan for the unique circumstances that may arise. During business continuity planning, financial institutions must consider and address the complexities associated with a pandemic because so many of the services offered by financial institutions are critical to the local and national infrastructure.

What Are The Fundamentals of Pandemic Planning?

According to FFIEC guidance and the Federal Reserve's subsequent SR Letter 07-18, *FFIEC Guid-*

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[1] Influenza Update II, February 2008, is available online at: <www.prepare.pitt.edu/newsletter/08/feb/feature.htm>.
[2] "FDA Panel OKs 3 New Flu Strains for Next Year's Vaccine," February 22, 2008, is available online at: <www.nlm.nih.gov/medlineplus/news/fullstory_61440.html>.
[3] SR Letter 06-5, *Influenza Pandemic Preparedness*, is available on the Board of Governors' website at: <fedweb.frb.gov/fedweb/bsr/srltrs/sr0605.htm>.
[4] "What is an influenza pandemic?," is available online at: <www.pandemicflu.gov/faq/pandemicinfluenza/2008.html>.
[5] The National Strategy for Pandemic Influenza is available online at: <www.pandemicflu.gov/plan/federal/index.html#national>.
[6] The *Interagency Statement on Pandemic Planning* is available online at: <www.ffiec.gov/press/pandemicguidance.pdf>.
[7] The *Interagency Advisory on Influenza Pandemic Preparedness*, March 2006, is available online at: <www.fdic.gov/news/news/press/2006/pr06030a.html>.

ance on Pandemic Planning, issued on December 12, 2007, a financial institution's business continuity plan should include the following:[8]

- A preventative program, which should establish controls in the workplace that are strengthened during the influenza season and may consist of off-site working arrangements for the ill or processes to reduce the transmission of infection, through hygiene tools and staff awareness.
- A documented strategy, which should provide for flexibility and be commensurate with the size, complexity, and activities of the institution. The strategy should outline the potential impact of a pandemic at various stages and include procedures for preparation and recovery.
- A comprehensive framework, which should establish contingency systems designed to maintain critical operations and services during significant periods of employee absenteeism. Facilities, systems, resources, and procedures necessary for the continuance of critical functions should be addressed and incorporated into an evolving risk assessment process. In addition, customer reaction and demand for electronic services should be considered.
- A testing program, which should provide for the overall effectiveness of the institution's pandemic planning and may include partnerships with members of various private or government sectors for support.
- An oversight program, which should ensure an ongoing review process and essential updates based on governmental guidance and the institution's monitoring system.

The FFIEC guidance on business continuity planning (BCP) serves as an excellent resource for developing and maintaining a sound and comprehensive BCP plan.[9] In addition, the *FFIEC Business Continuity Planning Booklet* has been updated to assist financial institutions with incorporating the elements of pandemic planning into an overall business continuity plan.

Who Is Responsible for Pandemic Planning?

It is important to note that, as with business continuity planning, all members of senior management within the organization who are involved in critical areas of operation, essential product lines, information technology, and human resources should be included in pandemic planning efforts. Senior management is charged with the development, internal communication, and regular testing of the pandemic plan. Ultimately, the board of directors is responsible for overseeing the actual development of the pandemic plan and should approve the written plan.

Financial institutions and their service providers alike should review the national strategy to better determine what actions may be most appropriate for them. Financial institutions with a global presence and those considered critical to the financial system may have greater preparation and response challenges. As with any unexpected event, a pandemic outbreak is a real possibility and potential menace to any financial institution. Benjamin Franklin coined the phrase "An ounce of prevention is worth a pound of cure." When it comes to pandemic preparation, the ounce of prevention is in the planning process; therefore, institutions and service providers should take the necessary measures to be prepared, should a pandemic outbreak occur.

Additional Resources

The Department of Homeland Security—*Pandemic Influenza Preparedness, Response, and Recovery Guide for Critical Infrastructure and Key Resources*. Available online at: <www.pandemicflu.gov/plan/pdf/cikrpandemicinfluenzaguide.pdf>.

The Department of Health and Human Services Center for Disease Control—*Interim Pre-Pandemic Planning Guidance: Community Strategy for Pandemic Influenza Mitigation*. Available online at: <www.pandemicflu.gov/plan/community/commitigation.html>.

