2001

Banks, credit unions, and other lenders and depository institutions industry developments - 2001-02; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Banks, Credit Unions, and Other Lenders and Depository Institutions Industry Developments—2001/02

Complement to AICPA Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies*

American Institute of Certified Public Accountants

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Notice to Readers

This Audit Risk Alert is intended to provide CPAs serving banks, credit unions, savings institutions, finance companies, and other depository institutions and lenders with an overview of recent economic, industry, regulatory, and other professional developments that may affect the engagements and audits they perform. The AICPA staff prepared this document. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. The discussions presented in this publication do not represent the views, positions, or opinions of the AICPA.

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How This Alert Helps You

This Audit Risk Alert helps you plan and perform your audits of financial institutions and other lenders. This Alert delivers knowledge to assist you in achieving a more robust understanding of the business environment your clients operate in. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of financial statements. Moreover, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

If you understand what is happening in the financial institution industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining and understanding that industry knowledge.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2001/02.*

Industry and Economic Developments

Are We There Yet? Recession

Children often pose the classic summer family vacation question, "Are we there yet?" Of late, many have been asking the same question regarding a recession. As of the fourth quarter of 2001, the U.S. economy and business environment is in a weak and uncertain state. The economic picture is expected to grow bleaker with plummeting earnings, higher unemployment, and a falling stock market. Other recession indicators include a decline in industrial production, real income, and trade profitability. The September 11 attack on America has been a jarring shock to the business environment. The aftermath of that attack may very well accelerate the economic decline. Although the short-term view of the business environment is grim, the economic decline is expected to be short and the long-term view is bright. So, are we there yet? Almost.

For a more thorough discussion of the U.S. business environment and economy and the economies of foreign nations, see the AICPA general *Audit Risk Alert—2001/02.*

The financial health of banks, savings institutions, credit unions, and other financial institutions depends on the overall economy and is therefore weakened by the current business environment. And, as stated above, that economic environment is not good. In fact, Superior Bank FSB recently failed. This failure is the single most costly loss to the bank insurance system in five years. The "Credit Risk Watch" section of this Alert addresses, in detail, the risks and issues involved in subprime lending—a major factor behind the failure of Superior Bank. These grim economic times generate risks to financial institutions and the accountants who audit them. You will need to assess how the declining business environment affects your client. Because each institution offers different products and services, audit risk can vary widely.

Risk Drivers Affecting Financial Institutions

Some specific factors that may drive increased risk for financial institutions and their auditors are presented in this section. You should consider whether these risk drivers are present at your clients and determine how their presence may affect the nature, timing, and extent of your audit procedures.

Deteriorating Credit Quality

A deteriorating economy can lead to a deterioration in the credit quality of an institution's loan portfolio. Apparently healthy loan portfolios may contain hidden losses that emerge during economic downturns. A number of major industry players are already incurring lower earnings due to higher loan loss provisions for nonperforming loans. Many loan write-offs already recorded have occurred because of corporate bankruptcies. Also, some institutions have incurred losses related to syndicated loans made to companies experiencing financial difficulties.

See the section of this Alert titled "Credit Risk Watch" for detailed guidance on accounting and auditing guidance related to loan loss allowances.

Changing Interest Rates

Interest rates are a crucial component of profitability for financial institutions. Almost every aspect of an institution's operations is affected by interest rate changes. The Federal Reserve Board (FRB) has cut interest rates significantly to remedy the ailing economy. This has spurred a flurry of commercial and mortgage refinancing activity that has both positive and negative influences on a financial institution. Loan origination and servicing fee revenues earned may increase due to an increase in new customers. However, as interest rates decline, margins may correspondingly decrease. Institutions are subject to prepayment risk in falling rate environments. Mortgage loans and other receivables may be prepaid by a debtor, so the debtor may refinance its obligations at new, lower rates. Prepayments of assets carrying the old, higher rates reduce the institution's net income and overall asset yields. In addition to loans, other items such as securities, deposits, debts, and derivatives all depend on interest rates.

Some Audit Considerations. You may need to consider whether the institution has adequate asset liability management procedures in place to understand and manage its market risk and liquidity risk in a falling interest rate environment. Credit risk also increases due to deteriorating credit quality. Finally, the impact of interest rates on the client's asset values and capital should be considered. For further information you can refer to the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (Product No. 012520kk).

Venture Capital Investment

Many financial institutions are heavily invested in venture capital, particularly related to the hard-hit telecommunications and high-tech industries. Institutions with investments and loans to these market sectors are going to be especially vulnerable in the economic downswing. An audit risk may exist concerning the proper accounting, valuation, and disclosure of these assets.

The Merger and Acquisition and Initial Public Offering Slowdown

Many financial institutions earn revenue through the financing of business combinations in both their own and other industries. Revenues from this source are expected to drop dramatically. Revenue streams flowing from a plethora of fees earned from startup initial public offerings (IPOs) are a thing of the past.

Some Audit Considerations. Budgeted revenue level targets will be more difficult to meet due to fewer customers desiring mergers and filings, and unusual pressure may be placed on management, especially at those institutions with management incentive programs.

USA Manufacturing Anemia

Capital markets are directly affected by capital investment, which is often greatest in the area of manufacturing. Traditional manufacturing is trying not to falter as the U.S. economy deteriorates. In the past 10 years U.S. companies have moved production overseas to cut costs, most notably in the textile and apparel sectors. Only a small core of manufacturing industries, including chemicals, steel, aluminum, and aerospace, is still centered in the United States.

Domestic industrial production has been dropping. Factories have laid off thousands of workers as a result of the poor business and economic environment. The reasons for this decline in manufacturing are complex and varied. As always, cheaper labor oversees has been one reason for the decline. Also, higher energy prices in the United States have burdened such heavy energy-reliant industries as steel and aluminum. In addition, the strong dollar overseas has contributed to a decrease in the sale of exported goods.

Some Audit Considerations. An unusually high concentration of customers within the manufacturing sector may create greater client risk due to potential loan defaults. Therefore, the auditor may need to pay special attention to outstanding loans related to this sector.

Demand for Autos

Many financial institutions depend on a high volume of auto lease revenue. Recently, losses related to auto leases have lowered financial institution earnings. In the past decade some institutions put significant money into auto leases for large vehicles. When the lease term ends, the vehicles are resold and the lease profit gained during the lease term is based on the difference between the new resale value and the original projected vehicle resale value. Demand for large used vehicles has recently dropped, so actual resale values are plummeting lower than the original projected values and earnings at these institutions have not been sufficient to absorb the losses. Many major players have taken large write-offs to cover these losses and are now hedging their lease portfolios. Additionally, many banks may not have adequately addressed the lease residual losses building in their portfolios.

Some Audit Considerations. Increased risk may exist related to the value estimates used by the client for the determination of the lease reserves and the related off-balance-sheet financing used to protect the portfolio. Asset impairment and valuation risks related to a client's auto lease portfolios may also exist.

Increased Unemployment

As financial institutions experience lower profits, they are cutting costs by terminating employees. This can have a serious effect on the financial institution's internal control and financial reporting and accounting systems.

Some Auditing Considerations. Key unfilled positions may have a negative effect on internal control. Institutions that in prior years had strong financial reporting and accounting controls could see those controls deteriorate due to a lack of qualified employees. Controls over other areas, such as lending and collections, could also suffer. You may want to consider these risk assessment issues while planning and performing the audit. Gaps in key positions may cause control weaknesses representing reportable conditions that should be communicated to management and the audit or supervisory committee in accordance with Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), and SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722). The federal banking regulatory agencies have issued warnings to financial institutions over the last several years to the effect that the agencies may have safety and soundness concerns if regulated banks were to scale back their internal and external auditing without sufficient controls in place to compensate for the changes.

September 11, 2001

The aftermath of the September 11 attacks may deepen the nation's economic malaise. A worsening business environment will negatively affect financial institutions and their customers. In addition to the obvious economic implications, a number of accounting and auditing issues are raised as a result of the September 11 attacks. These issues will influence those businesses and auditors directly affected by the attacks and those businesses and auditors whose clients, vendors, suppliers, and others were directly affected. See the AICPA general *Audit Risk Alert—2001/02* for a detailed discussion of how the September 11 attacks may affect the business environment, your clients, and the planning of your audits. The general Alert also discusses specific accounting matters related to the September 11 attacks.

Specific Financial Institutions Issues

Governmental and regulatory agencies have issued a number of announcements that auditors must now consider.

Joint Interagency Statement Issued. On September 14, 2001, a statement was issued by the FRB, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of Currency (OCC), and the Office of Thrift Supervision (OTS). In summary the statement suggested that market response could lead to temporary balance sheet growth at some banking organizations, including thrifts. This growth could occur if, for example, borrowers make unusual draws on their existing lines of credit or request new lines in response to a perceived need for extra liquidity, or if a banking organization were to receive unusually large deposit inflows. Financial institutions will have balance sheet effects that occur with significant increased lending or deposit inflows. Some organizations that experience significant asset growth may also experience a temporary decline in their regulatory capital ratios as a result of responding to customers' needs over this period. See the FDIC Web site at www.fdic.gov for more information.

Thrift Advice. On September 12, 2001, the OTS announced steps thrifts can take to assist customers affected by events related to the terrorist attacks in New York City and Washington, D.C. Recognizing that those events may have both direct and indirect ramifications for thrift institutions and their customers beyond the immediately affected areas, the OTS has provided guidance to thrifts designed to ensure that institutions do all that they can to help their customers cope with financial obligations under these difficult circumstances. See the OTS Web site at www.ots.treas.gov for more information.

Additionally, the OTS reminded thrifts about provisions of the Soldiers and Sailors Civil Relief Act of 1940 that affect certain financial liabilities of military personnel, including in particular military reservists called to active duty, and new members of the armed forces. Among its provisions, the Act requires financial institutions to lower the interest rate to a maximum of 6 percent on mortgage, auto, and other installment loans incurred by military active duty personnel. The Act also restricts a financial institution's ability to take default judgments and other judicial actions against military personnel in regards to mortgages and other loan obligations.

Federal Bureau of Investigation (FBI) Alert. The FBI continues to make requests of all domestic and foreign banking organizations and all securities-related entities operating in the United States to check their records for any relationships or transactions with the official list of terrorist suspects provided to federal financial institution supervisory agencies.

New Legislation. The Senate Banking Committee has approved legislation to prevent, detect, and punish money laundering by non-U.S. nationals and foreign financial institutions. The bill would give more authority to the Treasury secretary and attorney general to thwart the money laundering and financing of terrorist groups. The provisions include, but are not limited to, steps that target foreign shell banks, increases in the sharing of information, and the creation of due diligence policies for non-U.S. account holders. More information can be found at www.usinfo.state.gov. and www.treas.gov/ofac/.

Millennium Mortgage Madness

Mortgage lending has been experiencing rapid growth of late. One out of every four homeowners now has a second mortgage, and most homeowners who refinance take out larger mortgages. New homeowners have been buying and construction loans have been increasing.

What Factors Caused the Mortgage Madness and What Are the Related Audit Considerations?

Low Interest Rates. The housing market continues to be blessed by Federal Reserve interest rate cuts. Banks borrow short-term funds and lend long-term. Because the Fed has dramatically cut short-term rates while long-term rates have remained stable during the first three quarters of 2001, banks are initiating as many mortgage and construction loans as they can.

Because home equity loan interest rates are now in the 8 percent to 13 percent range, well below the 20 percent rates on many credit cards, second mortgages are popular with credit heavy borrowers. They roll their credit card debt into new home loans, lower their monthly payments, and most likely obtain a tax deduction.

Some Audit Implications. Auditors should consider the effects of declining loan portfolios at lenders that are being adversely affected by voluminous low-interest-rate refinancing. A lender's operations, earnings, and profits may suffer substantial decline that may lead to going-concern implications. Also, a lender's management will probably experience intense pressure from stakeholders to maintain profitability, thereby increasing the institution's risk of fraud.

Furthermore, future loan losses may increase if lenders lower their underwriting standards to boost current loan production. Finally, because, second-mortgage lenders rank below first-lien holders in collection efforts, the holder of the second lien is not able to collect until the first lender has been paid. Therefore, one should note the creditor status of the client's portfolio base.

Increase in Home Value. Home prices appear to be accelerating, despite the declining economy. In a report released by the National Association of Realtors, which covers price changes in 125 metro areas, the median prices of existing homes rose 6.4 percent during the second quarter of 2001, compared with 4.6 percent in the first quarter of 2001. The housing market appears strong, and buyers tend to refinance their homes when the value increases. Sometimes homeowners can borrow up to 125 percent of the appraised value.

Some Audit Implications. Home values may fall to the same extent as or more than they have previously risen. If home values fall in certain geographic areas, banks that lend significantly in those areas may face material impairment losses. Banks with geographically diverse home equity and mortgage portfolios are less likely to falter as home prices fluctuate regionally, rather than nationally.

