

# Supervisory Insights

Devoted to Advancing the Practice of Bank Supervision

Vol. 5, Issue 1

Summer 2008

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## **Supervisory Insights**

*Supervisory Insights* is published by the Division of Supervision and Consumer Protection of the Federal Deposit Insurance Corporation to promote sound principles and best practices for bank supervision.

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# Letter from the Director

Between July 2004 and January 2007, we witnessed the longest period in FDIC history without a bank failure. Today, disruptions in the financial markets, the downturn in the U.S. housing market, and other credit quality concerns are creating a more formidable set of conditions for insured institutions. Featured articles in this edition of *Supervisory Insights* deal with three issues that I believe would rank high on anyone's short list of key regulatory and policy challenges we are facing in the current environment.

An issue that has featured prominently in the discussions of policymaking groups around the world is how to enhance transparency and restore confidence in securitization markets, especially with regard to certain complex structured securities that have generated significant write-downs during this period. The current market turmoil has focused attention on the complexity and lack of disclosure about some of these products and highlighted the need for greater transparency. *"Enhancing Transparency in the Structured Finance Market"* details in specific terms some disclosure concerns with these products and summarizes actions the author believes would improve transparency.

The significant deterioration in lending standards in the U.S. mortgage market that has occurred in recent years is generally agreed to be a key causal factor in the current market difficulties. The federal banking agencies, and most states, published two significant guidance documents that addressed underwriting practices, one on nontraditional mortgage lending and another more specifically targeted to subprime mortgage lending—and adjustable-rate

subprime mortgage products in particular.<sup>1</sup> In addition, other legislative, regulatory, and private sector initiatives that remain under active debate have been put forward as remedies for the current instability in the mortgage market.



*"Hybrid ARMs: Addressing the Risks, Managing the Fallout"* describes the underwriting weaknesses and potentially deceptive marketing practices that contributed to the subprime mortgage crisis and discusses key principles for protecting consumers and managing the risks of hybrid ARMs.

The effects of the housing downturn are spilling over to the commercial real estate (CRE) sector, straining credit quality and profitability among banks with large undiversified CRE portfolios. The FDIC recently issued a Financial Institution Letter (FIL) on managing CRE concentrations that reemphasizes the importance of strong capital, an appropriate allowance for loan and lease losses, and robust risk management practices.<sup>2</sup> Against the backdrop of more difficult market conditions in certain geographical regions, an issue that FDIC examiners have been seeing with increasing frequency is the potentially inappropriate use of interest reserves. *"A Primer on the Use of Interest Reserves"* describes the use of interest reserves in Acquisition, Development, and Construction (ADC) lending, examines the risks this strategy presents, and identifies red flags that should alert lenders to potential problems at each stage of the ADC cycle.

The *"Accounting News"* feature examines communication of internal control deficiencies as a part of the audit process. This article summarizes the development of internal control audit-

<sup>1</sup> *Interagency Guidance on Nontraditional Mortgage Product Risks*, **Federal Register**, Vol. 71, No. 192, October 4, 2006, pp. 58609–58618. Also see FDIC FIL-89-2006 at <http://www.fdic.gov/news/news/financial/2006/fil06089.html> and *Statement on Subprime Mortgage Lending*, **Federal Register**, Vol. 72, No. 131, July 10, 2007, pp. 37569–37575. Also see FDIC FIL-62-2007 at <http://www.fdic.gov/news/news/financial/2007/fil07062.html>.

<sup>2</sup> Federal Deposit Insurance Corporation, "Managing Commercial Real Estate Concentrations in a Challenging Environment," FIL-22-2008, March 17, 2008, at <http://www.fdic.gov/news/news/financial/2008/fil08022.html>.



ing and attestation standards, provides examples of internal control deficiencies, explains how external auditors evaluate and communicate these deficiencies to management and boards of directors, and discusses how examiners can use the auditors' written internal control reports in examinations.

As always, we encourage our readers to continue to provide feedback on articles and suggest topics for future issues. Please e-mail your comments and questions to [SupervisoryJournal@fdic.gov](mailto:SupervisoryJournal@fdic.gov).

**Sandra L. Thompson**

*Director*

*Division of Supervision and  
Consumer Protection*

# Enhancing Transparency in the Structured Finance Market

The structured finance market experienced phenomenal growth and innovation during the past decade. However, recent turmoil in the credit markets has raised doubts about the future viability of some products that rely primarily on the securitization process to derive value. Significant concerns have been raised about the lack of transparency of some securitization products.

In this paper we review the availability of information about some of these complex products. Our review supports the conclusion that lack of transparency of these products is a significant problem. The paper contains a number of recommendations that we believe policymakers should consider to improve the transparency of these products. We conclude with some reminders about existing supervisory guidance that is relevant to these issues.<sup>1</sup>

## Inherent Opacity in the Securitization Process

Concerns about transparency in the securitization process are not new. Transparency concerns have existed and resurfaced on occasion since the securitization business model was introduced in 1985. These concerns first centered on the lack of standardized deal terms and documentation. Over time, a measure of standardization has been introduced, especially to more “plain vanilla” securitization products, such as mortgage-backed securities.<sup>2</sup> However, standardization and transactional transparency for more exotic forms of securitization, such as structured investment vehicles (SIVs) and collateralized debt obligations (CDOs), remains inadequate.<sup>3</sup>

Most structures provide general documentation about the type of underlying exposures and the credit ratings, if any, that have been assigned to the underlying exposures and the tranches of the structure itself. However, most do not provide a significant discussion concerning the specific risk drivers associated with underlying exposures, or how these risk drivers may cause the valuation of the underlying exposures and the structure itself to change in response to various economic conditions. For example, a CDO or SIV investor would generally find it difficult to determine whether an underlying exposure was subprime, or if the underlying exposure was itself exposed to subprime obligors.

The lack of transparency in complex securitization products has recently affected local government investments. News reports have stated that a number of state and municipal investment funds, such as Florida’s local government investment pool and Orange County, California, held significant investments in SIV debt, such as asset-backed commercial paper (ABCP), a common short-term debt instrument issued by SIVs.<sup>4</sup> This debt was reportedly purchased because it was AAA-rated and offered higher yields than that of other AAA-rated short-term securities. Many investors, especially government investors, operate under investment policies that limit the choice of investment instruments to only those that meet certain credit rating (for example, AAA- or AA-rated) and maturity (often short-term) criteria. As a result, these investors saw an opportunity to increase return within their investment limitations. However, few investors fully

<sup>1</sup>This article was commissioned by FDIC Chairman Sheila C. Bair and is intended to highlight policy issues associated with improving the transparency of certain securitization products for consideration by financial institution regulatory agencies and bank management.

<sup>2</sup>For example, the Bond Market Association, now the Securities Industry and Financial Markets Association, or SIFMA, Mortgage Securities Research Committee, published the first Standard Formulas guidelines in 1990.

<sup>3</sup>See Appendix A for an overview of the securitization process and selected definitions.

<sup>4</sup>Daniel Pimlott, “Municipal SIV Advocates Fly into Turbulence,” *Financial Times*, December 16, 2007, <http://www.ft.com/cms/s/0/cb60a480-ac0b-11dc-82f0-0000779fd2ac.html>.



understood the risks associated with the underlying SIV structures, which have been labeled as “some of the most confusing, opaque, and illiquid debt investments ever devised.”<sup>5</sup>

During the summer of 2007, SIVs were the object of concern within the investment community when it became obvious that the opaque structure of these instruments made it virtually impossible for investors to determine the structure’s relative exposure to subprime mortgages, much less appropriately assess the risk profile of the underlying exposures. As a result, investors began to shy away from investments in SIVs, creating a liquidity crisis in the securitization market, which began in August of 2007.

Concerns also have been raised regarding the lack of transparency in securitization products that are used by corporations to achieve risk transference or as a means of off-balance sheet funding. Investors and industry watch groups have voiced concern that the accounting and disclosures for off-balance sheet transactions, as well as the complexity of many securitization structures, have left them unable to assess whether risk has been significantly transferred away from the corporate issuer.<sup>6</sup> Although changes in accounting principles and the enactment of the Sarbanes-Oxley Act of 2002<sup>7</sup> have lessened concerns about financial disclosure, many investors believe that issuers continue to bear undisclosed risk.

The Securities and Exchange Commission (SEC) has recently taken steps to increase transparency through the implementation of Regulation AB<sup>8</sup> (Reg AB) which imposes initial disclosure requirements on some types of asset-backed securities.

Highlighting concerns in this respect, several large issuers of securitization products have provided considerable financial support to prevent investors in highly rated securitization tranches from recognizing losses. These issuers, while not legally compelled to provide support, did so to manage reputational risk and bolster investor confidence in subsequent securitization transactions. In addition, issuers of investment products, such as money market mutual funds, have also chosen to bear losses or provided financial support beyond their contractual requirements to protect investors from losses on commercial paper issued by CDOs and SIVs.

Another transparency concern relates to investors’ ability to properly assess the credit risk associated with the assets used to back securitization products. For instance, a residential mortgage-backed security (RMBS) can be collateralized by thousands of individual mortgages. For this reason, certain short-cuts are often used, such as accepting the reputation of various agents, for example, servicers, originators, and rating agencies, to minimize the amount of due diligence performed.

<sup>5</sup>David Evans, “Public School Funds Hit by SIV Debts Hidden in Investment Pools,” *Bloomberg News*, November 15, 2007, <http://www.bloomberg.com/apps/news?pid=20601170&refer=home&sid=aYE0AghQ51UA>.

<sup>6</sup>Congress held hearings soon after the failure of Enron to determine the extent to which banking entities assisted in concealing Enron’s true financial condition by arranging complex structured finance transactions. Senior staff at the Federal Reserve Board, Office of the Comptroller of the Currency, and the U.S. Securities and Exchange Commission (SEC) testified at these hearings. At these hearings and in subsequent correspondence, it was agreed that further guidance was necessary to ensure that banks maintain the proper controls for governing these activities in order to prevent abuses like those perpetrated by Enron, WorldCom, Parmalat, and others. On January 11, 2007, the federal banking agencies, along with the SEC (agencies), issued a final interagency statement (FIL-3-2007, “Complex Structured Finance Activities Interagency Statement on Sound Practices for Activities with Elevated Risk”) that describes some of the internal controls and risk management procedures that may help banks identify, manage, and address the heightened reputational and legal risks that may arise from elevated-risk Complex Structured Finance Transactions. The statement does not apply to products with well-established track records that are familiar to participants in the financial markets, such as traditional securitizations.

<sup>7</sup>Pub. L. No. 107-204, 116 Stat. 745.

<sup>8</sup>SEC Regulation AB (Registration Requirements for Asset-Backed Securities): 17 CFR 229.1100 through 1123.

In addition to these inherent characteristics of the securitization process that promote opacity, other external issues further hinder transparency.

## Roadblocks to Transparency

### Lack of Secondary Market Trading Information

Little price transparency is available on most structured finance securities. Market participants attribute this to the lack of an established secondary market for these securities as most ABS and CDO investors follow a buy-and-hold strategy, with trades executed bilaterally between the investor and the dealer bank. As a result, for many product types, actual trade prices generally are not reported in organized or centralized fashion, although market participants indicate that the dealer banks have access to this information. Concerns about the lack of price transparency are growing as banks continue to increase their presence in these markets as dealers, arrangers, underwriters, and investors. Further, with the increasing use of fair value accounting, the pricing of these complex securities directly affects bank earnings and regulatory capital.

Investors, regulators and other interested parties need to focus attention on the lack of liquidity in most structured finance offerings and work toward improving price discovery. Regulators should encourage market participants to openly share trading information about ABS and CDOs, such as daily volumes, bid/ask spreads, consensus prices, and price ranges and report this information to pricing services. Indeed, the industry should look to the publication of corporate bond information in daily business newspapers, such as *The Wall Street Journal* and *Financial Times*, as an example of transactional transparency.

Regulators need to reevaluate the supervisory treatment of ABS and CDOs that are not liquid and do not trade on

active secondary markets to ensure the risks associated with these securities are adequately captured in the examination process and in capital regulation. High credit ratings should not be viewed as a substitute for adequate due diligence on the part of the bank or for adequate supervision by the examiner. Bank management must have a thorough understanding of the terms and structural features of the structured finance products that they hold for investment. For example, bank management should know the type of exposures that collateralize the product, the credit quality of the underlying exposures, the methods by which the product is priced, and the key assumptions affecting its value.

### Private Placements

Historically, private placements of corporate bonds arose as a way to reduce the cost of the securities registration process for companies with an established track record. The rationale for allowing private placements seems less compelling with securitizations. In contrast to corporate bonds, securitizations consist of various pooled securities, including MBS and CDOs, that often have no track record and that require an in-depth modeling and understanding of a highly segmented amount of assets that comprise the collateral pool. For this reason, a lack of complete and public dissemination of a securitization's loan-level data reduces transparency and hampers the investor's ability to fully assess risk and assign value.

The practice of private issuance creates difficulties in obtaining deal-specific information for many analysts, including regulators and academics. As an example, most if not all CDOs typically are issued in private offerings. These offerings are exempt from registration and significant disclosure requirements of the Securities Act of 1933.

Because underwriters of structured finance products typically do not provide significant disclosure under Rule 144A



issuances, there is a danger that negative information may be muffled to obtain the best market pricing for the structure. This has the direct effect of improving the profitability of the security underwriter and improving the marketability to both sides of the transaction: the loan originators and security investors. As long as these securities perform, investors are not likely to question their transparency.

The SEC adopted new and amended rules and forms to address the registration, disclosure, and reporting requirements for ABS, referred to as Reg AB. Some consideration should be given to extending the disclosure requirements under Reg AB to all Rule 144A and private placement securities.

Banking regulators should consider other approaches in concert with the review of securities registration and disclosure enhancements. For instance, banking regulators should consider whether the capital treatment of structured finance products could be conditioned on the granularity and the quality of information provided in prospectuses and offering circulars, even if the bank is considered to be a qualified institutional buyer.

### Vendor Product Shortcomings

Securitization documentation, such as offering circulars, indentures, and trustee reports, are available only to dealers and certain qualified investors.<sup>9</sup> For this reason, some vendors collect, package, and sell this information. However, the price and complexity of vendor models and limitations to the informational disclosure do not eliminate the high hurdle to investors, analysts and academics—and regulators—wishing to analyze this sector.

A more comprehensive definition of interested parties should be considered. Regulators are responsible for ensuring the safety and soundness of financial institutions—and the banking system generally. Therefore, regulators must be able to quickly collect information that cuts across an entire industry or segment, rather than just an individual bank. To provide regulators with the tools needed to evaluate the capital markets as a whole, any restrictions that limit a regulator's ability to ascertain necessary market information should be reevaluated. The SEC could—and should—modify its definition of a qualified institutional buyer through rulemaking to include regulators.

### Rating Agency Disclosure of Securitization Information Lacking

Nationally Recognized Statistical Rating Organizations (NRSROs) rate securitization tranches to publish an opinion about the creditworthiness of these instruments. Such ratings have been criticized for being one dimensional in a multi-dimensional securitization world of risk. In the case of CDOs, agencies rate the notes but may not provide complementary information.

Table 1 (see p.8) provides a listing of a representative sample of CDOs reviewed by the FDIC in the course of its risk assessment activities relative to insured institutions. The table shows that of 24 CDOs reviewed, slightly more than half had a presale report that was made publicly available by an NRSRO. Further, for the same 24 CDOs, only 3 had robust performance data published by an NRSRO.

The SEC should review the quality and granularity of information provided on the rating agencies' public Web sites.

<sup>9</sup>Vendors of CDO and hedge fund data sometimes require that customers meet certain investment standards before gaining access to information. These rules in essence intend to keep smaller undiversified investors from accessing more sophisticated investments. However, the FDIC's not meeting certain standard investor definitions may hamper its regulatory research efforts. Such definitions may be identified under some documents, such as the Securities Act of 1933 or the Investment Company Act of 1940, and may include the terms Accredited Investor, Accredited Institutional Investor, Qualified Purchaser, and Qualified Institutional Investor or Buyer. Links to some working definitions include <http://www.sec.gov/answers/accred.htm> and <http://www.sec.gov/rules/proposed/33-8041.htm>.

