# Supervisory Insights

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## Inside



FDIC

## Supervisory Insights

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# Issue at a Glance

Volume 4, Issue 1 Summer 2007



## Articles



*Many community banks provide products and services through arrangements with third parties. Appropriately managed third-party relationships can enhance competitiveness, provide diversification, and ultimately strengthen the safety and soundness of insured institutions. Third-party arrangements can also help institutions attain key strategic objectives. But third-party arrangements also present risks. In this article, we show how failure to manage these risks can expose a financial institution to everything from financial loss to regulatory action and loss of customer relationships.*



*The Federal Bureau of Investigation reports having more than one thousand pending mortgage fraud investigations, with over half involving financial institutions as victims. However, they estimate the actual number of mortgage fraud cases to be closer to 36,000. This article discusses the housing boom of the early 2000s and how the resultant demand led to increases in mortgage fraud activity. The authors share examples from FDIC examiners and offer fundamental mitigation steps as well as links to other resources.*



*Hazard insurance has played a big role in mitigating the risk of loss of collateral value from catastrophic damage. Examiners have traditionally cited inadequacies in collateral insurance coverage as technical exceptions when reviewing loan files. But in the current environment, potentially widespread issues regarding insurance availability and affordability could result in consequences reaching beyond anything considered technical. This article explores the impact of the rising costs (and in some cases, the lack of availability) of wind hazard insurance, with a focus on Florida.*

## Regular Features



*An e-Exam, or electronic examination, is a financial institution examination in which electronic data are exchanged through a secure delivery method, thus improving examination efficiencies for both banks and examiners. Banks generally maintain a wide variety of information—written policies and procedures, customer disclosures, board minutes, and even loan files—in electronic format. This article discusses the FDIC's e-Exam policy and the impact that being able to exchange documents electronically is having on examinations.*



*Over the past year, the Financial Accounting Standards Board's Emerging Issues Task Force has addressed the accounting for endorsement and collateral assignment split-dollar life insurance arrangements under which employers and employees share the rights to the cash surrender value and death benefits of insurance policies. The consensuses reached by the Task Force will change how many banks have accounted for their existing split-dollar arrangements and will require them to recognize a liability at the beginning of 2008. This article discusses the principal elements of this recent accounting guidance and its effect on banks' capital and future earnings.*



*This feature provides an overview of recently released regulations and supervisory guidance.*

# Letter from the Director

The risk management examination and the compliance examination have long been regarded as separate disciplines. These examinations have traditionally been performed by separate teams of examiners, and each discipline had its own specialized training and a somewhat distinctive set of examination objectives. More recently, as the volume and variety of new bank products and services have evolved, a nexus between consumer protection and risk management in certain types of situations has become increasingly apparent. What once were perceived as strictly compliance issues or strictly risk management issues now are understood to share many common risk attributes. For example, abusive or predatory lending practices raise both asset quality and management considerations for risk management examiners, and also raise serious concerns on the compliance side about adherence to consumer protection laws and regulations. Cooperation and collaboration between the examination disciplines will be more important than ever as we strive to address these risks and maintain supervisory vigilance.

The FDIC has taken several steps to achieve greater synergy between the disciplines. We created Joint Examination Teams (JETs) made up of compliance and risk management examiners who work together on financial institution examinations to identify risks and collaboratively apply supervisory strategies. We have revised the assistant examiner training program to ensure a multidiscipline approach to training and developing examination staff, and we encourage all examiners to pursue inter- and cross-divisional training. This shared approach is needed to address both compliance and safety and soundness issues arising in the banking industry. High-risk products, including certain types of subprime and nontraditional loans, and issues such as overdraft protection programs, third-party arrangements, and identity theft all have risk management and consumer protection components that necessitate a coordinated supervisory response. Better consumer education, along with clear and accurate disclosures and marketing materials, might have prevented some of the problems we are seeing today.

In response to emerging issues in the mortgage industry, the FDIC and the other federal financial institution regulatory agencies (the agencies) issued *Interagency Guidance on Nontraditional Mortgage Product Risks* in September 2006. The publication addresses recent regulatory concerns with interest-only and payment-option adjustable rate mortgages (ARMs). In addition, in March of this year, the agencies and the National Credit Union Administration issued an *Interagency Proposed Statement on Subprime Lending*. This Statement proposes two clear guidelines for lenders: approve loans based on the borrower's ability to repay at the fully indexed rate, and provide borrowers with clear and accurate information to help them understand the transaction. These guidelines build on basic and long-standing consumer protection and risk management principles. We look forward to reviewing and considering all comments received on this Statement.

Problems in the subprime lending market also highlight the importance of proper due diligence when entering into third-party arrangements. In this issue, ***"Third-Party Arrangements: Elevating Risk Awareness"*** addresses both the benefits and potential risks associated with third-party agreements and offers some best practices for avoiding the financial losses and reputation risks that can result from poorly managed third-party arrangements. The article also highlights how, as third-party arrangements become more prevalent in all institutions, they present a broad spectrum of risks crossing all examination disciplines—risk management, compliance, trust, and information technology. As the examples in the article point out, the risks in many of these relationships (such as information technology or merchant processing) are well known, but others are often overlooked. Inadequate management and control of third-party risks can result in a significant financial impact on an institution, including legal costs, credit losses, increased operating costs, and loss of business. The problems highlighted in the article might have been avoided if the institutions had conducted thorough risk assessments, conducted proper due diligence on the parties with whom they were partnering, thoroughly reviewed contracts, and ensured that the third-party product or service meshed with the institution's goals and business plan and that those products or services were consistent with applicable supervisory policies. Examiners from all disciplines will continue to review banks' third-party arrangements to ensure that financial institutions understand and mitigate the potential risks.

Ineffective due diligence by financial institutions can have another unfortunate consequence: an increase in mortgage-related fraud. The explosive growth in mortgage lending over the past several years and competitive pressures on lenders to relax underwriting standards created a situation that was ripe for opportunists. ***"Staying Alert to Mortgage Fraud"*** discusses this increasing problem, explores common types of mortgage fraud, and provides some mitigating steps banks can take. The examples in the article demonstrate how a few simple, fundamental risk management practices by lenders might have significantly reduced fraud-related losses: monitoring concentration risks, providing training and oversight, establishing clear lending and quality control guidelines, and conducting due diligence when dealing with third parties or new employees, among others.

The devastating effects of the 2004 and 2005 hurricane seasons highlighted the importance of flood insurance in protecting real estate collateral values. As the United States gears up for the 2007 hurricane season, coastal communities are dealing with a new crisis in the insurance area: the rising cost and scarcity of property insurance coverage. ***"Wind Hazard Insurance: No Longer Just a Technical Exception"*** explores the issues arising from the reduced availability of wind hazard insurance coverage, including the impact on borrowers' cash flow and the larger economic impact in affected communities, particularly in Florida. Underinsured or uninsured collateral, declining collateral values, and declining debt service coverage expose lenders to more risk of default and loss. At the FDIC, community and consumer affairs staffs are working to educate consumers about this issue, while risk management examiners are reemphasizing the importance of insurance coverage in the overall assessment of loan quality. Bankers, in turn, must ensure that lending policies and loan agreements address insurance requirements, make reasonable efforts to maintain sufficient insurance coverage on collateral, and consider the increasing cost of wind hazard insurance when assessing repayment capacity.

Also in this issue are our two regular features. ***"From the Examiner's Desk"*** discusses how the FDIC's e-Exam policy is improving examination efficiencies, while ***"Accounting News"*** addresses recent developments affecting the accounting for split-dollar life insurance arrangements.

We encourage our readers to continue to provide comments on articles, to ask follow-up questions, and to suggest topics for future issues. All comments, questions, and suggestions should be sent to **SupervisoryJournal@fdic.gov**.

**Sandra L. Thompson**
*Director*
*Division of Supervision and Consumer Protection*

# Third-Party Arrangements: Elevating Risk Awareness

Community banks increasingly provide products and services through arrangements with third parties. Appropriately managed third-party relationships can enhance competitiveness, provide diversification, and ultimately strengthen the safety and soundness of insured institutions. Third-party arrangements can also help institutions attain key strategic objectives. But third-party arrangements also present risks. Failure to manage these risks can expose a financial institution to regulatory action, financial loss, litigation, and reputational damage, and may even impair the institution's ability to establish new or service existing customer relationships. Successful third-party relationships, therefore, start with financial institutions recognizing those risks and implementing an effective risk management strategy.

The FDIC routinely assesses third-party arrangements. The FDIC is concerned when an arrangement unduly heightens the risk to an insured depository institution or has potential adverse effects for consumers. The risks cross all examination disciplines and necessitate close communication among examination teams to thoroughly understand the risk presented by a bank's particular third-party arrangements. For example, compliance examiners may find legal problems with how a third party is managing a credit card operation. Those legal problems could result in substantial liability for the bank that could, in turn, affect its capital position. Conversely, risk management examiners reviewing suspicious activity reports filed by the institution about third-party mortgage brokers may find information about potentially unfair or deceptive practices that compliance examiners should review. Information technology examiners who review the operation of a third-party service provider may find security breakdowns that present both compliance and safety and soundness issues.

The purpose of this article is to heighten banker and examiner awareness of third-party risks and the effect these risks can have on financial institutions and the consumers they serve. Through examples drawn from actual examiner experiences, the authors provide some insights on identifying and managing third-party risk and how examiners assess third-party arrangements. The authors also provide a list of additional resources for further information.

## "Third Party" Defined

For purposes of this article, "third party" is broadly defined to include any entity that has entered into a business relationship with an insured depository institution. Often, these third parties are deeply involved in the delivery of financial services to the consumer. The third party may be positioned, directly or indirectly, between the financial institution and its customers or otherwise have unfettered access to the institution's customers. Consequently, the quality of that third party's performance is critically important to the financial institution's long term success. A third party can be a bank or a nonbank, affiliated or not affiliated, regulated or nonregulated, domestic or foreign.

The scope of the definition of third party is expansive by necessity. Within the banking industry, third-party relationships are pervasive. Financial institutions use third parties to

- Perform functions on their behalf;
- Facilitate customer access to the products and services of third-party providers; and

- Increase revenue by allowing third parties to conduct business on behalf of the financial institution by using the institution's name on the third parties' products and services.

## The Risks Are Familiar . . . Sometimes

Third-party risk is not a simple, easily identifiable risk attribute, but rather a combination of risks ranging from the familiar to the highly complex. Third-party risk can vary greatly, depending on each individual third-party arrangement. The risks are more widely recognized in certain arrangements, such as information technology and merchant processing. However, in many other arrangements, the risks can seem more innocuous—sometimes leading to critical gaps in bank management's planning and oversight of third-party arrangements.

Some of the risks are associated with the underlying activity itself—similar to the risks faced by an institution directly conducting the activity. Other potential risks arise from or are heightened by the involvement of a third party. Significant or more complex third-party arrangements will have identifiable risk attributes falling into the following broad categories.

***Strategic risk*** includes the risk arising from ill-advised business decisions or the failure to implement appropriate business decisions in a manner consistent with an institution's strategic planning objectives. The use of a third party to perform banking functions or offer products or services that do not help the financial institution achieve corporate strategic goals presents an obvious strategic risk. Third-party arrangements that do not provide a return commensurate with the level of risk assumed expose the financial institution to strategic risk.

***Reputation risk*** is the risk arising from negative public opinion. Dissatisfied customers, breaches of an institution's policies or standards, and violations of law can potentially harm the reputation of a financial institution in the community it serves. Negative publicity involving the third party, even if it is not related to the specific third-party arrangement, presents reputation risk to a financial institution.

***Transaction risk*** is the risk arising from problems with customer service or product delivery. A third party's failure to perform as expected by the financial institution or by customers—because of inadequate capacity, technological failure, human error, or fraud—exposes the institution to transaction risk. Inadequate business resumption or other appropriate contingency plans also increase transaction risk. Weak control over information technology could result in the inability to transact business as expected, unauthorized transactions, or breaches of data security.

***Credit risk*** is the risk that a third party, or any other creditor necessary to the third-party relationship, is unable to meet the terms of the contractual arrangements with the financial institution or to otherwise financially perform as agreed. The basic form of credit risk involves the financial condition of the third party itself. Some contracts with third parties provide assurance of some measure of performance relating to the underlying obligations arising from the relationship, such as loan origination programs. Whenever indemnification or any type of guarantee is involved, the financial condition of the third party is a factor in assessing credit risk. Credit risk to the institution can also arise from arrangements where third parties market or originate loans, solicit and refer customers, or analyze credit. Appropriate monitoring of third-party activities is necessary to ensure

# Third-Party Arrangements

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that credit risk is understood and remains within established limits.

***Compliance risk*** is the risk arising from violations of laws, rules, or regulations, or from noncompliance with internal policies or procedures or with the institution's business standards. Activities of a third party that are not consistent with law, policies, or ethical standards expose financial institutions to compliance risk. This risk is exacerbated by inadequate oversight or a weak audit function. A third party's failure to appropriately maintain the privacy of customer records will also create undue risk.

***Other risks.*** Third-party relationships may also subject financial institutions to a variety of unique risks: liquidity, interest rate, price, foreign currency translation, and country risks, among others. A comprehensive list of other types of risk that arise from an institution's decision to enter into a third-party relationship is not possible without a complete understanding of the arrangement.

## *Don't Neglect the Basics*

A simple participation loan is a very common third-party arrangement and provides a good introduction to our examples of third-party risk. The participating financial institution (or purchaser) does not underwrite the loan, and the borrower does not directly interact with the institution. A third party, perhaps not even an insured financial institution, assumes many critical functions in the underwriting and servicing processes. In the vast majority of participation loans, the outcome is as expected: the borrower pays as agreed and the arrangement is profitable for the bank. However, the myriad things that can go wrong highlight the basics of third-party risk.

Examiners sometimes find that a participation loan does not meet the financial institution's established underwriting standards, too often with predictable results. Institutions often "buy" the types of loans they cannot originate in their normal trade area; however, those institutions may lack lenders with sufficient expertise to analyze the participation loan. At other times, a financial institution's management may wish, in hindsight, that they had known more—not only about the borrowers, but also about the third party with whom they did business. Purchased loans, especially those from outside a financial institution's lending area, present the opportunity for misrepresentation or fraud. In addition to strategic and due-diligence issues, there are a multitude of risks specific to any given transaction.

***Addressing the Risks.*** Institutions entering into participation arrangements can avoid common pitfalls and mitigate third-party risks by

- Conducting a thorough risk assessment. Ensure that the proposed relationship is consistent with the institution's strategic plan and overall business strategy;
- Conducting a thorough due diligence. Focus on the third party's financial condition, relevant experience, reputation, and the scope and effectiveness of its operations and controls;
- Reviewing all contracts. Ensure that the specific expectations and obligations of both the bank and the third party are outlined and formalized;
- Reviewing applicable accounting guidance. Determine if the participation agreement meets the criteria for a loan sale or a secured borrowing. Key issues to consider include rights to repurchase and recourse arrangements. In some cases, participation loans meet applicable sales criteria, but warrant consideration under risk-based capital standards; and
- Developing a comprehensive monitoring program. Periodically verify that

the third party is abiding by the terms of the contractual agreement and that identified risks are appropriately controlled.