Fast Loan Approval. Increased technology, including computer appraisal and Internet access, has made loan approvals easy and fast, especially for second mortgages.

Some Audit Implications. The risk of technological error may increase with automation. Additionally, there may be a higher credit-quality risk given the less personalized, more automated nature of the loan process. Also, the technology-dependent nature of this loan process may necessitate increased scrutiny of the related internal controls.

Shift in Investment Strategy. Consumers who are apprehensive about the uncertain and bearish stock market are shifting money into residential real estate. This shift is evidenced by an increase in the average home down payment over the past two years.

Reverse Mortgage Portfolios. A reverse mortgage is a special class of loan available to homeowners aged 62 and older. An individual borrows against the equity accumulated in the home; this borrowing reverses the usual mortgage payment stream so the lender makes monthly payments to the homeowner in return for equity in the home. When the borrower moves out of the home or dies, the lender then recovers principal plus interest through the estate or sale of property.

The reverse mortgage market is growing fast. There are a number of factors contributing to the trend. First and foremost, the senior demographic is increasing rapidly, both due to the baby boomers reaching retirement age and increase in life span from medical advances. Census figures show that there are at least 12.9 million seniors with more than $1.3 trillion of home equity ready to be tapped by the reverse mortgage market. Large lenders are starting to expand their services into this niche marketplace.

Some Audit Implications. For the most part, the reverse mortgage market is a stable investment for lenders. Because federal regulations prohibit lenders from making reverse mortgage loans worth more than the value of the home, credit risk is reduced over other types of mortgages. Lenders are also allowed to charge higher origination fees, up to 2 percent of the value of the loan.

The auditor should note that federal regulations require applicants for reverse mortgages to attend loan-counseling sessions to fully understand loan implications and alternative products available.

Consolidation and Convergence

Many forces are at work shaping the financial institution industry. The industry has been consolidating and converging for decades; however, a marked slowdown in merger and acquisition activity occurred in 2001 due to the poor economy. The regulatory and competitive environment has made strategic alliances imperative and commonplace. In addition, new market entrants are expanding into the financial institution industry while existing institutions are expanding into new product lines for strategic advantage. A number of community-sized institutions have successfully partnered with brokerage firms, insurance companies, high-tech companies, and other entities to provide the kinds of products and services that the market demands.

Oligopoly?

The consolidation of the financial institutions industry over the past years is starting to have an aggregate oligopolistic effect, despite the fact that the financial institution industry remains one of the most fragmented industries in the nation. Indeed, a Federal Reserve study found that stock prices of 22 of the biggest U.S. banking organizations tended to move in tandem from 1989 to 1999. Across many financial product lines, more power is being concentrated in the hands of fewer companies, as the following discussions about credit card, corporate lending, and custody businesses illustrate.

Credit Cards. Thousands of banks issue credit cards. In the first half of 2001, 62 percent of credit cards were controlled by the five largest players—Citibank, MBNA, Bank One, Chase, and Providian. In contrast, these five entities controlled only 40 percent of the credit card business in 1995.

Corporate Lending. Five big lenders dominate the large corporate loan market: J.P. Morgan Chase, Citigroup, Bank of America Corp, CreditSuisse, and Deutsche Bank AG. (The small corporate loan market is dominated by community banks.) The recent merger boom has resulted in a shortage of lenders big enough to participate in the syndication of loans to large borrowers. This trend gives top players a competitive advantage.

Custody Services. The custodial business is expanding rapidly and is also exhibiting oligopolistic traits. Due to tiny profit margins, an institution must hold a large volume of assets to earn sizeable profits in this business. Consolidation has been advantageous to large players because it helps promote custody revenue as companies pool resources to invest in efficient technology and capitalize on economies of scale. The top 10 players now control 92 percent of the overall custody market, up from 40 percent in 1991. Leaders have a strong market position since a formidable barrier to entry exists—a massive investment in technology.

The Exceptions: Mortgages and Retail Banking

The mortgage and retail banking sectors have not experienced the same level of consolidation as some of the other sectors within the industry. The mortgage market is very competitive; the top 10 players control only approximately 40 percent of the market, an increase from approximately 27 percent from 1995. Small brokers and mortgage companies are offering stiff competition to the larger institutions. (For more information, see "Are Fannie and Freddie Cornering the Market?" in this section of the Alert.)

In the retail banking arena, large institutions have lost market share. Large institutions often close many branches during consolidation, allowing small market niche competitors to spring up. (See "The New 'Banks'" in this section of the Alert.) Branch closings sometimes frustrate or anger customers, providing an opportunity for small market niche banks. In fact, the share of deposits held by larger institutions has been declining.

Vertical Integration

Today, many financial institutions do not want to create and maintain in-house products and services that offer all things to all people. Instead, they look to integrate vertically by forming alliances with entities. Vertical integration may become even more prevalent in the future.

Audit Implications of Expanding Into New Areas of Business

Financial institutions that add or expand products, services, and businesses may generate audit risks and risks to themselves. Combining institutions may join together different financial sector products and services (for example, insurance, checking accounts, loans, asset management, and brokerage services) under one roof. The following factors should be considered when your client is adding or expanding products, services, or businesses:

- Management may lack expertise in the new areas. For example, bank management may not possess the knowledge and skills needed to manage the business and risk of selling insurance. This lack of expertise may contribute to financial statement misstatements and internal control weaknesses. You may want to assess management's level of expertise in the new areas of business and consider that assessment in the determination of your audit procedures.

- Management may not properly implement industry-specific accounting principles related to the new areas. You should determine that proper accounting principles are being applied concerning the new areas of business.

- The accounting, operations, and other systems related to the new areas may lack adequate testing and proper integration with core systems. Thus, these new systems may have inadequate internal control, which may result in unreliable accounting data. You should consider this when planning and performing the audit. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on internal control. In addition, you should be familiar with the requirements of SAS No. 60.

- According to SAS No. 60, auditors may become aware of matters relating to internal control that, in their judgment, should be communicated to the audit committee. Such matters represent significant deficiencies in the design or operation of internal control, which could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
- The institution may fail to comply with regulations attendant the new area of business. The institution's failure to comply may result from unfamiliarity with the regulations and a lack of expertise in the new area. You may want to inquire about the regulations that exist in new business areas (to the extent necessary to perform a proper audit). SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), describes an auditor's responsibilities regarding violations of laws or governmental regulations.

You may want to assess management's depth and an institution's strategic plans when a client enters complicated, new areas of business. If you require the help of a specialist, you should consider the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

Mergers, Community Charters, Field of Membership Expansions

The number of credit unions merging has continued to increase for a variety of reasons. First, smaller credit unions wish to offer their members expanded services. Second, many credit unions are converting from federal to state charters. Finally, there are a large number of multiple common bond expansions and conversions to community charters. Often accompanying the charter conversion to a state charter is approval of a new field of membership that may include a community covering a wider geographic area and new core membership groups.

Internal Control Strain

Mergers and conversions to community charters can present many similar challenges and internal control issues. Often the main control issue facing both mergers and charter conversions is the safe handling of substantial growth. Following a conversion to a community charter, a credit union may experience substantial growth due to increases in membership. Both mergers and expanding fields of membership can have a tremendous impact on internal controls. The growth puts additional strain on operations, employees, and physical capacities. Critical controls could be compromised due to these factors. For example, previous control responsibilities may be overlooked as employees take on additional responsibilities. The auditor should be aware of the impact of large growth on the internal control of the credit union. Mergers have the added challenge of integrating potentially disparate systems, policies, procedures, facilities, and personnel.

Wider Membership Base Concerns. Also, a credit union that previously serviced a single core group of members may now have a wider diversity of individuals within its field of membership if the credit union has expanded its field of membership recently. This presents potential control issues that need to be considered.

- Management and personnel may lack the experience or expertise in dealing with a wider membership base.
- There may be additional credit risks that the credit union has not properly considered. Underwriting criteria that was sound for a single core group of individuals may present additional credit risk when applied to a broader group of individuals who may have lesser credit capacity as a whole. The auditor would need to consider this in the evaluation of potential loan losses.
- There may be increased fraud exposure. There is less probability that the employees will know the members. This could create additional exposure to fraud resulting from checks, new accounts, credit applications, and identity theft. Previously, the credit union could gain more assurance to the member's identity and income through its affiliation

with a core employer group. Due to reasonable reliance on the past affiliations, employees may not be well trained in identifying potential fraudulent activity. Such items as fictitious credit applications will require closer scrutiny and will present potentially large exposure if overlooked.

Risk of Noncompliance With Regulations

If a credit union has converted from a federal to a state charter, a risk exists that the credit union may fail to comply with regulations due to unfamiliarity with the new requirements. The auditor may need to be aware of new regulations affecting the client and may need to inquire about the credit union's compliance with the new regulations. SAS No. 54 describes an auditor's responsibilities regarding violations of laws or government regulations.

The New "Banks"

Traditional financial institutions continue to compete with each other in many areas. Commercial banks, savings institutions, credit unions, and other financial entities actively compete for deposits and money market funds. Brokerage houses offer deposit-like services. Consumer and commercial finance companies, national retail chains, factors, insurance companies, pension trusts, and others all compete in the lending arena.

New entrants into the industry, coming from outside of the traditional financial institution family, are magnifying the competitive atmosphere. Car companies, retailers, and even universities are now setting up their own Internet banks. Products offered include credit card services, loans, mortgages, and checking and savings accounts. Many new banks are mostly Internet-based and lack the manpower and geographic branches to supply in-person customer contact. Some known participants who have already expanded into banking services include Nordstrom, BMW, Volkswagen, General Motors, and the universities of DePaul and Drexel, as well as H&R Block.

Established companies have fewer barriers of entry due to their established brand names. These new players capitalize on their already established customer base and brand loyalty. An example of established competitive advantage is the existence of an established customer credit unit. The unit ensures smooth transition for established customers and also provides companies with an alternative method of raising funds other than the debt market. Additionally, companies can borrow from other banks at low federal fund rates and no longer have to split credit card profits with outsiders.

Audit Implications

If your client is entering the financial services industry, you should familiarize yourself with the audit implications discussed in the previous section "Consolidation and Convergence." The already established company will face risks that accompany any expansion into a new market area. Note that an established brand name does not automatically ensure success. J.C. Penny left the credit card business early in 2001 due to poor results. These new banks are not immune to current economic difficulties and are struggling along with traditional financial institutions to earn profits in a declining economy.

Mortgage Loan Servicing and Secondary Market Sales

Some financial institutions have been significantly increasing their real estate loan portfolios, as well as enhancing their servicing portfolios of loans sold in the secondary market with servicing retained by the institution. Institutions in recent years have been much more likely than in the past to retain servicing for loans sold to secondary market investors. Not only has the number of financial institutions that are servicing portfolios grown considerably, but the size and dollar amount of institutions' servicing has also grown substantially. Conversely, the recent refinancing boom has adversely affected certain institutions, as borrowers have moved to other institutions in a highly competitive market.

The value of associated mortgage-servicing rights (MSRs) is an important material area for auditors. MSRs are now an emerging materiality area and may have a significant effect on your client's financial statements this year or in the near future.

Generally, the AICPA Audit and Accounting Guides *Banks and Savings Institutions and Audits of Credit Unions*, and Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires the following accounting treatment when real estate loans are sold with servicing retained by the financial institution.

- Servicing rights in the transferred assets (loans) are to be measured by allocating the previous carrying amount between the asset sold and the retained interests based on their relative fair values at the date of transfer.
- Servicing assets (or liabilities) are subsequently measured for financial reporting purposes by (1) amortization in proportion to and over the period of estimated net servicing income (or loss) and (2) assessment for asset impairment (or increased obligations) based on their fair values.

Audit Implications

For those institutions that have mortgage servicing operations, the auditor should evaluate whether the institution is complying with the requirements of the AICPA Audit and Accounting Guides *Banks and Savings Institutions and Audits of Credit Unions.* The auditor should gain assurance that the financial institution is properly recording the asset (or liability) and gain or loss on sale when loans are sold with servicing retained. Assurances should also be made that the institution is properly amortizing the MSRs and that procedures are in place to properly assess fair value for potential impairment.

Additionally, the various mortgage-related entities such as the Department of Housing and Urban Development (HUD), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), and Government National

Mortgage Association (GNMA) have various audit and reporting requirements. The client should understand what audit and financial reports are required and ensure that those requirements are met by the work performed by the independent auditor.

Another consideration is further activity related to the sales of such loans. As the income is recorded up-front and the expense is amortized, if the current level of sales activity is not sustained, the institution will be affected by the loss of such income.

The Accounting Standards Executive Committee's (AcSEC's) proposed Statement of Position (SOP) *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* is expected to be effective for the fiscal year beginning after December 15, 2001. That proposed SOP will require disclosures for entities subject to secondary market investor requirements, which include minimum net worth (capital) requirements imposed.