**Table 1: NRSRO Disclosure about CDOs is Limited**

	Type	CUSIP	Description	S&P	Fitch	Moody's
1	MBS CDO	XXXXXXXXXX	XXXXXXXXXXXXXX	No report	No rating	No report
2	MBS CDO	XXXXXXXXXX	XXXXXXXXXXXXXX	No report	No rating	No report
3	MBS CDO	XXXXXXXXXX	XXXXXXXXXXXXXX	No report	No rating	No report
4	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	No report	No rating	No report
5	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	No report	No rating	No report
6	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	No report	No rating	No report
7	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Not exact match	No rating	No report
8	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Not exact match	Not exact match	No report
9	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Not exact match	Not exact match	No report
10	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	No rating	Yes	No report
11	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	No rating	Yes	No report
12	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Not exact match	Yes	No report
13	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	No rating	No report
14	CDO Fixed (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	No rating	No report
15	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	Not exact match	No report
16	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	No report	No rating
17	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	Yes	No report
18	MBS CDO	XXXXXXXXXX	XXXXXXXXXXXXXX	No rating	Yes	No report
19	MBS CDO	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	Yes & performance	Yes & performance
20	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	No rating	Yes
21	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	No rating	Yes & performance	No rating
22	MBS CDO	XXXXXXXXXX	XXXXXXXXXXXXXX	No rating	Yes & performance	No rating
23	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	No rating	No rating
24	CDO Floating (AFS)	XXXXXXXXXX	XXXXXXXXXXXXXX	Yes	No rating	No rating

**NOTES:**

Yes = Agency rates the security and provides a pre-sale report.

Yes & performance = Agency rates the security and in addition to providing a pre-sale report, provides robust performance statistics after the rating was published.

No report = Agency rates that security but has provided a pre-sale report.

Not exact match = Agency rates that security but has not provided a pre-sale report; however, it provided a generic report that covers all CDOs in this series type.

No rating = This agency does not rate this security.

Rating agencies should be strongly encouraged to provide information on all aspects of a rated transaction, including loan-level information on the underlying collateral. Surveillance reports should be issued regularly and should note any material changes to the composition of the securitization vehicle.

Regulators also will need access to more granular information as part of the Basel II implementation process. Under the Internal Assessment Approach and the Supervisory Formula, regulators will need to have loan- and portfolio-level information to evaluate the appropriateness of the capital requirements. The regulators should begin a dialogue with the rating agencies to determine if enhancements to the transparency of the ratings process could also provide value to Basel II implementation efforts.

### Rating Agency Impact on Transparency

In many respects, NRSROs have contributed to transparency concerns. For example, NRSROs have been criti-

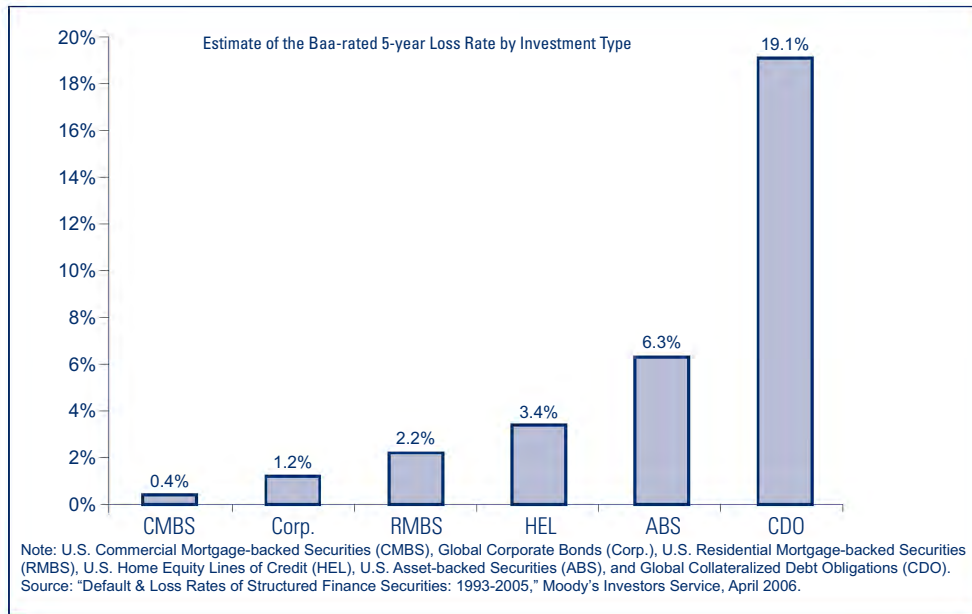
cized for assigning inconsistent ratings across different business sectors. At the extreme, during a recent event related to credit rating agency performance, a panel speaker suggested that for a given rating, CDOs were 250 times more risky when compared to municipal securities.<sup>10</sup> Even before problems with subprime mortgages emerged in late 2006, according to a Moody's presentation, all structured finance securities were likely to be downgraded on average by 3 notches, twice as severe as the 1.5 average downgrade for corporate securities.

In addition, ratings assigned to structured finance products generally have a much worse credit track record than corporate bond ratings. For instance, as shown in Chart 1 on page 9, the estimated 5-year loss rate for a Baa-rated (BBB-rated on the S&P scale) CDO is about 16 times the estimated loss rate for a Baa-rated corporate bond. Thus, two exposure types with identical ratings can have drastically different loss expectations.

Nonetheless, credit ratings do provide useful information to investors, as do

<sup>10</sup> "Is the Rating Agency System Broken or Fine?" Presentation given by the American Enterprise Institute for Public Policy Research, November 15, 2007, <https://www.aei.org/events/is-the-rating-agency-system-broken-or-fine/>.

Chart 1: Most Investment Grade Securitizations Performed Poorly Compared to Corporates



reports and other information provided by NRSROs. This information is especially useful in judging the loss expectation of one instrument relative to another within a specific product type. However, as discussed earlier in this article, it is especially important for investors to understand the limitations of credit ratings and to use them accordingly, as one component in the due diligence process along with an independent analysis of the risks associated with the pool of assets used as collateral.

### Rating Agencies' Attempt at Improving Transparency and Disclosure

The rating agencies have recognized that the lack of transparency in the structured finance market has contributed to current problems and have begun to reevaluate the ratings process. For example, on September 25, 2007, Moody's proposed a series of enhancements to the Non-Prime RMBS Securitizations<sup>11</sup> that they believe, if adopted, would improve the transparency and oversight on loans

sold into a securitization vehicle. Generally, the Moody's proposal is intended to address the need for third-party loan reviews, improve representations and warranties, and enhance reporting for increased transparency.

The enhancements proposed by Moody's would help increase transparency. However, transparency cannot be increased industry wide unless the SEC, as the regulator of NRSROs, endorses proposals such as this as a best practice and factors the standards into its supervisory oversight function. Ideally, all rating agencies would follow and provide more granularity on the underlying exposures in their publicly available presale and surveillance reports so that investors, regulators, and other interested parties can better assess the risks relating to these securities.

### President's Working Group's Objective to Improve Transparency

In March 2008, the President's Working Group on Financial Markets (PWG)

<sup>11</sup> Nicolas Weill, "Moody's Proposed Enhancements to Non-Prime RMBS Securitization," Special Report, Moody's Investors Service, September 25, 2007.

issued a report that included several recommendations designed to address weaknesses in the financial markets—weaknesses which the PWG believe to be significant contributing factors to the recent market turmoil.<sup>12</sup> In this report, the PWG notes the need to improve transparency and disclosure and develop better risk awareness and management to “mitigate systemic risk, help restore investor confidence, and facilitate economic growth.”<sup>13</sup>

This call for greater transparency includes a challenge to credit rating agencies to increase the transparency of the ratings and foster the appropriate use of ratings in the risk assessment process.<sup>14</sup> Similarly, the accounting profession is challenged to increase the transparency of U.S. accounting standards as they relate to consolidation and securitization.

## Investors Play a Key Role in Demanding Improved Transparency

Investors need to look beyond the ratings and develop a better awareness of the risks to which they are exposed. They should demand exposure-level information on the performance and composition of underlying assets as well as on the structural features that can quickly alter the terms of the deal. For example, much concern has been raised about SIVs and the possibility that adverse events (“triggers”) could result in the unwinding of several of these large funds and the dumping of tens of billions of securities onto an already uncertain market. Yet, few people possess sufficient information on how the triggers work, how close they are to being breached, or what action a sponsor would take, depending on the type

and severity of the breached trigger. Uncertainty could result in confusion and panic; improved disclosures would mitigate this confusion.

Efforts should be made to require financial firms to provide sufficiently detailed information about triggers and other events that could result in an unwinding of the securitization transaction or other changes to the underlying economic benefits. Any such changes to disclosure requirements would need to be addressed by the SEC through its regulatory rule-making process; however, regulators and rating agencies could provide beneficial support by encouraging firms to voluntarily make such disclosures.

Further, investors should also take into consideration the amount of financial support that is expected to be provided by the financial firm that sponsors a structured finance transaction, regardless of whether it is contractually obligated to provide liquidity or credit enhancements. The risk exposure to financial firms that results from this activity may not be fully appreciated by investors in those firms, or by investors who rely on the ability of those firms to provide the contractual support. Greater transparency in the financial reporting of all firms engaged in structured finance could serve to enhance transparency of the full spectrum of risks that are associated with the structured finance market.

## Supervisory Considerations Regarding the Use of Investment Ratings

Two significant factors in the recent market turmoil have been the overreliance on credit ratings and a misunderstanding of what those ratings mean. Longstanding supervisory guidance speci-

<sup>12</sup> The President’s Working Group on Financial Markets, “Policy Statement on Financial Market Developments,” March 2008.

<sup>13</sup> Henry M. Paulson, Jr., “Memorandum for the President, Regarding President’s Working Group on Financial Markets Policy Statement,” March 13, 2008.

<sup>14</sup> The President’s Working Group on Financial Markets, p. 17.

fies that while banks can consider credit ratings as a factor in the risk management process, ratings should not be the sole factor considered when evaluating the risks of investing in securities.

The FDIC's Risk Management Manual of Examination Policies includes a subchapter titled *Securities and Derivatives* which references the banking agencies' 1998 Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities<sup>15</sup> and the Interagency Policy on Classification of Assets and Appraisal of Securities.<sup>16</sup> FDIC-supervised banks should be familiar with the Manual of Examination Policies and each of these policies, as they remain in force.

Credit ratings should not be used as a substitute for pre-purchase due diligence or as a proxy for ongoing risk monitoring for banks with positions in complex securities. Banks should understand that the loss expectations associated with the rating scales used by credit rating agencies for various types of debt (corporate bonds, structured finance investments, and municipal debt) can differ. For example, the expected loss for a given rating may vary across products as does the volatility of ratings (as reflected by transition matrices) assigned.

Credit ratings do not capture all of the risks which should be considered during the risk management process, such as loss given default, the potential for downgrade (also known as ratings volatility risk), market liquidity, and price discovery. In many types of structured finance securities, these "other" risks can be material and can be the source of a significant degree of losses. The analysis of complex securities, such as CDOs, is particularly difficult, and potential buyers should be aware that the rating agencies and others may underestimate

difficult-to-measure risk factors, such as correlation.

Banks should conduct pre-acquisition and periodic analysis of the price sensitivity of securities. Risk factors include, but are not limited to, changing interest rates, credit risk deterioration, and reduced liquidity and marketability. Banks should anticipate difficulty when attempting to price illiquid and complex securities, and should limit concentrations of such holdings.

The 1998 Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities provides guidance and sound principles to bankers for managing investment securities and derivatives risks. It makes clear the primary importance of board oversight and management supervision, and focuses on risk management, controls, and reporting. Management should approve, enforce, and review policy and procedure guidelines that are commensurate with the risks and complexity of bank investment activities

The interagency Policy Statement emphasizes management's need to understand the risks and cash-flow characteristics of its investments, particularly for products that have unusual, leveraged, or highly variable cash flows. The Policy Statement also states that banks must identify and measure risks, prior to acquisition and periodically after the purchase of securities, and that management should conduct its own in-house pre-acquisition analyses, or to the extent possible, make use of specific third-party analyses that are independent of the seller or counterparty.

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<sup>15</sup> Federal Financial Institutions Examination Council (FFIEC), "Policy Statement on Investment Securities and End-User Derivatives Activities," 63 FR 20191, April 23, 1998.

<sup>16</sup> Federal Deposit Insurance Corporation, FIL 70-2004, *Interagency Policy on Classification of Assets and Appraisal of Securities*, June 15, 2004, at <https://www.fdic.gov/news/financial-institution-letters/2004/fil7004.html>.



## Appendix A

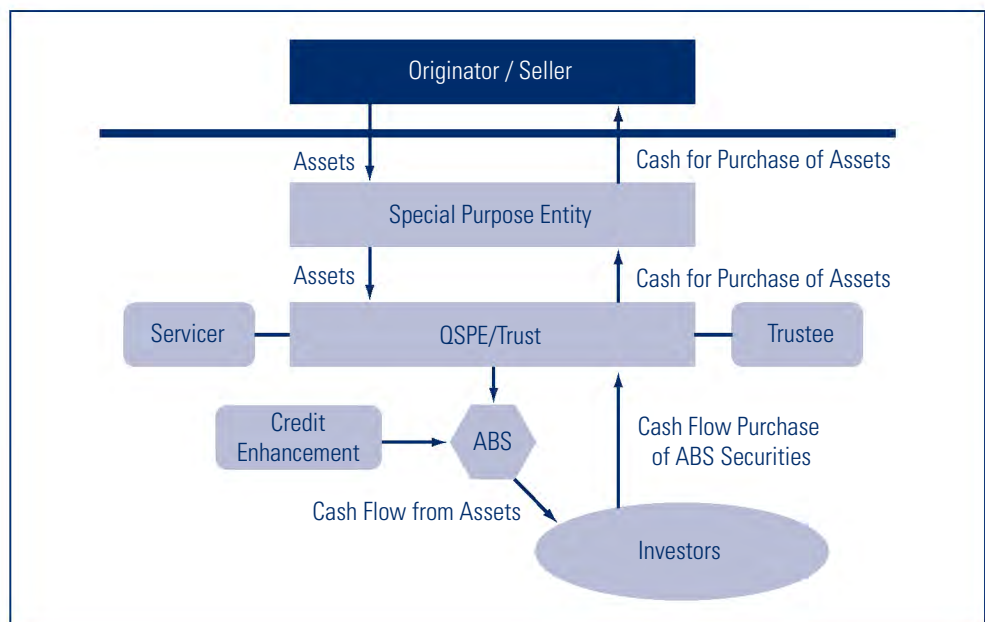
### Overview of the Securitization Process

In general, a securitization is the issuance of a financial instrument backed by the performance of identified assets where the investor has no recourse to the originator or seller of the asset. The typical securitization structure uses a two-step process that involves an originator/seller establishing a bankruptcy-remote special purpose entity (SPE). The originator then sells the assets that will serve as collateral for the asset-backed securities (ABS) to this SPE in order to attain true-sale accounting treatment and remove the assets from its balance sheet. To meet the provisions of FAS 140<sup>1</sup> the assets are often transferred to a second entity, a Qualified SPE (QSPE) or trust, that then issues the securities. Chart 1 illustrates this process for a simplified, generic securitization transaction.

This two-step process is followed to legally separate the collateral from the general assets and obligations of the originator. This separation ensures that the assets serving as securitization collateral cannot be consolidated with the general assets of the originator in the event of bankruptcy. The bankruptcy remoteness of the assets allows the securitization structure to achieve a higher credit rating than that of the originator. The issuer is able to achieve its desired credit rating by incorporating varying levels and forms of credit enhancement.

For *issuers*, the securitization process removes assets from the balance sheet, freeing equity capital that would otherwise be required to support those assets. Issuers of securitizations are also able to manage credit risk and other risk exposures, such as interest rate risk, by removing from the balance sheet assets that represent unwanted risk and dispersing the risk to securitization

Chart 1: A Simplified Overview of the Securitization Process



<sup>1</sup> FAS 140 provides that the assets and liabilities of a Qualifying Special Purpose Entity (QSPE) do not get consolidated into the financial statements of the transferor. For more information, see Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 140, September 2000.

investors within the financial market. The securitization process also provides issuers access to a new funding source and a vehicle with which to enhance income and return on assets. This is accomplished through the combination of receiving income from the sale of the assets and the simultaneous reduction in asset size.

The securitization process provides *investors* with several benefits over the origination, or purchase, of the assets individually. One fundamental benefit is the redistribution of risk. The tranching process, which is made possible through the pooling of assets, allows the various risks and characteristics inherent in the individual assets to be segregated, manipulated, and tailored. At least in theory, investors are able to select the specific risk-and-reward profile that best matches their objectives, including maturity, interest rate risk, prepayment risk, extension risk, and yield. Securitizations also offer

diversification, as the underlying assets include a number of different obligors that are geographically dispersed and often originated by a number of different entities. When they are secured by appropriately underwritten credit exposures, securitizations can provide a high quality investment.

### Selected Definitions

#### **Collateralized Debt Obligation (CDO).**

A CDO is a financial security that has collateral that consists of one or more types of debt, including corporate bonds, corporate loans, and tranches of securitizations.