As demonstrated in the examples discussed below, these key steps—risk assessment, due diligence, contract review, and oversight—are the basic elements of an effective third-party risk management process, regardless of the type of activity carried out by the third party.

## Beyond Credit Risk

Financial institutions sometimes focus almost exclusively on credit risk and overlook the potential for other risks. In one case, an institution decided to enter the credit card market by partnering with an entity that purported to specialize in marketing and processing credit cards. These credit cards, which were promoted as a product that provided customers with "benefits" and "satisfaction," were also marketed as a means of building or rebuilding a consumer's credit rating.

According to the agreement with the third party, the financial institution would underwrite and originate credit cards under its own name and immediately sell any related receivables to the third party. In return, the institution would receive a small amount every month for each outstanding card. If an individual cardholder was able to make the required payments in a timely manner, he or she could earn a refund of some, or all, of the origination fee. However, the program was structured so that only a small percentage of cardholders would ever use the card in a traditional manner. More often than not, the small credit line was completely consumed by fees at origination, leaving the cardholder with no available credit upon receipt of the card.

Examiners took exception to the product being marketed as a credit-building instrument because the institution was unable to provide substantive evidence that consumers' credit profiles actually improved by using the credit card. Examiners were also concerned that the card had minimal usefulness from the outset because of the high initial fees. Despite the claims of "satisfaction," a significant portion of cardholders canceled their credit cards within three to six months of issuance. The institution was found to be in violation of Section 5 of the Federal Trade Commission Act (relating to unfair and deceptive acts or practices),[1] was required to make customer reimbursements, and suffered damage to its reputation.

***The Importance of Effective Risk Identification.*** There are numerous risks that may arise from an institution's use of third parties. In this case, the institution was focused on credit risk rather than on compliance and reputation risk. As part of the risk assessment process, management should analyze the potential risks associated with the third party and the proposed activity. In retrospect, the financial institution could have mitigated many of the risks resulting from this arrangement by

- Conducting a thorough risk assessment;
- Making certain promotional materials were well-supported and not misleading;
- Reviewing the third party's previous experience with the product as well as monitoring results of the third-party arrangement, including records

[1] The Winter 2006 issue of *Supervisory Insights* contains a thorough discussion of Section 5 of the Federal Trade Commission Act (unfair or deceptive practices affecting commerce) and cites situations similar to this example. See "Chasing the Asterisk: A Field Guide to Caveats, Exceptions, Material Misrepresentations, and Other Unfair or Deceptive Acts or Practices," *Supervisory Insights,* Vol. 3, Issue 2, Winter 2006, www.fdic.gov/regulations/ examinations/supervisory/insights/siwin06/siwinter06-article2.pdf.

# Third-Party Arrangements

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of those customers who canceled their cards within a few months of issuance; and

- Reviewing the product for compliance with governing laws and regulations.

## Costly Lessons from Unsupervised Outsourcing

Institutions often use third parties, such as mortgage brokers, to generate mortgage loans. In such cases, financial institutions are expected to ensure that the risk management processes for loans purchased from or originated through third parties are consistent with applicable supervisory policies.

An examination of an institution well versed in mortgage lending revealed substantial problems related to its mortgage broker network. Product offerings by both the institution and its third-party mortgage brokers had rapidly evolved and expanded. To meet growing demand, the institution shifted its product and delivery channel strategies. In only a brief period of time, the institution's broker network expanded significantly.

At the same time, the institution's due diligence process for brokers was relaxed. The institution's financial standards for the third-party mortgage brokers it used quickly became more liberal than the institution's lending standards. Simple background checks, costing only a few dollars, were foregone for the sake of expediency. Monitoring processes were lax. The lending-volume threshold to trigger closer reviews of loan quality was set so high that practically no brokers were ever subject to the reviews. Underwriting standards were also relaxed. In effect, the institution became reliant on the brokers to protect its financial interest and reputation. Further, management reporting was cumbersome and incomplete. While the institution used a watch list, essentially brokers were placed on the list only if suspicious activity (i.e., fraud) was actually reported to federal authorities or if specific misconduct was identified. Even when a watch designation was assigned, the institution's systems allowed for continued funding without further review. Unfortunately, but not surprisingly, the institution recognized these inadequacies only after credit losses increased substantially.

***No Substitute for Due Diligence and Oversight.*** Problems arise not from the absolute volume of relationships, but from the quality of the risk management processes employed. In this example, controls over the network were perfunctory at best. The institution appeared to have a process but, in practice, the process controlled very little. The institution could have mitigated the risks discussed as well as the resulting impact on the institution by

- Exercising appropriate due diligence prior to entering into a third-party relationship and providing ongoing, effective oversight and controls;
- Conforming to supervisory standards, including those reiterated in the September 2006 Interagency Guidance on Nontraditional Mortgage Product Risks;[2] and
- Monitoring loan originations to ensure that loans met the institution's lending standards and were in compliance with applicable laws and regulations.

## Hitting the Bottom Line

One financial institution outsourced much of the development and administration of a new credit product for its customers. However, the third party was

[2] FIL-89-2006, Guidance on Nontraditional Mortgage Product Risks, and Addendum to Credit Risk Management Guidance for Home Equity Lending, October 5, 2006, www.fdic.gov/news/news/financial/2006/fil06089.html.

not fully aware of the various required disclosures or the annual percentage rate (APR) and finance charge calculations necessary for compliance with the Truth in Lending Act. As a result, customers received disclosure statements that significantly understated the finance charges related to the product.

The institution had already been cautioned by examiners to review new products carefully, as a result of due diligence inadequacies identified in past examinations. Despite these cautions, bank management did not invest sufficient resources to ensure a successful new product offered through the third party. Examiners discovered the inaccurate disclosure shortly after product launch. The institution suspended the product but not until numerous loans with faulty disclosures had been originated. The amount of reimbursements to customers was significant, along with the expense and embarrassment that came with rectifying the mistake. Had the problem not been identified early, the reimbursements required could have easily reached an amount large enough to jeopardize the capital accounts of the financial institution.

***Unidentified Risks Can Be Costly.*** Following an assessment of risks and a decision to proceed with a new product line developed and administered by a third party, the institution's management must carefully select a qualified entity to implement the program. Due diligence should be performed not only prior to selecting a third party, but also periodically during the course of the relationship. In this example, the institution could have mitigated the risks discussed as well as the resulting impact on the institution by

- Conducting a comprehensive due diligence that involved a review of all available information, including the third party's qualifications and experience with the product; and
- Monitoring the third party's activities to make sure the products produced were in compliance with existing laws, rules, and regulations, as well as the institution's internal policies, procedures, and business standards.

## A Supervisory Perspective

Before engaging in any third-party arrangement, a financial institution should ensure that the proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology potentially needed to monitor and manage the intended activities, and the establishment of appropriate feedback and control systems. If the activity involves consumer products and services, the board and management should establish a clear solicitation and origination strategy that allows for after-the-fact assessment of performance, as well as mid-course corrections.

Proper due diligence should be performed prior to contracting with a third-party vendor and on an ongoing basis thereafter. Management should ensure that exposures from third-party practices or financial instability are minimized. Negotiated contracts should provide the institution with the ability to control and monitor third-party activities (e.g., growth restrictions, underwriting guidelines, outside audits) and discontinue relationships that do not meet high quality standards.

Reputation, compliance, and legal risks are dependent, in part, upon the intended activities as well as the public perception of both the financial institution's and the third party's practices. Therefore, careful review is warranted,

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and an adequate compliance management program is critical. In some cases, an institution may need processes in place to handle potential legal action. In any case, management should establish systems to monitor consumer complaints and ensure appropriate action is taken to resolve legitimate disputes.

Finally, an institution's audit scope should provide for comprehensive, independent reviews of third-party arrangements as well as the underlying activities. Findings should be provided to the financial institution's board of directors and exceptions should be immediately addressed.[3]

A financial institution's board of directors and senior management are ultimately responsible for identifying and controlling risks arising from third-party relationships. The financial institution's responsibility is no different than if the activity was handled directly by the institution. In fact, as the examples in this article illustrate, greater care may be necessary depending on the risks inherent in the third-party arrangement.

FDIC examiners assess how financial institutions manage their significant third-party relationships. Trust, consumer protection, information technology, and safety and soundness examinations all include reviews of third-party arrangements. Examiners review bank management's record of and process for assessing, measuring, monitoring, and controlling risks associated with significant third-party relationships. The depth of the examination review depends on the scope of activity conducted through or by the third party and the degree of risk associated with the activity and the relationship. The FDIC considers the results of the review in its overall evaluation of management and its ability to effectively control risk. The use of third parties can have a significant effect on other key aspects of performance, such as earnings, asset quality, liquidity, rate sensitivity, and the institution's ability to comply with laws and regulations.

FDIC examiners address findings and recommendations relating to an institution's third-party relationships in the Report of Examination and within the ongoing supervisory process. Appropriate corrective actions, including enforcement actions, may be pursued for deficiencies related to a third-party relationship that pose significant safety and soundness concerns or result in violations of applicable federal or state laws or regulations.

## Conclusion

Bankers and examiners alike deal with third-party arrangements on a regular basis. Third-party arrangements can help financial institutions attain strategic objectives by increasing revenue or reducing costs and can facilitate access to needed expertise or efficiencies relating to a particular activity. However, inadequate management and control of third-party risks can result in a significant financial impact on an institution, including legal costs, credit losses, increased operating costs, and loss of business.

As illustrated in the preceding examples, the risks inherent in third-party arrangements are not significantly different from other risks financial institutions face. In fact, the risks are often the same—the difference is where to look for them. Likewise, the frame-

[3] From the FDIC's *Risk Management Manual of Examination Policies,* www.fdic.gov/regulations/safety/manual/index.html.

work for risk management is very similar. Risks should be identified, activities managed and controlled, information monitored, and processes periodically audited. Identified weaknesses should be documented and promptly addressed. As with any other undertaking by a financial institution, poor strategic planning, inadequate due diligence, insufficient management oversight, and a weak internal control environment are common elements in problem situations. Similarly, the primary element for success is effective management.

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## List of Resources:

*FDIC Risk Management Manual of Examination Policies, Related Organizations,* Section 4.3, "Examination and Investigation of Unaffiliated Third Parties," www.fdic.gov/regulations/safety/manual/section4-3.html.

*FDIC Risk Management Manual of Examination Policies, Loans,* Section 3.2, "Subprime Lending," www.fdic.gov/regulations/safety/manual/section3-2.html#subprime.

FIL-89-2006, Guidance on Nontraditional Mortgage Product Risks, and Addendum to Credit Risk Management Guidance for Home Equity Lending, October 5, 2006, www.fdic.gov/news/news/financial/2006/fil06089.html.

*FDIC Compliance Examination Handbook,* "Compliance Examinations," Sections II, V, VII, and IX, www.fdic.gov/regulations/compliance/handbook/html/index.html.

FIL-52-2006, Foreign-Based Third-Party Service Providers: Guidance on Managing Risks in These Outsourcing Relationships, June 21, 2006, www.fdic.gov/news/news/financial/2006/fil06052.html.

OCC Bulletin 2001-47, Third Party Relationships: Risk Management Principles, November 1, 2001, www.occ.treas.gov/ftp/bulletin/2001-47.doc.

OCC Advisory Letter 2000-9, Third Party Risk, August 29, 2000, www.occ.treas.gov/ftp/advisory/2000-9.doc.

Thrift Bulletin 82a, Third Party Arrangements, September 1, 2004, www.ots.treas.gov/docs/8/84272.pdf.

*Federal Financial Institutions Examination Council Information Security IT Examination Handbook,* July 2006, Appendix A: "Examination Procedures," www.ffiec.gov/ffiecinfobase/booklets/information_security/information_security.pdf.

# Staying Alert to Mortgage Fraud

The housing boom of the early 2000s affected many areas of the United States, as consumers and investors took advantage of low interest rates to purchase, upgrade, and invest in houses and condominiums. The entry, and general acceptance, of numerous nontraditional mortgage loan products into the financial landscape also bolstered many people's goal of achieving home ownership. The nontraditional products facilitated an increase in the dollar amount of mortgages individuals financed, which helped spur housing demand. As this demand increased, so did price appreciation, and the purchase of a house became more than just a home for many individuals: residential real estate became the new "golden egg."

Historically, a mortgage transaction involved two parties: the lender and borrower. Borrowers conducted their business across a desk at a local bank, and the only other people involved in the process were bank employees (or individuals closely associated with the bank). Today, a single mortgage transaction can involve a wide number of independent parties who may never meet the borrower or the lender. In addition, the pressure to close a loan quickly is paramount, as fast-paced consumers look for more convenience and less hassle. Unscrupulous individuals are increasingly manipulating these types of circumstances to their advantage, resulting in a significant and growing mortgage fraud problem throughout the country.

The following example demonstrates the egregious nature of mortgage fraud. Picture 1 was included in a fraudulent appraisal used to secure a $250,000 mortgage loan on this home in Atlanta, Georgia. However, the appraiser failed to include the second picture, which shows the rear view of the property! The loan was granted, and the lender incurred a material loss upon subsequent foreclosure and disposition of the property.[1]

*Picture 1*

*Picture 2*

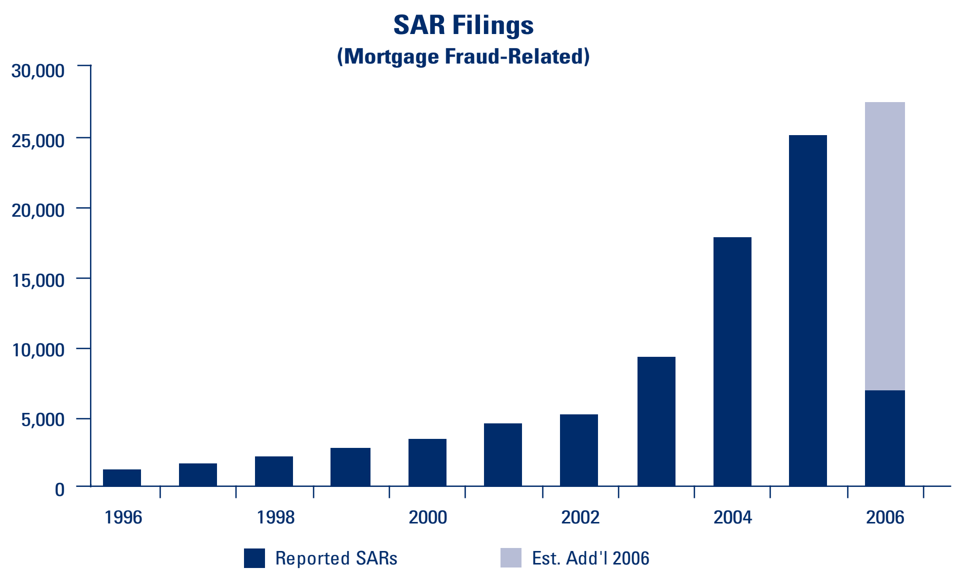
This article explores common types of mortgage fraud, focusing on examples from a recent poll of FDIC examiners. The authors also offer suggestions and links to additional information for further support in mitigating the risks of mortgage fraud.