That proposed SOP will also change the recognition for loans retained with the servicing sold. Before the adoption of that proposed SOP, the proceeds from such sales should be accounted for in a manner similar to loan discounts and amortized using the interest method as an adjustment to the yield of the related loans. The proposed SOP requires that sales of servicing rights relating to loans that are retained should also be recognized in income and, at the date of sale, the carrying amount should be allocated between the servicing rights and loans retained using relative fair values in a manner consistent with paragraph 10(b) of FASB Statement No. 140. See the "On the Horizon" section of this Alert for information and other proposed SOPs.

Internal Control of Servicing Operations. Apart from the proper accounting treatment for loans sold and accounting for retained servicing, the auditor may also want to evaluate the internal control of the servicing operations. The financial institution will have numerous financial and compliance obligations and responsibilities, such as collecting and remitting loan payments, ensuring compliance with federal and state regulations covering escrow accounts and other servicing requirements; compliance with the seller/servicing agreement with a third party such as Fannie Mae and Freddie Mac; properly collecting on delinquent accounts; and collecting and paying taxes and insurance. Failure to properly comply with any of these requirements could have serious financial impact on the financial institution.

Reminder About Privacy Regulations and Safeguarding Information

In 2000, the FDIC, OCC, FRB, National Credit Union Administration (NCUA), and OTS issued final regulations to implement provisions of the Gramm-Leach-Bliley Act that protect the privacy of consumers' nonpublic personal information. Financial institutions had to comply with the regulations on July 1, 2001.

The new regulation on the privacy of consumers' financial information:

- Requires a financial institution to provide notice to customers about its privacy policies and practices.
- Describes under what conditions a financial institution may disclose nonpublic personal information about consumers to nonaffiliated third parties.
- Provides an "opt out" method for consumers to prevent the financial institution from disclosing that information to nonaffiliated third parties.

Protected Information

Under the regulation, restrictions on sharing information with nonaffiliated third parties apply to "nonpublic personal information" about a consumer. Nonpublic personal information is "personally identifiable financial information" that is provided by a consumer to a financial institution, that results from any transaction with or service performed for the consumer, or that is otherwise obtained by the financial institution.

The regulation excludes "publicly available information" from the definition of nonpublic personal information. Publicly available information is any information that an institution has a reasonable basis to believe is lawfully made available to the general public from government records; widely distributed media; or disclosures to the public required to be made by federal, state, or local law.

Privacy Policy Notice

Under the regulation, financial institutions must provide a clear and conspicuous notice that accurately reflects their privacy policies and practices. The notice must be given to any individual who becomes a customer of the financial institution by the time the customer relationship is established, and annually thereafter as long as the relationship continues. Also, the notice must be given to any consumer who does not become a customer before nonpublic personal information about the consumer may be shared with nonaffiliated third parties.

Opt-Out Requirement

Before an institution can share nonpublic personal information with nonaffiliated third parties, consumers must be given a reasonable opportunity to opt out from having that information shared. The opt-out notice must be given to:

- Customers as a part of the initial notice of the financial institution's privacy policies and practices, or before sharing nonpublic personal information about them with nonaffiliated third parties.
- Individual consumers who do not become customers of the financial institution, and former customers, before nonpublic personal information about them may be shared with nonaffiliated third parties.

The regulation does provide certain exceptions that permit a financial institution to share nonpublic information with third parties without providing privacy or opt-out notices. These exceptions include disclosures of nonpublic personal information made:

- In connection with certain processing and servicing transactions
- With the consent of or at the direction of the consumer

- To protect against potential fraud or unauthorized transactions
- To respond to judicial process

Disclosures to independent auditors in connection with the audit process are also exempted. This includes any peer review of CPA firms. It is less clear whether the exemptions also cover work done by consultants not in conjunction with the audit.

Other Privacy Regulations and Laws

Institutions should also be aware of existing state privacy regulations and emerging regulations. Privacy is a new and growing concern, and new rules likely will continue to develop. Also, under the federal privacy law, if the Federal Trade Commission (FTC) determines that state laws and regulations should provide greater consumer protection, those requirements will be incorporated into the federal requirements. Several states have recently passed or proposed various privacy regulations.

> **Help Desk**—Further information about the new privacy regulations can be found at the Web sites of the various agencies. For instance, visit the FRB site at www.federalreserve.gov/boarddocs/press/boardacts/2000/20000510/default.htm.

Audit Implications

The auditor should obtain appropriate representations from management that the institution has taken steps to ensure compliance with legal or regulatory requirements. Noncompliance could result in significant financial and reputational risk to the institution.

Deferred Compensation Plans

Many financial institutions have implemented various retirement plans for executives such as split dollar life insurance plans and deferred compensation plans (Internal Revenue Code section 457 plans). The auditor should ensure that the institution has properly accrued for its retirement benefit liability. Generally, the present value of an employee's expected future benefits is to be expensed over the employee's employment period with a systematic and rational method. For additional guidance, see FASB Statements No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 87, *Employers' Accounting for Pensions*; FASB Technical Bulletin 85-4, and Accounting Principles Board (APB) Opinion No. 12, *Omnibus Opinion—1967*, can provide additional guidance.

Are Fannie and Freddie Cornering the Market?

New legislation has been introduced in Congress to reduce Fannie Mae and Freddie Mac's current market power. A bill was introduced in July 2001 that would create a new regulator for the companies—the Federal Reserve. (The Office of Federal Housing Enterprise Oversight currently regulates these two government-sponsored, publicly traded companies.) Under the new proposal, the Fed would set minimum capital requirements for Fannie and Freddie and would approve any new activities. Moreover, another new proposal in 2001 recommended that the government charter new companies to compete with the two mortgage giants.

Why all the hoopla against Fannie and Freddie? These two government-sponsored enterprises (GSEs) have been quietly and steadily gaining market share. They have some unique competitive advantages not shared by other financial institutions and have become, in the eyes of some, Boardwalk and Parkplace on the game board of mortgage lending.

The Competitive Advantages Enjoyed by Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac were created by the U.S. government. Fannie and Freddie make mortgages available to the general public. The companies buy loans from lenders and supply those financial institutions with more cash to make new loans. Fannie and Freddie then either hold those loans in their portfolios or package them into securities for sale to investors. The historical formation of these companies and the continued government sponsorship of these enterprises subsequent to the release of government control in the 1960s have created the following list of unique qualities not shared by other institutions:

- The GSE securities are designated as "government securities" for purposes of the Securities Exchange Act of 1934 and the Federal Reserve Act. GSEs do not have to register their securities with the Securities and Exchange Commission.
- Both GSEs are exempt from state and local income taxes.
- Both GSEs have lower capital requirements than comparable banking institutions.
- Fannie and Freddie maintain an approximate $2.5 billion line of credit with the U.S. Treasury. This very special relationship leads investors to believe that their debt is backed by the full faith and credit of the federal government, which translates into low borrowing costs.
- Both GSEs have been assigned low-risk weights for bank and thrift risk-based capital and investment diversification standards.

Other participants in the mortgage industry find it difficult to compete with the GSEs because of the aforementioned benefits of their quasi-governmental status. The special advantages conferred on Fannie and Freddie give them significant financial and product advantages.

Euro Conversion

The euro has been used electronically in foreign trade and financial-market transactions since January 1, 1999, and has lost nearly a quarter of its worth against the dollar in the 30 months since its virtual inception. On January 1, 2002, Europe will convert the 12 European currencies worth $315 billion to real euro notes and coins. Economists expect the costs of conversion to reduce 2002 economic growth in these European countries by at least .25 percentage points. Hopefully, the new currency will spark a growth spurt corresponding to a broader global recovery.

Countries outside of the euro zone will be affected as well. For example, up to $35 billion worth of deutsche mark notes circulate outside the euro zone, mainly in Eastern Europe. Ironically, authorities report that criminals are busy converting marks into dollars to avoid unwanted scrutiny around the required date of transition. Additionally, U.S. financial institutions will be affected by the transition because they will be heavily involved in the conversion process.

Steps in the Euro Conversion

The following steps remain in the euro conversion process:

- Autumn 2001: New coins start arriving in banks and big stores. Bank accounts are denominated in euro. New accounts are opened only in euro.
- December 2001: Euro notes start arriving in banks and stores. Consumers can buy small "starter packs" of euro currency from financial institutions.
- January 2002: Euro introduced. Automated teller machines and banks give only euro. Shops make change in euro only. Withdrawal of the national currencies starts.
- March 1, 2002: Old currencies will no longer be accepted and must be exchanged at banks.

Potential Advantages of the Euro Conversion

Advantages include:

- The conversion to notes and coins should give new legitimacy and power to the single currency and may strengthen European unity.
- Trade between euro-zone nations could grow dramatically, as could the euro-zone economy.
- The euro will make it more difficult for individual countries to block cross-border mergers and acquisitions, especially in financial services, where regulators still tend to defend their individual financial systems.

- Price, wage, and tax differences among countries will become obvious and will naturally equalize over time.

Potential Disadvantages of the Euro Conversion

Disadvantages include:

- The costly conversion process will slow Europe's already anemic economy. Millions of products and services will have to be repriced. Money exchange machines (for example, ATMs, parking meters, and 3.2 million vending machines) will need to be adjusted.
- Repricing logistics may increase inflation as money exchanged is collected. Even now, some merchants are currently refusing to give change to consumers due to conversion confusion.
- Banks have been criticized for their plan to charge exchange fees. If they do, conversion costs will be shifted to stores (free exchange). While banks may profit from these fees in the short term, the consumer trickle effect may subsequently increase inflation and reduce consumer borrowing.
- Labor groups and consumers will not be happy with the differences in prices and salaries across national boundaries that will become evident upon conversion.
- Unprepared businesses may have cash flow and payment problems.
- All banks, including American banks, will experience costs related to conversion.

Some Auditing Considerations

Consider these points when assessing the effect of the euro conversion at your clients:

- Emerging Issues Task Force (EITF) Abstract D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union*, discusses accounting issues related to the euro, including comparative financial statements issuance.

- Securities and Exchange Commission (SEC) Staff Legal Bulletin No. 6 outlines the disclosure obligations related to the euro.
- European-based entities may now prepare their financial statements in either euros or their original currency.
- Certain audit procedures may be necessary to assess the euro conversion's effects on your client's financial statements.
- Conversion costs could potentially exceed year 2000 compliance costs. Management will need to accrue any liability.
- Accounting systems will need to be flexible to handle all the varied necessary functions related to the euro. Systems must be able to perform conversion functions that comply with the European Monetary Unit, and they must minimize potential aggregate material conversion rounding differences.
- Financial operations in Europe will need to address implementation in a timely and appropriate manner.
- Management may need to review contracts and agreements with legal counsel and address potential issues as soon as possible. Currency values used in legal documents will be replaced by their euro equivalent at the fixed exchange rate.
- For most U.S. entities, there should be no income tax consequences from the conversion. However, companies with certain straddles or hedges should review tax issues.

Help Desk—Information about the euro conversion can be obtained at the European Federation of Accountants Web site at www.euro.fee.be.

Credit Risk Watch

Guidance to Help You Audit Loan Loss Allowances

As stated earlier, the grim economic picture seriously heightens concerns about credit quality. As business earnings plunge and layoffs occur, loan delinquencies and defaults may increase sharply. Moreover, the quality of an institution's loan portfolio may deteriorate. Remember that most bad loans are made during good times. Institutions may have eased their underwriting standards to attract additional customers during the antecedent economic growth period. Management and auditors need to be especially alert during these poor economic times to ensure that loan loss allowances are adequate and impaired loans are properly accounted for.

When evaluating credit risk, the quality of loans, and the adequacy of loan loss allowances, auditors should consider the matters discussed in this Alert and determine whether there is a heightened level of audit risk. If so, it may be necessary to alter the nature, timing, and extent of audit procedures and to increase the level of testing. The evaluation of loan quality and loss allowances can be a complicated process, and the following specific literature will aid you in the accounting and auditing process. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information* provide guidance on auditing estimates.

Accounting and Auditing Considerations

FASB and AICPA Guidance

Currently, the accounting guidance for the measurement of the allowance for loan losses available to financial institutions is addressed in FASB Statements No. 5, *Accounting for Contingencies*, and No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by FASB Statement No.118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*; EITF Topic D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio*; FASB Interpretation No. 14, *Reasonable Estimation of the*

Amount of a Loss (an interpretation of FASB No. 5); and the AICPA Audit and Accounting Guide *Banks and Savings Institutions.*

The FASB Viewpoints Article on Loan Loss Allowances. The April 12, 1999 issue of FASB *Viewpoints* addressed the application of FASB Statements No. 5 and No. 114 to a loan portfolio and discussed how those Statements interrelate. The *Viewpoints* article discusses numerous issues, including the following questions:

- How should a creditor identify loans that are to be individually evaluated for collectibility under FASB Statement No. 114?
- How should a creditor determine if it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan agreement under FASB Statement No. 114?
- If a creditor concludes that an individual loan specifically identified for evaluation is not impaired under FASB Statement No. 114, may that loan be included in the assessment of the allowance for loan losses under FASB Statement No. 5?