The Department of Health and Human Services—checklists to help prepare for a pandemic across all segments of society, including state and local governments, U.S. businesses with overseas operations, the workplace, individuals and families, schools, the healthcare industry, and community organizations. Available online at: <www.pandemicflu.gov/>. ☐

[8] SR Letter 07-18, *FFIEC Guidance on Pandemic Planning*, is available online at: <fedweb.frb.gov/fedweb/bsr/srltrs/SR0718.htm>.
[9] FFIEC guidance on business continuity planning is available online at: <www.ffiec.gov/ffiecinfobase/html_pages/It_01.html>.

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specting, and examining of banking organizations to assess their condition and compliance with relevant laws and regulations. Both are essential to a safe and sound financial system. Today, supervisors and policymakers are reviewing existing supervisory policies, guidance, and regulation while conducting lessons-learned exercises in an effort to strengthen oversight of the financial system.

A significant challenge that supervisors face is how to adapt supervision to a rapidly changing financial landscape. We cannot return to the days of highly segmented financial regulation based on a strict interpretation of rules and regulations. Accordingly, a key question for supervisors and policymakers is: When is the appropriate time for intervention to protect consumers and restrain excessive risk-taking across all financial institutions and the entire balance sheet?

A significant challenge that supervisors face is how to adapt supervision to a rapidly changing financial landscape.

Financial institutions are getting bigger and becoming more integrated and interconnected with each other and the markets in which they participate. Supervisors, as a result, will be increasingly challenged by a wider range of risks stemming from this integration of financial participants and markets.[4] In addition, we cannot lose sight of the regulatory burden that falls unevenly on regional and community banks, given the important role they play in the regional and national economy.

So, how do we move forward? To ensure that markets are transparent and function well and to restore investor and consumer confidence, we need new ways to think about financial markets and the risks they face. First, we need a stronger set of protections for consumers that balances an effective system of firmwide regulation and risk management with sufficient education so consumers can make informed decisions. This does not necessarily mean more regulation, but better regulation and consistent enforcement of regulation. Second, our policy responses must promote market discipline in ways that reduce our vulnerabilities to systemic risk and cost to the public, while at the same time minimize moral hazard.

Third, investors and regulators should not depend exclusively on credit ratings when evaluating risk in new products and complex instruments. The rating agencies themselves are changing their methodologies to reflect differences in the performance of AAA-rated corporate securities and AAA-rated structured securities. Fourth, we need to consider how to introduce more transparency when transferring risks off-balance sheet. Finally, our supervisory and regulatory framework must address the increasing array of players in the market that are subject to vastly differing rules.

Past and present financial crises highlight the fact that risk management challenges will always be with us. Although we can never completely eliminate risk, we must attempt to better understand and manage it.

As our financial system continues to become more complex and interconnected, financial industry participants must focus on strengthening their risk management practices, and policymakers must assist them in their efforts. Promoting strong risk management practices can be an effective means of public policy, taking the form of guidance, regulation, dissemination of best practices, and adherence to minimum standards. The challenge of the Federal Reserve and other regulators will be to manage the balance between effective regulation that allows the markets the freedom to innovate and creates the appropriate incentives that will encourage market discipline and self-correction. □

[4] Hoenig, Thomas M., "Financial Regulation, Prudential Supervision, and Market Discipline: Striking a Balance," October 1, 1999, available online at: <www.kansascityfed.org/SpeechBio/finanreg.htm>.

Revisiting SFAS 15: Potential Restructuring Activities and the Re-Emergence of the TDR *...continued from page 5*

and yields a market rate at the time of restructuring (i.e., the effective rate is equal to or greater than what the bank is willing to accept for a new loan with comparable risk). Restructured loans and leases that are 30 or more days past due or are on nonaccrual are reflected in the appropriate columns in Memoranda Item No. 1 under Schedule RC-N (Past Due).

It should be noted that starting in the first quarter of 2008, Memoranda Item No. 1 under Schedules RC-C and RC-N has been expanded to include restructured loans secured by 1–4 family residential properties.

Tax Implications for Borrowers

In some instances, debt forgiveness may accompany a restructure program. Generally, borrowers must include debt forgiven by lenders as income on their tax returns. Depending on the amount of debt forgiveness, lenders normally would have to issue Form 1099-A or 1099-C to borrowers. Lenders should consult with their tax advisors regarding the responsibilities associated with debt forgiveness and properly inform borrowers of the tax implications as part of a prudent renegotiation disclosure process.