## Mortgage Fraud Reaches New Heights

Mortgage fraud activity has increased markedly in recent years. In 2005, reported losses associated with mortgage fraud passed the $1 billion mark

[1] Ann D. Fulmer, Vice President of Industry Relations, Interthinx™; HUD STOP Conference, June 22, 2006, Savannah, Georgia.

Chart




Source: *Mortgage Loan Fraud: An Industry Assessment Based upon Suspicious Activity Report Analysis,* November 2006

nationwide for the first time.[2] As shown in the chart titled SAR Filings, suspicious activity reports (SARs)[3] involving mortgage fraud doubled from 2003 to 2004 and continue to increase. According to the National Association of Mortgage Brokers, as many as two-thirds of all mortgages are originated by mortgage brokers. When one considers that mortgage brokers are not required to file SARs, the actual volume of mortgage fraud activity could be much higher.

As of early March 2007, the Federal Bureau of Investigation (FBI) had 1,036 pending mortgage fraud investigations,[4] compared with 818 and 721, respectively, in the two previous years. The FBI estimates, however, that the actual number of mortgage fraud cases was closer to 36,000 for the fiscal year ended September 30, 2006, compared with 22,000 the previous year.[5] More than half of the current investigations involve expected losses greater than $1 million, and financial institutions represent 57 percent of the victims.

## Categorizing Mortgage Fraud

The bulk of mortgage fraud falls into two broad categories based on the motivation behind the fraud.

[2] Mortgage Bankers Association, "Mortgage Fraud Perpetrated Against Residential Lenders," July 2006, from their website. See www.mortgagebankers.org/files/Library/IssuePapers/MortgageFraudPerpetratedAgainstResidentialLenders.pdf.

[3] A suspicious activity report is a standard form used by all federally insured financial institutions to report activities of suspected criminal violations of federal law or suspicious transactions potentially related to money laundering.

[4] FBI, *Mortgage Fraud: New Partnership to Combat Problem,* March 9, 2007. See www.fbi.gov/page2/march07/mortgage030907.htm.

[5] Bob Tedeschi, "Mortgages: Fraud Cases Are Rising, FBI Says," *New York Times,* January 14, 2007, http://homefinance.nytimes.com/nyt/article/mortgage-column-by-bob-tedeschi/2007.01.14.fraud-cases-are-rising-fbi-says.

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- ***Fraud for property*** typically involves a borrower who will overstate income or asset values on his or her financial statement to qualify for a loan to purchase a home. In many of these cases, expectations are that if the income does not rise to meet the payment, the home will be sold at a profit from appreciation.
- ***Fraud for profit*** involves more complicated schemes and presents a higher exposure to the market. Fraudulent methods are used to acquire and dispose of property with the inflated profits going to the perpetrators of the fraudulent transaction. Participants in these fraudulent transactions involve a variety of insiders and third parties: straw borrowers, sellers, loan originators, brokers, agents, appraisers, builders, and developers. Opportunities for fraud for profit involving insiders are limited only by the perpetrator's imagination.[6]

## Case Studies: Reports from Examiners

Bearing headlines such as "Eight Indicted in Loan Scam" (*Dallas Morning News,* March 9, 2007) and "Mortgage Fraud Alleged in 149 Transactions" (*Journal Gazette,* Fort Wayne, Indiana, April 1, 2007), the media are filled with stories demonstrating the pervasiveness of mortgage fraud. Rarely, however, do these stories offer insights into what might have been done to detect or prevent the fraud or the effect of the fraud on the insured institutions involved.

To get a picture of how mortgage fraud might be affecting insured financial institutions, and to provide some practical advice, the authors asked examiners from across the country to provide examples of the more common types of fraud they were encountering. The types of fraud most prevalent in examiners' responses were

- Broker-facilitated fraud;
- Loan documentation fraud;
- Appraisal fraud;
- Property flipping; and
- Misapplication of funds from construction or rehabilitation projects.

*As illustrated in the examples that follow, examiners are often not the ones to first discover a case of fraud. The vast majority of fraud instances are discovered and reported by the institutions themselves.*

### Broker-Facilitated Fraud

According to a study by BasePoint Analytics LLC, broker-facilitated fraud has surfaced as the most prevalent segment of mortgage fraud nationwide.[7] Broker-facilitated mortgage fraud occurs when a broker materially misrepresents, misstates, or omits information that a loan officer relies on to make the decision to extend credit.[8] Broker-facilitated fraud can be fraud for property, fraud for profit, or a combination of both. For example, the borrower may be committing the fraud with the primary interest of obtaining a home, while the broker facilitating the fraud is motivated by profit from closing the loan. The following represents a case of fraud for profit.

[6] *The Detection, Investigation and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper,* Federal Financial Institutions Examination Council (FFIEC) Fraud Investigations Symposium, February 2005, www.ffiec.gov/exam/3P_Mtg_Fraud_wp_oct04.pdf.

[7] BasePoint Analytics LLC, *Broker-Facilitated Fraud—The Impact on Lenders: A White Paper* (2006), www.basepointanalytics.com/mortgagewhitepapers.html.

[8] *Broker-Facilitated Fraud.*

***Example:*** A $165 million community bank decided to enter the mortgage banking business. The bank purchased a small mortgage company and hired an experienced mortgage banker to run the operation. Nearly five years into the relationship, an investor notified the bank that several loans—all originated through the same third-party broker—were being returned for repurchase. During the bank's investigation of these loans, the FBI alerted the bank that they were investigating this same broker for possible fraud. The bank notified its primary federal regulator, which then contacted the FDIC because of the potential impact on the bank's financial condition.

Further investigation revealed that the broker was working in collusion with a builder and an appraiser to flip properties over and over again for higher, illegitimate profits. In total, more than 100 loans were originated to one builder in the same subdivision. The bank incurred a loss of approximately $6 million and went to the third-party broker for reimbursement of the loss. The broker refused to make the payments, and the case went into litigation. The bank was eventually awarded $3.5 million.

***Lessons Learned:*** In a subsequent discussion with FDIC examiners, the bank's president indicated that he had always heard that the most difficult part of mortgage banking was making sure you implemented the right hedge to offset any interest rate risk the bank might incur while warehousing a significant volume of mortgage loans. He did not focus much attention on mortgage loan origination because the bank made sure the contracts with the brokers it used included language requiring the brokers to reimburse the bank for any nonconforming loans that were returned by the ultimate investor for repurchase. The bank had representation and warranty clauses in contracts with its brokers and thought it had recourse with respect to the loans being originated and sold through the pipeline.

During the litigation, the third-party broker argued that the bank should share some responsibility for this exposure because its internal control systems should have recognized a loan concentration to this one subdivision and instituted measures to deter this risk. The bank president acknowledged that the monitoring system used at that time did not adequately measure concentration risk with respect to loans being generated by the mortgage banking business. In addition to establishing an adequate system to monitor concentration risk, the bank president said that if he had it to do over again, he would institute regular surprise audits to sample loan origination documentation and make sure loans were being underwritten according to the bank's standards.

**Mitigating Steps:**

- Establish a system to monitor concentration risk by broker and by project.
- Institute surprise audits to sample loan origination documentation.

## Loan Documentation Fraud

While broker-facilitated fraud and loan documentation fraud are closely aligned, loan documentation fraud extends beyond mortgage brokers to all individuals involved in the process. Loan documentation fraud may involve a borrower, broker, or lender knowingly making written false statements or concealing material facts to influence the approval of the loan.

According to the BasePoint Analytics study, the most common types of fraud are employment, income, and occupancy

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misrepresentations—all of which relate to documentation.[9] The Mortgage Asset Research Institute (MARI) reports that in a sample of loans by one of MARI's clients, 90 percent of stated incomes were exaggerated by 5 percent or more, and 60 percent of stated incomes were inflated by more than 50 percent.[10] The ultimate effect of loan documentation fraud on property values and the overall economy remains to be seen. Loan documentation fraud is most often fraud for property, although if the lender or broker is aware of the deception, as in the first example below, fraud for profit (income for the lender or broker) may also be involved.

***Example:*** A $43 million community bank hired a mortgage loan officer for a new loan program designed to benefit minority individuals with poor or no credit histories. The loan officer began generating consistent business, and management did not closely monitor her activities. The loan officer provided credit to individuals who were using false or stolen Social Security numbers. She also accepted, and in some cases actually generated, false or questionable documents to support the loans, including false rental and utility payment histories. The bank became aware of the problem only when another institution, which had purchased some of these loans, conducted due diligence and discovered the falsified information. The bank had to repurchase these loans, but the bank's total exposure has not yet been determined. The FDIC became aware of this fraud through a routine review of SARs filed by both institutions.

***Lessons Learned:*** A thorough background check on the loan officer would have disclosed that she used a false Social Security number to obtain her position with the bank and falsified other information on her employment application. A call to her former employer would have revealed that she had been terminated from that financial institution for orchestrating the very same type of fraud. In addition, instituting periodic quality control measures, such as sampling loan files, could have identified these practices early and limited the bank's exposure.

**Mitigating Steps:**

- Establish a "Know Your Employee" program.
- Conduct background checks on new employees.
- Conduct periodic credit checks on existing employees.
- Establish clearly defined quality control requirements.
- Provide ongoing employee oversight and training.
- Structure compensation agreements to include loan quality as a contributing factor.

***Example:*** A $1 billion urban financial institution became heavily involved in wholesale mortgage lending and began pressuring employees to increase loan production. A disgruntled employee notified FDIC examiners about widespread documentation fraud in the bank's residential mortgage banking business. Reportedly, intense pressure from senior management to increase loan production resulted in a practice of altering documents by cutting and pasting customer signatures on different forms to manufacture false loans. These loans were being packaged and sold to third-party investors, leaving the bank vulnerable to potential buyback claims. The disgruntled employee surrendered documents to the FDIC that bank management allegedly told him to

[9] *Broker-Facilitated Fraud.*

[10] Merle Sharick, Erin E. Omba, Nick Larson, and D. James Croft, "Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association," Mortgage Asset Research Institute, Inc. (April 2006), www.mari-inc.com/reports.html.

destroy in an effort to hide the files from regulators. The FDIC continues to investigate this case, including possible false statements by one senior manager that may result in a prohibition action, criminal violations, and prosecution.

***Lessons Learned:*** The board of directors and the audit committee did not establish comprehensive reporting and monitoring procedures, largely delegating this responsibility to operating management. Information provided to the board was usually informal and lacked adequate, useful detail. Examiners recommended that the board establish clear expectations for the timing and reporting of periodic quality control initiatives (e.g., loan documentation sampling). Examiners also recommended that management perform a risk assessment to determine areas of increased exposure and provide fraud identification training to staff, including originators, processors, underwriters, and internal audit personnel. Properly trained staff can help identify red flags such as white outs, squeezed-in names or numbers, and illegible signatures with no supporting identification or verification information.

**Mitigating Steps:**

- Adopt periodic quality control measures, including loan file sampling.
- Train personnel to identify and report red flags.
- Institute adequate internal reporting procedures.

## Appraisal Fraud

Appraisal fraud is usually outright fraud or negligence on the part of the appraiser, often in collusion with other parties. Some institutions have internal appraisers, but most use outside companies. Manipulating or inflating the comparable locations, market values, and property characteristics are all tactics of appraisal fraud. Questionable practices include "windshield appraisals," where appraisers merely drive by a property and use inappropriate comparables that will get the value where they want it to be. In some cases, appraisers may fraudulently overstate the benefits of a particular property to back into the value needed for the loan. Appraisal fraud can be used to qualify an undervalued home for a higher mortgage amount (usually fraud for property) or to inflate the value of real estate so that the property can be resold or flipped quickly to a straw or duped buyer and the profit retained by perpetrators (fraud for profit). Under the first scenario, appraisers may be pressured by mortgage brokers or loan officers to falsify an appraisal so that a loan transaction can be approved. Under the second scenario, the appraiser actually works in collusion with other conspirators to perpetrate the fraud.

***Example:*** A small community bank (total assets less than $250 million) became involved in an inflated appraisal fraud scheme. The bank discovered inflated appraisals on residential properties securing loans to two borrowers when those borrowers defaulted on the debts. The bank later determined that one of the borrowers owned the appraisal firm that prepared the original appraisals for these properties. The borrowers allegedly worked in collusion with bank loan officers to finance these properties at inflated values. In total, the bank financed dozens of residential properties, with a combined original (fraudulent) appraised value totaling approximately $2 million. After the defaults, these properties were reappraised at less than one-third of their original appraised value. The bank suffered a significant loss, which has been difficult for it to absorb. The FDIC is seeking a removal/prohibition action against the loan officers involved, who have resigned from the bank. The FDIC became aware of this fraud by reviewing SARs submitted by the institution.

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***Lessons Learned:*** Once these activities were uncovered, the bank worked aggressively to identify all relevant exposure by getting new appraisals and providing adequate loan loss reserves. However, some improvements to the bank's loan review and monitoring procedures could have helped the bank identify negative trends prior to the borrowers defaulting on the debts. First, the bank's monitoring procedures were not sophisticated enough to establish a connection between either the borrowers or the appraisals supporting these loans. As a result, this increasing level of exposure remained largely undetected. Second, while each loan was relatively small, the combined total of these loans was significant. However, because of the small size of each loan, the bank's internal loan review did not pick up any of the loans. The bank would have benefited by changing the scope of its loan review to include a sampling of loans from all loan officers, regardless of the loan size. Finally, the bank was not completely familiar with the appraisal firm used to value the collateral supporting these loans. If the ownership structure of the appraisal firm had been investigated initially, the bank would have discovered this apparent conflict of interest, which would have triggered additional investigation.

**Mitigating Steps:**

- Develop reports that track problem loans by loan officer, broker, appraiser, underwriter, branch office, settlement agent, and so on.
- Vary the internal loan review scope to include a sample from all loan officers.
- Research the background and ownership of appraisal firms. See 12 CFR 323 of FDIC Rules and Regulations for additional guidelines on appraisal and appraiser requirements.

## Property Flipping

Property flipping is the practice of purchasing properties and reselling them at artificially inflated prices to straw or duped buyers[11] and is strictly fraud for profit. Flipping schemes typically involve fraudulent appraisals, doctored loan documentation, or inflated buyer income. Financial incentives to buyers, investors, brokers, appraisers, and title company employees are also common and indicate the degree of collusion necessary to flip a property. Based on existing investigations and mortgage fraud reports, the FBI estimates that 80 percent of all reported fraud losses involve collaboration or collusion by industry insiders.[12] A particularly troublesome aspect of property flipping is that it taints property sale databases and presents the illusion of rising property values in neighborhoods where the flipping takes place.