The FASB *Viewpoints* publication can be obtained at the FASB Web site at www.fasb.org.

SOP 94-6. Financial institutions and auditors also need to follow the guidance in SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

More specifically, SOP 94-6 requires entities to disclose certain concentrations (described in paragraph 22 of the SOP) if, based on information known to management before issuance of the financial statements, all of the following criteria are met:

- The concentration exists at the date of the financial statements.
- The concentration makes the entity vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

Examples of concentrations that might be found at financial institutions include:

- Sale of a substantial portion of or all receivables or loan products to a single customer.
- Loss of approved status as a seller to or servicer for a third party.
- Concentration of revenue from issuances involving a third-party guarantee program.
- Concentration of revenue from mortgage banking activities.

AICPA Audit and Accounting Guides. Auditors should read chapters 6 and 7 of the Audit and Accounting Guide *Banks and Savings Institutions*, chapters 5 and 6 of the Audit and Accounting Guide *Audits of Credit Unions*, and chapter 2 of the Audit and Accounting Guide *Audits of Finance Companies*, as applicable, for a thorough discussion of auditing procedures regarding loans and loan loss allowances.

Regulatory Guidance

SEC Financial Reporting Release (FRR) No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and an Interagency Policy Statement on the Allowance for Loan and Lease Losses (Interagency Policy Statement) were jointly issued on December 21, 1993, by the SEC and the federal banking regulators. For nonpublic financial institutions, the guidance in the Interagency Policy Statement requires allowance for loan loss documentation very similar to that outlined in FRR No. 28.

More specifically, FRR No. 28 requires a registrant to follow a procedural discipline in determining the allowance for loan losses. The SEC staff expects a registrant to maintain allowance for loan loss documentation that indicates:

- That a systematic methodology was employed each period in determining the amount of loan losses to be reported.
- The rationale supporting each period's determination that the amounts reported were adequate.

Thus, even though the allowance for loan loss documentation requires numerical calculations, it is critical that financial institutions have written, qualitative narrative supporting the thought process behind the calculations in satisfying the procedural discipline required by FRR No. 28.

Moreover, financial institutions should maintain a self-correcting mechanism that adjusts loss estimation methods in order to reduce differences between estimated and actual observed losses.

Also note that FRR No. 28 requires registrants to describe their procedural discipline in the business section of the annual report.

SEC Issues New Guidance. On July 6, 2001, the SEC released Staff Accounting Bulletin (SAB) No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, which provides certain views of the staff on the development, documentation, and application of a systematic loan loss allowance methodology in accordance with generally accepted accounting principles (GAAP) as required by FRR No. 28. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses. The SAB applies to registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial statements.

Federal Financial Institutions Examination Council Issues New Guidance. In conjunction with the release of SAB No. 102, the Federal Financial Institutions Examination Council (FFIEC) issued on July 6, 2001, an Interagency Policy Statement titled *Allowance for Loan Loss and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions*.

The Policy Statement provides guidance on the design and implementation of ALLL methodologies and supporting documentation practices. Specifically, it:

- Clarifies that the board of directors of each institution is responsible for ensuring that controls are in place to consistently determine the appropriate level of the ALLL;

- States that the ALLL process must be appropriate, systematic, and consistently applied and must incorporate management's current judgments about the credit quality of the loan portfolio;
- Emphasizes the banking agencies' long-standing position that institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, and applicable supervisory guidance; and
- Provides guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the institution and its loan portfolio.

The Policy Statement also includes illustrations of implementation practices that institutions may find useful for enhancing their own ALLL processes; an appendix that provides examples of certain key aspects of ALLL guidance; a summary of applicable GAAP guidance; and a bibliographical list of relevant GAAP guidance, joint interagency statements, and other literature on ALLL issues.

The Policy Statement does not change existing accounting guidance in, or modify the documentation requirements of, GAAP or guidance provided in the relevant joint interagency statements. In this regard, the Policy Statement recognizes that estimating an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of loan losses. The text of the full document is located at the FDIC Web site at www.fdic.gov.

Interagency Guidance Points Out Important Practices. A joint interagency letter (issued July 12, 1999, by the SEC, the FDIC, FRB, OCC, and OTS) reaffirmed aspects of loan loss allowance practices.

Disclosures Related to Loan Loss Allowances. When evaluating management's discussion and analysis (MD&A) and SEC Industry Guide 3 disclosures, institutions need to fully disclose all pertinent trends, events, and uncertainties related to the allowance for loan losses. Moreover, the narrative disclosures in MD&A need to be consistent with the MD&A financial tables relating to the allowance for loan losses and loan portfolio, and with the financial statements and related footnotes.

The discussion in MD&A should be in quantified detail, explaining the changes in the specific elements of the allowance for loan losses, including instances where the overall allowance has not changed significantly. The effects of any changes in methodology should be explained and justified.

SEC Staff Actions Concerning MD&A. If statistical data, quantitative analysis, or disclosures in a registrant filing appear inconsistent with loan loss allowance levels, the SEC staff may require the institution to explain those inconsistencies. For example, data commonly used to evaluate the appropriateness of the loan loss allowance may indicate an inconsistency between the accounting for the allowance and the disclosure of material risks in the portfolio for which the allowance was maintained. In such a case, the SEC staff may issue comments on the filing relating to the loan loss allowance.

Additionally, disclosures in the filing should be consistent with the documentation supporting the level of the loan loss allowance. The SEC staff may question allowances that appear too low as well as those that appear too high, as compared with the disclosures made and the supporting documentation.

The SEC letter on the allowance for loan losses issued in January 1999 provides essential information that needs to be considered and included in the "Description of Business," MD&A, and financial statements (see the SEC Web site at www.sec.gov/rules/othern/banklla.txt). Additionally, the August 2001 SEC current accounting and disclosure letter (section K) provides further loan loss guidance (www.sec.gov/divisions/corpfin/acctdisc.html).

Earnings Manipulation and Some Audit Considerations

Given the current weak business environment, financial institutions often have good reason to increase their loan provisions, due to decreased credit quality. But how much is too much? Increasing allowances excessively in times of economic slowdown allows for potential earnings manipulation in subsequent years. The auditor may wish to determine whether the client has sound rationale for current year provision additions for 2001. Beware of large fourth quarter 2001 adjustments that are blamed only on the slow economy without specific rationale. Finally, consider historical provision percentages during former times of an institution's economic hardship. Management may manipulate earnings through the use of accounting estimates. SAS No. 57, *Auditing Accounting Estimates*, and the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information* will aid you in addressing potential manipulation.

Real Estate and Mortgage Lending

The growth in real estate lending over the past couple of years has continued in 2001. Some financial institutions are seeing increased real estate losses due to the economic slowdown, some lax underwriting standards in recent years, and the growth in subprime real estate lending. The FDIC notes that 20 percent of all mortgages written in 2000 were for loans with loan-to-value (LTV) rates in excess of 90 percent. Additionally, home equity loans have proliferated, and many consumers are carrying substantial debt loads. Given these facts, a risk of increased losses related to real estate and mortgage loans may exist at some financial institutions.

Audit Implications

The auditor should be aware of the potential for losses, particularly if the client maintains a substantial real estate and mortgage loan portfolio. If the client has been granting real estate loans to subprime members or has made a substantial number of loans with high LTV ratios, the auditor may need to evaluate the potential for future increases in losses, especially if the economy takes more time to recover than originally anticipated.

Subprime Lending Alert

In the economic downturn of the early 1990s, subprime loans were largely made by independent finance companies outside the sphere of bank regulation. Now, 10 of the 25 largest subprime lenders are parts of banks, according to *Inside Mortgage Finance*.

The subprime loan business is a particularly high-risk area because borrowers have poor credit history, job continuance issues, or other high-risk default factors. The current economic downturn has reduced the credit worthiness of the national subprime market. The percentage of subprime mortgage delinquencies nationwide rose from 5.55 percent at December 31, 2000, to 6.37 percent in May 2001.

Bank regulators have become concerned about a variety of subprime loans, including home mortgages, car loans, and credit cards. The FDIC notes that subprime lending has been to blame, at least in part, for seven of the last 19 bank failures in the country, including the recent failure of Superior Bank FSB, a large Chicago-based thrift.

Approximately 140 banks with the highest concentration of subprime loans have invested more than 25 percent of their own capital in the sector. These banks, which carry a total of $60 billion to $80 billion in loans on their books, account for only 1.5 percent of the total number of banks and thrifts, but nearly one-fifth of all problem institutions. Regulators have insisted that these banks with subprime concentrations increase their loan loss allowance and capital protection.

Large institutions have been consolidating with subprime lenders and bolstering their own subprime lending units. When properly managed, subprime lending need not cause serious problems. High rates of return counteract expected delinquencies, and profit margins help institutions post growth. However, the declining economy has increased subprime loan delinquency ratios.

Accounting Guidance

If your client maintains a high level of subprime assets or related exposures during this period of economic deterioration, you should be especially alert that adequate loan loss allowances exist for those subprime loans, that loan impairments are identified and properly accounted for and that necessary disclosures are made in the financial statements. See the guidance in this Alert about accounting and auditing considerations related to loan loss allowances. AcSEC is expected to issue an SOP, *Accounting for Purchases of Loans and Certain Debt Securities*, which gives accounting and reporting guidance for purchased loans and debt securities when the purchaser does not expect to collect all contractual cash flows and there is evidence of credit deterioration since origination. When issued, this SOP will update and supercede Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, and is expected to be effective for transfers of loans in fiscal years beginning after June 15, 2002.

The EITF addressed the accounting for retained interests in Issue 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." A consensus was reached at the July 19 through 20, 2000, EITF meeting; however, clarifications were made at the meetings held on September 20 through 21, 2000, November 15 through 16, 2000, and January 17 through 18, 2001, and the transition date was changed to March 15, 2001. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, recognizes that if an entity sells a portion of an asset that it owns, the portion retained becomes an asset separate from the portion sold and separate from the assets obtained in exchange. The issue was how interest income and impairment should be recognized for retained interests in securitizations classified as available-for-sale or held to maturity.

Subprime Lending Risks

Subprime lending is not simply prime lending with a little more risk. Not only do these loans default more frequently than prime loans, they also prepay more frequently both when interest rates decline and when a borrower's credit worthiness improves. Sudden changes in economic conditions or in interest rates can cause losses to mount quickly and high market valuations to disappear. Increased competition in the subprime market has significantly narrowed lending margins, encouraging institutions to specialize in what they believe to be their strengths. To finance greater levels of originations and servicing, institutions engaged in subprime lending have often turned to securitization, rather than deposits, as a major funding source. Risks from securitization arise from problems funding aggressive growth; over-dependence on a highly credit-sensitive funding source; creation of accelerated and unrealized earnings; and less sound, more volatile balance sheets from leveraged and concentrated residual risk, all of which are compounded in the case of subprime lending.

Subprime Securitizations and Valuation Issues

Securitized subprime loan pools present an even greater challenge to the proper valuation of residuals and servicing rights for several reasons. First, by definition, subprime loans are extensions of credit to borrowers with weak credit histories. The ability of these borrowers to make loan payments is very sensitive to changes in overall economic conditions.

Second, institutions' involvement in the subprime market has not been tested during a period of prolonged economic downturn. Higher than expected default rates reduce the value of both residual assets (since these are in the most junior position) and the servicing rights, as future payments cease and collection costs increase when loans default. As this occurs, book values of residual assets and the servicing rights should be written down. This will swiftly lower the level of regulatory capital for institutions with high levels of residual assets and servicing rights.

Third, subprime borrowers will refinance their loans to reduce interest costs if overall interest rates drop sufficiently to overcome disincentives to prepayment, as they have recently, or as borrowers' credit ratings improve. This second factor (credit-induced prepayment) is not present in prime mortgages and further complicates the valuation of servicing rights, as prepayments for either reason stop servicing income.

Fourth, some institutions have been able to use residual interests and gain-on-sale accounting (that is, the immediate recognition of the present value of expected future cash flows) to improve their capital positions by securitizing assets. This happens most often when an originator securitizes higher-risk assets such as subprime loans. Because securitization gains are directly proportional to the volume of loans securitized, in some cases the primary source of ongoing earnings growth is increased loan origination and securitization volume. This may eventually lead to the dilemma where market conditions warrant a reduction in loan origination volume; but the result would be to reduce earnings.