#### **Structured Investment Vehicle (SIV).**

An SIV is a special purpose entity (including a business trust or a corporation) with assets that consist primarily of highly rated securities. The assets are financed through the proceeds of commercial paper and medium-term note issuances.

# Hybrid ARMs: Addressing the Risks, Managing the Fallout

Recent turmoil in U.S. residential mortgage markets has shattered the long-held belief that home mortgage lending is inherently a low-risk activity. During the early part of this decade, a confluence of events contributed to the highest level of homeownership in our nation's history.<sup>1</sup> Low interest rates, a strong domestic economy, rapid rates of home price appreciation, and greater access to the capital markets created almost ideal conditions for the residential mortgage market to expand. This environment generated tremendous demand for, and supply of, home loans, prompting lenders to relax underwriting standards and offer adjustable-rate mortgages (ARMs) with risk-layering features to a broader spectrum of borrowers.

Many mortgage originators inundated consumers with misleading advertisements that touted low "fixed" interest rates or payment amounts. The combination of potentially deceptive marketing claims and extremely favorable lending conditions fueled unprecedented growth in subprime mortgages, especially hybrid ARMs that enabled many borrowers who did not otherwise qualify for a mortgage to obtain a loan.<sup>2</sup> However, these products were fundamentally flawed as long-term financing vehicles. In many instances, failure to assess borrowers' repayment ability according to the actual loan terms forced many homeowners to refinance, as they could not afford the payment after the rates reset. This departure from prudent underwriting standards has contributed to an increasing number of foreclosures and rising credit losses, and is generally believed to have contributed to a house price bubble that is now deflating.

The ramifications of the lending and marketing practices described in this

article have been profound, and extend far beyond the practice of bank supervision. Most of the policy responses that have been proposed or are being considered remain under active debate and are beyond the scope of this article. In addition to the supervisory guidance that is the focus of this article, a partial list of other initiatives includes proposed legislation to strengthen protections to mortgage borrowers, proposed changes to Federal Reserve Regulation Z,<sup>3</sup> public and private sector initiatives to encourage loan modifications, and initiatives by rating agencies and other proposals to strengthen due diligence and enhance transparency in the rating of securities.

There also have been proposals for governmental intervention to stabilize the current situation in the mortgage market. These include Federal Deposit Insurance Corporation (FDIC) Chairman Sheila C. Bair's recent proposal for Home Ownership Preservation loans to pay down a portion of unaffordable loans to prevent unnecessary foreclosures, while avoiding any taxpayer losses or new bureaucracies. The scope and fundamental nature of many of these proposals underscore the gravity of the problems that widespread deficiencies in lending practices can bring, and the importance of supervisory guidance in keeping such practices in check.

This article describes misleading marketing practices and underwriting weaknesses that heightened the risks that hybrid ARM products pose to borrowers and lenders.<sup>4</sup> It also discusses the principles, policies, and practices that protect consumers and underpin an effective risk management and monitoring system. The article concludes with an overview of the

<sup>1</sup> United States Department of Commerce, *Census Bureau Reports on Residential Vacancies and Homeownership*, April 27, 2007, p. 4.

<sup>2</sup> According to *Inside Mortgage Finance* (2007), subprime mortgages increased from 6 percent of total originations in 2002 to 20 percent in 2006.

<sup>3</sup> Section 129(h) of TILA, 15 U.S.C. 1639(h); 12 C.F.R. § 226.34(a)(4).

<sup>4</sup> Hybrid ARMs do not have a fixed or variable interest rate for the entire term of the loan. Instead, they start with a fixed rate for an introductory period, often two to three years, then reset to a variable rate.

considerable financial damage attributable to the subprime mortgage crisis, and a brief summary of interagency guidance and encouragement for financial institutions to work constructively with borrowers to modify loans or otherwise mitigate losses, and preserve home ownership.

## Risks to Borrowers

Between 2004 and 2007, significant volumes of hybrid ARMs were originated to borrowers who did not have the ability to repay the loans according to their terms. In many cases, the viability of these loans was contingent on the borrower refinancing (typically with a substantial prepayment penalty) or selling the property. The wave of foreclosures that ensued raised credit risk issues for lenders, but also raised concerns about the appropriateness of these loans for some borrowers.

The experience with hybrid ARMs illustrates the close nexus that can exist between safe-and-sound lending and lending that complies with applicable laws, regulations, and supervisory guidance. Specifically, lending that results in significant credit losses also generates significant compliance issues, reputation risk, and litigation.

It is important to emphasize that the bank regulatory agencies' (agencies) concerns in this respect are not with lending to subprime borrowers per se. The *Statement on Subprime Mortgage Lending* and the *Interagency Guidance on Nontraditional Mortgage Product Risks* (interagency guidance) explicitly recognize that subprime mortgage lending is not synonymous with predatory lending.

The term subprime is often misused to refer to certain "predatory" or "abusive" lending practices. The agencies have previously expressed their support for lending practices designed to responsibly service customers and enhance credit access to borrowers with special credit needs. Subprime lending that is appropri-

ately underwritten, priced, and administered can serve these goals. However, the agencies also recognize that some forms of subprime lending may be abusive or predatory. Such lending practices appear to have been designed to transfer wealth from the borrower to the lender/loan originator without a commensurate exchange of value. This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may threaten the borrower with foreclosure/repossession to elicit payment.

Accordingly, the interagency guidance warns institutions against engaging in the types of predatory lending practices discussed in *Expanded Guidance for Subprime Lending Programs*. Predatory lending involves at least one of the following elements:

- Making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms;
- Inducing a borrower to repeatedly refinance a loan to charge high points and fees each time the loan is refinanced ("loan flipping"); or
- Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

The interagency guidance states that a fundamental consumer protection principle relative to the underwriting and marketing of mortgage loans is to approve loans based on the borrower's ability to repay the loans according to its terms. As discussed in more detail in the next section, many subprime hybrid ARMs were not underwritten in accor-

# Hybrid ARMs

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dance with this fundamental principle. The interagency guidance also states that another fundamental consumer protection principle is to provide information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

Consumers need clear, balanced, and timely information on mortgage loan terms to make informed decisions at crucial points in the product selection and loan application process. Unfortunately, adequate disclosures about the material terms, costs, and risks of hybrid ARM loans have not always been provided. For example, many advertisements described hybrid ARMs as having a “fixed” interest rate or payment amount. The term “fixed” typically describes an interest rate or payment amount that will remain unchanged for the term of the loan. However, using this term to describe adjustable-rate products, which have “fixed” rates or payment amounts for only a few years, is misleading.

In September 2007, the Federal Trade Commission (FTC) determined that “many mortgage advertisers are making potentially deceptive claims about incredibly low rates and payments.”<sup>5</sup> The FTC warned mortgage brokers and lenders that some advertising claims appearing in Web sites, newspapers, magazines, direct mail, and unsolicited e-mails and faxes may violate federal law. The agency determined that many marketing materials failed to indicate clearly that the stated rate and low advertised payments were in effect for a short time and concluded that “some ads promoted only incredibly low monthly payments, but failed to disclose adequately the terms of repayment, including payment increases (payment shock) and a final balloon payment.”<sup>6</sup>

To help ensure that consumers understand that their interest rate or payment amount may change, communications—

including advertisements and mortgage product descriptions—should provide clear and balanced information about the terms of hybrid ARM products with any of these features:

- *Payment shock*: disclosing when the introductory fixed interest rate expires, how the monthly payment amount will be calculated, and the dollar amount of potential payment increases.
- *Balloon payment*: specifying when it will be due and how much will be owed.
- *Responsibility for taxes and insurance*: explaining whether these required housing-related expenses will be escrowed and, if not, that the consumer is responsible for their payment and that the amount due can be substantial.
- *Cost for a reduced documentation or “stated income” loan*: informing borrowers if they will be charged a pricing premium for a reduced documentation or stated income loan program.
- *Prepayment penalties (PPPs)*: indicating the existence of these penalties, how they will be calculated, and when they will be imposed. In general, PPPs should expire 60 days before the reset date and should not exceed the initial reset period.

Mortgage originators should provide information about these features *during the product selection process*—not only when an application is submitted or a loan is consummated. The FDIC is monitoring institutions’ efforts to ensure that consumers are receiving adequate disclosures in an appropriate timeframe through the supervisory review process. Many of the aforementioned misleading and potentially deceptive loan marketing practices served to mask some of the

<sup>5</sup> “FTC Warns Mortgage Advertisers and Media That Ads May be Deceptive,” press release, September 11, 2007.

<sup>6</sup> Payment shock refers to a significant increase in the amount of the monthly payment that generally occurs when hybrid ARMs reset to a fully indexed, fully amortizing repayment basis.



lax underwriting features in these hybrid ARM products.

## Underwriting Weaknesses

The mortgage loan industry has offered hybrid ARM products to meet the financing needs of certain prime borrowers for some time. However, the extremely strong demand for subprime mortgages from late 2004 through the first half of 2007 heightened competition among originators to generate greater volume. In retrospect, this emphasis on quantity over quality clearly reflects that neither investors nor originators were sufficiently concerned with due diligence or the ramifications of risk-layering practices in an adverse economic environment. These practices included the following:

- Offering hybrid ARM loans to individuals who may have had *limited repayment capacity* or little experience with credit as a means of expanding the pool of potential loan candidates.
- Relaxing *ability to repay* standards to qualify borrowers based on the low introductory payment (rather than the fully indexed, fully amortizing payment required once the loan reset) and without consideration of other housing-related expenses, such as real estate taxes and insurance.
- Creating *payment shock* when the low introductory payments increased substantially after the reset, forcing many subprime borrowers to refinance their loans, as they could not afford the new higher payment amount.
- Allowing *interest-only* or *payment-option* terms that heightened payment shock by deferring the repayment of principal.

- Using *simultaneous second-lien loans*, or *piggyback loans*, that permitted borrowers to make a minimal or no down payment, resulting in their having little, if any, equity in their home.
- Permitting *reduced documentation* or *No Doc* loans, causing lenders to rely on unverified income information to analyze a borrower's repayment capacity.<sup>7</sup> Lenders offering these No Doc loans often charged borrowers a higher rate of interest for this service. Borrowers could have avoided this fee by providing copies of pay stubs, tax returns, bank statements, or other similar, readily available documentation.
- Imposing *prepayment penalties* that kept borrowers from refinancing their loans at a reasonable cost.

These weak underwriting practices enabled more borrowers to obtain loans that they could not afford to repay. The increased volume of hybrid ARMs contributed to record levels of net income at financial institutions, which were attributable, at least in part, to high levels of fee income from originating high-risk assets sold into the secondary market.<sup>8</sup> However, these short-term profits are quickly dissipating. As of March 14, 2008, financial institutions have written off more than \$195 billion in losses stemming from subprime loans, and most observers expect further losses as the subprime mortgage crisis works its way through the financial markets.<sup>9</sup>

## Risk Management Practices for Hybrid ARMs

The interagency guidance specifies that an institution's analysis of a borrower's

<sup>7</sup> Mortgage Asset Research Institute, *Eighth Periodic Mortgage Fraud Case Report to the Mortgage Bankers Association*, April 2006, reported that one lender that reviewed a sample of 100 No Doc loans (for which it subsequently verified the borrowers' income) found that almost 60 percent of the stated amounts were exaggerated by more than half.

<sup>8</sup> "Insured Banks and Thrifts Report Record Earnings in 2006," press release, February 22, 2007; and *Quarterly Banking Profile*, "All Institutions Performance Fourth Quarter 2006."

<sup>9</sup> Bloomberg, "Subprime Losses Reach \$195 Billion," March 14, 2008.

# Hybrid ARMs

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repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the decision and the borrower's repayment capacity. Typical situations where mitigating factors might exist could include a borrower with a strong performance history, whose financial condition has not deteriorated, and who is seeking to refinance with a similar loan, or a borrower with substantial liquid reserves or assets that support the prospect of repaying.<sup>10</sup> However, a higher interest rate is *not* considered an acceptable mitigating factor. Reliance on any mitigating factors should be documented, and policies should govern the use of reduced documentation, which generally should not be accepted for subprime borrowers.

Institutions that engage in hybrid ARM lending activities need robust risk management practices and written policies that establish acceptable underwriting standards, including protocols governing risk-layering features. The written policies should establish the internal parameters that will be used for categorizing loans as subprime, if such parameters differ from those specified in regulatory guidance. For example, many institutions classify borrowers as subprime based on a Fair Isaac Company (FICO) credit score of 620 or less; however, regulatory guidance describes a FICO credit score of 660 or less as a characteristic of a subprime borrower.<sup>11</sup>

In addition, the interagency guidance states that hybrid ARM lending activi-

ties warrant an enhanced management information system (MIS) that proactively identifies and alerts the user of increasing risk given changing market conditions. The MIS should generate reports that segment the hybrid ARM portfolio by key characteristics, such as loans with high debt-to-income ratios, high combined loan-to-value ratios, the potential for negative amortization, low credit scores, non-owner-occupied investors, or a combination of these or other risk-layering features.

The probability of default and potential for loss should be measured across portfolio categories. Risk assessments based solely on recent historical performance may not adequately measure the risk in the segmented pools, given the strong housing market conditions experienced a few years ago. To help ensure an accurate assessment of portfolio risk, analyses should be based on current performance trends and local economic conditions. Loan segments characterized by weak underwriting standards and unreasonable credit risk may warrant adverse classification regardless of the delinquency status.<sup>12</sup>

Risk exposure may not be limited to the loan portfolio. The securities portfolio may harbor investments supported by pools of subprime hybrid ARMs. Bond rating agencies recently have downgraded the ratings of many mortgage-backed securities. For example, a national bond rating agency downgraded or placed a negative CreditWatch on 6,389 classes of securities and 1,953 collateralized debt obligations backed by subprime residential mortgages during the course of a single day.<sup>13</sup> If a rating falls below investment grade, the security

<sup>10</sup> *Interagency Statement on Subprime Mortgage Lending*, July 10, 2007; and the *Interagency Guidance on Nontraditional Mortgage Product Risks*, October 4, 2006.

<sup>11</sup> *Statement on Subprime Mortgage Lending*, July 10, 2007; *Interagency Guidance on Nontraditional Mortgage Product Risks*, October 4, 2006; *Expanded Guidance for Subprime Lending Programs*, January 31, 2001; and the *Interagency Guidance on Subprime Lending*, March 1, 1999.

<sup>12</sup> *Uniform Retail Credit Classification and Account Management Policy*, June 12, 2000.

<sup>13</sup> Standard & Poor's, *Ratings Direct*, "Projected Losses for U.S. RMBS Transactions Affected by Jan. 30, 2008, Rating Actions," February 4, 2008.

should be classified according to existing regulatory policy.<sup>14</sup>

Hybrid ARM lending activities can negatively affect other performance criteria. Earnings may be significantly lower because of impairments in the investment portfolio, reduced fee income, compressed interest margins, or increased loan provisions. The interagency guidance specifies that institutions should maintain the allowance for loan and lease losses and capital levels that are commensurate with the risk characteristics of the portfolio.

Contingency planning, counterparty risk assessments, and back-up lines of credit are critical to ensure adequate funding is available if product demand weakens in the secondary market. Ultimately, the failure to recognize or properly manage any of the associated risks of assets backed by hybrid ARM loans could reflect negatively on management. Robust risk management protocols consistent with the size and complexity of the operation are critical to properly managing the risks in hybrid ARM lending activities. The FDIC is closely reviewing management's efforts to implement and adhere to prudent guidelines and procedures at institutions that engage in hybrid ARM lending activities.

## Measuring and Managing the Fallout from Deficiencies in Mortgage Lending Practices

In 2007, hundreds of billions of dollars in subprime hybrid ARM debt began to reset. Almost 1.3 million subprime

hybrid loans are scheduled to undergo their first reset during 2008, with an additional 422,000 subprime hybrid loans to reset in 2009.<sup>15</sup> As reflected in Chart 1, the subprime ARM delinquency rate had risen to 20.4 percent in 2007, which was more than double the rate from one year earlier. The rising delinquency rate and continued deterioration in home prices have caused a surge in foreclosures. As shown in Chart 2, the rate of subprime ARMs in foreclosure also almost doubled from the prior year. Although subprime ARMs accounted for only 7 percent of total outstanding residential mortgage loans as of December 31, 2007, these products represented 42 percent of foreclosure starts.<sup>16</sup>

One report estimates that a foreclosure costs a lender about \$50,000.<sup>17</sup> However, the cost extends beyond a lender's credit losses. Foreclosures inflict financial and less quantifiable costs on individual homeowners and their families and negatively affect neighborhoods and communities. A study of the external costs of foreclosure found that a single-family home foreclosure lowers the value of homes within one-eighth of a mile (or one city block) by an average 0.9 percent, and more so—as much as 1.4 percent—in a low- to moderate-income community.<sup>18</sup> A contagion effect also may develop. As more foreclosures occur in close proximity, the value of nearby properties drops, resulting in even more foreclosures in the same community.<sup>19</sup>

An increase in foreclosure activity could contribute to escalating credit losses. In July 2007, a Merrill Lynch study forecast

<sup>14</sup> Interagency *Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts*, June 15, 2004.