***Example:*** During a routine examination of a $1 billion financial institution, examiners became suspicious when they noticed that one loan officer worked apart from other loan originators and had processing personnel dedicated to his loan originations. Bank management indicated the loan officer was the bank's highest producer and that "even a bad month was a good month" for that loan officer. The loan officer maintained a high number of loan originations, even though he took no referrals from the phone queue. On further investigation, the FDIC discovered that the loan officer had an undisclosed relationship with a local mortgage broker. Examiners' review of the officer's lending activity revealed several loans that had been originated, sold, and then quickly fell into foreclosure. Properties were also refinanced rapidly, with an affiliate of the

[11] Vernon Martin, "Detection of Mortgage Fraud," *RMA Journal,* September 2004, www.findarticles.com/p/articles/mi_m0ITW/is_1_87/ai_n14897572.

[12] FBI, "Financial Crimes Report to the Public, Fiscal Year 2006." See http://www.fbi.gov/publications/financial/fcs_report2006/financial_crime_2006.htm.

broker placing second mortgages on the property that would immediately be paid from the next refinance. A sample of the officer's loan documentation discovered altered or falsified account statements, purchase and sale agreements, income figures, credit reports, and verification of deposit forms. The loan officer has since resigned from the institution and is the subject of an ongoing criminal investigation. Total loss exposure to the bank is still being determined; however, the bank has already had to repurchase several loans as a result of this officer's actions.

***Lessons Learned:*** Bank management focused on income generated by this loan officer and overlooked or ignored several key matters that would normally trigger further investigation. First, the isolation of this loan officer from others, including separate processing support, allowed him to dominate transactions from start to finish. The lack of dual control over these transactions greatly enhanced the loan officer's ability to perpetrate the fraud. Second, the lack of proper review and oversight allowed the relationship with the mortgage broker to remain undisclosed to management. Implementing periodic quality control audits to verify the accuracy and completeness of documentation would have brought these activities to light, including the rapid refinancing of properties and falsified loan support documentation.

**Mitigating Steps:**

- Verify the quality of business generated by high-volume producers.
- Establish dual control over loan processing and fund disbursement.
- Implement periodic audits of loan originations by officers.
- Conduct postmortem reviews of loan losses and look for common names of participants in the loan origination or processing areas.

## Misapplication of Funds from Construction or Rehabilitation Projects

Construction or rehabilitation project loans are normally established as operating lines of credit. Borrowers make draws upon these lines of credit and use these funds to complete various phases of a proposed construction or rehabilitation project. Draws are usually matched to the percentage of the project that is complete, with a final percentage held back as an abundance of caution. For example, a builder may ask for a draw that represents 20 percent of the loan/line total, with verified completion actually totaling around 23–25 percent. The draw is used to pay subcontractors for work performed, as well as to provide working capital for the builder, whose fees are built into the line.

Under fraudulent circumstances, builders may use funds or draws on one project to pay for improvements related to another project, or may simply divert funds or draws for their own enrichment—fraud for profit. When this happens, subcontractors do not get paid, and, in some cases, no improvements are made to the property. In the end, the builder exhausts the line of credit, and the bank is left to dispose of a property with very little supporting value.

***Example:*** A $365 million community bank authorized 13 construction lines of credit to a local builder for the construction of speculative houses—those built without a buyer or signed purchase agreement. As soon as the lines were approved, the builder began requesting draws. The builder used falsified sales contracts to mislead the loan officer into believing many of the homes were presold. The loan officer routinely advanced funds to the builder and signed off on construction inspection documentation without ever actually inspecting the construction sites. After some time had elapsed with no corresponding sales activity, the loan

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officer began pressing the builder about the status of construction and requests for new money. The builder confessed that no houses had been constructed on 11 of the bank's 13 construction lines. The bank ultimately recorded a loss of $2 million on the $2.6 million construction line. The builder was convicted of fraud and sent to federal prison. The FDIC banned the loan officer from banking. The loss had a significant impact on the bank's earnings, and the institution's reputation was tarnished as a result of local media coverage. The FDIC became aware of this fraud by reviewing SARs submitted by the institution.

***Lessons Learned:*** The monetary reward and success of attracting and signing a loan client is much more attractive than the subsequent job of properly administering the credit; however, both are equally important to a financial institution. In this instance, the loan officer became busy with other responsibilities and did not devote the time necessary to properly monitoring construction draws and documenting the proper allocation of funds to each project. The institution had no established procedures or forms for conducting and documenting on-site inspections, except to check the "inspection" box on the disbursement form. Consequently, to authorize a construction draw and deter loan review attention, the loan officer would falsely indicate on loan disbursement forms that construction inspections had been completed. Loan oversight was limited to verifying that the "inspection" box was checked, with no subsequent confirmation or review of supporting documentation. In addition, the bank did not review or monitor the builder's deposit account activity, which would have revealed construction draws being used for a multitude of purposes unrelated to the project. Verifying the legitimacy of the sales contracts with the proposed purchasers also would have immediately alerted the bank of a possible problem.

**Mitigating Steps:**

- Monitor construction draws.
- Complete and document on-site inspections.
- Verify sales contracts.
- Monitor builder checking account activity.

## Establishing Controls: A Commonsense Approach

Fraud is often compared to a triangle, with the three points of the fraud triangle being motive, rationalization, and opportunity. The element of opportunity is particularly heightened at financial institutions because of the cash and financial transaction nature of the business. As can be seen from the examples and mitigating steps in this article, developing and implementing a sound internal control environment—including sound lending fundamentals, quality control procedures, and audit programs—is a key factor in reducing the opportunity for all types of mortgage loan fraud. While most institutions are aware of these safeguards, the cost/benefit of internal controls sometimes precludes management from making internal controls a top priority.

In addition to the mitigating steps already identified, some banks are exploring automated fraud detection products introduced over the past several years. These software applications search bank loan databases and compare borrowers, loan participants, common names, addresses, employers, appraisers, and the like, to detect potential red flags or signs of mortgage fraud. These products produce summary ratings or reports that serve to identify loans or groups of loans that may represent an increased risk of mortgage fraud and require further investigation. The ultimate decision as to whether these products represent a cost-effective solution remains an independent choice for each institution. However, it is important that all institutions consider the potential impact of fraud and establish adequate provisions for this risk as part of their normal profitability and budgeting process.

## Conclusion

Mortgage loan fraud is a large and growing problem. It can occur in any neighborhood and requires that all parties concerned maintain a high level of vigilance. Bank management should keep alert to fraud triggers, ask questions, review mortgage documentation, perform verifications, and report suspicious activity to the appropriate regulatory and law enforcement authorities in a timely manner. While even the best internal control environment will not prevent mortgage fraud in all instances, strong internal controls, coupled with an alert and knowledgeable staff, are a financial institution's best line of defense.

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### Resource Links

Community groups, industry-related coalitions, regulatory authorities, and federal, state, and local governments have volumes of information and resources available to anyone looking for additional information on mortgage fraud. Many states provide websites with consumer information and online access to forms used to report fraud. The following is a list of a few of the many available resources:

*The Detection, Investigation and Prevention of Insider Loan Fraud: A White Paper,* FFIEC Fraud Investigations Symposium, May 2003

*Mortgage Fraud Perpetrated Against Residential Lenders*, Mortgage Bankers Association, July 2006

*Financial Crimes Report to the Public,* Federal Bureau of Investigation and Department of Justice, May 2005

Federal Deposit Insurance Corporation, *Risk Management Manual of Examination Policies,* Sections 9.1–Fraud, and Section 10.1–Suspicious Activity and Criminal Violations

**Websites:**

www.occ.treas.gov: Office of the Comptroller of the Currency (federal regulator for national banks)

www.fdic.gov: Federal Deposit Insurance Corporation (federal regulator for state-chartered nonmember banks)

www.ots.treas.gov: Office of Thrift Supervision (federal regulator for federally chartered savings institutions)

www.federalreserve.gov: Board of Governors of the Federal Reserve System (regulator for state-chartered member banks)

www.hud.gov: Department of Housing and Urban Development

www.fbi.gov: Federal Bureau of Investigation

www.mortgagefraudblog.com: Central clearinghouse on recent mortgage fraud schemes, indictments, and prevention

www.grefpac.org: Georgia Real Estate Fraud Prevention and Awareness Coalition (and similar community groups throughout the country)

www.mbafightsfraud.mortgagebankers.com: Mortgage Bankers Association

www.ganet.org/dbf.dbf.html: Georgia Department of Banking and Finance (and other appropriate state regulatory authorities)

# Wind Hazard Insurance: No Longer Just a Technical Exception

The banking industry has long relied on real estate as collateral for various types of loans. Hazard insurance has played a big role in mitigating the risk of loss of collateral value from catastrophic damage. Traditionally, examiners have cited inadequacies in collateral insurance coverage as technical exceptions when reviewing loan files. But in today's environment, issues regarding insurance availability and affordability may soon reach beyond anything considered technical.

In this article, we present an overview of the impact of the rising cost, and in some cases the lack of availability, of wind hazard insurance, with a focus on Florida. Although the issue is not new to Florida, it has intensified to the point that it is often labeled a crisis.

Virtually no part of the eastern and southern U.S. coastline is immune from the threat of severe storm systems. However, because of the growth in Florida's population and infrastructure, national storm modeling firms consider Florida to have the highest level of risk in the nation for catastrophic storm damage.[1] Insurers that continue to offer coverage in high-risk areas are rapidly and significantly increasing rates charged to policyholders to replenish reserves, account for the updated modeling forecasts, and pay the higher cost of reinsurance from the anticipated increased risk. Map 1 illustrates how rising rates have already squeezed many Florida homeowners in terms of their budgets and spending habits. According to the Insurance Information Institute, rates are likely to rise between 20 and 100 percent over the next year for the 43 percent of the U.S. population living in coastal areas stretching from southern Texas to the northern tip of Maine.[2] Given Florida's higher risk exposure, even higher increases in Florida would not be unlikely.

Wind insurance premium increases are having a direct negative effect on commercial and residential borrowers' overall budgets, including their ability to service debt. It has also been widely reported that borrowers and investors are becoming hesitant to buy properties affected by significantly increasing insurance premiums. The reported slowing in real estate sales activity in Florida may be exacerbated by insurance issues.

The considerable concern to the banking industry lies in the fact that the risk in much of its lending activity—loans secured by real estate—has historically been mitigated with property insurance, including coverage for wind damage. Prudent bankers will monitor the effect of this issue on real estate markets in their geographic areas of lending, as well as the effect on the overall economy. Concerned lenders will also consider the potential effects of changes in wind hazard insurance coverage and premiums in underwriting loans and in monitoring their overall real estate loan portfolios.

## Historical and Insurance Industry Perspective

After a series of hurricanes hit Florida in the 1940s and 1950s, the state began pursuing a more consistent statewide building code. In 1974, the state implemented a uniform building code system that seemed reliable until 1992,[3] when

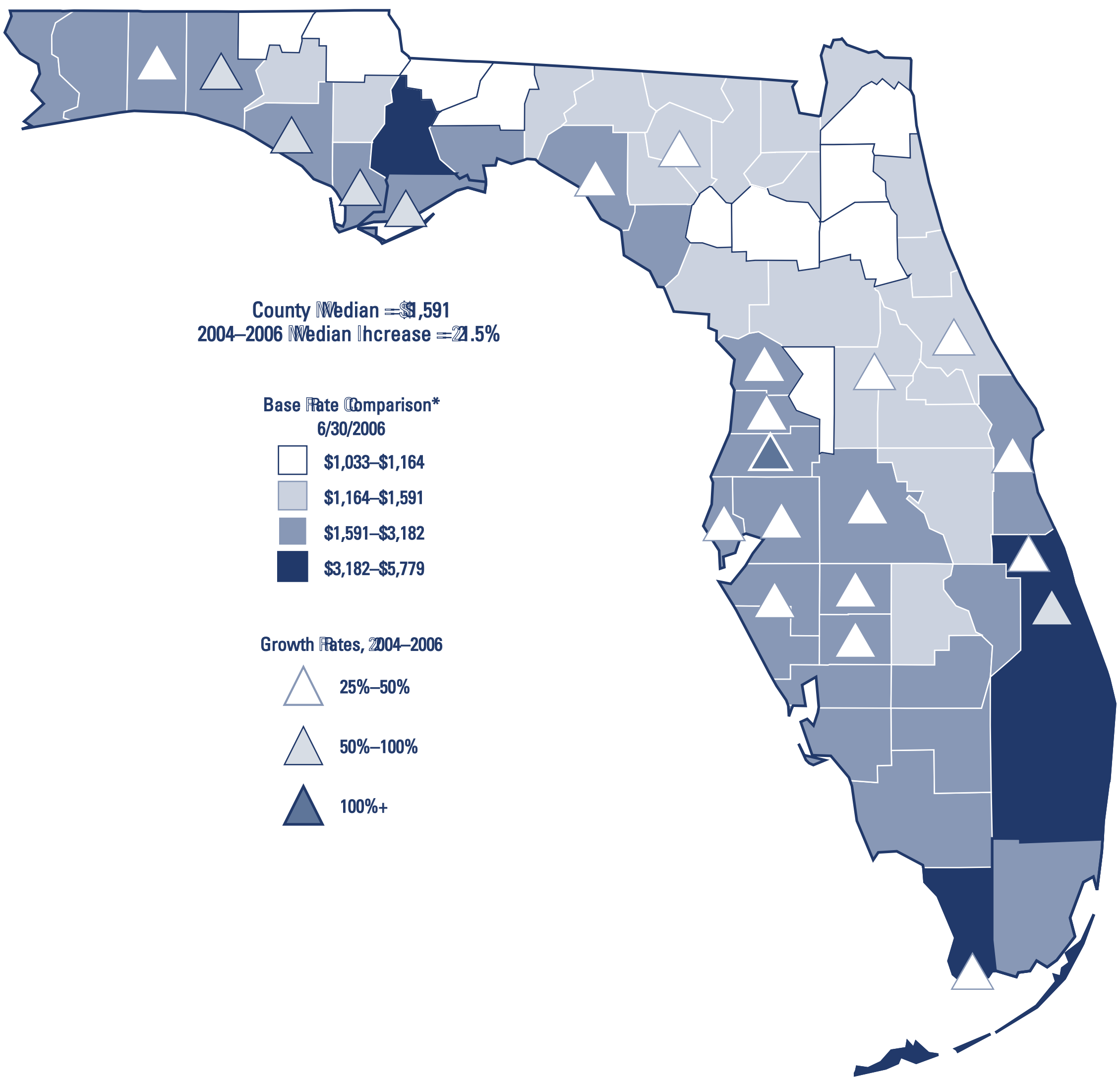
[1] Property and Casualty Insurance Reform Committee, *Property and Casualty Insurance Reform Committee Final Report and Recommendations,* November 15, 2006, p. 2, www.myfloridainsurancereform.com/finalrpt.htm.