Regulatory Guidance

The federal banking agencies addressed subprime loans in March 1999 with the guidance *Interagency Guidance on Subprime Lending*. That guidance stressed the management and operational challenges in subprime lending, and warned of the need for increased capital and loan loss allowances. In January 2001, the agencies issued expanded and supplemental guidance, *Expanded Guidance for Subprime Lending Programs*, intended to strengthen the examination and supervision of institutions with significant subprime lending programs.

In December 1999, the federal banking agencies published *Guidance on Asset Securitization*. The interagency guidance addressed supervisory concerns with risk management and oversight of these securitization programs. The securitization guidance highlighted the most significant risks associated with asset securitization, and emphasized agency concerns with certain residual interests generated from the securitization and sale of assets. The guidance provided fundamental risk management practices that the agencies expected of institutions that engage in securitization activities. The securitization guidance stressed the need for institution management to implement policies and procedures that include limits on the amount of residual interests that may be carried as a percentage of capital.

Final Rule to Revise the Regulatory Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

At the end of October 2001, the FDIC approved a final rule that amends its regulatory capital standards regarding the treatment of certain recourse obligations, direct credit substitutes (that is, guarantees on third-party assets), residual interests in asset securitizations, and other securitized transactions that expose institutions primarily to credit risk. The other three banking agencies are also adopting this rule. The final rule amends the regulatory capital standards by:

- Providing a more consistent risk-based capital treatment for recourse obligations and direct credit substitutes and adding new standards for residual interests.
- Applying a ratings-based approach that sets capital requirements for positions in securitized transactions according to their relative risk exposure, using credit ratings from nationally recognized statistical rating organizations (rating agencies).
- Deducting from Tier 1 capital, and from assets, for regulatory capital purposes, the amount of credit-enhancing interest-only strips (a type of residual interest) that exceeds 25 percent of Tier 1 capital (concentration limit).
- Requiring a dollar in total risk-based capital for each dollar of residual interests (dollar-for-dollar capital requirement) not deducted from Tier 1 capital, except those qualifying under the ratings-based approach.
- Permitting the limited use of an institution's qualifying internal risk rating system or qualifying rating agency programs and software to determine the risk-based capital requirement for certain unrated direct credit substitutes and recourse obligations, but not residual interests.
- Providing each agency with reservation of authority to modify a stated risk-weight or credit conversion factor on a case-by-case basis.

The final rule is the product of two rulemakings: (1) the proposed rule concerning the risk-based capital treatment of recourse obligations and direct credit substitutes (Recourse Proposal) which was published in the *Federal Register* on March 8, 2000, and (2) the proposed rule regarding the capital treatment of residual interests in asset securitizations and other transfers of financial assets (Residuals Proposal), which was published in the *Federal Register* on September 27, 2000. The decision to merge the rulemakings is generally consistent with the Residuals Proposal, which discussed the similarities in the types of credit enhancements covered under the two Proposals, disclosed the differences in the two Proposals for the capital treatment of these credit enhancements, and acknowledged the need to reconcile these differences in any final rule.

Provided the final rule is published in the *Federal Register* by the end of November 2001, this final rule will be effective January 1, 2002, for any transaction covered under this rule that settles on or after the effective date. Banking organizations that have entered into transactions before the effective date of the final rule may elect early adoption, as of the publication date, of any provision of the final rule that results in a reduced risk-based capital requirement. Banking organizations that have entered into transactions that settle before the effective date of this final rule that result in increased capital requirements may delay the application of this rule to those transactions until December 31, 2002.

Treatment of Recourse and Direct Credit Substitutes Under the Final Rule

Recourse refers to an arrangement in which an institution retains risk of credit loss in connection with a sale of its own assets, where the risk retained exceeds a pro rata share of the institution's claim on the assets. Although the banking agencies' existing risk-based capital standards address the treatment of assets sold with recourse, the term *recourse* would be defined for the first time in the final rule. As defined in the existing capital standards, direct credit substitutes generally are off-balance sheet financial guarantees and equivalent arrangements, including financial standby letters of credit, in which an institution assumes risk of credit loss from a third party's assets. The final rule revises the coverage of this term to explicitly include items such as purchased subordinated interests and agreements to absorb credit losses that arise from purchased loan servicing rights. The final rule's definitions are intended to cover all arrangements that are recourse or direct credit substitutes in form or in substance.

The final rule generally treats recourse and direct credit substitutes consistently by extending the current gross-up treatment of assets sold with recourse, along with the low-level recourse rule, to direct credit substitutes. However, certain recourse arrangements and direct credit substitutes in asset securitization transactions could qualify for a more favorable treatment under the final rule's ratings-based approach.

Treatment of Residual Interests

The final rule imposes a concentration limit on a subset of residuals defined in the final rule as credit-enhancing interest-only strips and a dollar-for-dollar capital requirement on residual interests not deducted from Tier 1 capital. Under the dollar-for-dollar requirement, a banking organization that sells $100 in assets and retains a residual interest of $10 would generally be required to hold $10 in capital for this exposure. Under the existing rules, the same banking organization would only be required to hold $8 in capital for the $10 exposure, $8 being the full capital charge on the $100 in underlying assets sold.

Residual interests generally include any on-balance-sheet asset created by a sale of financial assets that results in the retention of any credit risk directly or indirectly associated with the transferred assets, where the retained risk exceeds a *pro rata* share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include, but are not limited to, credit-enhancing interest-only strips, spread accounts, and cash collateral accounts. Residual interests also include purchased credit-enhancing interest-only strips.

Under the final rule, credit-enhancing interest-only strips, a type of residual interest, would be limited to 25 percent of Tier 1 capital, with the excess deducted from Tier 1 capital and from assets. Those credit-enhancing interest-only strips not deducted from Tier 1 capital would be subject to the dollar-for-dollar capital requirement. Credit-enhancing interest-only strips are generally assets created from the excess interest on assets sold (after administrative expenses, investor interest payments, servicing fees, and credit losses on investors' interests in these assets are recognized) that serve as credit enhancements for the investors.

The agencies limited the type of residuals subject to the concentration limit to credit-enhancing interest-only strips in recognition of the fact that these assets generally serve in the first loss position and are typically the most vulnerable to significant write-downs. These write-downs can occur because actual losses or prepayments are greater than originally estimated or because of a more general need to revise the assumptions used to value these assets. In addition, credit-enhancing interest-only strips are the asset type most often associated with the creation of capital as a result of gain-on-sale accounting, which allows a banking organization to leverage the capital created based on the current recognition of uncertain future cash flows. The capital created, however, may no longer be available to support these assets if write-downs later become necessary.

The aggregate capital requirement for residual interests should not exceed 100 percent of their on-balance-sheet exposure. The final rule will allow banking organizations the option of netting existing associated deferred tax liabilities against residual interests for regulatory capital purposes. In addition, residual interests (with the exception of credit-enhancing interest-only (I/O) strips) may qualify for a more favorable treatment under the ratings-based approach. Under this approach, the face amount of residual interests that have been rated by a nationally recognized statistical rating organization investment grade or one category below investment grade are risk-weighted at from 20 percent to 200 percent, depending on the rating category. Residuals that are "traded" must have at least one rating, while those that are not "traded" must have at least two ratings. A residual's risk weight is determined by its lowest rating.

The Computer Home Appraiser

In the past, a visit from a loan appraiser meant having every nook and cranny of a house dusted for financial impairment or improvement. Due to the high cost of appraisals, some mortgage lenders are turning to automated systems that use statistical models to compute appraisal values in seconds. The systems, which are often provided to lenders by either Fannie Mae or Freddie Mac, analyze databases of neighborhoods and then compare those properties to the property under appraisal. Another variable used in the calculation is the historical selling price information for the particular property.

Fannie and Freddie release buyers from a formal appraisal only when the automated valuation is similar to the buyer's price. If the appraisal is significantly less, a traditional in-house or less invasive "drive-by" valuation is used. A traditional appraisal usually costs $250 to $400. Fannie's automated appraisal is free and Freddie's ranges from $50 to $200.

However, the new system is generating a lot of controversy, especially from appraisers. Some appraisers believe the system is useful in certain cases but are concerned that significant trouble could occur if the appraisal system is found to be inaccurate down the road.

Auditing Considerations

Unfortunately, sometimes institutions do not worry about whether an appraisal is correct. Inflated appraisals were a large part of the savings and loan crises of the 1980s. Lenders are increasingly selling the loans they make to secondary-market investors, like Fannie and Freddie. Additionally, many home loans are issued through mortgage brokerage firms, which are relatively unregulated compared to banks. The brokers often charge fees based on a loan's size and have little or no stake in the ultimate performance of the mortgage. They could be tempted to pressure appraisers to come up with bigger values.

Another audit consideration is the increased use of credit scoring by clients in their loan approval decision process. As loan decisions become more automated, institutions are using credit scores to a greater extent to approve loans and determine the loan's interest rate and other terms. Traditional, more manual underwriting and evaluations of customers' credit capacity are often relied on to a lesser extent, as credit scores become the predominant factor in the loan approval decision process. The auditor may need to thoroughly understand the effect of the credit scores in evaluating current and future expected loan losses and in the evaluation of management's loan approval process. Assurance should be gained that the scoring system in use is reliable and properly validated. For further information on credit scoring, see the "Consumer Loan Delivery Channels and Systems" section of this Alert.

Fraud and Illegal Activities

Money Laundering Developments

Criminals use financial institutions to launder the proceeds of crime. Omnibus providers of diversified financial services may be particularly vulnerable because they provide a broad range of financial services that money launderers want and need, often in higher-risk jurisdictions.

Definition of Money Laundering

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from $500 billion to $1.5 trillion.

Money Laundering in the Electronic Age

Recent cases underscore how criminals are increasingly using personal computers, banking software, electronic funds transfers, and the Internet to launder the proceeds of their illicit activities. Large volumes of high-speed wire transfers between institutions on a daily basis make it exceedingly difficult for regulators, law enforcement, and financial institutions to identify money laundering activities.

Inadequate Controls Increase Risk of Money Laundering

Evidence suggests that financial institutions penetrated by money launderers may not have sufficient controls in place for effective money laundering risk management, including adequate processes for identifying unusual activity and determining whether unusual activity is really suspicious and reportable.

In a number of instances, organized crime associates were employed at the affected institutions and existing controls were inadequate for management to detect suspicious or improper relationships and activities involving the criminals.

Related Laws and Regulations

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the Treasury Department to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money-laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties.

The BSA contains a suspicious activity reporting (SAR) requirement that applies to insured banks, savings associations, savings association service corporations, credit unions, bank holding companies, non-bank subsidiaries of bank holding companies, edge and agreement corporations, and U.S. branches and agencies of foreign banks operating in the United States. These financial institutions are required to report suspicious activity following the discovery of insider abuse involving any amount, violations aggregating $5,000 or more when a suspect can be identified, violations aggregating $25,000 or more regardless of a potential suspect, or transactions aggregating $5,000 or more that involve potential money laundering or violations of the BSA. In June, 2000 the NCUA, FRB, FDIC, OCC, and OTS issued a newly revised SAR form.

The BSA also contains regulations requiring financial institutions to file currency transaction reports (CTRs) for cash transactions greater than $10,000.

BSA Compliance Deficiencies. Recent examinations by the OCC have revealed some common BSA compliance deficiencies. The OCC found that some institutions failed to adequately:

- Document and evaluate new, high-risk accounts for money laundering.
- Establish controls and review procedures for high-risk services.
- Monitor high-risk accounts for money laundering.
- Conduct adequate, independent testing of high-risk accounts for the possibility of money laundering.
- Train employees to detect suspicious activity in higher-risk areas.
- Review CTR filing patterns for suspicious activity.

The OCC reminds financial institutions that they must have adequate internal controls, independent testing, responsible personnel, and training to comply with the BSA.

Federal Government Initiative Looks to CPAs to Fight Money Laundering

The government's National Money Laundering Strategy Report of September 2001 identifies addressing the role of "legal and accounting professionals in combating money laundering" as a priority supporting the objective of increasing usefulness of reported information to law enforcement agencies and the financial industry (www.treas.gov).

Money Laundering and Financial Statements

Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than are such types of fraud as misappropriations and consequently is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money-laundering activities may have indirect effects on an entity's financial statements.

Nevertheless, independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients*, to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements.

Possible indications of money laundering include the following:

- Transactions that appear inconsistent with a customer's known legitimate business or personal activities or means; unusual deviations from normal account and transaction patterns.
- Situations in which it is difficult to confirm a person's identity.
- Unauthorized or improperly recorded transactions; inadequate audit trails.
- Unconventionally large currency transactions, particularly in exchange for negotiable instruments or for the direct purchase of funds transfer services.
- Apparent structuring of currency transactions to avoid regulatory recordkeeping and reporting thresholds (such as transactions in amounts less than $10,000).
- Businesses seeking investment management services when the source of funds is difficult to pinpoint or appears inconsistent with the customer's means or expected behavior.