<sup>15</sup> Estimates are based on the Loan Performance Securities database. They reflect data collected through August 2007 on first-lien mortgages secured by owner-occupied properties where the mortgage has been securitized in private mortgage-backed securities issues. These figures have been adjusted to include an estimate of subprime securitized loans that are not included in the Loan Performance Securities database.

<sup>16</sup> Mortgage Bankers Association, *National Delinquency Survey*, Fourth Quarter 2007. The seriously delinquent rate includes loans that are 90 days or more delinquent or in the process of foreclosure.

<sup>17</sup> Special Report by the United States Congress Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, April 17, 2007, p. 16.

<sup>18</sup> Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate* 17, no.1 (2006).

<sup>19</sup> NeighborWorks America, *Effective Community-Based Strategies for Preventing Foreclosures*, September 2005.

# Hybrid ARMs

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Chart 1: Seriously Delinquent Subprime ARMs Soar to Record High

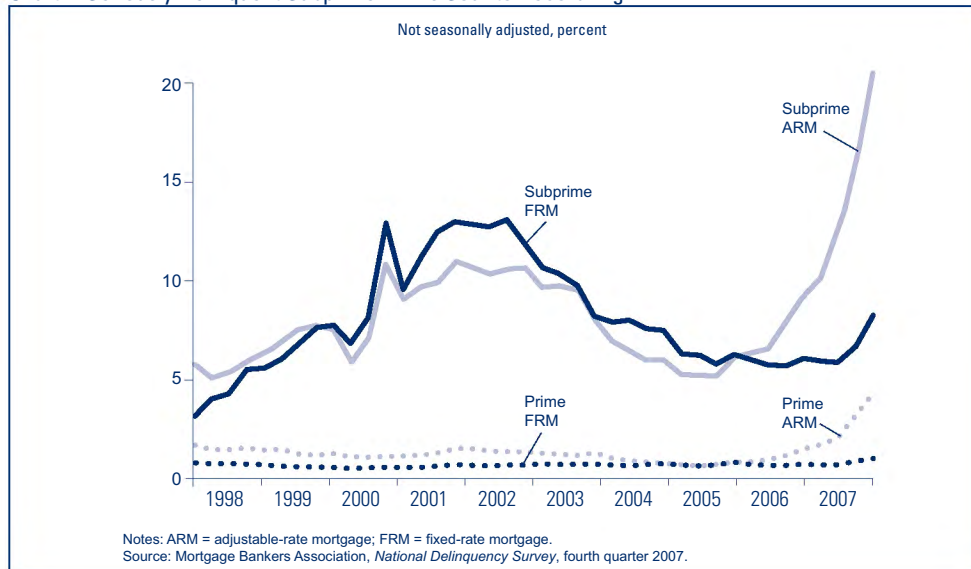
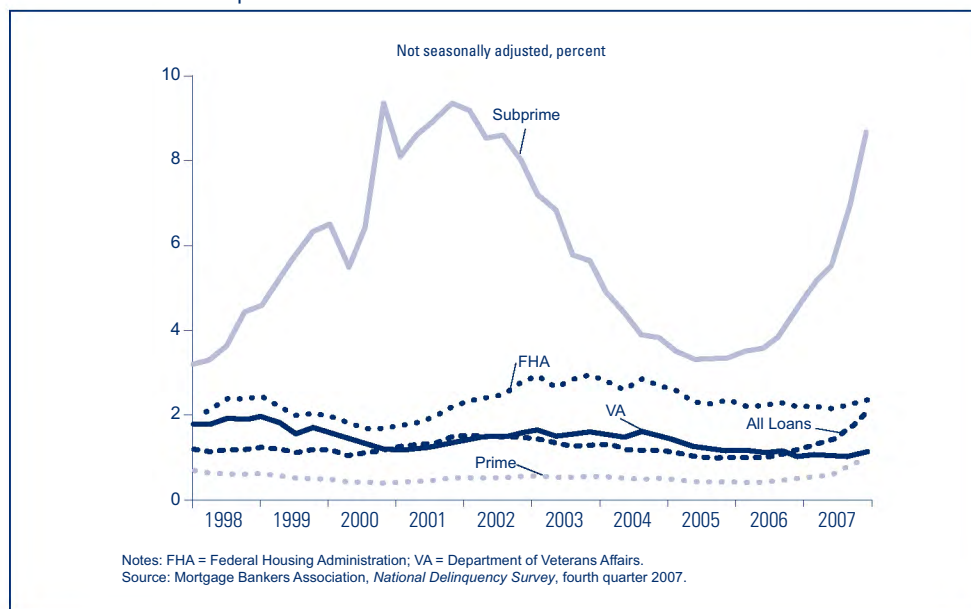


Chart 2: The Rate of Subprime ARMs in Foreclosure Almost Doubled from the Prior Year



subprime credit losses of \$146 billion and Alt-A credit losses of \$25 billion.<sup>20</sup> In December 2007, Merrill Lynch raised this projection to \$300 billion, with subprime credit losses aggregating about \$250 billion and Alt-A credit losses total-

ing about \$50 billion.<sup>21</sup> These figures approximate Standard & Poor's January 2008 estimate that hybrid ARMs will result in more than \$265 billion in losses for financial institutions.<sup>22</sup> Unfortunately, asset quality has continued to decline

<sup>20</sup> Merrill Lynch, "Economic Analysis: Credit Crunch Update: \$500 Billion in Total Losses," December 18, 2007, pp. 8–9. Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans because of the underwriting standards of the loans, not necessarily the credit quality of the borrowers.

<sup>21</sup> Merrill Lynch, "Industry Overview: Magnitude, Distribution, and Timing of Losses," July 20, 2007, p. 9.

<sup>22</sup> Reuters, "S&P Sees Mortgage-Related Bank Losses Topping \$265 Billion," January 30, 2008.

significantly. On May 14, 2008, FitchRatings issued a report that estimates total losses of \$400 billion to \$550 billion.<sup>23</sup> In comparison, aggregate losses sustained from the savings and loan crisis are estimated at \$199 billion.<sup>24</sup> These statistics bring into sharp focus the seriousness of the situation caused by weak underwriting and deceptive marketing practices.

The agencies and the Conference of State Bank Supervisors have encouraged federally regulated institutions and state-supervised entities that service mortgage loans to pursue loss mitigation strategies that preserve homeownership.<sup>25</sup> The agencies issued guidance that describes prudent risk management practices and loss-mitigation strategies that institutions and servicers should consider in workout arrangements, as well as in loan modifications for residential mortgage borrowers (see Interagency Guidance inset box).

The agencies support other loan modification programs. The American Securitization Forum and the Hope Now Alliance developed industry guidance titled *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*, which establishes a framework that the industry can use to modify certain securitized subprime mortgage loans.<sup>26</sup> This guidance strongly encourages institutions that retain subprime hybrid ARMs in their loan portfolio or service these loans to incorporate streamlined loan modification procedures as part of loss-mitigation strategies.

#### Interagency Guidance

- Statement on Working with Mortgage Borrowers
- Statement on Loss Mitigation Strategies for Residential Mortgage Servicers
- Servicing for Mortgage Loans: Supplemental Information for Loss Mitigation Strategies

Institutions generally should consider implementing streamlined loan modification procedures for mortgages that meet the Hope Now Alliance program eligibility criteria (see inset box on page 22).<sup>27</sup> The FDIC also urges institutions to consider developing streamlined loss-mitigation strategies for borrowers who do not qualify under the Hope Now Alliance program, but face payment shock when their hybrid ARMs reset.

Further, the agencies will not penalize institutions that pursue streamlined loan modifications or reasonable workout arrangements with borrowers who cannot afford their payments after their loans reset. Institutions that engage in a significant volume of hybrid ARM activity should adopt reporting mechanisms that detail the types and success rates of these strategies. Institutions are encouraged to discuss the correct reporting of loss-mitigation strategies with accounting consultants, as some loan modifications could result in a troubled debt restructuring.

<sup>23</sup> FitchRatings, Special Report, *Subprime Mortgage-Related Losses: A Moving Target*, May 14, 2008.

<sup>24</sup> Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review* 13, no. 2 (2000): 26–35. The report estimates losses from the savings and loan crisis at \$153 billion in 1995, which equals about \$199 billion in 2007 on an inflation-adjusted basis.

<sup>25</sup> The term "federally regulated institutions" refers to state- and nationally chartered banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

<sup>26</sup> The American Securitization Forum (ASF) is a broad-based professional forum through which participants in the U.S. securitization market can advocate their common interests on important legal, regulatory, and market practice issues. Hope Now is an alliance between counselors, mortgage market participants, and mortgage servicers to create a unified, coordinated plan to reach and help as many homeowners as possible.

<sup>27</sup> American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*, "Executive Summary," December 6, 2007.



## Conclusion

Approximately 1.5 million foreclosures occurred in 2007, an increase of 62 percent from a year earlier.<sup>28</sup> Current market conditions suggest this negative

trend will continue, as housing prices are unlikely to rebound in the near term. Much attention has focused on the negative impact that the payment shock in hybrid ARMs will have on subprime borrowers and the compounding effect of declining home prices. A second wave of credit distress could occur when other nontraditional mortgages, such as interest-only or payment-option loans, begin to reset or recast in 2009. Losses could increase as more borrowers have negative equity in their homes or are unable to make their payments.

In response to these developments, policymakers are considering a host of far-reaching responses that remain under active debate. Whatever may ultimately come of these proposals, it has become clear that sound and responsible lending practices play a critical role in supporting the long-term economic health and stability of our nation. Seen in this context, the role of supervisors in promoting prudent underwriting standards is vital to maintaining the public's confidence in the integrity of the residential mortgage market.

### American Securitization Forum/Hope Now Alliance Loan Modification Criteria

This streamlined framework applies to all first-lien subprime ARM loans on borrowers' primary residences with an initial fixed interest rate for a period of 36 months or less that:

- Were originated between January 1, 2005, and July 31, 2007;
- Are included in securitized pools of residential mortgage loans; and
- Have an initial interest rate reset between January 1, 2008, and July 31, 2010.

Borrowers with these types of loans then must meet the following eligibility criteria:

- The payment amount will increase by more than 10 percent when the loan resets.
- The loan must not be more than 30 days past due at the time the loan modification is being considered, and it must not have been more than 60 days past due more than once over the past 12 months.
- The amount of the first-lien loan must be greater than 97 percent of the home's market value.
- The borrower's current FICO (Fair Isaac Company) credit score is less than 660 and is less than 10 percent higher than the borrower's FICO credit score when the first-lien loan originated.

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<sup>28</sup> FDIC estimate based on the fourth quarter 2007 Mortgage Bankers Association *National Delinquency Survey*.

# A Primer on the Use of Interest Reserves

During much of this decade, the U.S. banking industry posted record earnings, attributable, at least in part, to strong growth in commercial real estate (CRE) lending. This expansion included a considerable increase in land acquisition, development, and construction (ADC) lending. This loan segment almost tripled, from \$231 billion to more than \$600 billion, and grew from 9 percent to 13 percent of total real estate loans from 2001 to 2007.<sup>1</sup> Delinquency rates for the ADC portfolio were historically low during much of this time. However, credit quality began to show signs of weakening in 2006 as the level of noncurrent ADC loans began to rise. By year-end 2007, noncurrent loans had reached 3.15 percent—the highest level in more than 10 years—and more than triple the rate for other commercial real estate loans.<sup>2</sup>

In response to concern about a downturn in the housing market and potential effects on construction and development lending, the FDIC issued a Financial Institution Letter (FIL), *Managing Commercial Real Estate Concentrations in a Challenging Environment*, on March 17, 2008, that reemphasized the importance of robust credit risk management practices. Among other things, this FIL noted examiner observations of underwriting weaknesses in ADC loan portfolios where lenders added extra interest reserves when the underlying real estate project was not performing as expected. This practice can mask loans that would otherwise be reported as delinquent and erode collateral protection, increasing a lender's exposure to credit losses.<sup>3</sup> Examiners have observed instances

where ADC loans with interest reserves make up a substantial proportion, or even a multiple, of bank capital.

This article focuses on the use of interest reserves in ADC lending, examines the risks this underwriting practice presents, and reviews regulatory guidance on the use of interest reserves. Finally, the article identifies “red flags” that should alert lenders to potential problems at each stage of the ADC cycle and reinforces the importance of evaluating the appropriateness of interest reserves when ADC projects become troubled.

## The Use of Interest Reserves

For most lenders, the decision to establish a loan-funded interest reserve upon origination of an ADC loan is appropriately based on the feasibility of the project, the creditworthiness of the borrower and guarantors, and the protection provided by the real estate and other collateral.

The interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. Frequently, ADC loan budgets will include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sell-out or lease-up period.

The calculation of the interest reserve depends on the size and complexity of the ADC loan. The amount of the interest reserve is generally calculated by multiplying the average outstanding

<sup>1</sup> Loan data obtained from Call Reports and Thrift Financial Reports submitted by FDIC-insured financial institutions.

<sup>2</sup> Noncurrent level for nonfarm, nonresidential loans was 0.81 percent, and the noncurrent level for multifamily residential real estate loans was 0.76 percent. Third Quarter 2007 *Quarterly Banking Profile*, Chart 7, “The Noncurrent Rate of Construction Loans Has Been Rising From Historic Lows,” and Fourth Quarter 2007 *Quarterly Banking Profile*, Table V-A, “Loan Performance, All FDIC Insured Institutions,” <https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/index.html>.

<sup>3</sup> FIL 22-2008, <http://www.fdic.gov/news/news/financial/2008/fil08022.html>.

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balance of the loan by the interest rate and the length of the expected development/construction period. In those instances when an ADC loan has an adjustable interest rate, the lender factors the potential for rate changes into the interest reserve calculation.

Some lenders require the borrower to pay interest as an out-of-pocket expense or may require the borrower to establish a borrower-funded interest reserve to ensure payment.<sup>4</sup> When applied appropriately, an interest reserve can benefit both the lender and the borrower. For the lender, an interest reserve provides an effective means for addressing the cash flow characteristics of a properly underwritten ADC loan. Similarly, for the borrower, interest reserves provide the funds to service the debt until the property is developed, and cash flow is generated from the sale or lease of the developed property.

## Risks in the Use of Interest Reserves

Although potentially beneficial to the lender and the borrower, the use of interest reserves carries certain risks. Of particular concern is the possibility that an interest reserve could mask problems with a borrower's willingness and ability to repay the debt consistent with the terms and conditions of the loan obligation. For example, a project that is not completed in a timely manner or falters once completed may appear to perform if the interest reserve keeps the troubled loan current. This is a much different scenario from most credit transactions in which cash flow problems are eventually reflected in late or past-due payments and sometimes even in nonpayment. A loan with a bank-funded interest reserve would not exhibit these warning signs.

With little potential for monetary default during the interest reserve period, some lenders may delay recognizing and evaluating the financial risks in a troubled ADC loan. In some cases, lenders may extend, renew, or restructure the term of certain ADC loans, providing additional interest reserves to keep the credit facility current. As a result, the true financial condition of the project may not be apparent and developing problems may not be addressed in a timely manner. Consequently, a bank may end up with a matured ADC loan where the interest reserve has been fully advanced, and the borrower's financial condition has deteriorated. In addition, the project may not be complete, its sale or lease-up may not be sufficient to ensure timely repayment of the debt, or the value of the collateral may have declined, exposing the lender to increasing credit losses.

Some lenders also have used interest reserves on loans where interest and possibly principal should be paid by the borrower, given the nature and purpose of the loan. For example, the use of interest reserves in the following situations may not be appropriate and, as such, could heighten the lender's vulnerability to credit losses:

- Loans on projects that have experienced development or construction delays, cost overruns, sales or leasing shortages, or are otherwise not performing according to the original loan agreement and have inadequate collateral support;
- Loans used to purchase real estate with no immediate or defined plans for development or construction;
- Conversion and rehabilitation loans or renewals with no immediate plans for construction, rehabilitation, or development; and

<sup>4</sup> Neil B. Wedewer, *Best Practices in Lending to Homebuilders*, *RMA Journal* 89 (November 2006): 38–45.

- Loans secured by income-producing rental properties (residential or commercial) that should be amortizing.

Overall, the use of interest reserves without prudent underwriting and loan portfolio risk management practices could heighten an insured financial institution's risk profile and exacerbate loan losses, especially during times of economic stress.