[2] John Simmons, "Risky Business: With $58 Billion in Claims to Pay for Last Year Alone, U.S. Insurers Are Jacking Rates, Canceling Policies and Learning to Cope with Climate Change," *Fortune Magazine* (November 2, 2006), retrieved March 26, 2007, from http://money.cnn.com/magazines/fortune/fortune_archive/2006/09/04/8384736/index.htm.

[3] *Property and Casualty Insurance Reform Committee Final Report and Recommendations,* p. 33.

Map 1

**Citizens Property Insurance Corporation's Premiums Have Increased Rapidly in Several Counties**




*Represents base rates without any underwriting criteria such as discounts/credits or surcharges. Data for HO-3 (Homeowners) additional risk: $150,000 masonry structure, 2% hurricane deductible, $500 deductible for all other perils, Coverage: Both hurricane and non-hurricane.
Source: Market Research Unit, Florida Office of Insurance Regulation

Hurricane Andrew caused $15.5 billion in damage ($21.5 billion in 2006 dollars). As a result of this damage, there were 12 insurer insolvencies and the insurance market began to collapse. The Florida legislature passed a moratorium to prevent insurers from dropping coverage to reduce their own hurricane exposure risk.[4] In 2000, the legislature authorized a new uniform Florida Building Code, which became effective on March 1, 2002, making Florida the only state in the nation with a statewide building code.[5]

[4] Office of Insurance Regulation, *Doing Business in Florida's Property Insurance Marketplace*, August 12, 2006, p. 7, www.flains.org/HC/oirmarkeroverview806.pdf.

[5] *Property and Casualty Insurance Reform Committee Final Report and Recommendations*, pp. 33–34.

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Also in 2002, the Florida legislature passed Senate Bill 1418, known as the Windstorm Bill.[6] The bill created Citizens Property Insurance Corporation (Citizens), a federally tax-exempt corporation, to provide full wind, hurricane, and hail policies for residential and commercial properties that are unable to obtain insurance in the voluntary market, i.e., an insurer of last resort. Citizens receives no direct state government funding; its claims and operational costs are paid from premiums collected. If Citizens runs a deficit within a fiscal year, it has the authority to assess all property insurance companies to cover the amount of the deficit. These assessments are passed on directly to the policyholders.[7]

Nevertheless, a total of eight hurricanes in 2004 and 2005, including Katrina, caused nearly $36 billion in losses within Florida. As if that was not enough, hurricane forecasting models are predicting more frequent and severe storm systems in the region, which are expected to only heighten the pattern of losses.[8]

While residents and business owners are frustrated over increasingly expensive insurance rates, insurers must raise rates to replenish reserves in preparation for future claims. In his testimony to one of Florida's state legislative committees, Dr. Robert P. Hartwig, senior vice president and chief economist of the Insurance Information Institute of New York, stated, "After brief periods of profitability, the market is periodically jarred by catastrophic losses that wipe out all or most of the profits since the last major event."[9]

With billions of dollars in exposure being added to Florida each year from the infrastructure needed to support continuing population and economic growth, the insurance industry in general seems to be reaching the maximum level of risk it is willing to accept. Many insurance companies are no longer writing new wind hazard policies and are canceling existing policies to reduce their exposure in the state. Some insurers have completely stopped writing property insurance policies in Florida.

Between 1998 and the second quarter of 2006, the number of insurance companies writing residential policies in Florida dropped from 225 to 167. In that same time period, the number of insurance companies writing commercial policies declined from 120 to 80.[10] With the burden of insuring residential and commercial properties getting pushed more and more onto the state, Citizens—whose policies number nearly 1.3 million—is writing more than 70,000 new policies per month. As the second largest homeowner insurer in Florida, next to State Farm, Citizens was exposed to $434.3 billion in insured risks as of April 6, 2007.[11]

The difficulties in obtaining insurance coverage are not limited to Florida. Insurance companies are either not renewing homeowner policies or are significantly raising premiums to compensate for the risk in states all along the Gulf of Mexico and Atlantic Ocean coasts. For example, last year, Allstate did not renew any of its homeowner policies in New York City and three counties in the area, which

[6] Senate Bill 1418 can be retrieved from the Florida legislature's website at www.leg.state.fl.us/session/index.cfm?Mode=Bills&Submenu=1&BI_Mode=ViewBillInfo&Billnum=1418&Year=2002.

[7] My Florida Insurance Reform, "Why am I being assessed for Citizens Insurance if they are not my insurer?" www.myfloridainsurancereform.com/faq.htm#3.

[8] *Property and Casualty Insurance Reform Committee Final Report and Recommendations,* p. 25.

[9] "Overview of Florida Hurricane Insurance Market Economics," testimony delivered on January 19, 2005, by Robert P. Hartwig, Ph.D., CPCU, to the Florida Joint Select Committee on Hurricane Insurance.

[10] *Property and Casualty Insurance Reform Committee Final Report and Recommendations,* p. 15.

[11] "Policies in Force and Exposure," retrieved April 23, 2007, from www.citizensfla.com.

Allstate considers the "catastrophe-prone areas" of New York. According to Howard Mills, New York state's insurance superintendent, "We need to dramatically increase awareness that we are in an area not only susceptible to a hurricane, but long overdue for a hurricane. . . . There's a reason why companies like Allstate are trying to reduce their exposure. It's an inevitability."[12]

Allstate cancelled 95,000 homeowner policies in Florida in 2005. As of November 2006, Allstate had dropped an additional 120,000 policies that had come up for renewal and is no longer writing new policies in Florida. According to Edward Liddy, Allstate's chief executive officer, "We [Allstate] do not get adequate rates in that regulated system."[13]

## *Rising Reinsurance Costs and Availability Issues*

In 2006, then-Governor Bush appointed a special Property and Casualty Insurance Committee[14] (Committee), and the Florida state legislature convened special sessions to discuss the insurance issue and reinvigorate the state-run insurance provider of last resort. According to the Committee, which was charged with researching the problems plaguing the insurance industry and offering recommendations to stabilize insurance rates for homeowners and commercial property owners, "Reinsurance capacity for Florida property risk is nearly tapped out."[15] (See text box "Florida Addresses the Insurance Crisis" for more discussion of actions being taken within the state.) With the insurance industry's exposure rising so significantly, rating agencies such as Standard & Poor's, Moody's, and Fitch have begun requesting that reinsurance companies infuse or retain more capital or curtail their exposure—or risk being rated less favorably.

## *Potential Economic Impact*

The economic impact of rising insurance costs on Florida and in other parts of the nation is difficult to quantify. According to the Florida Demographic Estimating Conference data as of February 19, 2007, over the next ten years, Florida's population will grow by 3.8 million, or 21 percent, compared to a growth of 3.7 million, or 25 percent, over the previous ten-year period. There is concern, however, that the wind-hazard insurance crisis, particularly in and around the coastal areas of the state, could adversely affect the normally robust in-migration and investment in Florida real estate of all types. If in-migration were to slow significantly, economic growth in Florida would also be expected to slow.

Jack McCabe, a real estate consultant in Deerfield Beach, Florida, reported, "We are seeing insurance rates 200 to 300 percent more than a year ago," and higher insurance costs have contributed to the sluggish real estate market. Mr. McCabe added that "it makes Florida look not as affordable for vacation home buyers."[16]

In July 2006, *The New York Times* featured an article in its National Perspectives section on so-called "half-backs," natives of northern states who retire to Florida but later change their

[12] Jeff Vandam, "Storm Fears Touch Off a Scramble for Insurance," *New York Times* (August 27, 2006), retrieved March 10, 2007, from http://query.nytimes.com/gst/fullpage.html?res=9B04E5D8133EF934A1575BC0A9609C8B63.

[13] Simmons, "Risky Business."

[14] The Committee was formed on June 27, 2006, through Executive Order Number 06-150. See www.myfloridainsurancereform.com.

[15] *Property and Casualty Insurance Reform Committee Final Report and Recommendations,* p. 51.

[16] Amy Gunderson, "Home Away; Bracing for Higher Premiums," *New York Times* (January 3, 2007), retrieved February 12, 2007, http://query.nytimes.com/gst/fullpage.html?res=9805E4DD1130F930A35752C0A9619C8B63.

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## Florida Addresses the Insurance Crisis

Florida legislators and business interests have established committees, task forces, and programs to begin to sort through possible solutions to the problem. Recent actions include the following:

- In a special session in January 2007, the Florida legislature passed House Bill 1A, Hurricane Preparedness and Insurance.[a] The special session, which considered the recommendations of the Property and Insurance Reform Committee and other interested parties, concentrated on hurricane insurance premium rate-hike relief and restructuring of the insurers of last resort in the state. The House bill effectively reduces in the near term the wind insurance portion of premium rates, varying by type and location of the property location. The reductions average 24 percent across Florida, varying from 10 percent in the panhandle area of north Florida to 53 percent in the Miami-Dade County area of south Florida.
- House Bill 1A also expands the reinsurance and catastrophic loss coverage levels provided by the Florida Hurricane Catastrophe (CAT) Fund. The CAT Fund, a trust fund created in 1993 and administered by the state, serves as a mandatory source of reinsurance for residential property insurers. This reinsurance is provided at significantly less expensive rates than private reinsurance. Insurance companies normally purchase private reinsurance to cover their losses below their CAT Fund retention rate or to cover their exposure that exceeds CAT Fund coverage.[b] Under the new law, costs undertaken by insurance companies for reinsurance that duplicates available CAT Fund coverage cannot be factored into rates assessed against insured property owners.
- The Property & Casualty Joint Underwriting Association for Commercial Wind Coverage (JUA) was established in August 2006 to provide wind-only policies for commercial properties valued at $1 million or less, as well as coverage for contents and business interruption up to $750,000 and $250,000, respectively, for total maximum coverage of $2 million.[c]
- In 2006, the Florida Department of Financial Services created the Florida Comprehensive Hurricane Damage Mitigation Program (FCHDMP), also known as the "My Safe Florida Home" program, to help Florida residents strengthen their homes against natural disasters. The FCHDMP offers free home inspections by qualified hurricane mitigation inspectors to eligible homeowners, and it provides matching grants for qualifying residents who mitigate the risk of potential storm damage through strengthening their homes.[d]
- The Florida Bankers Association created an Insurance Task Force in September 2006 to help solve the imminent property insurance crisis from a banker's perspective.[e] The task force presented an 11-point agenda with recommendations to the special January 2007 legislative session and is continuing to work with federal and state legislators to ensure that banking interests are represented in solving Florida's insurance crisis.

[a] House Bill 1A, January 25, 2007. See www.myfloridahouse.gov.

[b] Property and Casualty Insurance Reform Committee, *Property and Casualty Insurance Reform Committee Final Report and Recommendations,* November 15, 2006, pp. 47–48, www.myfloridainsurancereform.com/finalrpt.htm.

[c] *Property and Casualty Insurance Reform Committee Final Report and Recommendations,* pp. 28–29.

[d] See www.mysafefloridahome.com.

[e] "FBA Announces Insurance Agenda," September 28, 2006, See Press Releases at www.floridabankers.com/StaticPages/Publication_Media_Info.aspx.

minds and move "half way" back north. They are leaving Florida to live in states to the north, such as Tennessee, to take advantage of cheaper real estate prices and to escape rising insurance costs and other hurricane-related expenses. Bob Gilley, principal owner of Tellico Lake Realty in Tennessee, recently reported that 40 percent of the people coming to Tellico are from Florida.[17]

Data provided by the Florida Association of Realtors show that Florida's existing-home sales declined each month in 2006 as compared with a year earlier; the number of existing-home sales in December 2006 was 29 percent below the sales of existing homes in December 2005. While there are certainly a number of factors tied to the declining sales, the cost of wind hazard insurance may be a contributing factor.

[17] Lisa Chamberlain, "Drawn to Eastern Tennessee's Natural Beauty," *New York Times* (July 9, 2006), retrieved January 14, 2007, from http://query.nytimes.com/gst/fullpage.html?res=9B03E5D81330F93AA35754C0A9609C8B63&partner=rssnyt&emc=rss.

## Impact on Insured Financial Institutions

Commercial real estate (CRE) lending is a key component of lending programs for many Florida financial institutions. Acquisition, construction, and development loans are a significant portion of CRE lending in Florida community banks. This lending is a niche for many community banks that feel they can compete with larger institutions based on local decision making and personal service. A slowdown in real estate development and investment caused by the rising cost of wind insurance could affect the ability of some smaller banks to thrive. Moreover, underinsured or uninsured collateral, declining collateral values, and declining debt-service coverage expose lenders to more risk of default and loss.

Banks are facing a number of situations brought on by the insurance crisis. Since summer 2006, the FDIC's Atlanta Region has been tracking Florida bank examination findings as they relate to the cost and availability of wind hazard insurance. Examiners are also closely monitoring issues related to wind insurance and have discussed the actual and potential effects with the industry and other regulators in various forums. The examples below are indicative of what examiners have encountered:

- Investors are declining to purchase Florida real estate because of the prohibitive cost or lack of available wind hazard insurance.
- Borrowers are reporting policy nonrenewals and cancellations. Some banks report a slight increase in the use of forced-placed insurance as some borrowers are unable to find insurance.[18] So far, these banks have been able to find policies, although at a higher cost.
- Insurance premiums are increasing—in excess of 500 percent for some borrowers.
- Some banks are considering approving loans without insurance where the land-only value is twice the loan balance.
- Some banks are requiring more collateral in consideration for waiving full insurance coverage; others are refusing to waive insurance at all.
- Borrowers are increasing deductibles to help curb the increases in premiums for wind hazard insurance on collateral.
- Some borrowers have considered self-insuring collateral.

Other federal banking agencies and the state of Florida's Office of Financial Regulation report similar findings.

While troubling, these situations have not yet risen to a level that has substantially elevated the risk profile of a particular bank. However, Florida bankers are generally concerned and are closely monitoring the effects of the wind insurance crisis on their banks.

## Prudent Risk Management Practices

No federal banking statute or regulation requires full hazard insurance coverage on all real estate collateral improvements or bank premises, although some of the federally sponsored lending organizations (Federal Housing Administration, Federal National Mortgage Association, Federal Home Loan and Mortgage Corporation, Small Business Administration, etc.) may require full insurance coverage prior to committing to purchase or guarantee all or part of commercial or residential real estate loans. States

[18] Force placing is a normal part of a loan agreement where the bank obtains and directly pays for an insurance policy and passes the cost on to the borrower.

# Wind Hazard Insurance

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vary as to insurance requirements, and Florida has no statutes or regulations requiring full wind insurance protection of loan collateral or bank premises. FDIC Rules and Regulations (see 12 CFR 365) require prudent real estate lending policies, which would include the general requirement of insurance to enhance loan quality. However, this requirement is applied on a macro lending basis. Individual loan exceptions are normally listed as technical exceptions in the Report of Examination and not criticized unless excessive.