- Uncharacteristically premature redemption of investment vehicles, particularly with requests to remit proceeds to apparently unrelated third parties.
- The purchase of large cash value investments, soon followed by heavy borrowing against them.
- Large lump-sum payments from abroad.
- Purchases of goods and currency at prices significantly below or above market.
- Use of many different firms of auditors and advisers for associated entities and businesses.
- Forming companies or trusts that appear to have no reasonable business purpose.

Money laundering is considered to be an illegal act with an indirect effect on financial statement amounts. Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts have occurred. If specific information comes to your attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, you should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

You should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

Section 10A of the Securities Exchange Act of 1934. The Private Securities Litigation Reform Act of 1995, among other things, amended the Securities Exchange Act of 1934 (the Exchange Act) to add Section 10A. This section requires that each audit under the Exchange Act include procedures regarding the detection of illegal acts, the identification of related party transactions, and an evaluation of the issuer's ability to continue as a going concern. Section 10A also codified certain then-existing professional auditing standards regarding the detection of illegal acts by issuers and imposed expanded obligations on auditors to report in a timely manner to management any information indicating that an illegal act has, or may have, occurred. The auditor must ensure that the audit committee or board of directors is adequately informed with respect to an illegal act, as broadly defined by Section 10A, unless the illegal act is clearly inconsequential.

In addition, Section 10A requires the issuer to notify the SEC within one business day after the issuer's board of directors is informed by its auditor that the auditor reasonably expects to resign from the audit engagement or to modify its audit report due to an illegal act that has a material effect on the issuer's financial statements for which appropriate remedial action has not been taken by senior management and the board of directors. If the issuer does not notify the SEC within that period, then the auditor, within the next business day, must provide a copy of the illegal acts report (or documentation of any oral report) that it gave to the board directly to the SEC. Section 10A provides for cease and desist and civil money penalties to be imposed against auditors who willfully fail to provide the required reports.

Financial Crimes Enforcement Network Advisories

The Financial Crimes Enforcement Network (FinCEN) is the policy-making and law enforcement agency within the U.S. Department of the Treasury that supports law enforcement investigative efforts and fosters interagency and global cooperation against domestic and international financial crimes. FinCEN constantly issues advisories about transactions. These advisories normally instruct financial institutions to give enhanced scrutiny to any transaction originating in or routed through "higher-risk" jurisdictions. Periodically, the federal government reviews and reassesses foreign government and financial system risk, cooperation, and compliance and accordingly adds names to and removes names from the sanction lists. It should be emphasized that the issuance of these advisories does not mean that financial institutions should curtail legitimate business with these jurisdictions.

National Interdiction and Sanction Laws

The Department of the Treasury's Office of Foreign Assets Control (OFAC) administers sanction programs against Libya, Iraq, Cuba, the National Union for the Total Independence of Angola (UNITA), Syria, Sudan, Yugoslavia, Burma, Iran, the Taliban in Afghanistan, and generally persons who are classified as "specially designated nationals" (SDNs), who may include known international terrorists and narcotics traffickers. Financial transactions with these regimes, entities, and individuals may be prohibited or restricted by federal law. Information concerning OFAC rules, lists of prohibited entities, and general OFAC information can be obtained on the OFAC Web site at www.ustreas.gov/ofac.

In the Spotlight

Consumer Loan Delivery Channels and Systems

New and expanding competitive forces, consumer demands, and technological capabilities have all contributed to a changing lending environment. Consumer loans today must be processed, approved, and funded timely and efficiently to satisfy ever-increasing consumer expectations and competitive cost pressures. Every day the list of available sources for consumer loans is growing, including new online competitors, such as electronic lenders (e-lenders), and the growing presence of captive finance companies such as (GMAC).

Numerous lending channels, resources, and tools have been developed in the past few years with the goal of helping institutions compete in the marketplace and produce loans more timely and efficiently. New and growing delivery sources include online loan applications and approvals, dealer indirect lending, loan kiosks, third-party 24-hour phone approval centers, in-house call centers, and various joint ventures. The goal of these different channels is to increase the speed and efficiency of loan processing, approval, and funding. To process loans through this expanding list of delivery channels while meeting consumer demands for quick and efficient loan approvals, financial institutions are placing an ever-increasing reliance on credit scores, risk-based pricing, and other information tools to approve and process loans.

With these new delivery channels, lending tools, and technologies come new types of credit risks and internal control factors that need to be addressed. In implementing these various new lending systems, it is critical that management is aware of and has taken reasonable measures to control these emerging risks for each critical new loan channel and source. The auditor should gain assurances that reasonable controls are in place to prevent and detect losses and potential fraudulent activity. Additionally, reasonable systems to evaluate loan quality across the different loan systems should be tested. Critical risks and control factors for various loan channels and systems are summarized below.

Dealer Indirect Lending

In some areas of the country there has been tremendous growth during the last couple of years in financial institution dealer indirect lending programs. Auto lending has traditionally been one of the largest components of a lending portfolio, but in the past these loans have mainly been made directly with the customers, while other financial institutions have developed financing relationship with auto dealers. Due to several factors, institutions have recently begun to take advantage of indirect lending opportunities. Many institutions are now deriving a substantial portion of loan growth from this new revenue source.

Because the vast majority of auto loans still originate at dealerships, indirect lending provides a tremendous resource for institutions to continue to expand their loan portfolios, and indirect lending will likely continue growing as one of the more important sources of consumer loans. While the dealer lending programs offer benefits and much opportunity for growth, there are also new risks, challenges, and internal controls that must be addressed by management to ensure the programs are operated in a safe and sound manner.

Whether the indirect lending program is offered through an in-house program with the institution dealing directly with the dealer or with the use of a third party, there are several new controls that should be considered. Substantial losses can occur in a short period if an indirect program is established without reasonable procedures and controls. The auditor may need to gain an understanding of the controls in place over the indirect program and assess the overall quality of the indirect loans in the portfolio.

Typically, there are two types of programs: one in which the dealer is paid the entire amount of interest up-front and one in which the dealer is paid as the loan is collected. Customs of the local markets usually dictate which program is prevalent. With the first type of arrangement, there is considerable risk since the dealer has already been paid up-front. When a loan is paid off early, the institution is then burdened to collect that prepaid interest from the dealer. If the dealer is unable to pay back the institution, the dealer may provide more loans to in effect cover its deficiency. In the end, the institution can be saddled with loans from a dealer who is unable to repay in the not-so-rare event of prepayment of the loan.

Common Indirect Lending Control Weaknesses. Some common pitfalls and control weaknesses associated with indirect lending programs that could potentially result in material losses and other problems include:

- Poor monitoring procedures
- Deficient program quality controls
- A lack of segregation of duties
- A lack of standardization between dealers and a general lack of dealer monitoring and controls
- Matrix (approval and pricing) factors that are subject to dealer manipulation without reasonable procedures to substantiate or otherwise test the validity of these factors
- No established program limits
- Inadequate planning, pricing analysis, and credit scoring or other approval analysis

- A lack of review by legal counsel
- Deficient operational policy statements and procedures
- Noncompliance with the regulatory issues such as UCC, Reg. Z, and state laws and regulations

Recommended Internal Controls. The following controls can help ensure the soundness of an indirect lending program:

- System controls to flag the dealer accounts
- System controls to identify the loans by dealer code and score
- Program delinquency reports (delinquency by dealer, loan-to-value by dealer, first payment defaults by dealer, charge-off by dealer, forced-placed insurance by dealer, title problems by dealer, grade of paper received by dealer)

Loan Credit Scoring and Risk-Based Lending

The use of credit scores as a tool in the loan approval decision process has grown considerably over the past few years. One of the more common scores is a FICO (Fair Isaac Company) score. As loan decisions become more automated, financial institutions are using credit scores to a greater extent to approve and determine the interest rate for consumer loans. Traditional underwriting and evaluations of customers' credit capacity are often relied on to a lesser extent, as credit scores become the predominant factor in the loan approval decision process. The auditor and management should thoroughly understand the impact of the credit scores in evaluating expected loan losses.

Assurance should be gained that the scoring system in use is reliable and has been properly validated. Management must have the capability to properly estimate the expected performance of each category of credit scores. System controls should be in place to capture and report relevant credit scoring information, including the ability to monitor performance by credit scores.

Another lending tool or system that has grown considerably is the use of risk-based lending (RBL) or pricing programs. RBL programs are becoming increasingly common in many financial institutions. RBL refers to pricing different categories of loans according to the risk or probability of default. Not all borrowers are viewed as equals, but rather loans are made and priced according to the borrower's credit. An applicant's creditworthiness is rated usually in conjunction with a credit scoring system. Hopefully, the result is greater loan volume and greater overall portfolio returns because the institution can better price loans in accordance with risk, expand its customer and loan base, and reach more underserved customers who may otherwise be declined. Even though RBL programs can serve as a valuable program and resource and help the financial institution meet expanding competitive pricing constraints, the programs also present substantial new risks of losses and compliance concerns.

Common Credit Scoring and Risk-Based Lending Control Weaknesses. Some common pitfalls and control weaknesses with credit scoring and risk based pricing/lending programs that could potentially result in material losses and other problems include:

- Making substantially more high-risk loans than intended
- Inadequate reporting mechanisms to alert management and the board of potential problems
- Lack of training and understanding by personnel and management covering credit scoring and risk-based lending
- Using old or outdated scoring models and a lack of validations and revalidation resulting in faulty loan approval and pricing decisions
- Incomplete policies and procedures covering both RBL and credit scoring
- Inefficient use of databases, purging of data, and lack of controls covering data entry
- Inconsistent decisions and excessive overrides of scores

- Errors in calculations of scores and rates. System parameters established incorrectly and with lack of proper knowledge and control
- Improper pricing of risk tiers
- A lack of knowledge and information on the profitability of the individual risk tiers
- Incomplete monitoring of scoring and RBL

The auditor may need to determine that the financial institution has established a reasonable control environment for its RBL and that it has properly addressed any regulatory advisories and requirements. An understanding should be gained of the potential effect of higher risk loan categories on loan losses and the allowance for loan losses.

Online Lending

In the last few years several institutions have been offering loan applications on their Web sites. Only recently has this process expanded into true online lending, whereby the customer not only can apply for a loan online, but also can get his or her loan automatically approved and potentially disbursed over the Internet. This online approval process will continue to grow in the near future. Obviously, this emerging delivery channel presents new security and other risks.

Potential Risks. Security risks include those that encompass the institution's entire electronic commerce (e-commerce) controls. The institution must have reasonable controls to validate the identity of the individual customer who is applying for a loan online. Also, because critical financial and personal information is contained in a loan application, the financial institution must ensure that all loan application information is properly secured. In addition, a risk exists that approval decisions reached for online loans may not be reasonably consistent with loans approved through other delivery channels.

Help Desk—For a thorough understanding of e-business risks, internal control matters, and e-business audit considerations, see the Audit Risk Alert *E-Business Industry Developments—2001/02.*

Regulatory Compliance. Another important consideration is regulatory compliance. There is a potential that critical loan regulations may be overlooked for loans applied for and processed over the institution's Web site. Because these systems are often still developing, compliance with regulations may not be complete. For example, the required lending disclosures may not be posted on the Web site.

Traditional Securitization Components

Securitizatons in their traditional form can be lucrative from both profitability and funding perspectives. In other words, the use of these instruments is not problematic by any means as long as the bank is knowledgeable in the activities in which they engage. For instance, in a "plain vanilla" securitization, the bank originates mortgages and packages them into securities through the secondary market. In this case, the bank may retain the servicing portion only or may hold some of the securities in its portfolio. The key is understanding and appropriately valuing the components retained, which comes from experience in dealing with these types of instruments.

Securitization

Securitization enables an institution to convert a pool of loans into a mix of top-investment grade, highly marketable securities (typically sold for cash), and lower-grade, subordinate credit-risk-concentrated securities. The cash flows (interest and principal payments) are reapportioned from the loan pool to the security holders in the order of their seniority. Any shortfall in cash flows due to losses in the loan pool affects the residual security holders first, because they are the last to be paid. The residual security holder is in a "first dollar loss" position and thus is exposed to the risk of the entire loan pool. The lower yield on high-quality, low-risk senior securities may offset the higher yields required on more junior positions. This is especially true if the issuer, who is in the best position to evaluate the credit quality of the loan pool, keeps the most risk-exposed subordinate positions. In essence, the issuer is certifying the quality of the pool by a willingness to be exposed to the most risk.

The ability to leverage origination capacity and supplement revenues through servicing fee income has been an important benefit for financial institutions. Accompanying this relaxation of funding constraints, however, may be increased exposure in areas such as operational capabilities. This pressure grows exponentially when securitization becomes the only viable method of funding ongoing operations and meeting business objectives. The substantial fixed costs associated with establishing and maintaining origination and servicing facilities and staff require a continual high volume of loan originations and securitizations.