## Regulatory and Accounting Guidance

Beginning in 1985, the federal banking regulatory agencies issued guidance that addressed the use of interest reserves in the broader context of real estate lending standards and CRE concentrations.

- The Office of the Comptroller of the Currency (OCC) issued an Examining Circular in May 1985 describing OCC policies governing the accounting treatment for capitalization of interest on loans.<sup>5</sup> This circular states that even though regulatory and generally accepted accounting principles (GAAP) do not provide specific guidance as to when it is appropriate to recognize interest income from an interest reserve, in practice it should be based on sound lending policies, prudent credit judgment, and a thorough evaluation of the creditworthiness of the borrower.

- The *Interagency Guidelines for Real Estate Lending Policies*, issued in 1992, establish the core underwriting and risk management practices for all extensions of credit secured by real estate.<sup>6</sup> One provision addresses the need for an institution to establish standards for the acceptability of, and limits on, the use of interest reserves.

- The FDIC, the Office of Thrift Supervision (OTS), and the Federal Reserve Board (FRB) address the use of interest reserves as part of existing examiner guidance. Overall, this guidance reinforces the importance of providing clear standards on the use of interest reserves as part of a bank's loan policy, monitoring the adequacy of the remaining interest reserve as part of an ADC lending project, and assessing the appropriateness of the use of interest reserves during the entire term of the loan.<sup>7</sup>

Although the Financial Accounting Standards Board has not issued any standards focused specifically on the use of interest reserves from the lender's standpoint, longstanding accounting concepts that govern the recognition of income are applicable to interest reserves. Thus, in general, interest that has been added to the balance of a loan through the use of an interest reserve should not be recognized as income if its collectibility is not reasonably assured.<sup>8</sup> This accounting concept has been incorporated

<sup>5</sup> Comptroller of the Currency, *Guidelines for Capitalization of Interest on Loans*, Examining Circular (EC) 229, May 1, 1985, <http://www.occ.treas.gov/ftp/ec/ec-229.txt>.

<sup>6</sup> See *Interagency Guidelines for Real Estate Lending Policies*: 12 CFR 365 and appendix A (FDIC), <http://www.fdic.gov/regulations/laws/rules/2000-8700.html#2000appendixatopart365>; 12 CFR 34, subpart D and appendix A (OCC); 12 CFR 208, subpart E and appendix C (FRB); and 12 CFR 545 and 563 (OTS).

<sup>7</sup> FDIC Examination Modules, Construction, and Land Development Core Analysis Procedures, November 1997. Office of Thrift Supervision's *Examination Handbook*, Section 213, Asset Quality—Real Estate Lending Standards Rule, pp. 213.1–2, January 1994, <https://www.occ.gov/static/ots/exam-handbook/ots-exam-handbook-213.pdf>. Federal Reserve Bank's *Commercial Bank Examination Manual*, Section 2100.1, Real Estate Construction Loans—Interest Reserves, November 1995, <http://www.federalreserve.gov/boarddocs/SupManual/cbem/200705/0705cbem.pdf>.

<sup>8</sup> See Accounting Research Bulletin No. 43, Chapter 1A, paragraph 1; Accounting Principles Board Opinion No. 10, paragraph 12; and Statement of Financial Accounting Concepts No. 5, paragraph 84(g).

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into the criteria for placing an asset in nonaccrual status for purposes of the Consolidated Reports of Condition and Income (Call Report). The Call Report instructions present these criteria in the general rule in the Glossary entry for “Nonaccrual Status,” which provides in part that banks should not accrue interest on any asset for which payment in full of principal or interest is not expected.<sup>9</sup>

Overall, this accounting and reporting guidance represents a framework that ensures that regulatory reports accurately reflect the economic substance of a transaction, taking into consideration a key factor that bears on whether interest income is both realized (or realizable) and earned. For example, the accrual of uncollected interest and its capitalization into the loan balance (e.g., through the use of interest reserves) will not be appropriate when an ADC loan becomes troubled and the full collection of contractual principal and interest payments is no longer expected.

## Managing Potential Risks

In addition to existing regulatory and accounting guidance, a number of risk management practices are being recommended during examinations of FDIC-insured institutions with ADC portfolios. Recommended risk management practices include the following:

- Establish loan policies and procedures that detail the circumstances and types of loans where interest reserves may be used, with limits on time and amount of such reserves, including situations involving renewals, extensions, and refinancing;
- Maintain effective and ongoing controls for monitoring compliance

with loan covenants for the advancement of funds and determination of default conditions, such as receipt of zoning variances and entitlements, limits on construction starts, and delivery of qualified pre-sales;

- Periodically evaluate and monitor real estate market conditions by independently analyzing demand, supply, and price fluctuations for properties being developed;
- Periodically reexamine property appraisals and establish steps to ensure proper evaluation of collateral when material changes occur in the real estate market;
- Regularly obtain sufficient current financial statements on the borrowing entity and guarantors to perform a global cash-flow analysis and examine the potential pressures of other projects and financial commitments; and
- Maintain effective procedures for monitoring ADC projects to ensure that loan underwriting and oversight are appropriate in light of the project’s status, the borrower’s financial condition, and the collateral protection based on present market conditions.

In addition, banks should implement monitoring procedures to ensure that appropriate action is taken if and when “red flags” emerge. Each phase of an ADC loan carries with it particular vulnerabilities (as discussed below). The timely recognition of potential problems will help lenders ensure that the loan is appropriately administered and reported on its financial statements. Of particular importance is the lender’s assessment of whether the use of an interest reserve remains appropriate given emerging risks or weaknesses in the ADC credit.

<sup>9</sup> Instructions—Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council, Glossary, page A-59.



## Acquisition

When acquiring land, the borrower generally does not yet have approval to develop the property. During this period, a number of rezoning and permitting obstacles may arise that could significantly delay or never allow the proposed project to develop as intended.

## Development

After the property is acquired and necessary approvals are obtained, the land is developed for future construction of homes, commercial space, or other planned structures. During development, the lender must ensure that the borrower is using loan proceeds to convert the property into construction-ready building sites. Many factors can delay the scheduled start and completion of a real estate development project that could cause significant cost overruns and prevent the borrower's ability to procure permanent financing or inhibit ADC project sales or lease-up.

## Construction

Once the property is developed, the proposed structure(s) are built. Potential risks that emerge during the construction period could determine whether the project will be completed on schedule and at the projected cost.

Another critical red flag that can occur during any phase of an ADC loan is a change in economic or real estate market conditions. Adverse changes in the economy or real estate markets can lower the purchase price and alter the timing of sales or leases (i.e., absorption rate) of the land or properties under development. In extreme cases, a serious downturn in market conditions can halt an ADC project whose cost to develop significantly exceeds the realizable value. These changes can materially affect the value of collateral,



Red Flags in the **Land Acquisition** stage typically involve delay, neglect, or failure by the borrower to:

- Perform engineering, environmental, and feasibility studies;
- Prepare preliminary site and architectural plans;
- Submit a formal application and filing fee to the appropriate planning and zoning commissions (municipal, county, state, and federal);
- Comply with mandatory meetings between the petitioner and planning and zoning commissions, as well as public hearings; and
- Obtain zoning variances and building permits.



Red Flags in the **Development** stage typically involve the delay, suspension, or failure to perform property improvements involving:

- Subdividing, leveling, and grading;
- Building roads and right-of-way access;
- Laying of sewers, water pipes, and utility cables and connecting to municipal water and sewer systems;
- Acquiring zoning changes and securing state, local, and federal permits (environmental and construction); and
- Obtaining support from the various stakeholder groups or communities affected by the project.



Red Flags in the **Construction** phase may arise for a number of reasons, including:

- Borrower's failure to properly estimate costs for the entire project;
- Project management and ownership disagreements;
- Subcontractor failure;
- Diversion of construction or other project funds; and
- Vandalism and natural disasters (e.g., tornado).

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the borrower's cash flow, and his or her overall ability to repay the loan. As a result, lenders should diligently monitor economic and real estate market conditions and carefully assess the effect on an ADC loan to ensure that it is properly administered and reported on financial statements.

## Conclusion

In instances where lenders see red flags or an ADC project actually becomes troubled, the lender should carefully evaluate the factors underlying the borrowing relationship—including the status of the project, the financial condition of the borrower and any guarantors, and the collateral protection in light of present market conditions. Lenders should then take the necessary steps to manage the emerging risks, as well as properly report the distressed ADC loan on their regulatory reports, including for purposes of interest income recognition and the determination of an appropriate level for the allowance for loan and lease losses.

As part of an ongoing review of the ADC project, the lender should evaluate the appropriateness of the overall administration and regulatory reporting of the loan, including the accrual of uncollected interest through an interest reserve. The ongoing accrual of uncollected interest should be pursued only when the facts and circumstances underlying the ADC loan continue to reasonably support the contractual payment of principal and interest.

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# External Auditors' Reports: Communication of Internal Control Deficiencies

*This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to [SupervisoryJournal@fdic.gov](mailto:SupervisoryJournal@fdic.gov).*

Effective internal control is a foundation for the safe and sound operation of a depository institution. The importance of internal control is recognized in Section 39 of the Federal Deposit Insurance Act, the provisions of which the federal banking agencies have implemented through the issuance of Interagency Guidelines Establishing Standards for Safety and Soundness.<sup>1</sup> These standards direct each institution to develop and implement an internal control system appropriate to its size and the nature, scope, and risk of its activities.

Internal control is a process effected by an entity's board of directors, management, and other personnel. It is designed to provide reasonable assurance about the achievement of the institution's objectives with regard to the reliability of financial reporting, the effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The design and formality of an entity's internal control will vary depending on its size, the industry in which it operates, its culture, and management's philosophy.<sup>2</sup>

Examiners perform an overall assessment of an institution's system of internal control during each examination. In addition, although the federal banking agencies generally require only institutions with \$500 million or more in total assets to have an annual audit of their financial statements, the agencies have long encouraged all institutions to have an external audit.<sup>3</sup> In this regard, the Management component rating in the Uniform Financial Institutions Rating

System specifically includes as an evaluation factor the adequacy of audits and internal control. Recent changes in the requirements governing external auditors' communication of internal control deficiencies have made this information more readily accessible to examiners. As a result, an understanding of these changes will assist examiners in assessing the quality of an institution's internal control environment and the actions management is taking to remedy any identified deficiencies. This article discusses internal control communication as a part of the audit process, summarizes the development of internal control standards, provides examples of control deficiencies, explains how these deficiencies should be evaluated and communicated by the auditor, and looks ahead to potential changes to authoritative guidance. As a starting point, we describe how this internal-control related information is used in the examination process.

## The Role of Internal Control Information in the Examination Process

Subsequent sections of this report describe the evolution of, and recent changes to, professional standards governing an external auditor's communication of internal control matters. These recent changes, particularly those mandating that communications be in writing, should improve an examiner's ability to assess the quality of the internal control system at an institution that has undergone a financial statement audit or an internal control audit or attestation, either at the institution level or a consolidated parent company level. For such an institution, its total assets and whether it is a public company or a subsidiary of a

<sup>1</sup> Appendix A to Part 364 of the FDIC's regulations.

<sup>2</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraph 3.

<sup>3</sup> See the Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (FIL-96-99, October 25, 1999, <http://www.fdic.gov/news/news/financial/1999/fil9996.html>).

public company (and, if so, whether the public company is an accelerated or non-accelerated filer) will dictate the types of written communication about internal control the external auditor should have provided to management and the audit committee. An examiner's consideration of an institution's internal control begins during pre-examination planning. Ideally, the examiner should obtain these written communications as part of this process. The examiner's evaluation of the external auditor's internal control communications should be an integral part of the planning activities and play a key role in the overall assessment of a bank's internal control system.

An institution subject to Part 363 of the FDIC's regulations is required to file copies of audit-related reports received from its external auditor with the appropriate FDIC regional or area office. These reports also must be filed with the district or regional office of its primary federal regulator, if other than the FDIC, and its appropriate state supervisor if it is state chartered. For example, if copies of these reports have not already been furnished to the FDIC examiner's field office, copies should be obtained from the regional or area office. Depending on an institution's size and whether it or its parent is a public company, internal control-related reports submitted pursuant to Part 363 would include the auditor's report on the effectiveness of internal control over financial reporting, either as part of the Part 363 annual report or separately; reports on significant deficiencies and material weaknesses; and reports on other internal control matters, which may be in the form of a management letter.<sup>4</sup> If it appears that any internal control-related reports required to be filed under Part 363 have not been submitted, the exam-

iner should ask management during the pre-examination planning process to provide a copy of the report to the examiner and to submit copies to the FDIC regional or area office and other appropriate federal and state supervisors. An institution's failure to file an audit-related report with these offices in a timely manner represents an apparent violation of Part 363, which should be cited in the examination report.

In the case of an FDIC-supervised bank not subject to Part 363 whose financial statements are audited (or are included in its parent company's audited consolidated financial statements), the FDIC has requested that the bank submit copies of its audit report and any other reports it receives from its external auditor, including any management letter, to the appropriate regional or area office and state supervisor.<sup>5</sup> The reports prepared by the external auditor that an examiner should expect to see vary depending on whether the institution (or its parent company) is a public accelerated or non-accelerated filer or a nonpublic company. If audit-related reports are not available to the examiner at the beginning of the pre-examination planning process, the examiner should request copies of these reports from management.

Given the timely filing requirement for external auditors' reports that applies to institutions subject to Part 363, existing policy guidance directs FDIC regional and area offices to review these filings after their receipt. In light of the long-standing request for FDIC-supervised banks not subject to Part 363 that undergo audits to submit these types of reports to the appropriate regional or area office, these reports also should be reviewed after receipt as part of an institution's ongoing oversight and supervision. The purpose of promptly review-

<sup>4</sup> The Part 363 Annual Report also includes audited comparative financial statements, a statement of management's responsibilities, an assessment by management of compliance during the year with laws and regulations on insider lending and dividend restrictions, and, for institutions with \$1 billion or more in total assets, management's assessment of the effectiveness of internal control over financial reporting as of year-end.

<sup>5</sup> FIL-96-99, October 25, 1999.

ing reports prepared by an institution's external auditor is the early identification of the need for improvements in the institution's financial management. If the review of these reports discloses control deficiencies that raise significant or immediate safety and soundness concerns about an institution, field supervisors should advance the examination date for the institution, schedule a visit, or initiate other appropriate follow-up with the institution. Reported control deficiencies of less immediate or significant concern should be flagged for consideration during the pre-examination planning process for the next examination.

An examiner's preliminary assessment of risk areas during the pre-examination planning process considers the CAMELS (capital, asset quality, management, earnings, liquidity, and sensitivity to market risk) components, as well as such areas as internal control. The examiner determines the perceived risk in each risk area, as this will dictate whether greater-than-normal, normal, or less-than-normal examination resources will be devoted to the area. In general, sources of information include the bank's previous examination reports and examination workpapers, correspondence files, and financial information and ratios. In the internal control area, the written communications from the external auditor described above and the results of previously conducted reviews of these documents should be evaluated. For institutions with \$1 billion or more in total assets and those that are public companies (or subsidiaries of public companies), management's report on its assessment of the effectiveness of internal control over financial reporting should also be obtained and evaluated. The examiner is also expected to contact the external auditor as part of the pre-examination planning, which enables the examiner to ask follow-up questions about the auditor's written communications and inquire about and discuss any other recommendations that the auditor

may have provided to management. Also relevant to the examiner's effort to reach a conclusion on the level of perceived internal control risks within the bank is work performed by the internal audit function, as well as management's responses to the control deficiencies, particularly any material weaknesses, identified by external or internal auditors or by management itself. Depending on the examiner's conclusion regarding the perceived level of risk, if management and the external auditor have performed assessments of internal control over financial reporting, the examiner may determine that a better understanding of the bank's internal control structure and procedures would be gained by reviewing the external auditor's workpapers and the records maintained by management to support its internal control assertion.

During the examination, internal control deficiencies and other matters noted in the external auditor's communications to management and the audit committee (or board of directors), as well as any deficiencies identified by the institution itself, and corrective actions taken by management should be reviewed and evaluated. The examiner should also consider the reasonableness of any decision by management not to remedy an identified deficiency based on management's conscious acceptance of specific risk due to factors such as cost or the mitigating effect of compensating controls. If the examiner concludes that management's actions are not adequate under the circumstances, the examiner should make recommendations for improvement. The deficiencies in internal control and management's responses should be described in the report of examination on the Risk Management Assessment page or the Examination Conclusions and Comments page, depending on the level of significance of the deficiencies and management's willingness or unwillingness to implement appropriate corrective actions. Discussion of these matters during any meeting with the institution's board of



directors to discuss the examination findings also may be warranted. The nature and severity of identified internal control deficiencies and management's action or inaction to address these matters should be considered in the assignment of the Management component rating.