Examiners in the FDIC's Atlanta Region were recently reminded that insurance coverage should be reviewed as part of the normal loan review and examination function. As is normal for any emerging risk, examiners are expected to ensure that banks monitor the insurance situation as it affects loan collateral and make reasonable documented efforts to maintain sufficient insurance. Examiners are not expected to criticize banks when uninsured or underinsured collateral results from circumstances beyond management's control.

The FDIC is monitoring significant insurance issues closely and is communicating with the other regulatory agencies and the industry to keep to the forefront emerging risk management, asset quality, and consumer affordability issues. The wind insurance crisis poses potentially difficult decisions for bankers regarding the acquisition of insurance for existing loan collateral or whether certain loans can be originated without the benefit of wind insurance. As with any emerging risk, prudent considerations and practices of bankers may include

- Ensuring that lending policies and procedures address insurance requirements and the reporting of exceptions to the board of directors of the financial institution;
- Ensuring that mortgage loan agreements and other pertinent documentation address insurance requirements;
- Making reasonable, documented efforts to obtain and maintain sufficient insurance coverage on collateral;
- Including potential hazard insurance effects in the underwriting and ongoing analysis of debt service; and
- Considering significant insurance issues when analyzing the allowance for loan and lease losses.

## Bank Premises Insurance Coverage

Banks' lending activities are not the only area affected by the rising cost of insurance. Banks generally insure their own premises against the possibilities of fire or storm damage using extended insurance packages that indemnify against losses from windstorms, cyclones, tornados, hail, and other natural disasters. In evaluating the effectiveness of a bank's risk management program, examiners look to see that management determines if, and how much, extended coverage is warranted.[19] Variables for both examiners and bankers to consider include the locations of the bank premises, the probability of storm occurrence, the number and locations of bank branches, the adequacy of disaster recovery plans, the bank's capital level, and the amount of risk the board of directors is ultimately willing to take.

Most banks have prudently acquired property insurance as a cost-effective means of hedging against a catastrophic event. However, some Florida banks have

[19] FDIC, *Risk Management Manual of Examination Policies,* Section 3.5, "Premises and Equipment," www.fdic.gov/regulations/safety/manual/section3-5_toc.html.

not been able to secure the continuation of full windstorm coverage for some or all of their buildings. When such insurance is unavailable or otherwise cost-prohibitive, banks are expected to continue working to obtain adequate coverage and to provide capital at sufficient levels to absorb potential wind damage expenses not covered by insurance, while also following accounting rules regarding the establishment of contingency reserves if necessary. As with insurance for collateral, examiners are expected to ensure that banks monitor their insurance situation with respect to bank premises and make reasonable, documented efforts to maintain sufficient coverage.

## Looking Ahead

While the Florida legislature, community groups, and industry associations have worked diligently to provide relief to home and business owners, the 2007 hurricane season is fast approaching. Forecasters predict the 2007 Atlantic hurricane season will be more active than the average for the 1950–2000 seasons. They further predict a 40 percent probability for at least one major (category 3, 4, or 5) hurricane landfall for the U.S. coast, including the Florida peninsula. (This compares with an average probability of 31 percent for the last century.)[20] With each new hurricane season comes the potential for damage and losses that could put further pressures on the insurance industry. However, effective risk management practices may help to lessen the impact on financial institutions.

Insurance is a highly valued tool for mitigating credit risk, but problems with maintaining affordable insurance are forcing lenders and borrowers alike to rethink what makes a sound loan and investment. Regulators, bankers, and developers all understand just how sensitive the value and debt-service capability can be for an income-producing property when insurance costs materially change. Increasing insurance costs have cut into profits and reduced disposable cash, and they have the potential to negatively affect collateral values. While the FDIC has not seen significant deterioration in individual banks, examiners will be looking for prudent bank practices, such as monitoring real estate collateral, taking reasonable precautions in keeping collateral insured, stress testing loan-to-values and debt-service abilities, and documenting banks' efforts. Although no one knows when another catastrophe might occur, it is critical for institutions to continue to employ proper risk mitigation efforts to protect against possible losses.

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[20] Philip J. Klotzbach and William M. Gray, "Extended Range Forecast of Atlantic Seasonal Hurricane Activity and U.S. Landfall Strike Probability for 2007," Department of Atmospheric Science, Colorado State University, December 8, 2006.

# From the Examiner's Desk . . . The e-Exam

It is Friday afternoon, and an examination of the bank starts on Monday. The bank has not provided paper copies of its policies, procedures, board minutes, or sample customer disclosures. No loan files have been pulled. The bank has spent minimal time and resources responding to examiner requests for information. Yet preexamination planning has been completed, and, using standard procedures, the examination has been risk-scoped.

How was this achieved? The bank is undergoing an e-Exam, conducted under the FDIC's e-Exam policy.[1] All of the documents and data needed for preexamination planning were provided electronically using appropriate security measures. Moreover, a significant amount of the examination activities will be conducted in the FDIC's offices—not at the bank.

## The Changing Face of Examinations

An important component of bank examinations is the review of a bank's books and records, which includes a wide variety of written documents. Improved technology for electronic storage and retrieval of written documents has created opportunities to improve the quality and timeliness of the document review conducted during examinations. Over the past few years, examiners have asked for more and more off-site information, performing most of the preexamination analysis and some of the ongoing examination tasks outside the bank. In most cases, however, much of the information needed for an examination was aggregated and copied by the bank, which was time consuming, burdensome, and often resulted in several boxes of documents being created for the examiners. Until recently, examiners had to be on-site at least for certain tasks: to analyze the areas requiring extensive documentation that could not be readily copied, such as loan files or other sizeable financial reports, and to obtain missing information.

Given the advancements in technology, FDIC examiners have explored how the examination process could be made more efficient. By securely exchanging electronic information, could we reduce the burden of the examination process on both bank management and examiners, while still maintaining an effective, risk-focused examination process?

## Introducing the e-Exam

An e-Exam, or electronic examination, is a financial institution examination in which electronic data are exchanged through a secure delivery method. E-Exam procedures can be used for all examinations conducted by the FDIC, including risk management, compliance, and Community Reinvestment Act examinations. State authorities and other regulatory agencies also may employ e-Exam procedures at joint examinations with the FDIC.

Banks generally maintain a wide variety of information—written policies and procedures, customer disclosures, board minutes, and even loan files—in electronic format, either as an originally created document or as a scanned image. Managers at many institutions have been offering their imaging tools to examiners for some time, usually allowing access to imaged documents through compact discs (CDs) or bank terminals on-site. In early 2004, institutions began approaching the FDIC via telephone calls and personal contacts at trade events suggesting that examiners

[1] Division of Supervision and Consumer Protection Memorandum, "e-Exam Policy," Transmittal No. 2006-018, July 7, 2006. Under the e-Exam policy, examiners are directed to maximize the use of electronic information, when available, to conduct examinations and visitations.

use banks' imaging technology during examinations to make the process more efficient for both them and the examiners. Developing policies and procedures for electronically transferring such documents was the next logical step, and it is the basis of the e-Exam concept.

The FDIC's e-Exam policy is designed to meet the needs of bankers and examiners by using these imaging tools to enhance the examination process. Under the policy, board minutes and financial reports can be reviewed off-site in the preexamination planning stage, loan reviews can be conducted off-site using imaged loan files, and additional information requests or amended documents responding to examiner questions or concerns can be transmitted electronically as the examination comes to a close. Examiners can and do, however, go on-site for discussions with management and certain types of transaction testing.[2]

## Improving Examination Efficiencies for Bankers and Examiners

Industry response to e-Exams has been positive. Examination work conducted on-site requires extensive bank resources, including work space, employee time, and distractions from the normal course of bank business. Moreover, providing documentation to examiners electronically, rather than as the traditional hard copy, saves considerable time and effort for bank management.

Nikki Beisler, a senior vice president with First Bank and Trust Company of Indiantown, Florida, offers the following thoughts on the e-Exam policy and a recent e-Exam at her institution: "I love it. It saves time as I do not have to take time to create paper copies. It is easier to send documents electronically because we already have them in an electronic format. I am able to be more organized through this process. Being from a small institution, I have to wear a lot of hats, and there is not enough time to get things done. The process is simple to use and allows me to save time and be organized. The examination went very smoothly."

As for the examination force, the response has been overwhelmingly positive. Many examiners consider the potential reduction in travel—one of the most-often-cited reasons for examiners leaving the FDIC—to be one of the most important benefits of the e-Exam program. The e-Exam policy also supports the flexibility examiners have in choosing their work environment through the FDIC's Telework Program.

## Security Is Paramount

The FDIC's e-Exam policy accommodates financial institutions' desire to provide imaged documentation and realizes the benefits of using emerging technologies as part of the examination process. However, enhanced policy and procedure considerations are necessary to mitigate information security risks arising from the use of e-Exam procedures. Strict adherence to applicable information security policies and procedures are required to effectively accommodate the use of emerging technologies.

The extent of imaging technologies employed, the financial institution management's willingness to participate in e-Exams, and the available security measures represent the primary considerations when implementing e-Exam procedures. Although many technologies are available to accommodate the electronic exchange of information, the only

[2] The following portions of the fair lending review must be conducted on-site: criteria interview, a sample of actual loan files to ensure imaged files received electronically are complete, and any follow-up discussions if the off-site file review indicates possible disparate treatment.

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## Perspectives from an FDIC Examiner

While FDIC strives to complete examinations with local examiners, for a variety of reasons, that is not always possible. When that happens, examiners from out of the area—sometimes even out of the region—help out. I recently served as the examiner-in-charge (EIC) of a bank located in another region. Having the option of conducting an e-Exam facilitated getting much of the work done at my field office, while shortening some of my on-site activities.

The $68 million bank effectively transmitted the requested items, including loan files, through FDIC*connect*. Using the information provided in advance by the bank, my crew of eight examiners, all from out of the bank's area, was able to effectively risk scope the examination. Four examiners conducted portions of the examination at the bank, while the remaining four examiners conducted the loan review from the field office. Using FDIC*connect,* the examiners were able to review loan files, collect missing documentation, and complete the loan review with little difficulty.

As EIC, I felt the e-Exam was efficient and cost effective. We were able to save considerable dollars in travel expenses and, by saving more than 60 hours of travel time, complete the examination in only one week. Overall, bank management was receptive to the process and expressed their preference for having fewer examiners on-site than in past examinations.

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ones currently approved for use in an e-Exam are FDIC*connect*, web-based applications, and electronic media (including CDs and DVDs). These three delivery technologies, which are discussed later in this article, have proven their reliability and consistency and provide a degree of security for delivery of bank information. In all instances, however, the increased volume of portable, electronic confidential information associated with e-Exams necessitates enhanced security measures to ensure the continued confidentiality, integrity, and availability of financial institution records and data. Therefore, the FDIC has structured formal security policies according to the specific delivery channels used, and the e-Exam policy outlines the necessary measures to mitigate the unique threats and challenges that each delivery channel presents.

## *Different Technologies Facilitate the e-Exam*

Based on the results of ongoing surveys[3] completed by FDIC examiners and bankers, the FDIC estimates that approximately 800 FDIC-supervised institutions have some document imaging capabilities, with more than 250 of these institutions being fully imaged. The e-Exam policy provides examiners the flexibility to work with various technologies banks may employ to facilitate an e-Exam. As previously mentioned, three delivery methods are currently used during examinations to navigate and view imaged documents in a secure manner: FDIC*connect*, CDs/DVDs, and web-based applications.

### FDIC*connect*

Using a secure Internet connection, FDIC*connect* provides on-demand file exchange capabilities and automated encryption with the transmission and storage of data. All FDIC examiners and insured financial institutions registered with FDIC*connect* can use the Examination File Exchange (EFE) module of FDIC*connect*. (See text box for information on registering with FDIC*connect*.) The FDIC*connect* application is easy for both examiners and bankers to navigate,

[3] In 2004, the FDIC implemented a Document Imaging Survey, completed by examiners in conjunction with examinations, to assess the potential for using imaging technologies in future examinations. The survey was replaced on May 21, 2007, with an enhanced e-Exam Imaging Inventory, which examiners will use to monitor the extent of banks' use of imaging technologies and to assist with identifying developing technologies.

providing a user-friendly, safe, and secure method for transmitting files during examinations. Bankers simply aggregate and copy requested examination information to FDIC*connect* for review by examiners. Currently, this is the most frequently used method of exchanging examination-related information—most likely because it is easy to use and bankers and examiners are comfortable with FDIC*connect* 's built-in security and encryption features.

## Compact Discs

Prior to the development and acceptance of FDIC*connect*, CDs/DVDs were often the primary means of obtaining imaged documents at examinations. Many bankers and examiners continue to use CDs/DVDs, particularly when Internet connections are not available or access speeds are poor. Bank management can aggregate and copy requested examination information to CDs/DVDs for review by examiners, much as they would for e-Exams using FDIC*connect*. Bankers and examiners have also found that CDs/DVDs can easily be used to obtain missing documentation or to meet additional examiner requests once the examination has commenced. For example, if examiners are on-site and missing just a couple of policies or a loan file, it may be easier to copy these documents to a CD/DVD and simply hand it to the examiners rather than establishing an FDIC*connect* session for an electronic transfer. In general, using CDs/DVDs requires very little technical assistance. However, some additional security precautions are necessary. Bankers sometimes express reservations about having electronic data, including confidential customer information, outside the institution's control because of privacy and security issues related to safeguarding such information. The FDIC shares this concern and therefore requires that CDs/DVDs be properly secured through encryption and that proper physical security controls be in place when transporting disks.

## Web-Based Applications

Some institutions maintain information on a web server. Under this arrangement, examiners use standard web browsers and FDIC laptops to retrieve images over the Internet via encrypted sessions. The institution and the FDIC are able to secure the confidentiality and integrity of bank information by using user ID/password authentication and by enforcing appropriate access controls to restrict examiners' abilities to create, modify, or delete bank information.

### Registering with FDIC*connect*

The FDIC encourages all financial institutions to register to use FDIC*connect* by completing a Designated Coordinator (DC) Registration Form available at www2.fdicconnect.gov. Because an executive officer of the financial institution is required to sign the registration form, each institution's management is aware of the principal person on their staff who "speaks for the institution" using FDIC*connect*.

Institutions should choose the coordinator carefully and implement controls to address operational risks inherent in online transactions. FDIC*connect* staff will provide the coordinator with technical guidance for using FDIC*connect*. The coordinator may designate other individuals' access to execute transactions on behalf of the institution. These users can be employees of the institution, the holding company, an outside data servicer, or a law firm. When appropriate, such as in the case of data servicers, authorized FDIC*connect* users may execute transactions on behalf of more than one institution.