As the securitization market has matured, issuers have offered incremental changes in their obligations and enhancements to structural credit to increase the value of their investment-grade securities. Examples include revolving-asset structures, typical in credit card securitizations, and seller-provided credit enhancements, such as cash collateral or spread accounts. Issuers also may credit enhance their securities by using "A" and "B" pieces, with "B" pieces having risk of first loss and they also use I/O strips to credit enhance. The extent to which an institution has transferred the risks of a loan pool to outside investors has become much more difficult to ascertain with the advent of these new credit enhancements. Assumptions made by institutions regarding, for example, seller-servicing actions and residual asset valuations, and the complexity of accounting rules make the determination of the extent of retained risk and the valuation of the retained interests difficult.

One of the key issues arising out of subprime securitizations is the valuation of retained subordinate positions—seller-provided servicing and residual interests.

Seller-Provided Servicing

The primary duty of a servicer is the collection and pass-through of funds from the underlying borrowers to the trustee, investors, or both. Other duties include loss mitigation and workout, investor accounting, custodial account management, collateral protection through foreclosure, and escrow management. There has been a migration of originators into subprime and/or lower quality asset types, as well as a growing number of instances where originators are providing both servicing and credit enhancement to the same transaction. This combination has raised new issues regarding the assumption of risk for seller-servicers that may be able to offset losses by artificially keeping loans current through servicer advances. The concern is that investors, who receive principal and interest payments from loans that are not paying as agreed, may be unaware that the credit enhancement vehicle that supports their receipt of principal and interest payments is slowly being exhausted. At some point, this vehicle will be unable to support further advances to the investor and the investor's securities will be downgraded. This situation may be compounded if the issuer continues to recognize inflated over-collateralization assets on its balance sheet.

Residual Interests

Residual interests are subordinated assets that typically expose the holder of these assets to concentrated levels of credit and prepayment risk. Not all securitization transactions result in the retention of residual interests. Structural enhancements that involve a seller's retention of risk typically take two forms:

1. Loss positions where an originator offers its right to excess interest income (after servicing, coupon payments, and normal loss expectations) and/or a cash collateral account. These are designed to cover some small multiple of expected losses on the underlying asset pool.

2. Loss positions where an originator may retain a subordinated interest in the securitized asset pool or pledge additional assets as an overcollateralization cushion. These are designed to cover more severe or catastrophic levels of loss.

Collectively, these exposures are referred to as "residual interests" for accounting and risk-based capital purposes. Because a large portion of the risk associated with the assets sold in a securitization is often embedded within these residual interests, revisions to the underlying assumptions on these assets can have a dramatic effect on the fair value of the residual interests. Fair value is the basis for the initial measurement and, in many cases, the ongoing measurement of residual interests on institutions' balance sheets.

Reliable fair values are particularly difficult to obtain on residual interests because no active market exists for many of these assets. Fair value estimates may be based on a variety of highly variable assumptions about expected cash flows. The institution should have in place a methodology that is consistently applied and considers prepayment estimates, appropriate discount rates, realistic loss assumptions, and cash flow modeling. Without such methodology and discipline in place, the institution can be in a position of having subsequent write-downs to reflect more realistic outcomes or changes in market conditions. Obviously, this can leave institutions with a large volume of residual interests in a considerably weaker financial position. Residual interests are exposed to a significant level of credit and interest rate risk that make their values extremely sensitive to changes in the underlying assumptions. This sensitivity is magnified in the case of subprime residuals. As a result, these volatile residual interest assets provide little real capital support, particularly in times of stress.

Two-Step Securitization Required

Non-bank securitizers tend to use a two-step process to structure many securitizations in order to satisfy the isolation requirements of FASB Statement No. 140. This Statement requires that transferred assets must be put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. If transferred assets are not sufficiently isolated, the transfers will not qualify for sale treatment under GAAP and the transferred assets must be reported as assets on the institution's balance sheet with the sale proceeds reported as a secured *borrowing*. The two-step approach solves the problem of complying with this isolation requirement.

Many banks, however, use a single step approach when securitizing. This single-step approach makes the securitization vulnerable to an arcane legality called an "equitable right of redemption." This legality might theoretically permit a transferor to recover transferred assets, which is at odds with FASB Statement No. 140's isolation requirement. Recent FASB guidance requires banks (and other similarly positioned transferors) to use the two-step approach to structure many securitizations (assuming that the goal is to account for the securitization as an off-balance sheet sale). The change will affect many transactions, particularly revolvers and deals that feature securities issued in debt form.

What Are the Steps for the Proper Isolation of a Securitization?

1. The parent (P) establishes a wholly owned subsidiary (S), carefully designed to be bankruptcy remote. P transfers assets to S, and a payable arises for S. Even without the exchange of cash, lawyers deem this transfer a true sale. As a result, accountants are content that the transaction satisfies the isolation requirement of FASB Statement No. 140. However, at this point, no funds have been raised and securitization has not yet occurred.
2. S transfers assets to the Issuer (I) for the exchange of cash and a retained interest in I's assets. I is a securitization vehicle (often but not necessarily, a qualifying special purpose entity). Step 2 introduces credit enhancements so the retained interest may be subordinated to I's senior interests or S may be entitled to reserve fund proceeds if credit losses are not above expectations. Enhancements such as these leave doubt about whether step 2 is a true sale alone. Instead, step 2 might be judged only a secured borrowing, falling short of the FASB Statement No. 140 criteria.

Subsequent to step 2, I may choose to issue assets to third party beneficial interests in exchange for cash and use the funds received to purchase assets (for example, pools of credit card balances from the bank).

FASB Statement No. 140 permits an aggregate holistic view of the first two steps for an isolated securitization transaction and rules that isolation has been met because of the first step. However, many banks have set up transactions without step 1, with P transferring assets directly to I, with I only being a "qualifying special purpose entity" that is not bankruptcy-remote, rather than a isolated subsidiary.

How Will Transition Work?

In order to restructure current deals, banks usually must obtain the affirmative approval of a majority of investors in each of the beneficial interests. Therefore, transition time will end on the earlier of obtaining the necessary investor approvals or five years subsequent to the publication of FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets.*

Use the following table to see when an institution must apply the proposed transition provision.

The Bank (P) Transfers Assets Directly to an Issuer (I) in a Single Step Securitization and:	*FASB Statement No. 140 Transition Rules*	*Transition Guidance of Technical Bulletin*
No assets are transferred nor beneficial interests issued after 3/31/01.	FASB Statement No. 140 does not apply. Continue to account for the old transfers under accounting standards prevailing at the time of the transfer.	None needed.
Assets are transferred after 3/31/01 pursuant to pre-3/31/01 commitments to third-party beneficial interest holders (e.g., a revolving commitment in a credit card deal). No new beneficial interests issued after 3/31/01.	FASB Statement No. 140 does not apply. Account for the committed transfers under accounting standards prevailing at the time of the commitment.	None needed.
Assets are voluntarily transferred after 3/31/01 (e.g., not pursuant to a commitment) and new beneficial interests are issued.	Transfer requirements of FASB Statement No. 140 apply for post 3/31/01 transfers. If the issuer is a QSPE, FASB Statement No. 140 QSPE guidance applies.	Yes. The isolation provisions of FASB Statement No. 140 continue to apply to transfers during 2001. Additional transition time may be available.

The FASB notes that many series of beneficial interest outstanding today will have paid off within the five-year window, eliminating the need for the institution to obtain approval from these series holders. However, the one condition that must be met before an institution can benefit from additional transition rules is that all new beneficial interests issued after the publication of the Technical Bulletin must permit the use of a two-step transfer.

Auditing Considerations

The structure of transactions must be examined for legal isolation requirements and the timing of transactions will need to be scrutinized for proper compliance.

The value of retained interests in securitizations must be supported by objectively verifiable documentation of the assets' fair market value, using reasonable, conservative valuation assumptions. Retained interests that do not meet such standards or that fail to meet the supervisory standards will be classified as losses and disallowed as assets of the bank for regulatory capital purposes. Bank management should implement policies and procedures that include limits on the amount of retained interests that may be carried as a percentage of capital.

Institutions that lack effective risk management programs or engage in practices that present safety and soundness concerns may be subject to more frequent supervisory review, limitations on retained interest holdings, more stringent capital requirements, or other supervisory response.

Auditors should determine that an institution complies with the accounting requirements encompassed in FASB Statement No. 140 and FASB Technical Bulletin No. 01-1. In November 2001, the Auditing Standards Board (ASB) issued auditing Interpretation No. 1, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336). Interpretation No.1

supersedes the Interpretation "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125," issued in February 1998 and amended in October 1998. The new Interpretation No. 1 is effective for auditing procedures related to transfers of financial assets that are required to be accounted for under FASB Statement No. 140, as amended by FASB Technical Bulletin No. 01-1. The new Interpretation addresses the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets has met the isolation criterion in paragraph 9(a) of FASB Statement No. 140.

Issuance of FASB Technical Bulletin No. 01-1

FASB Technical Bulletin No. 01-1 was issued to provide transitional relief to institutions that are faced with some difficult logistical consequences of this requirement to follow a two-step securitization process. See the "Accounting Pronouncements and Guidance Update" section of this Alert for more information about FASB Technical Bulletin 01-1.

Predatory Lending

Predatory lenders take advantage of people who have tarnished credit histories or may not have access to lower cost sources of credit. Borrowers may lack financial experience and adequate information. Predatory lenders use lending practices that are unfair, deceptive, or fraudulent. Through a combination of questionable marketing tactics, collection procedures, and loan terms, predatory lenders deceive and exploit such borrowers. Predatory lenders often charge excessive fees and manipulate borrowers into loans they cannot afford to pay. Often, serious harm is inflicted upon the financial health of people who are the targets of predatory lenders.

Unfortunately many predatory lending variables mirror the subprime lending market. Subprime lenders responsibly loan money to people with tarnished credit who would otherwise not qualify for loans.

Legislation Proposed on Predatory Lending

The Senate Banking Committee held a series of hearings in July 2001 on predatory lending. The hearings also laid the foundation for possible future comprehensive legislation. Proposed legislation calls for increasing the number of loans subject to protection under the Home Ownership Equity and Protection Act of 1994. The proposed bill suggests expanding the government's power by restricting a creditor from financing any prohibiting prepayment penalties after the first two years of the loan and limiting the prepayment penalties during the first two years, up to 3 percent of the loan's total. The proposed legislation also would outlaw up-front payment or financing of credit insurance on single-premium bases, prevent balloon payments, and limit mandatory arbitration clauses to make it easier for borrowers to sue lenders.

Lending Loophole

Many legal loopholes exist for financial institutions to bypass existing laws and regulations to make predatory loans. For example, the Virginia state cap on interest rates is 36 percent. However, a cash outlet chartered in Virginia recently charged a consumer an incredible 443 percent for a short-term "payday" loan; so called because these loans typically must be retired by the next payday. The outlet avoided the state law by not lending the money itself. Instead, a small, federally charted bank located in California issued the loan. Under well-established federal law, federally chartered banks are permitted to bypass state usury and other laws.

In response to market demand and the expansion of cash outlets, about 30 states have created exemptions that allow payday lenders to charge rates much higher than those permitted under state usury laws. Legislatures have been willing to do this because they see a great demand for payday loans, but want to keep the rates somewhat in check to keep people out of the clutches of illegal loan sharks. Moreover, payday loans are viewed by many as a lesser evil than a prior alternative, so-called title loans, where the lender takes claim to the borrower's vehicle in the case of default.

Getting federal banks involved has allowed payday lenders to increase interest rates over the legal limit in states that allow payday loans. Between 5 percent and 10 percent of payday loans are now made through national banks.

Risky Business

Auditors should note that the losses on predatory loans are higher than average. Also, cash outlets suffer the loss because they take over the loan from the bank usually within a day and assume responsibility for collections as well as 95 percent of the risk and profits. Traditional financial institutions themselves may be purchasing interests in organizations offering payday loans in order to capitalize on this new type of consumer revenue stream. Such business decisions could increase an institution's risk of loss and legal liability. Predatory lending subjects institutions that may be directly or indirectly involved to costly litigation. Additionally, predatory practices may involve violations of fair lending statues and other consumer protection provisions.

Regulatory Action

Due to the issues surrounding predatory lending, a task force of representatives from the federal banking agencies, the NCUA, the Department of Justice, FTC, and HUD is studying the issue and plans on developing recommendations and actions to curb predatory practices. Ideas under consideration include stricter enforcement of fair lending rules and new laws to further regulate predatory lending. Already, the Treasury Department and HUD have issued proposals to crack down on predatory lending practices. These proposals include increased consumer education and new legislation that would outlaw certain predatory practices. State regulators are already implementing new standards and issuing fines to predatory lenders, and Fannie Mae and Freddie Mac are taking increasingly aggressive actions to ensure that their loan purchases do not encourage predatory lending.