## **Audits of Financial Statements and Internal Control**

An external auditor brings an independent and objective view to an institution's financial reporting process. This, in turn, contributes directly to the achievement of the institution's objectives for this process by performing a financial statement audit and, in some cases, an internal control audit or examination. Indirectly, this process provides information useful to management, the board of directors, and its audit committee in carrying out their responsibilities. The objective of an audit of an institution's financial statements is for the external auditor to express an opinion on the fairness with which the financial statements present, in all material respects, the institution's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.<sup>6</sup> The auditor's opinion is communicated to the institution's board of directors, audit committee, and management through the auditor's report. When conducting a financial statement audit, the auditor must obtain a sufficient understanding of the institution's internal control to plan the audit and determine the nature, timing, and extent of tests to be performed during the audit. Although the auditor may become aware of control deficiencies during the course of a financial statement audit, the auditor is not required to perform procedures for the specific purpose of identifying deficiencies in internal control. Nevertheless, among the responsibilities of the external auditor in connection with a financial

statement audit is to communicate to management and the audit committee (or board of directors) matters related to the institution's internal control over financial reporting that were identified during the audit. An external auditor may also be engaged to audit or examine the effectiveness of an institution's internal control over financial reporting and express an opinion on it at the end of the fiscal year. In connection with such an engagement, the auditor also has a responsibility to communicate certain information concerning internal control matters to management and the audit committee.

During the financial statement audit and the internal control audit or examination, the auditor may discover deficiencies related to an institution's internal control over financial reporting that should be reported to management and those charged with governance. Guidelines and professional standards related to the auditor's communication of internal control deficiencies are continually evolving. Standards are established by the American Institute of Certified Public Accountants (AICPA) for nonpublic company audits and attestation engagements and, since 2003, by the Public Company Accounting Oversight Board (PCAOB) for public company audits.

## **History of Internal Control Communications by External Auditors**

Reporting on internal control matters is not a new development in the auditing profession. Table 1 presents a timeline of certain professional standards and laws and regulations pertinent to an external auditor's communication of internal control matters.

<sup>6</sup> AICPA Professional Standards, AU Section 110, "Responsibilities and Functions of the Independent Auditor," November 1972, paragraph 1.

Table 1

<b>An Auditor's Required Communication of Internal Control Deficiencies</b>			
<b>Date</b>	<b>Standard, Law, or Regulation</b>	<b>Required Communication</b>	<b>To Whom Communicated</b>
August 1977	AICPA SAS 20, "Required Communication of Material Weaknesses in Internal Accounting Control" (superseded by SAS 60)	Material weaknesses	Management and board of directors
July 1980	AICPA SAS 30, "Reporting on Internal Accounting Control" (superseded by SSAE 2)	Report on the study and evaluation of the system of internal accounting control, including any material weaknesses	The entity being studied, its board of directors, or its stockholders
April 1988	AICPA SAS 60 "Communication of Internal Control Structure Related Matters Noted in an Audit" (superseded by SAS 112)	Reportable conditions and material weaknesses, preferably in writing	Audit committee (or those with equivalent authority and responsibility)
May 1993	AICPA SSAE 2, "Reporting on an Entity's Internal Control Structure Over Financial Reporting" (codified as AT501) (superseded by SSAE 10)	Attestation report on management's assertion about the effectiveness of internal control over financial reporting; reportable conditions and material weaknesses, preferably in writing	Audit committee (or those with equivalent authority and responsibility)
June 1993	FDIC Part 363, "Annual Independent Audits and Reporting Requirements" (amended November 2005)	For insured institutions with \$500 million or more in total assets, requires an auditor's attestation report on management's internal control assessment report	Audit committee, FDIC, other appropriate federal and state depository institution supervisors, and the public in the Part 363 annual report
January 2001	AICPA SSAE 10, "Attestation Standards: Revision and Recodification": Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" (codified as AT 501)	Report on management's assertion about the effectiveness of internal control over financial reporting; reportable conditions and material weaknesses, preferably in writing	Management and "those charged with governance" (audit committee and/or board of directors)
July 2002	Sarbanes-Oxley Act of 2002, Section 404, "Management Assessment of Internal Controls"	For public companies, requires an annual auditor's attestation report on management's assessment of the effectiveness of internal control over financial reporting	Public in Form 10-K annual report
March 2004 (approval by SEC in June 2004)	PCAOB AS-2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" (superseded by AS-5)	Significant deficiencies and material weaknesses. Requires an auditor's attestation report on management's internal control assessment report and an audit report on internal control over financial reporting to be filed with the annual report	Management and audit committee; material weaknesses disclosed to public in Form 10-K annual report
September 2004 (approval by SEC in November 2004)	Amendments to SAS 60 in PCAOB's interim standards to bring them into conformity with AS2	Significant deficiencies and material weaknesses identified in an audit only of financial statements	Management and audit committee
November 2005	Amendments to FDIC Part 363, "Annual Independent Audits and Reporting Requirements"	Raised the asset-size threshold for the auditor's report on the assessment of the effectiveness of internal control over financial reporting from \$500 million to \$1 billion	See Part 363 above (June 1993)
May 2006	AICPA SAS 112, "Communicating Internal Control Related Matters Identified in an Audit"	Significant deficiencies and material weaknesses	Management and "those charged with governance" (audit committee and/or board of directors)
August 2006	Amendments to AICPA AT 501 "Reporting on an Entity's Internal Control Over Financial Reporting"	Significant deficiencies and material weaknesses	Management and "those charged with governance" (audit committee and/or board of directors)
May 2007 (approval by SEC in July 2007)	PCAOB AS-5, "An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements"	Significant deficiencies and material weaknesses. Requires an auditor's report on the audit of internal control over financial reporting to be filed with the annual report	Management and audit committee; material weaknesses disclosed to public in Form 10-K annual report

## Standards for Auditors of Nonpublic Companies

All companies not subject to the registration or periodic reporting requirements of the Securities Exchange Act of 1934 are considered nonpublic companies. The AICPA's standards applicable to the preparation and issuance of audit and attestation reports for nonpublic companies include Statements on Auditing Standards (SASs) and Statements on Standards for Attestation Engagements (SSAEs).

SASs are issued by the Auditing Standards Board (ASB), the senior technical body of the AICPA designated to issue pronouncements on auditing, attestation, and quality control matters applicable to the performance and issuance of audit and attestation reports for nonpublic companies. In 1972, all previous Statements on Auditing Procedures (SAP No. 33 to SAP No. 54) were codified into SAS 1, ushering in the modern era of professional auditing standards. In August 1977, SAS 20, "Required Communication of Material Weaknesses in Internal Accounting Control," was issued and introduced the concept of a "material weakness." In April 1988, SAS 20 was superseded by SAS 60, "Communication of Internal Control Structure Related Matters Noted in an Audit," to introduce the concept of a "reportable condition."

In May 2006, the ASB issued SAS 112, "Communicating Internal Control Related Matters Identified in an Audit," superseding SAS 60. SAS 112 applies to audits of nonpublic companies. Although SAS 60 is no longer applicable to audits of nonpublic companies, an amended version issued by the PCAOB remains applicable to audits of public companies, as detailed below. SAS 112 establishes standards and provides guidance on communicating matters related to an institution's internal control over financial reporting identified in an audit

of financial statements. Specifically, SAS 112

- Defines the terms "control deficiency," "significant deficiency," and "material weakness";
- Replaces the term "reportable condition," which had been included in SAS 60;
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements;
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies in internal control, as well as indicators of control deficiencies that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control; and
- Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

SAS 112 is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) of a nonpublic entity. SAS 112 took effect for audits of financial statements of nonpublic companies for periods ending on or after December 15, 2006. Thus, for institutions with calendar year fiscal years, this auditing standard first applied to year-end 2006 audits. SAS 112 is codified in the AICPA's Professional Standards as AU Section 325.<sup>7</sup>

SSAEs also are issued by the AICPA's ASB. Attestation standards apply only to attest services other than a financial statement audit rendered by a certified public accountant in the practice of public accounting. Attestation standards do not override the requirements of any existing SAS. At present, the attestation standard

<sup>7</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," May 2007, p. 431.

specifically addressing communication of internal control matters is Chapter 5, “Reporting on an Entity’s Internal Control Over Financial Reporting,” of SSAE No. 10, “Attestation Standards: Revision and Recodification.” Chapter 5 is codified in the AICPA’s Professional Standards as AT Section 501 (AT 501). AT 501 was effective for internal control attestations on or after June 1, 2001. As its title indicates, SSAE No. 10 superseded the then-existing attestation standards, including the predecessor to Chapter 5, SSAE No. 2, “Reporting on an Entity’s Internal Control Structure Over Financial Reporting,” which was issued in May 1993 largely in response to the enactment of Section 36 of the Federal Deposit Insurance Act as part of the Federal Deposit Insurance Corporation Improvement Act of 1991. As shown in Table 1, SSAE No. 2 superseded an earlier SAS.

In August 2006, the ASB amended AT 501 to incorporate the new terms, related definitions, and guidance on identifying and evaluating control deficiencies and communicating significant deficiencies and material weaknesses that were introduced by the issuance of SAS 112. Thus, the changes the ASB made to AT 501 were the same as those made in replacing SAS 60 with SAS 112, as discussed above. In addition, the ASB revised the illustrative internal control attestation reports in AT 501 to be consistent with SAS 112. The effective date of these conforming changes to AT 501 corresponds to that of SAS 112, that is, for internal control attestations as of or for a period ending on or after December 15, 2006.<sup>8</sup>

### Standards for Auditors of Public Companies

A public company is any company that has a class of securities registered with the Securities and Exchange Commission (SEC) or the appropriate banking

agency under Section 12 of the Securities Exchange Act of 1934 (the Act) or that is required to file reports with the SEC under Section 15(d) of the Act. The SEC, in Rule 12b-2 of the Act, divides public companies into three categories: large accelerated filers, accelerated filers, and non-accelerated filers. In general, large accelerated filers are public companies whose voting and non-voting common equity held by non-affiliates has an aggregate market value of \$700 million or more. Accelerated filers are public companies whose voting and non-voting common equity held by non-affiliates has an aggregate market value of between \$75 million and \$700 million, and non-accelerated filers are public companies whose voting and non-voting common equity held by non-affiliates has an aggregate market value of less than \$75 million.

In July 2002, Congress passed the Sarbanes-Oxley Act (SOX), Section 404 of which established new provisions related to internal control over financial reporting for public companies. Section 404 requires a public company’s management to assess and report on the effectiveness of the company’s internal control over financial reporting and the company’s external auditor to examine the effectiveness of, and attest to management’s assessment of, this internal control structure. SOX also created the PCAOB, a private-sector non-profit corporation, to oversee the external auditors of public companies as a means of protecting the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.<sup>9</sup> The PCAOB is authorized to establish auditing and related attestation, quality control, ethics, and independence standards and rules to be followed by public company auditors in the preparation and issuance of audit reports. Furthermore, auditors of public entities are required to register with the PCAOB, which conducts an inspection program to

<sup>8</sup> AICPA Professional Standards, AT Section 501, “Reporting on an Entity’s Internal Control Over Financial Reporting,” AT 501, May 2007, pp. 2709–2732.

<sup>9</sup> PCAOB Mission Statement, <http://www.pcaobus.org/index.aspx>.



assess these auditors' compliance with federal securities laws and regulations, the PCAOB's rules, and professional standards in connection with their audits of public companies.

Although the ASB no longer has the authority to establish standards for audits of public companies, on April 16, 2003, the PCAOB adopted the AICPA's then-existing auditing and attestation standards as its interim standards. Public company auditors must comply with these interim standards to the extent they have not been superseded or amended by the PCAOB. The interim standards originally included SAS 60 and AT 501 in the form in which they existed on April 16, 2003, and had been codified in the AICPA's professional standards. In March 2004, the PCAOB issued Auditing Standard No. 2 (AS-2), "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements." Among the key elements of AS-2 is a requirement that the auditor communicate in writing to a public company's management and its audit committee all significant deficiencies and material weaknesses identified during the audit. AS-2 superseded the AT 501 interim standard for public companies.

The auditors of all accelerated filers were required to implement the provisions of AS-2 in an integrated audit of financial statements and internal control over financial reporting for fiscal years ending on or after November 15, 2004. However, non-accelerated filers have not yet been required to undergo an audit of internal control over financial reporting when their financial statements are audited. As a consequence, in September 2004, the PCAOB adopted conforming amendments to its interim standards resulting from its adoption of AS-2.

These amendments revised SAS 60 in the interim standards to require the auditor of a non-accelerated filer to report to management and the audit committee only those control deficiencies identified in the audit of the financial statements that are either significant deficiencies or material weaknesses, which is similar to the AS-2 communication requirement.<sup>10</sup> The PCAOB's conforming amendments to SAS 60 became effective for audits of financial statements for periods ending on or after July 15, 2005.

After its adoption of AS-2, the PCAOB monitored how auditors had implemented the requirements of this auditing standard. The PCAOB determined that audits of internal control over financial reporting provided significant benefits, particularly in terms of corporate governance and quality of financial reporting; however, these benefits had come at a significant cost. The PCAOB observed that the costs were often higher than anticipated and the related effort in some cases has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.<sup>11</sup> In May 2007, after considering public comments received and input from the SEC, the PCAOB decided to replace AS-2 with a revised standard on auditing internal control, Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements" (AS-5). AS-5 is effective for internal control audits of public entities for fiscal years ending on or after November 15, 2007, with earlier adoption permitted after July 25, 2007, the date of the SEC's approval of AS-5. The PCAOB's intent in adopting AS-5 was to focus the internal control audit on the areas of greatest risk, eliminate unnecessary procedures, scale the internal control audit to a public company's size and complexity, and simplify the text of

<sup>10</sup> PCAOB Conforming Amendments, Release No. 2004-008, September 15, 2004, p. 7.

<sup>11</sup> PCAOB Proposed Auditing Standard: An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements and Related Other Proposals, PCAOB Release No. 2006-007 (December 19, 2006).



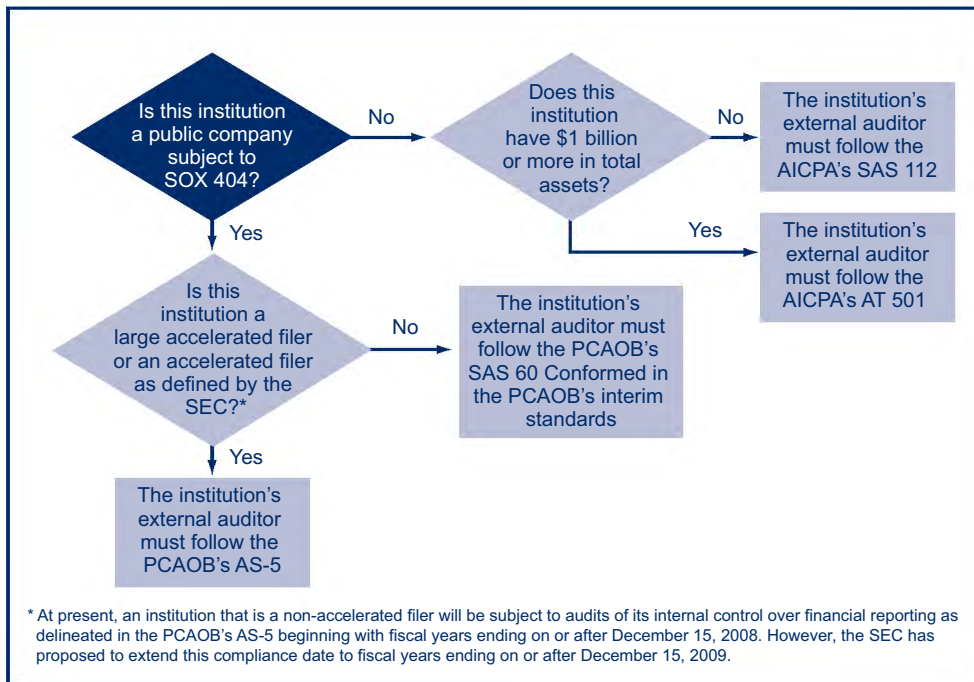
the standard compared with AS-2.<sup>12</sup> AS-5 also revised the definitions of material weakness and significant deficiency (see “Communication of Significant Deficiencies and Material Weaknesses” later in this article). Because of these definitional changes, the PCAOB also adopted additional conforming amendments to the version of SAS 60 in its interim standards (“SAS 60 Conformed”).