Conclusion

Stressed housing and credit market conditions are increasing the need for lenders to understand the accounting treatment and regulatory reporting requirements for TDRs. The main accounting standards for TDRs are prescribed in FAS 15, as amended by FAS 114. Regulatory reporting schedules have been expanded to provide additional disclosures on TDRs for residential mortgages. Lenders should also be mindful of the tax implications associated with TDRs, particularly as they relate to prudent disclosure practices. For further information regarding the accounting treatment and regulatory reporting requirements for TDRs, contact Eddy Hsiao (eddy.hsiao@phil.frb.org) at (215) 574-3772 or Sharon Wells (sharon.wells@phil.frb.org) at (215) 574-2548. □

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What issues arise in your daily operations? What questions concern you in the course of business? What else would you like to see in an upcoming issue of SRC Insights?

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Regulatory Recap—Second Quarter 2008
Supervision and Regulation Letters and Other Announcements

SR 08-02/CA 08-02, *Statement to Financial Institutions Servicing Residential Mortgages on Reporting Loss Mitigation of Subprime Mortgages*
Issued March 3, 2008

The Federal Reserve encourages financial institutions that service subprime mortgage loans to follow uniform standards for reporting loss mitigation activities. This statement builds on a previous statement issued by the Federal Reserve and the other federal banking agencies. Please refer to SR 07-17/CA 07-4, *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages*, and SR 07-6/CA 07-1, *Working with Mortgage Borrowers*.

SR 08-3, *FFIEC Business Continuity Planning Booklet*
Issued March 19, 2008

The Federal Financial Institutions Examination Council (FFIEC) has issued updated guidance for examiners, financial institutions, and technology service providers to identify business continuity risks and evaluate controls and risk management practices for effective business continuity planning. The updated guidance is included in the *FFIEC Information Technology Examination Handbook*, and it is an update to the March 2003 *Business Continuity Planning Booklet*.

The revised booklet includes enhancements to the business impact analysis and testing discussions, and it addresses emerging threats and lessons learned in recent years. The booklet also stresses the responsibilities of board and management to employ an enterprisewide approach to business continuity planning by considering technology, business operations, communications, and testing strategies for the entire institution.

Announcements

April 1, 2008
The Federal Reserve has announced the availability of a set of dynamic maps and data that display regional variation in the conditions of securitized, owner-occupied subprime and Alt-A mortgage loans throughout the United States. The maps are maintained by the Federal Reserve Bank of New York, and they are available online at <www.newyorkfed.org/mortgagemaps>.

April 24, 2008
FinCEN has submitted a proposal for public comment to make it easier for depository institutions to exempt some customers from the requirement to report transactions in currency in excess of $10,000. Modification of the currency transaction report exemption procedures is a part of the Department of the Treasury's continuing effort to increase the efficiency and effectiveness of its anti-money laundering and counter-terrorist financing policies. The FinCEN press release, including a link to the full context of the Notice of Proposed Rulemaking, is available online at <www.fincen.gov/20080423.pdf>.

Written comments must be received on or before June 23, 2008.

All SR Letters are available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2008/>.

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

The Federal Reserve's Partnership for Progress Program

The Partnership for Progress program is intended to preserve and promote minority-owned institutions and enhance their ability to thrive in an increasingly competitive banking environment.

Supporting minority-owned institutions is fundamental to the Federal Reserve's mission to provide a safe, sound, and accessible banking system that protects consumers and promotes competition. Minority-owned institutions that remain stable, operate in a safe and sound manner, and grow to a size that allows them to meet credit needs and provide financial services, often to underserved populations and markets, add strength and vitality to the communities they serve and provide stability to the U.S. economy.

The Partnership for Progress outreach program will serve as a premier source of information for minority-owned institutions. The program has multiple distribution channels to ensure that it has a broad reach and a variety and depth of resource materials to address the diverse needs of different minority-owned institutions. The online feature of the program will provide bankers with the opportunity to review a wealth of information on their own. Workshops will provide a channel for participant feedback that will be used to enhance the program. Although the program's primary target audience is minority-owned institutions, portions of the program apply more broadly to de novo institutions, which may find the information and participation in the program useful.

The Partnership for Progress program website will be available soon. For more information on the program, please contact H. Robert Tillman, program manager, at 215-574-4155.

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