# From the Examiner's Desk . . .

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Because much of the information required to conduct an examination is already available on the institution's web server, bank management often has to extend little, if any, effort to meet examiner requests for information. This approach for accessing bank information is considered reliable, consistent, and effective. Again, there are some additional security precautions that have to be taken with web-based applications. Although there is some concern that direct website access may not support multifactor authentication (i.e., user ID/password, biometrics, or token-based devices), examiners' limited access (just for the duration of the examination, only within business hours, and to a single URL address) reduces the potential for examiners to be misdirected or subject to a successful phishing attempt.

## The Future of the e-Exam

Technology will continue to offer new ways to make examinations more efficient. As the banking industry continues to take advantage of advancements in technology, such as document imaging and remote access capabilities, the use of e-Exam procedures will doubtless grow.

The FDIC has established an e-Exam Working Group to monitor developments in technology, including imaging. This working group, with the help of subject-matter experts in the FDIC regions, will

- Monitor changes in technology;
- Provide an accurate system for tracking institutions with document imaging;
- Ensure that policies and procedures are updated;
- Provide recommendations for meeting increases or changes in hardware and software needs so that we can respond to advancements in the industry; and
- Pilot, test, and develop procedures for new technologies.

As the landscape of technology evolves, the examination process must also evolve to ensure that the FDIC is conducting business in the most effective, efficient, and secure manner. The FDIC's e-Exam policy was developed in that spirit, improving the efficiency of the examination process without compromising its integrity.

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# Accounting News: Recent Developments Affecting the Accounting for Split-Dollar Life Insurance Arrangements

In recent years, an increasing number of banks have acquired life insurance assets to finance the cost of employee benefits, protect against the loss of key persons, or provide retirement and death benefits as part of certain employees' compensation. Data reported in the Consolidated Reports of Condition and Income (Call Report) reveal that more than 47 percent of all banks held life insurance assets as of December 31, 2006. For these banks, their total life insurance assets exceeded $96 billion, which represented more than 11 percent of their aggregate equity capital.

Banks often use split-dollar life insurance arrangements to provide retirement and death benefits to employees. These arrangements are commonly structured as either "endorsement" split-dollar arrangements or "collateral assignment" split-dollar arrangements. Although both types of split-dollar life insurance arrangements have existed for many years, within the past year the Financial Accounting Standards Board (FASB) has ratified separate consensuses reached by its Emerging Issues Task Force (EITF) on the accounting for these two types of arrangements. The consensuses in EITF Issues No. 06-4 and No. 06-10 cover endorsement and collateral assignment split-dollar life insurance arrangements, respectively.[1] The EITF addressed the accounting issues associated with these arrangements because of diversity in practice with respect to the deferred compensation and postretirement benefit aspects of typical split-dollar arrangements. As a consequence, institutions that have entered into split-dollar arrangements with employees now need to review how they account for them. For many banks, the application of the EITF consensuses will result in a change in accounting principles that will require them to recognize a liability at the beginning of 2008 for any benefits provided to these employees that extend to postretirement periods.

## *Split-Dollar Life Insurance Arrangements*

The December 2004 Interagency Statement on the Purchase and Risk Management of Life Insurance,[2] which provides guidance regarding supervisory expectations for the acquisition and holding of life insurance by banks and savings associations, also addresses split-dollar life insurance arrangements. As noted in the Interagency Statement, under split-dollar arrangements, the employer and the employee share the rights to the insurance policy's cash surrender value (CSV) and death benefits. In general, the difference between endorsement and collateral assignment split-dollar life insurance arrangements is in the ownership and control of the life insurance policy. In an endorsement arrangement, the employer (bank) owns the insurance policy and controls all rights of ownership; in a collateral assignment arrangement, the employee owns the policy and controls all rights of ownership.

According to the EITF's description of a typical endorsement split-dollar arrangement,

> An employer purchases a life insurance policy to insure the life of an

[1] See EITF Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* (EITF 06-4), and EITF Issue No. 06-10, *Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements* (EITF 06-10). The FASB ratified the EITF's consensuses on these issues on September 20, 2006, and March 28, 2007, respectively.

[2] FIL 127-2004, Bank-Owned Life Insurance: Interagency Statement on the Purchase and Risk Management of Life Insurance, December 7, 2004, www.fdic.gov/news/news/financial/2004/fil12704.html.

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employee and pays a single premium at inception of the policy. Based on the insurance carrier's experience (for example, mortality) it can either charge or credit the policyholder for the negative or positive experience, respectively. The additional premium or credit is typically effectuated through an adjustment to the cash surrender value of the policy. The employer enters into a separate agreement that splits the policy benefits between the employer and the employee….To effect the split-dollar arrangement, the employer endorses a portion of the death benefits to the employee (the employee designates a beneficiary for this portion of the death benefits). Upon the death of the employee, the employee's beneficiary typically receives the designated portion of the death benefits directly from the insurance company and the employer receives the remainder of the death benefits.[3]

In contrast, as described in the EITF's materials, a typical collateral assignment split-dollar arrangement has the following characteristics:

> An employee purchases a life insurance policy through an arrangement with the employer to insure the employee's life…[or] the employer purchases a life insurance policy and transfers ownership of the insurance policy to the employee…The employer usually pays all or a substantial part of the premium. The employee irrevocably assigns a portion or all of the death benefits to the employer as collateral for the employer's interest in the insurance policy [i.e., the employer's loan to the employee] (the collateral assignment arrangement). Amounts due to the employer vary but, typically, the employer is entitled to receive a portion of the death benefits equal to the premiums paid by the employer or premiums paid plus an additional fixed or variable return on those premiums.[4]

The appendix to the 2004 Interagency Statement contains similar descriptions of these two split-dollar arrangements. The Interagency Statement further provides that an institution's economic interest in the insurance policy underlying the split-dollar arrangement should at least be equal to the premium or premiums paid plus a rate of return comparable to returns on investments of similar maturity and credit risk.

### *Liability Recognition for Split-Dollar Arrangements under the EITF Consensuses*

The EITF reached similar conclusions as to whether an employer should recognize a liability and related compensation costs for postretirement benefits associated with both endorsement and collateral assignment split-dollar life insurance arrangements. For both types of split-dollar arrangements, determining whether the employer should recognize a liability for postretirement benefits should be based on the substantive agreement with the employee. Thus, "if the employer has agreed to maintain a life insurance policy during the employee's retirement or provide the employee with a death benefit,"[5] the employer should recognize a liability for its postretirement benefit obligation to the employee. The liability must be recognized in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions (FAS 106),* "if, in

[3] *EITF Abstracts,* Issue No. 06-4, paragraph 2.

[4] EITF 06-10, Issue Summary No. 1, paragraph 2.

[5] Unless otherwise noted, this quotation and subsequent quotations are taken from the *EITF Abstracts* for Issue No. 06-4 or Issue No. 06–10.

substance, a postretirement benefit plan exists," or Accounting Principles Board Opinion No. 12, *Omnibus Opinion—1967* (APB 12), "if the arrangement is, in substance, an individual deferred compensation contract." To determine the substance of an arrangement, all available evidence should be considered, including the "explicit written terms of the arrangement, communications made by the employer to the employee, the employer's past practices in administering the same or similar arrangements, and whether the employer is the primary obligor for the postretirement benefit."

Furthermore, when evaluating a collateral assignment split-dollar arrangement, an employer would be deemed to have agreed to maintain a life insurance policy "if the employer has a stated or implied commitment to provide loans to an employee to fund premium payments on the underlying insurance policy during the postretirement period." In the absence of evidence to the contrary, there is a presumption that an employer will "provide loans to an employee to fund premium payments on the underlying insurance policy in the postretirement period if the employer has provided loans in the past or if the employer is currently promising to provide loans in the future." For example, if, under the terms of the collateral assignment arrangement, the employer has either a stated or implied obligation "to provide loans to an employee to cover the experience gains and losses of the insurance company, that may indicate that the employer has a postretirement benefit obligation" to be recognized.

Therefore, after considering all available evidence surrounding a split-dollar arrangement, if the substance of the arrangement is the employer's agreement to maintain a life insurance policy on the employee during his or her retirement, "the estimated cost of maintaining the insurance policy during the postretirement period should be accrued." Similarly, if the substance of the arrangement is the employer's agreement "to provide the employee with a death benefit, the employer should accrue, over the service period, a liability for the actuarial present value of the future death benefit as of the employee's expected retirement date." These accruals should be made in accordance with FAS 106 or APB 12, as appropriate.

APB 12 requires that

> an employer's obligation under a deferred compensation agreement be accrued according to the terms of the individual contract over the required service period to the date the employee is fully eligible to receive the benefits, i.e., the "full eligibility date."...[It] does not prescribe a specific accrual method for the benefits under deferred compensation contracts, stating only that the "cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner." The amounts to be accrued each period should result in a deferred compensation liability at the full eligibility date that equals the then present value of the estimated benefit payments to be made under the individual contract.[6]

FAS 106 also directs an employer to "recognize and measure the obligation for postretirement benefits based on the actuarial present value of all future benefits attributed to an employee's service rendered to that date [i.e., to the full

[6] *Instructions for the Preparation of Consolidated Reports of Condition and Income,* Glossary, "Deferred Compensation Agreements," page A-15 (3-04). Further guidance on accounting for deferred compensation agreements, including examples, is provided in the Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-owned Life Insurance. See FIL-16-2004, Accounting and Reporting, February 11, 2004, www.fdic.gov/news/news/financial/2004/fil1604.html.

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eligibility date]. FAS 106 requires an employer to attribute the costs of those postretirement benefits over the required service period."[7]

The EITF noted that the facts and circumstances relating to a collateral assignment split-dollar arrangement may change in periods after the inception of the arrangement, for example, as a result of an amendment to the arrangement or a change from the employer's past practice in administering these arrangements. Therefore, an employer should periodically evaluate the substance of its collateral assignment arrangements to determine whether any change in an arrangement has altered its substance and, hence, whether a liability for a postretirement benefit obligation should be recognized or a previously recognized liability should be adjusted.

## *Asset Recognition for Split-Dollar Arrangements under the EITF Consensuses*

An employer must also ensure that it properly recognizes the asset resulting from its split-dollar arrangements with employees. Because the owner of the insurance policy differs under the two types of split-dollar arrangements, the resulting asset held by the employer must reflect the nature of the employer's interest in the life insurance.

In an endorsement split-dollar arrangement, the employer owns the insurance policy. Thus, the accounting guidance in the FASB's Technical Bulletin 85-4, *Accounting for Purchases of Life Insurance* (TB 85-4), as interpreted by the EITF in Issue No. 06-5, *Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin* 85-4 (EITF 06-5), should be applied to the insurance policy. Under TB 85-4, "the amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset." Normally, this amount is the CSV of a policy, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV. However, EITF 06-5 explains that the employer, as policyholder, should also consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract.

In this regard, EITF 06-5 notes that an insurance policy's contractual terms may include a "claims stabilization reserve" account and a provision that allows the policyholder to recover the upfront "deferred acquisition costs" (DAC) tax over a specified period of time.[8] When either of these amounts is present in an insurance policy used in an endorsement split-dollar arrangement and the amount is realizable based on the policy's contractual terms, this realizable amount should be included as part of the amount reported as a life insurance asset on the balance sheet. Thus, as long as the split-dollar arrangement entitles the employer to the entire CSV reported by the insurance carrier (less any applicable surrender charges not reflected therein) plus any additional realizable amounts, the employer should report this total amount as an asset.

In contrast, because the employee owns the life insurance policy in a collateral assignment split-dollar

[7] EITF 06-4, Issue Summary No. 1, Supplement No. 2, Revised, page 20.

[8] Under EITF 06-5, when measuring the amount that could be realized under an insurance contract, "amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy [such as the DAC tax] should be discounted in accordance with" Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables* (APB 21).

arrangement, an employer's process for recognizing and measuring the asset in such an arrangement is not as straightforward. According to EITF 06-10, this process should be "based on the nature and substance" of the arrangement, which requires the employer to "evaluate all available information." To determine the nature and substance, "the employer should assess what future cash flows the employer is entitled to, if any, as well as the employee's obligation and ability to repay the employer." As an example, the EITF cited a collateral assignment split-dollar arrangement in which the employer is entitled to recover only the CSV of the employee's insurance policy even if the employer's loan to the employee is a larger amount. Under such an arrangement, the employer's asset as of any balance sheet date would be limited to the CSV. As a second example, if the employee is required "to repay the [loan from the] employer irrespective of the collateral assigned and the employer (a) has determined that the employee loan is collectible and (b) intends to seek recovery beyond the cash surrender value of the life insurance policy, the employer should recognize the value of the loan (including accrued interest, if applicable) considering the guidance in" APB 21.

Under APB 21, if the employer's loan to the employee requires repayment only of the premiums paid by the employer on the insurance policy, i.e., without the payment of interest or a rate of return on those premiums, the employer should "record a receivable from the employee at a discounted amount for the premiums paid."[9] Thus, the employer would need to determine the expected repayment date of the loan to the employee based on the terms of the split-dollar life insurance arrangement as well as the appropriate interest rate at which to discount the loan. APB 21 states that "the rate used for valuation purposes will normally be at least equal to the rate at which the debtor [i.e., the employee] can obtain financing of a similar nature from other sources at the date of the transaction. The objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions." The employer would apply the interest method to amortize the resulting discount on the loan to the employee over the life of the loan at the rate used for valuation purposes.

## *Effective Date for the EITF Consensuses*

The consensuses reached on EITF 06-4 and EITF 06-10 are expected to represent a significant change in accounting practice for many banks with split-dollar life insurance arrangements. As a result, the EITF delayed the effective date of these consensuses to allow adequate time for implementation. Thus, both consensuses take effect for fiscal years beginning after December 15, 2007, i.e., as of January 1, 2008, for banks with calendar year fiscal years. Calendar year banks with split-dollar life insurance arrangements must first report in accordance with these consensuses in their March 31, 2008, Call Reports and in any first quarter 2008 financial statements they issue. Earlier application of the consensuses is also permitted.

When the EITF initially reached a tentative consensus in EITF 06-4 in June 2006, it proposed that the consensus should take effect for fiscal years beginning after December 15, 2006. For calendar year banks, this meant that they would have had to apply this consensus at the beginning of 2007. In considering comments received on its

[9] EITF 06-10, Issue Summary No. 1, paragraph A2.

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tentative consensus on EITF 06-4 that requested a delay in the effective date, the EITF recognized that, absent any changes to banks' existing endorsement split-dollar arrangements, many banks with such arrangements would see a reduction in their Tier 1 capital upon their initial application of the consensus. This regulatory capital reduction would be the consequence of having to recognize a liability for postretirement benefits that these banks had not previously accrued on their balance sheets. Accordingly, the EITF reconsidered the effective date and moved it one year into the future. When the EITF subsequently reached its consensus on EITF 06-10 for collateral assignment split-dollar arrangements, it decided in the interest of consistency to set the same delayed effective date as for EITF 06-4.