### Insured Depository Institutions

For insured depository institutions with \$500 million or more in total assets, the annual audit and reporting requirements in Part 363 of the FDIC’s regulations include provisions that address the external auditor’s communications about and reporting on the internal control structure and procedures for financial reporting. Since Part 363 was initially adopted by the FDIC in 1993, Section 363.4(c) has

required each insured institution to file a copy of any management letter or other audit-related report issued by its external auditors within 15 days after receipt with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor. Institutions with at least \$500 million but less than \$1 billion in total assets that are also public companies or subsidiaries of public companies subject to the provisions of Section 404 of SOX for the most recent fiscal year must also file their auditor’s report on the audit of internal control over financial reporting as an “other report.” All institutions with \$1 billion or more in total assets, both public and nonpublic, are required to submit the external auditor’s audit or attestation report concerning the institution’s internal control structure and procedures for financial reporting as part of the Part 363 annual report.<sup>13</sup>

Chart 1: External Auditors’ Communication on Internal Control Over Financial Reporting for Insured Depository Institutions



<sup>12</sup> PCAOB News Release, “Board Approves New Audit Standard for Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule,” May 24, 2007.

<sup>13</sup> Financial Institution Letters FIL-119-2005, Annual Independent Audits and Reporting Requirements Amendments to Part 363, <http://www.fdic.gov/news/news/financial/2005/fil11905a.html>.

## Definitions

In evaluating an institution's internal control environment, following the correct standard is critical, as previously discussed. Moreover, each standard

defines key terms linked to the standard's communication requirements. The definitions in these standards have similarities and differences that should be noted to ensure the appropriate level of auditor evaluation and communication.

Professional Standard	SAS 112 and AT 501 <sup>14,15</sup>	AS-5 and SAS 60 Conformed <sup>16,17</sup>
<b>Definition</b>		
Control Deficiency	A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect financial statement misstatements on a timely basis.	
Control Deficiency: Deficiency in Operation	A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.	
Control Deficiency: Deficiency in Design	A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective <i>is not always met</i> .	A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective <i>would not be met</i> .
Significant Deficiency	A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the institution's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the institution's financial statements that is <i>more than inconsequential</i> <sup>18</sup> will not be prevented or detected.	A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
Material Weakness	A material weakness is a significant deficiency, or combination of significant deficiencies, that results in <i>more than a remote likelihood</i> that a material misstatement of the financial statements will not be prevented or detected.	A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a <i>reasonable possibility</i> that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

<sup>14</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraphs 5–8.

<sup>15</sup> AICPA Professional Standards, AT Section 501, "Reporting on an Entity's Internal Control Over Financial Reporting," paragraphs 36–40.

<sup>16</sup> PCAOB Standards, AS-5, August 6, 2007, paragraphs A3, A7, A11.

<sup>17</sup> PCAOB Conforming Amendments, August 6, 2007, Release 2007-005A, pp. 482–484.

<sup>18</sup> For the SAS 112 definition of significant deficiency, the phrase "more than inconsequential" describes the magnitude of a potential misstatement that could occur as a result of a significant deficiency and is the threshold for evaluating whether a control deficiency or a combination of such deficiencies is a significant deficiency. In making this evaluation, the auditor determines whether a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be material to the financial statements. The auditor should consider both qualitative and quantitative factors when determining whether a potential misstatement would be more than inconsequential.

A material weakness, as defined in the context of SAS 112 and AT 501, adopts the standard of “more than a remote likelihood” that a material misstatement of the financial statements will not be prevented or detected. By contrast, AS-5 and SAS 60 Conformed characterize a material weakness as a deficiency or combination of deficiencies in internal control over financial reporting such that there is a “reasonable possibility” that a material misstatement will not be prevented or detected. Both a “reasonable possibility” and “more than a remote likelihood” of an event, as used in these standards, occur when the likelihood of the event is either “reasonably possible” or “probable,” as those terms are used in Statement of Financial Accounting Standards No. 5, “Accounting for Contingencies” (FAS 5). According to FAS 5, a contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss that will ultimately be resolved when one or more future events occur or fail to occur. When a loss contingency exists, the likelihood that the future event or events will confirm the loss can range from “probable” to “remote.”<sup>19</sup> “Probable” means that the future event or events are likely to occur, and “reasonably possible” means that the chance of the future event or events occurring is more than remote but less than likely.<sup>20</sup> In addition, FAS 5 uses the term “remote” to mean that the chance of the future event or events occurring is slight.

## Internal Control Deficiencies Under SAS 112

### Examples of Circumstances That May Be Control Deficiencies, Significant Deficiencies, or Material Weaknesses Under SAS 112<sup>21</sup>

#### Deficiencies in the Design of Controls

- Inadequate design of internal control over the preparation of the financial statements being audited
- Inadequate design of internal control over a significant account or process
- Inadequate documentation of the components of internal control
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment
- Absent or inadequate segregation of duties within a significant account or process
- Absent or inadequate controls over the safeguarding of assets if the auditor determines this is necessary for effective internal control over financial reporting
- Inadequate design of information technology (IT) general and application controls that prevents the information system from providing complete and accurate information consistent with financial reporting objectives and current needs
- Employees or management who lack the qualifications and training to fulfill their assigned functions
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the institution’s internal control over time
- The absence of an internal process to report deficiencies in internal control to management on a timely basis

#### Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation
- Failure to perform reconciliations of significant accounts
- Undue bias or lack of objectivity by those responsible for accounting decisions
- Misrepresentation by client personnel to the auditor (an indicator of fraud)
- Management override of controls
- Failure of an application control caused by a deficiency in the design or operation of an IT general control

<sup>19</sup> Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, “Accounting for Contingencies,” paragraph 1.

<sup>20</sup> Financial Accounting Standards Board, Statement on Financial Accounting Standards No. 5, “Accounting for Contingencies,” paragraph 3.

<sup>21</sup> AICPA Professional Standards, AU Section 325, “Communicating Internal Control Related Matters Identified in an Audit,” paragraph 32.

## Evaluating Control Deficiencies Identified as Part of a Financial Statement Audit

In evaluating identified control deficiencies, the auditor should consider the likelihood and magnitude of misstatement of the financial statements as well as the effect of compensating controls. The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. In this regard, the absence of an identified misstatement does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses.<sup>22</sup>

### Examples of Factors Influencing Whether a Control Could Fail to Prevent or Detect a Financial Statement Misstatement<sup>23</sup>

- The nature of financial statement accounts, disclosures, and assertions involved (e.g., suspense accounts and related-party transactions involve greater risk)
- The susceptibility of the related assets or liabilities to loss or fraud
- The subjectivity and complexity of the amount involved, and the extent of judgment needed to determine that amount
- The cause and frequency of any known or detected exceptions related to the operating effectiveness of a control
- The interaction or relationship of the control with other controls
- The interaction of the control deficiency with other control deficiencies
- The possible future consequences of the deficiency

When multiple control deficiencies affect the same financial statement account balance or disclosure, the combination of these deficiencies may constitute a significant deficiency or material weakness, even though the deficiencies are individually insignificant. Factors affecting the magnitude of a financial statement misstatement resulting from a control deficiency or combination of deficiencies include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency. (The maximum amount

of an overstatement is generally the recorded amount, but not for an understatement because of the potential for unrecorded amounts.)

- The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods.

A compensating control is a control that limits the severity of a deficiency in another control and thereby prevents that other control from becoming a significant deficiency or a material weakness. Therefore, when evaluating whether a control deficiency or a combination of deficiencies is a significant deficiency or a material weakness, an auditor should evaluate the possible mitigating influence of compensating controls found to be effective. However, even if the compensating controls prevent a control deficiency from rising to the level of a significant deficiency or a material weakness, they do not eliminate the control deficiency.

### Deficiencies in the Following Areas Ordinarily Are at Least Significant Deficiencies in Internal Control<sup>24</sup>

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles (e.g., having sufficient expertise in selecting and applying accounting principles)
- Antifraud programs and controls
- Controls over nonroutine and nonsystematic transactions
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements

<sup>22</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraphs 9 and 10.

<sup>23</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraph 11.

<sup>24</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraph 18.

## Deficiencies in the Following Areas Should Be Regarded as at Least a Significant Deficiency and a Strong Indicator of a Material Weakness in Internal Control<sup>25</sup>

- Ineffective oversight of the institution's financial reporting and internal control by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the institution's internal control. This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts.
- An ineffective internal audit function or risk assessment function at an institution for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities. An ineffective regulatory compliance function relates solely to those aspects for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.
- Identification of fraud of any magnitude on the part of senior management. The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud. However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial misstatements—on the part of senior management.
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

### Communication of Significant Deficiencies and Material Weaknesses

When conducting an audit, the auditor follows the appropriate professional standard as described above. When the auditor discovers control deficiencies, the same professional standards provide guidance about the level and form of communication required to be presented to the institution's board of directors or the audit committee.

### SAS 112

Whenever an auditor audits the financial statements of a nonpublic institution and identifies control deficiencies, SAS 112 requires the auditor to communicate significant deficiencies and material weaknesses in writing to management and the board of directors or its audit committee. The standard states that this written communication is best made by the report release date, but must be made no later than 60 days following the report release date. The report release

<sup>25</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraph 19.



date is the date the auditor grants the institution permission to use the auditor's audit report (opinion) in connection with the financial statements, which is typically the date the auditor delivers the audit report to the institution. Significant deficiencies and material weaknesses identified during the audit, regardless of any conscious decision by management to accept that degree of risk, must be communicated to management and the board and/or audit committee as a part of each audit. This communication includes any significant deficiencies and material weaknesses communicated in previous audits that remain unremediated. The auditor may communicate in writing concerning unremediated deficiencies and weaknesses by referring to the previously issued written communication and the date of that communication.<sup>26</sup>

The auditor's written communication regarding significant deficiencies and material weaknesses identified during an audit of financial statements should state that the purpose of the audit was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the institution's internal control over financial reporting. The auditor should also state that the auditor is not expressing an opinion on internal control effectiveness. The written communication should include the definitions of the terms "significant deficiency" and, where relevant, "material weakness," and it should identify the matters considered to be significant deficiencies and, if applicable, material weaknesses.<sup>27</sup>

If no material weaknesses were identified during an audit of a nonpublic institution's financial statements, the auditor may, at the institution's request, issue a written communication advising management and the board of directors or its

audit committee of this fact. However, the auditor should add a statement to the written communication disclaiming an opinion on the effectiveness of the institution's internal control. In contrast, the auditor should not issue a written communication stating that no significant deficiencies were identified during the audit, because of the potential for the limited degree of assurance provided by such a communication to be misinterpreted. If the auditor has performed an examination of internal control over financial reporting under the provisions of AT 501 for the same period or "as of" date as the audit of the financial statements, the auditor should not issue a report indicating that no material weaknesses were identified during the audit of the financial statements.<sup>28</sup>

## AT 501

AT 501 is not applicable when an auditor performs only an audit of a nonpublic institution's financial statements. Rather, SAS 112 applies to such an audit. Under AT 501, an auditor engaged to examine the effectiveness of a nonpublic institution's internal control over financial reporting reports directly on the effectiveness of the institution's internal control or on management's written assertion about the effectiveness of the institution's internal control. The latter type of auditor's report is currently required for internal control attestations for nonpublic institutions with \$1 billion or more in total assets conducted under AT 501. The auditor also is required to communicate significant deficiencies and material weaknesses in writing to management and the board of directors or the audit committee. Unless a significant deficiency or material weakness is of such significance that an interim communication would be warranted, the audi-

<sup>26</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraphs 20 and 21, and AU Section 339, "Audit Documentation," footnote 6.

<sup>27</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraph 25.

<sup>28</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraphs 28 and 29.

tor's written communication takes place after the examination is concluded.<sup>29</sup>

### AS-5

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When an auditor performs an audit of a public institution's internal control over financial reporting that is integrated with the audit of the financial statements, AS-5 requires the auditor to communicate material weaknesses in writing to management and the audit committee. This should occur prior to the issuance of the auditor's report on internal control over financial reporting. An "integrated audit" is required for public institutions that are either large accelerated filers or accelerated filers as defined by the SEC. Significant deficiencies must also be communicated in writing to the audit committee; however, AS-5 does not specify when such communication should be made. If there are control deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the institution's internal control over financial reporting, unless there is a restriction on the scope of the engagement. The auditor should also determine the effect that the adverse opinion on internal control has on the auditor's opinion on the financial statements. In addition, the auditor should disclose whether the auditor's opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.<sup>30</sup>

### SAS 60 Conformed

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In an audit of a public institution's financial statements without an integrated internal control audit, SAS 60 Conformed requires the auditor to communicate in writing to management and the audit committee all significant deficiencies and

material weaknesses identified during the audit. Currently, only nonaccelerated filers as defined by the SEC are allowed to undergo financial statement audits without an integrated internal control audit. The auditor's written internal control communication should be made before the issuance of the auditor's report on the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses.<sup>31</sup>

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### Other Communication of Internal Control Deficiencies

During the course of an audit, the auditor may discover internal control deficiencies that do not rise to the level of significant deficiencies or material weaknesses. These should be communicated to institution management in compliance with professional standards.

### AS-5

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During the course of an audit of a public institution's internal control over financial reporting that is integrated with the audit of its financial statements, the auditor may identify deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses. The auditor should communicate to management, in writing, all such deficiencies and inform the audit committee when such a communication has been made. (Some of these deficiencies may be significant deficiencies about which the auditor must communicate in writing to the audit committee, as mentioned above.) When making this communication to management, it is not necessary for the auditor to repeat information about such deficiencies in internal

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<sup>29</sup> AICPA Professional Standards, AT Section 501, "Reporting on an Entity's Internal Control Over Financial Reporting," paragraphs 49 and 50.

<sup>30</sup> PCAOB Standards, AS-5, August 6, 2007, paragraphs 78, 80, 90, and 92.

<sup>31</sup> AICPA Professional Standards, AU Section 325, "Communicating Internal Control Related Matters Identified in an Audit," paragraph 4.

control over financial reporting if they have been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the institution. Furthermore, the auditor is not required to perform audit procedures sufficient to identify all control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which the auditor is aware. However, because the audit of internal control over financial reporting does not provide the auditor with assurance that he has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.<sup>32</sup>

As a separate matter, if the auditor concludes that the oversight of the institution's external financial reporting and internal control over financial reporting by the institution's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.<sup>33</sup>

## SAS 60 Conformed

During an audit of the financial statements of a public institution when an audit of internal control over financial reporting is not required to be conducted, the auditor may identify matters in addition to those required to be communicated by SAS 60 Conformed. These matters include control deficiencies that are neither significant deficiencies nor material weaknesses, and are matters the institution may request the auditor be alert to that go beyond those contemplated by SAS 60 Conformed. The auditor may report such matters to management, the audit committee, or others, as appropriate, although the communication is not required to be in writing. However, if the

auditor did not identify any significant deficiencies during the audit of the financial statements, the auditor should not report in writing that no such deficiencies were discovered because of the potential for the limited degree of assurance associated with such a report to be misinterpreted. When timely communication of internal control deficiencies is important, the auditor should communicate such deficiencies during the audit rather than at the end of the engagement. The decision about whether to issue an interim communication should be based on the relative significance of the matters noted and the urgency of corrective follow-up action required.<sup>34</sup>

SAS 60 Conformed does not explicitly require the auditor to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements. However, if the auditor becomes aware that the audit committee's oversight of the institution's external financial reporting and internal control over financial reporting is ineffective, the auditor must communicate that information in writing to the board of directors. Such ineffective oversight should be regarded as an indicator that a material weakness in internal control over financial reporting exists.<sup>35</sup>

## SAS 112

When an auditor performs a financial statement audit for a nonpublic institution, the auditor may communicate, either orally or in writing, to management and the board of directors or its audit committee, other matters that the auditor believes to be of potential benefit to the institution, such as recommendations for operational or administrative efficiency or for improving internal control. In addition, the auditor should report on any matters requested by the

<sup>32</sup> PCAOB Standards, AS-5, August 6, 2007, paragraphs 81–83.

<sup>33</sup> PCAOB Standards, AS-5, August 6, 2007, paragraph 79.

<sup>34</sup> PCAOB Conforming Amendments, Release 2004-008, September 15, 2004, pp. A-12–A-16.

<sup>35</sup> PCAOB Conforming Amendments, August 6, 2007, Release 2007-005A, p. 483.

institution, such as control deficiencies that are not significant deficiencies or material weaknesses.

## What Does the Future Hold?

As discussed in this article, the AICPA modified its attestation standards in AT 501 and replaced its auditing standards in SAS 60 with SAS 112 to conform its professional standards to the terminology and communication requirements of the PCAOB's AS-2. AT 501 was in the process of a more comprehensive revision in early 2006, but the AICPA delayed this initiative when the PCAOB announced in May 2006 that it would undertake an initiative to amend AS-2. The PCAOB later decided against amending AS-2 and elected instead to replace AS-2 with a new auditing standard, which became AS-5. As a result, the definitions of certain internal control-related terms and auditors' communication standards currently differ somewhat for audits of public companies and nonpublic companies. Changes to SAS 112 and AT 501 to bring these standards more in line with those of the PCAOB are the purview of the AICPA's ASB. Although the PCAOB adopted AS-5 in May 2007, the ASB is waiting to see what changes the International Auditing and Assurance Standards Board will make to the International Standards on Auditing on auditor communication as part of its "Clarity" project.

The PCAOB also is continuing to develop for auditors of smaller public companies guidance for applying AS-5 and is continuing to hold Forums on Auditing in the Small Business Environment to better monitor implementation issues related to smaller public companies.<sup>36</sup>

In October 2007, the FDIC Board of Directors approved the publication of

proposed amendments to Part 363 of the FDIC's regulations that would, among other things, address communications between an institution's external auditor and the audit committee. These reporting requirements are intended to strengthen the relationship between the audit committee and the external auditor. The FDIC previously stated that effective communication between the external auditor who audits the institution's financial statements and the institution's audit committee assists the committee in carrying out its responsibilities. For this reason, the FDIC has encouraged institutions, regardless of whether they are public companies, to arrange with their external auditor to institute these reporting practices. One of the proposed amendments to Part 363 would establish a uniform minimum requirement for external auditor communications with the audit committees of both public and nonpublic institutions subject to this regulation. As proposed, the external auditor would be required to report on a timely basis to the audit committee about other written communications the auditor has provided to management, such as a management letter or schedule of unadjusted differences.<sup>37</sup>

As a result of these changes, the auditing profession and communications of internal control deficiencies identified in an audit are continuing to evolve. Overall, these changes are positive and are making information generated during audits about such deficiencies more readily available to examiners as they plan and conduct examinations.

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<sup>36</sup> PCAOB News Release, "Board Approves New Audit Standard for Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule," May 24, 2007.

<sup>37</sup> *Federal Register*, Vol. 72, No. 212, Part II, Federal Deposit Insurance Corporation, 12 CFR Parts 308 and 363, "Annual Independent Audits and Reporting Requirements; Proposed Rule," November 2, 2007, pp. 62310–62335, <https://www.fdic.gov/resources/regulations/federal-register-publications/2007/07proposenov2.pdf>.

# Overview of Selected Regulations and Supervisory Guidance

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.

## ACRONYMS and DEFINITIONS

FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
NCUA	National Credit Union Administration
Banking agencies	FDIC, FRB, and OCC
Federal bank and thrift regulatory agencies	FDIC, FRB, OCC, and OTS
Federal financial institution regulatory agencies	FDIC, FRB, OCC, OTS, and NCUA

Subject	Summary
<b>Deposit Insurance Assessments—Notice of Proposed Rulemaking on Dividends (FIL-24-2008, March 26, 2008; Federal Register, Vol. 73, No. 57, p. 15459, March 24, 2008)</b>	The FDIC sought comments on regulations to implement dividend requirements in the Federal Deposit Reform Act of 2005 and the Federal Deposit Insurance Conforming Amendments Act of 2005. The final rule will replace the existing FDIC regulations on dividends, which will expire on December 31, 2008. Comments were due by May 23, 2008. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08024.html">http://www.fdic.gov/news/news/financial/2008/fil08024.html</a> .
<b>Proposed Revisions to Interagency Questions and Answers Regarding Flood Insurance (PR-26-2008, March 21, 2008, FIL-23-2008, March 21, 2008; Federal Register, Vol. 73, No. 56, p. 15259, March 21, 2008)</b>	The federal financial institution regulatory agencies and the Farm Credit System requested public comment on proposed revisions to the Interagency Questions and Answers regarding flood insurance. New questions and answers, as well as substantive and technical revisions to the existing guidance, address several topics, including construction loans, residential condominium loans, loan syndications and participations, gap insurance policies, and mandatory civil money penalties. Comments were due by May 20, 2008. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08023.html">http://www.fdic.gov/news/news/financial/2008/fil08023.html</a> .
<b>Managing Commercial Real Estate (CRE) Concentrations in a Challenging Environment (PR-24-2008, March 17, 2008, FIL-22-2008, March 17, 2008)</b>	The FDIC re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices for institutions with concentrated CRE exposures, consistent with the December 6, 2006, Interagency Guidance on CRE lending and the December 13, 2006, Interagency Policy Statement on the Allowance for Loan and Lease Losses. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08022.html">http://www.fdic.gov/news/news/financial/2008/fil08022.html</a> .
<b>Agencies Release Annual Community Reinvestment Act (CRA) Asset-Size Threshold Adjustments for Small and Intermediate Small Institutions (PR-107-2007, December 19, 2007, FIL-18-2008, March 10, 2008; Federal Register, Vol. 72, No. 245, p. 72571, December 21, 2007)</b>	The federal bank and thrift regulatory agencies announced the annual adjustment to the asset-size thresholds: “small bank” or “small savings association” refers to an institution that, as of December 31 of either of the prior two calendar years, had assets of less than \$1.061 billion; “intermediate small bank” or “intermediate small savings association” refers to an institution with assets of at least \$265 million as of December 31 for both of the prior two calendar years and less than \$1.061 billion as of December 31 of either of the prior two calendar years. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08018.html">http://www.fdic.gov/news/news/financial/2008/fil08018.html</a> .



Subject	Summary
<p><b>FDIC Statement on Reporting of Securitized Subprime Adjustable Rate Residential Mortgages (PR-19-2008, March 3, 2008, FIL-17-2008, March 3, 2008)</b></p>	<p>The FDIC strongly encourages state nonmember institution mortgage servicers to use the HOPE NOW alliance’s loan modification and loss mitigation reporting standards for securitized adjustable-rate subprime residential mortgage loans to streamline refinancing, loan modification, and loss avoidance. The FDIC also encourages state nonmember institution mortgage servicers to be responsive to other ongoing data and information requests designed to track loss mitigation efforts, including the State Foreclosure Prevention Working Group. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08017.html">http://www.fdic.gov/news/news/financial/2008/fil08017.html</a>.</p>
<p><b>Publication on Calculating Deposit Insurance Coverage for Revocable and Irrevocable Trusts (PR-17-2008, February 29, 2008, FIL-16-2008, February 29, 2008)</b></p>	<p>A new FDIC publication, <i>FDIC Guide to Calculating Deposit Insurance Coverage for Revocable and Irrevocable Trusts</i>, provides detailed information and guidance on how to calculate FDIC coverage for deposits held by such trusts. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08016.html">http://www.fdic.gov/news/news/financial/2008/fil08016.html</a>.</p>
<p><b>Revisions to the Consolidated Reports of Condition and Income for 2008 (FIL-13-2008, February 20, 2008)</b></p>	<p>The Federal Financial Institutions Examination Council (FFIEC) approved revisions to the reporting requirements. These revisions were implemented as of March 31, 2008, with certain items optional until the June 30, 2008, report date. The agencies are making a number of reporting changes related to one- to four-family residential mortgage loans, such as reporting interest and fee income on, and the quarterly average for, such mortgages separately from the income on, and the quarterly average for, all other real estate loans. The agencies also are adding new items for restructured troubled mortgages and mortgage loans in process of foreclosure. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08013.html">http://www.fdic.gov/news/news/financial/2008/fil08013.html</a>.</p>
<p><b>Interagency Statement on Pandemic Planning (FIL-6-2008, February 6, 2008)</b></p>	<p>The FFIEC issued this Interagency Statement identifying actions that financial institutions should take to minimize the potential adverse effects of a pandemic. An institution’s business continuity plan should address pandemics and provide a preventive program, a documented strategy scaled to the stages of a pandemic outbreak, a comprehensive framework to ensure the continuance of critical operations, a testing program, and an oversight program to ensure the plan is reviewed and updated. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08006.html">http://www.fdic.gov/news/news/financial/2008/fil08006.html</a>.</p>
<p><b>Guidance issued on the Internal Control Attestation Standards to Comply with FDIC’s Part 363 Audit and Reporting Requirements (FIL-5-2008, February 1, 2008)</b></p>	<p>The FDIC provided guidance on the internal control attestation standards that auditors of insured institutions with \$1 billion or more in total assets should follow to comply with Part 363 of the FDIC’s regulations. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08005.html">http://www.fdic.gov/news/news/financial/2008/fil08005.html</a>.</p>
<p><b>Proposed Rulemaking Notice for Processing Deposit Accounts in a Bank Failure and Modernizing Large-Bank Insurance Determination (PR-106-2007, December 19, 2007, FIL-2-2008, January 14, 2008; Federal Register, Vol. 73, No. 9, p. 2364, January 14, 2008)</b></p>	<p>The FDIC issued a two-part proposed rule related to the potential failure of an FDIC-insured depository institution. The first part of the proposal would govern how and at what point deposit account balances would be determined in the event of a failure, and applies to all FDIC-insured depository institutions. The second part proposes requirements to facilitate the process for determining the insurance status of depositors of large insured depository institutions in the event of failure. Comments were due by April 14, 2008. See <a href="http://www.fdic.gov/news/news/financial/2008/fil08002.html">http://www.fdic.gov/news/news/financial/2008/fil08002.html</a>.</p>

# Regulatory and Supervisory Roundup

continued from pg. 47

Subject	Summary
<b>Comments Sought on Proposed Procedures to Enhance the Accuracy and Integrity of Information Furnished to Consumer Reporting Agencies.</b> (PR-98-2007, November 29, 2007, FIL-115-2007, December 21, 2007; <i>Federal Register</i> , Vol. 72, No. 239, p. 70944, December 13, 2007)	The federal financial institution regulatory agencies and the Federal Trade Commission (FTC) propose regulations and guidelines implementing Section 312 of the Fair and Accurate Credit Transactions Act (FACT Act), which amended Section 623 of the Fair Credit Reporting Act. The proposed accuracy and integrity regulations require entities that furnish information about consumers to a consumer reporting agency to establish reasonable policies and procedures for implementing the proposed guidelines. The proposed rules would allow consumers to dispute inaccuracies about certain information reflected on their consumer reports directly with the furnishers of that information. Comments were due by February 11, 2008. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07115.html">http://www.fdic.gov/news/news/financial/2007/fil07115.html</a> .
<b>Managing Risks Associated with Lapses in Flood Insurance Coverage</b> (FIL-114-2007, December 21, 2007)	The FDIC issued guidance to emphasize the importance of ensuring adequate internal controls are in place to maintain appropriate levels of flood insurance coverage for the term of a loan when that loan is secured by improved real estate located, or to be located, in a special flood hazard area of a community participating in the National Flood Insurance Program. Such controls include monitoring renewal notices, commencing force placement procedures when the institution determines required flood insurance coverage is deficient or lapsed, and checking flood insurance policies to confirm coverage. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07114.html">http://www.fdic.gov/news/news/financial/2007/fil07114.html</a> .
<b>Final Regulation Implementing Section 312 of the USA PATRIOT ACT – Special Due Diligence Programs for Certain Foreign Accounts</b> (FIL-113-2007, December 21, 2007; <i>Federal Register</i> , Vol. 72, No. 153, p. 44768, August 9, 2007)	The Financial Crimes Enforcement Network issued a final rule to implement enhanced due diligence requirements for correspondent accounts for certain foreign banks. The rule applies to any correspondent account maintained for a foreign bank that operates under an offshore banking license, a banking license issued by a country designated as noncooperative with international anti-money laundering principles, or a banking license issued by a country designated by the Secretary of the Treasury as warranting special measures. The rule applies to correspondent accounts for certain foreign banks established after February 5, 2008, and then applies to all applicable correspondent accounts on May 5, 2008, regardless of when the account was established. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07113.html">http://www.fdic.gov/news/news/financial/2007/fil07113.html</a> .
<b>Final Rule on Advanced Capital Adequacy Framework for Basel II Risk-Based Capital</b> (PR-91-2007, November 5, 2007, FIL-107-2007, December 7, 2007; <i>Federal Register</i> , Vol. 72, No. 235, p. 69288, December 7, 2007)	The federal bank and thrift regulatory agencies issued the final rule concerning the domestic application of selected elements of the Basel II capital framework. The final rule requires some banks and permits other banks to use an internal ratings-based approach to calculate regulatory capital requirements for credit risk and an advanced measurement approach to calculate regulatory capital requirements for operational risk. The rule is effective April 1, 2008. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07107.html">http://www.fdic.gov/news/news/financial/2007/fil07107.html</a> .
<b>Revisions to the FDIC Information Technology (IT) Officer's Questionnaire</b> (FIL-105-2007, December 4, 2007)	The FDIC has updated its risk-focused IT examination procedures for FDIC-supervised financial institutions. As part of the revision, the IT Officer's Questionnaire was enhanced to provide greater coverage of vendor management and outsourcing topics, credit card and automated clearing house payment system risks, and an institution's overall information security program. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07105.html">http://www.fdic.gov/news/news/financial/2007/fil07105.html</a> .

Subject	Summary
<p><b>Final Rule and Guidelines Implementing Sections 114 and 315 of the Fair and Accurate Credit Transactions Act of 2003 on Identity Theft “Red Flags” and Address Discrepancies (FIL-100-2007, November 15, 2007; <i>Federal Register</i>, Vol. 72, No. 217, p. 63718, November 9, 2007)</b></p>	<p>The federal financial institution regulatory agencies and the FTC issued this final rule, which requires financial institutions and creditors to implement a written identity theft prevention program; card issuers to assess the validity of change of address requests; and users of consumer reports to reasonably verify the identity of the subject of a consumer report in the event of a notice of address discrepancy. The guidelines also contain a list of 26 “red flags” that financial institutions and creditors may consider incorporating into their identity theft prevention programs. The regulation and guidelines were effective January 1, 2008, with compliance required by November 1, 2008. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07100.html">http://www.fdic.gov/news/news/financial/2007/fil07100.html</a>.</p>
<p><b>The Final Rule Amending Section 344.9(a)(3) of Part 344, the FDIC’s Recordkeeping and Confirmation Requirements for Securities Transactions (FIL-99-2007, November 15, 2007; <i>Federal Register</i>, Vol. 72, No. 206, p. 60546, October 25, 2007)</b></p>	<p>The FDIC amended its regulation governing the reporting of personal securities transactions by bank officers and certain employees. The amendment extends the deadline for providing quarterly reports of personal securities transactions from ten business days to 30 calendar days after the end of the calendar quarter. The final rule was effective November 26, 2007. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07099.html">http://www.fdic.gov/news/news/financial/2007/fil07099.html</a>.</p>
<p><b>Final Rule to Implement the Affiliate Marketing Provisions of the Fair Credit Reporting Act (FCRA) as amended by the Fair and Accurate Credit Transactions Act (FACT Act) (FIL-98-2007, November 7, 2007; <i>Federal Register</i>, Vol. 72, No. 215, p. 62910, November 7, 2007)</b></p>	<p>The federal financial institution regulatory agencies, the Securities and Exchange Commission, and the FTC jointly published a final rule that implements Section 214 of the FACT Act, which generally prohibits a person from using information received from an affiliate to make a solicitation for marketing purposes to a consumer unless the consumer is given notice and a reasonable opportunity and a reasonable and simple method to opt out of making such solicitations. The final rule was effective January 1, 2008, and compliance is required by October 1, 2008. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07098.html">http://www.fdic.gov/news/news/financial/2007/fil07098.html</a>.</p>
<p><b>Volunteer Income Tax Assistance (VITA) – Potential CRA and Business Opportunities (FIL-97-2007, November 6, 2007)</b></p>	<p>Recent amendments to the Internal Revenue Service rules created more opportunities for financial institutions to help consumers save a portion of their refund. Financial institutions involved with VITA programs may be eligible for favorable considerations under Community Reinvestment Act rules, and may develop opportunities to facilitate education, open accounts, and provide other financial services to underserved individuals. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07097.html">http://www.fdic.gov/news/news/financial/2007/fil07097.html</a>.</p>
<p><b>Comments Sought on Proposed Amendments to Part 363 of FDIC Rules and Regulations – Annual Auditing and Reporting Requirements (FIL-96-2007, November 2, 2007; <i>Federal Register</i>, Vol. 72, No. 212, p. 62310, November 2, 2007)</b></p>	<p>The FDIC requested comments on proposed amendments to Part 363 in light of changes in the industry; certain sound audit, reporting, and audit committee practices incorporated in the Sarbanes-Oxley Act of 2002; and the FDIC’s experience in administering Part 363. The amendments are also intended to provide clearer and more complete guidance for compliance. Comments were due by January 31, 2008. See <a href="http://www.fdic.gov/news/news/financial/2007/fil07096.html">http://www.fdic.gov/news/news/financial/2007/fil07096.html</a>.</p>

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