For a bank whose split-dollar life insurance accounting practices differ from the consensuses reached by the EITF, the effects of applying the relevant consensus for the type of split-dollar arrangement into which the bank has entered with its employees should be recognized "through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings…as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods." Because each Report of Income in a bank's Call Report covers a single discrete calendar year-to-date period rather than presenting comparative statements, a bank is not permitted to implement a change in accounting principle through retrospective application to prior years' Call Reports. Therefore, unless a calendar year bank elects earlier application of the relevant split-dollar EITF consensus, it will report the cumulative effect of applying the consensus as of January 1, 2008, as a direct adjustment to its equity capital in item 2 of Call Report Schedule RI-A—Changes in Equity Capital, and disclose this amount in item 4 of Schedule RI-E—Explanations.

## *Examination Considerations*

Under the 2004 Interagency Statement on the Purchase and Risk Management of Life Insurance, institutions should have a comprehensive risk management process for purchasing and holding life insurance. A prudent risk management process includes effective senior management and board oversight as well as an effective ongoing system of risk assessment, management, monitoring, and internal control. As a key aspect of the ongoing monitoring process, management should provide a risk management review of the institution's insurance assets to the board of directors at least annually. The Interagency Statement provides examples of situations when more frequent reviews are appropriate. Although changes in accounting requirements are not specifically included among the examples, the EITF's two recent consensuses are of sufficient significance as to warrant a review outside of the annual cycle.

Among other elements, an institution's risk management review should include a comprehensive assessment of the risks of its life insurance holdings. In particular, the Interagency Statement notes that transaction/operational risk arises due to the tax and accounting treatments of life insurance products and instructs an institution to thoroughly review and understand how the accounting rules will apply to the insurance products it is considering purchasing. Therefore, when accounting rules change, a thorough review and understanding of the effect of the changes should be an integral part of the institution's risk management review. The Interagency Statement also notes that "[s]plit-dollar life insurance has complex tax and legal consequences" and that material modifications of these arrangements may unfavorably alter their tax treatment. As a consequence, the Interagency Statement cautions institutions to "consult qualified tax, insurance, and legal advisors" before entering into or modifying split-dollar life insurance arrangements.

Because the application of the consensuses in EITF 06-4 and EITF 06-10 may require banks with split-dollar life insurance arrangements to initially recognize a liability for postretirement benefits, which will reduce both equity capital and regulatory capital, and to subsequently recognize compensation costs over the remainder of the employees' required service periods until their full eligibility dates, banks should use the transition period during 2007 for risk management reviews that assess the substance of their split-dollar arrangements. In these reviews, banks should also consider the nature of their interest in the life insurance policies associated with their split-dollar arrangements to ensure that they are properly reporting their insurance assets. The results of these reviews, including consultations with their external accountants and other qualified advisors, should enable management to understand and evaluate the accounting consequences of the EITF consensuses; ascertain the impact of the consensuses on equity capital on their effective date and on earnings thereafter; and determine the actions needed, if any, to remedy the effects of applying the consensuses beginning in 2008. These actions may include considering whether to eliminate or reduce the postretirement benefits provided under these arrangements after addressing any relevant tax consequences from such modifications.

Thus, when examining banks that have entered into split-dollar life insurance arrangements with employees, examiners should ensure that management is aware of the recent accounting guidance issued by the EITF and is assessing, or has completed an assessment of, the impact that the consensuses will have on their organization as part of a timely risk management review of these insurance arrangements. In cases where management has not yet taken appropriate action, examiners should seek management's commitment to promptly address the EITF guidance relevant to its split-dollar arrangements.

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# Regulatory and Supervisory Roundup

**This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release (PR) or Financial Institution Letter (FIL) designations are included so the reader may obtain more information.**

| Subject | Summary |
|---|---|
| **New Government-Wide ID Theft Home Page Established (PR-33-2007, April 23, 2007)** | The Federal Deposit Insurance Corporation (FDIC), a participant in the government-wide Identity Theft Task Force, provided a direct link to the new, centralized government website on identity theft. The new site, www.idtheft.gov, was launched April 23, 2007. Initially, the site will provide the task force's strategic plan. The plan, which represents the input of 17 federal agencies, including the FDIC, sets out recommendations to prevent identity theft, to help identity theft victims recover from those crimes, and to prosecute and punish identity theft–related criminals. |
| **Institutions Encouraged to Work with Mortgage Borrowers Who Are Unable to Make Their Payments (PR-32-2007, FIL-35-2007, April 17, 2007)** | The FDIC, Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), and National Credit Union Administration (collectively, the federal financial institution regulatory agencies) issued a statement encouraging financial institutions to work with homeowners who are unable to make mortgage payments. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interests of both the financial institution and the borrower. Institutions will not face regulatory penalties if they pursue reasonable workout arrangements with borrowers. See www.fdic.gov/news/news/press/2007/pr07032.html. |
| **Comments Sought on Proposed Model Privacy Form (FIL-34-2007, April 16, 2007; PR-24-2007, March 21, 2007)** | The federal financial institution regulatory agencies, the Securities and Exchange Commission (SEC), the Federal Trade Commission, and the Commodity Futures Trading Commission jointly published a notice of proposed rulemaking (NPR) seeking comment on a model privacy form financial institutions could use to satisfy the privacy notice requirements of the Gramm-Leach-Bliley Act (GLBA). The proposed privacy form would also provide consumers with the opportunity to limit certain information-sharing practices, as permitted by the GLBA and the Fair Credit Reporting Act. Comments on the proposed rule were due by May 29, 2007. See www.fdic.gov/news/inactive-financial-institution-letters/2007/fil07034.html. |
| **Supervisory Policy on Identify Theft Issued (FIL-32-2007, April 11, 2007)** | The FDIC issued its *Supervisory Policy on Identity Theft*. The policy describes the characteristics of identity theft. It also sets forth the FDIC's expectations that institutions under its supervision take steps to detect and prevent identity theft and mitigate its effects to protect consumers and help ensure the safe and sound operation of financial institutions. See www.fdic.gov/news/news/financial/2007/fil07032a.html. |
| **Comments Sought on Expanded Examination Cycle for Certain Institutions (PR-29-2007, April 3, 2007)** | The FDIC, FRB, OCC, and OTS (collectively, the federal bank and thrift regulatory agencies) requested public comment on proposed interim rules expanding the range of small institutions eligible for an extended 18-month on-site examination cycle. The proposed interim rules, which became effective May 10, 2007, allow well-capitalized and well-managed banks and savings associations with up to $500 million in total assets and a composite rating of 1 or 2 to qualify for an 18-month (rather than a 12-month) on-site examination cycle. Until recently, only institutions with less than $250 million in total assets could qualify for an extended 18-month on-site examination cycle. The proposed interim rules also revise the provisions governing the on-site examination cycle for the U.S. branches and agencies of foreign banks. The public comment period closed May 10, 2007. See www.fdic.gov/news/press/2007/pr07029.html. |

**Comments Requested on Proposed Statement on Subprime Mortgage Lending (FDIC-PR-18-2007, March 2, 2007; FIL-26-2007, March 9, 2007)**

The federal financial institution regulatory agencies sought comment on the proposed *Statement on Subprime Mortgage Lending* (Subprime Statement). The Subprime Statement addresses the risks and emerging issues relating to subprime mortgage lending practices, most notably certain adjustable rate mortgage lending products. Comments were due by May 7, 2007. See www.fdic.gov/news/news/press/2007/pr07018a.html.

**Comments Requested on Proposed Supervisory Guidance for Basel II (PR-13-2007, February 15, 2007; FIL-20-2007; February 28, 2007; *Federal Register,* Vol. 72, No. 39, p. 9084, February 28, 2007)**

The federal bank and thrift regulatory agencies sought comment on proposed guidance describing the agencies' expectations for banking organizations that would adopt the Advanced Internal Ratings-Based Approach (IRB) for credit risk and the Advanced Measurement Approaches (AMA) for operational risk under the proposed new Basel II capital framework. The proposed guidance also establishes the process for supervisory review and the implementation of the capital adequacy assessment process under Pillar 2 of the Basel II framework. Comments on the proposed guidance were due May 29, 2007. See www.fdic.gov/news/news/financial/2007/fil07020.html.

**Comments Requested on Proposed Guidelines on Assessment Rate Adjustment for Large Institutions and Insured Foreign Branches in Risk Category I (FIL-19-2007, February 27, 2007; *Federal Register,* Vol. 72, No. 34, p. 7878, February 21, 2007)**

The FDIC sought comment on a proposed set of ten guidelines that would govern the process for determining when an assessment rate adjustment is appropriate and what the magnitude of the adjustment should be. These guidelines are intended to further clarify the analytical processes and the controls applied to them in making assessment rate adjustments. Comments on the proposed guidelines were due March 23, 2007. See www.fdic.gov/news/news/financial/2007/fil07019.html.

**Certain Reporting Requirements Repealed (FIL-7-2007, January 26, 2007)**

The FDIC issued a final rule repealing FDIC Part 349, Reports and Public Disclosure of Indebtedness of Executive Officers and Principal Shareholders to a State Nonmember Bank and Its Correspondent Banks. The final rule became effective on December 22, 2006. See www.fdic.gov/news/news/financial/2007/fil07007.html.

**Supervisory Policy on Predatory Lending (FIL-6-2007, January 22, 2007)**

The FDIC issued its *Supervisory Policy on Predatory Lending,* which describes certain characteristics of predatory lending and reaffirms that such activities are inconsistent with safe and sound lending and undermine individual, family, and community economic well-being. The statement describes the FDIC's supervisory response to predatory lending, including a list of policies and procedures that relate to consumer lending standards. See www.fdic.gov/news/news/financial/2007/fil07006a.html.

**Final Statement Concerning Elevated Risk Complex Structured Finance Activities (PR-3-2007, January 6, 2007)**

The federal financial institution regulatory agencies and the SEC issued a final statement on the complex structured finance activities of financial institutions. The statement describes the types of internal controls and risk management procedures that should help financial institutions identify, manage, and address the heightened legal and reputational risks that may arise from certain complex structured finance transactions. See

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www.fdic.gov/news/news/press/2007/pr07003a.html.

**Comments Requested on Draft Guidelines on Small-Dollar Loans (PR-107-2006, December 4, 2006)**

The FDIC sought comment on proposed guidelines from state nonmember banks to encourage them to offer affordable small-dollar loan products. FDIC-supervised institutions that offer these products in a responsible, safe, and sound manner may receive favorable consideration under the Community Reinvestment Act. Comments were due February 2, 2007. See www.fdic.gov/news/news/press/2006/pr06107a.html.

**Final Rule Amending Part 328, Advertisement of FDIC Membership (FIL-112-2006, December 27, 2006; *Federal Register,* Vol. 71, No. 218, p. 66098, November 13, 2006)**

The FDIC issued the final rule amending FDIC Part 328, Advertisement of Membership. Recent amendments to the Federal Deposit Insurance Act required the FDIC to prescribe an official sign that all FDIC-insured depository institutions would be required to display. The rule accomplishes that requirement and provides for other changes to the regulation. The final rule took effect November 13, 2006. See www.fdic.gov/news/news/financial/2006/fil06112.html.

**Comments Requested on Modifications to the Risk-Based Capital Framework (Basel IA) (PR-112-2006, December 5, 2006; FIL-111-2006, December 26, 2006; *Federal Register,* Vol. 71, No. 247, p. 77446, December 26, 2006)**

The federal bank and thrift regulatory agencies jointly issued an NPR and sought comment on possible modifications to the risk-based capital standards for all domestic banks, bank holding companies, and savings associations that are not subject to the risk-based capital framework proposed in the Basel II NPR. The comment period closed March 26, 2007. See www.fdic.gov/news/news/financial/2006/fil06111.html.

**Comments Requested on Large-Bank Deposit Insurance Determination Modernization Proposal (PR-111-2006, December 5, 2006; FIL-109-2006, December 21, 2006; *Federal Register,* Vol. 71, No. 239, p. 74857, December 13, 2006)**

The FDIC, through an advance notice of proposed rulemaking (ANPR), sought comment on whether and how the largest insured depository institutions should be required to modify their deposit systems so that the FDIC may calculate deposit insurance coverage quickly in the event of an institution's failure. Comments were due March 13, 2007. See www.fdic.gov/news/news/financial/2006/fil06109.html.

**Revised Policy Statement Issued on the Allowance for Loan and Lease Losses (PR-115-2006, December 13, 2006; FIL-105-2006, December 13, 2006)**

The federal financial institution regulatory agencies issued a revised *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL) and supplemental frequently asked questions. The policy statement revises and replaces the banking agencies' 1993 policy statement on the ALLL. See www.fdic.gov/news/news/financial/2006/fil06105a.pdf.

**Joint Guidance Issued on Commercial Real Estate Lending (PR-114-2006, December 6, 2006;**

**FIL-104-2006, December 12, 2006; *Federal Register,* Vol. 71, No. 238, p. 74580, December 12, 2006)**

The federal financial institution regulatory agencies jointly issued *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* The guidance reminds institutions that strong risk management practices and appropriate levels of capital are essential elements of a sound commercial real estate (CRE) lending program, particularly when an institution has a concentration in CRE loans. See www.fdic.gov/news/news/financial/2006/fil06104.html.

**Final Rules on Deposit Insurance Assessments and the Designated Reserve Ratio (PR-101-2006, November 2, 2006; FIL-102-2006, and FIL-103-2006, November 30, 2006; *Federal Register,* Vol. 71, No. 230, pp. 69270 and 69282, November 30, 2006)**

The FDIC issued final rules to amend Part 327 of the FDIC rules and regulations. One rule creates a new system for risk-based assessments and sets assessment rates beginning January 1, 2007. The other rule sets the designated reserve ratio at 1.25 percent. The amendments were made to implement the Federal Deposit Insurance Reform Act of 2005 and were intended to make the deposit insurance assessment system react more quickly and more accurately to changes in institutions' risk profiles and to ameliorate several causes for complaint by insured depository institutions. The final rule took effect January 1, 2007. See www.fdic.gov/news/news/financial/2006/fil06102.html and www.fdic.gov/news/news/financial/2006/fil06103.html.

**Guidelines for an Environmental Risk Program Issued (FIL-98-2006, November 13, 2006)**

The FDIC issued updated *Guidelines for an Environmental Risk Program* to reflect changes to the Comprehensive Environmental Response, Compensation, and Liability Act. Environmental contamination and its associated liability can have a significant effect on the value of real estate collateral. It is also possible for a lending institution to be held directly liable for the environmental cleanup of collateral acquired by the institution. Institutions should have in place appropriate safeguards and controls to limit exposure to this potential environmental liability. See www.fdic.gov/news/news/financial/2006/fil06098a.pdf.

**Final Rule Issued on Late Deposit Insurance Assessment Penalties (FIL-97-2006, November 9, 2006; *Federal Register,* Vol. 71, No. 217,**

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