On July 25, 2000, the OCC issued an Advisory Letter (www.occ.treas.gov/ftp/advisory/2000-7.txt) to institutions they regulate and to their examining personnel. The advisory alerts appropriate individuals to abusive lending practices that may involve violations of fair lending and other consumer protection laws and regulations.

On April 5, 2000, the OTS issued an Advance Notice of Proposed Rulemaking titled "Responsible Alternative Mortgage Lending" (www.ots.treas.gov:8765/query.html). The notice seeks public input on potential approaches that will facilitate thrifts' efforts to responsibly address the lending needs of traditionally underserved markets, consistent with safe and sound operation.

Recent Regulatory Actions at a Glance

The financial institution industry in general is subject to various monetary and fiscal policies and regulations, which include but are not limited to those determined by the FRB, the OCC, the FDIC, state regulators, the OTS and the NCUA.

This section presents some important recent regulatory actions. The list of regulatory actions is not comprehensive and information provided represents only summaries of the regulations. Readers should visit the Web sites of the various regulatory agencies for complete listings of new regulations and for full descriptions of the regulations. Regulatory Web sites are:

- FDIC: www.fdic.gov
- FFIEC: www.ffiec.gov
- FRB: www.federalreserve.gov
- NCUA: www.ncua.gov
- OCC: www.occ.treas.gov
- OTS: www.ots.treas.gov
- SEC: www.sec.gov

Interagency Guidance

- On January 10, 2001, the Federal Reserve and Treasury Department approved a joint final rule governing the merchant banking activities of financial holding companies (www.federalreserve.gov).
- On January 17, 2001, the FRB, FDIC, OCC, and OTS adopted guidelines for financial institutions to safeguard customer information. These safeguards relate to administrative, technical, and physical safeguards for customer records and information (www.federalreserve.gov).
- On January 19, 2001, the Federal Reserve and Treasury Department approved a final rule establishing the alternative criteria that certain large banks may satisfy to control a financial subsidiary under the Gramm-Leach-Bliley Act (www.federalreserve.gov).
- On January 22, 2001, the FRB, OCC, OTS, FDIC, and the Treasury and State Departments issued guidance to banks on accounts held by senior foreign officials and closely related persons or entities that may involve proceeds from corruption (www.fdic.gov/news/news/financial/2001/fil0106.html).
- On January 31, 2001, the FRB, FDIC, OCC, and OTS issued expanded guidance intended to strengthen the examination and supervision of institutions with significant subprime lending programs. The guidance supplements previous guidance issued on March 1, 1999, and principally applies to institutions with subprime lending programs that equal or exceed 25 percent of an institution's Tier 1 regulatory capital (www.federalreserve.gov, www.occ.ustreas.gov).
- On May 10, 2001, the OCC, FDIC, FRB, OTS, and NCUA jointly issued "Interagency Guidance on Certain Loans Held for Sale." This issuance covers accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held-for-sale account (www.fdic.gov, www.federalreserve.gov).

- On April 9, 2001, the OCC, FRB, FDIC, and OTS issued interagency guidance on sound risk management practices for institutions engaged in leveraged financing. The purpose of this guidance is to clarify and implement sound practices (www.fdic.gov).
- On May 11, 2001, the OCC, FRB, FDIC, and OTS issued an advisory on the risks of brokered and other rate-sensitive deposits (www.fdic.gov/news/news/press/2001/pr3701.html).

Federal Deposit Insurance Corporation

- On January 8, 2001, the FDIC revised the agency's regulation governing the activities of insured state banks, Part 362 of the FDIC's rules and regulations. The revisions reflect statutory changes made pursuant to the new financial modernization law, the Gramm-Leach-Bliley Act. The revised final rule provides the framework for subsidiaries of state nonmember banks to engage in financial activities—including securities underwriting—that the new law permits national banks to conduct through a financial subsidiary (www.fdic.gov).
- On October 23, 2001, the FDIC addressed new guidance on securitizations and residual interests.

Federal Financial Institutions Examination Council

- On February 28, 2001, the FFIEC issued a statement on the major revisions to Article 9 of the Uniform Commercial Code, which governs transactions involving the granting of credit secured by personal property and the sale of accounts and chattel paper (www.fdic.gov/news/news/financial/2001).
- On July 6, 2001, the FFIEC issued guidance titled "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions." Developed in collaboration with the SEC,

the policy statement clarifies the agencies' expectations and provides guidance and documentation (www.ffiec.gov). See the "Credit Risk Watch" section of this Alert for more detailed information.

Federal Reserve Board

- On January 16, 2001 the FRB issued guidance for financial institutions on anti-money-laundering programs. It is intended to build upon existing anti-money laundering and due diligence programs (www.federalreserve.gov).
- On March 15, 2001, the FRB adopted the final rule revision to the Official Staff Commentary of Regulation E. The revision implements the Electronic Funds Transfer Act (ETFA). The final rule took effect on March 15, 2001; however, mandatory compliance is required as of January 1, 2002 (www.federalreserve.gov).
- On May 4, 2001, the FRB adopted on an interim basis, rules on derivative transactions between banks and affiliates. The ruling addresses the use of sections 23A and 23B of the Federal Reserve Act and requires institutions to adopt policies to monitor, manage, and control credit exposures arising out of bank-affiliate transactions and clarify that they are subject to section 23B. The rules are effective January 1, 2002 (www.federalreserve.gov).
- On May 4, 2001, the FRB issued a final rule granting exemptions from and providing interpretations of section 23A of the Federal Reserve Act concerning relationships between banks and broker-dealer affiliates (www.federalreserve.gov).
- On August 13, 2001, the FRB approved a final rule that permits state member banks that qualify under the Gramm-Leach-Bliley Act to establish financial subsidiaries (www.federalreserve.gov).

National Credit Union Administration

- On March 8, 2001, the NCUA amended its chartering and field of membership manual to ease the burden on applicants for community charters, expansions, or conversions. The rule was effective March 20, 2001 (www.ncua.gov).
- On April 19, 2001, the NCUA revised its regulations pertaining to the Community Development Revolving Loan Program for Credit Unions. This final ruling increases the manner in which NCUA may deliver technical assistance to participating credit unions. The effective date is April 26, 2001 (www.ncua.gov).
- On July 26, 2001, the NCUA revised its rule concerning credit union investments in and loans to credit union service organizations. The effective date is September 4, 2001 (www.ncua.gov).

Office of the Comptroller of the Currency

- In June 2001, the OCC released guidance clarifying issues concerning its supervision of national banks' audit programs, including reviews of external audit programs, key independence issues affecting outsourced internal audit activities, and responsibilities of audit committees. The guidance states that an OCC review of a bank's external audit program is not intended to be an "audit of the auditors." It is an assessment of whether statutory and regulatory requirements for external audit and audit committee are met, whether the bank's board has implemented an appropriate external audit program, and whether a bank's board effectively oversees the external audit program. To obtain a copy of the memorandum (MM 2001-1, Audit Policy Clarification), contact the OCC's Public Information Room by telephone at (202) 874-5043 or by fax at (202) 874-4448.
- On July 2, 2001, the OCC adopted a final rule amending 12 CFR parts 1, 7, and 23 to update and revise the OCC's regulations to keep pace with developments in the law and

national banking system. Changes include, but are not limited to, rules surrounding municipal revenue bonds, non-interest charges, and residual value reliance (www.occ.ustreas.gov).

- On July 2, 2001, the OCC published a final rule affecting provisions governing investment securities, bank activities and operations, and leasing (www.occ.ustreas.gov). The effective date is August 1, 2001.

Securities and Exchange Commission

- On May 18, 2001, the SEC adopted interim final rules that implement certain exemptions for banks from broker-dealer registration requirements under the Securities Exchange Act of 1934. The rules have significant implications for banks' securities, and fiduciary and custody activities and are effective October 1, 2001 (www.sec.gov).
- On July 6, 2001, the SEC released SAB No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, which provides certain views on the development, documentation, and application of a systematic loan loss allowance methodology in accordance with GAAP as required by FRR No. 28 (www.sec.gov). See the "Credit Risk Watch" section of this Alert for more detailed information.

Finally, the AICPA has developed a practice guide to assist members in observing regulatory FTC and SEC privacy and disclosure requirements established by the Gramm-Leach-Bliley Act (www.aicpa.org/public/download/news).

Auditing and Attestation Pronouncements and Guidance Update

This section presents a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. The AICPA general *Audit Risk Alert—2001/02* contains a summary explanation of all these issuances. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/ technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy* and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 94	*The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319)
SOP 01-3	*Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*
SSAE No. 10	*Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 2, AT secs. 101–701)
Audit Guide	*Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
Audit Guide	*Auditing Revenue in Certain Industries*
Audit Guide	*Audit Sampling*
Audit Guide	*Analytical Procedures*
Auditing Interpretation No. 1	"The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," of SAS No. 73, *Using the Work of a Specialist*
Practice Alert 01-1	*Common Peer Review Recommendations*
Practice Alert 01-2	*Audit Considerations in Times of Economic Uncertainty*

Of the pronouncements and other guidance listed in the previous table, one having particular significance to the bank, credit union, and other financial institutions industry is briefly explained in the following paragraph. This summary is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard.

Auditing Interpretation No. 1 of SAS No. 73

In November 2001, the ASB issued auditing Interpretation No. 1, of "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," of SAS No. 73. This Interpretation supersedes the Interpretation, *The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125*, issued in February 1998 and amended in October 1998. The new Interpretation is effective for auditing procedures related to transfers of financial assets that are required to be accounted for under FASB Statement No. 140, as amended by FASB Technical Bulletin No. 01-1. The new interpretation addresses the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets has met the isolation criterion in paragraph 9(a) of FASB Statement No. 140.

Accounting Pronouncements and Guidance Update

This section presents a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert—2001/02* contains a summary explanation of all these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	*Business Combinations*
FASB Statement No. 142	*Goodwill and Other Intangible Assets*
FASB Statement No. 143	*Accounting for Asset Retirement Obligations*

(continued)

FASB Statement No. 144	*Accounting for the Impairment or Disposal of Long-Lived Assets*
FASB Technical Bulletin No. 01-1	*Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
SOP 00-3	*Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*
SOP 01-1	*Amendment to Scope of Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*
SOP 01-2	*Accounting and Reporting by Health and Welfare Benefit Plans*
AICPA Audit and Accounting Guide	*Audits of Investment Companies*
Questions and Answers	*FASB Statement No. 140*

Of the pronouncements and other guidance listed in the previous table, those having particular significance to the bank, credit union and other financial institutions industry are briefly explained in the following paragraphs. These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard.

FASB Technical Bulletin No. 01-1

The Technical Bulletin defers, until 2002, application of the isolation standards of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* as clarified in FASB staff guidance published in April 2001 (see this section and the "Two-Step Securitization Required" section of this Alert), to banks and certain other financial institutions. Those institutions also will be allowed up to five years of additional transition time for transfers of assets to certain securitization master trusts. That additional transition time applies only if all beneficial interests issued to investors after July 23, 2001, permit the changes in structure necessary to comply with those isolation standards.

Questions and Answers About FASB Statement No. 140

The FASB published a Special Report on February 15, 2001, that addresses the most frequently asked questions about FASB Statement No. 140. On April 19, 2001, the FASB staff published a set of questions and answers about isolation of financial assets transferred by banks and other entities, focusing on rights of redemption. (See the section of this Alert titled "Two-Step Securitizations" for more specifics). Finally, on August 7, 2001, the FASB staff published a set of questions and answers about the limitations on the activities of a qualifying special-purpose entity set forth in paragraphs 35 through 44 of FASB Statement No. 140.

FASB Statement No. 141, *Business Combinations*

This Statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises.* All business combinations in the scope of this Statement are to be accounted for using one method—the purchase method. Use of the pooling-of-interests method is no longer permitted.

FASB Statement No. 142, *Goodwill and Other Intangible Assets*

Issued concurrently with FASB Statement No. 141, this Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supercedes APB Opinion No. 17, *Intangible Assets.* It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements.

FASB Statement No. 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Thus, amortization of goodwill, including goodwill recorded in past business combinations, will cease upon adoption of this Statement.

The provisions of this Statement must be applied starting with fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued.

Credit union management is often familiar with pooling of interest merger accounting, but many credit unions may not have ever addressed the goodwill concept in merger accounting. Practitioners should keep this in mind when implementing both FASB Statement No. 141 and No. 142 for their credit union clients.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and related guidance that may affect their engagements. Presented here is information about certain projects that are especially relevant to the financial institution industry. Remember that exposure drafts are non-authoritative and cannot be used as a basis for changing GAAP or generally accepted auditing standards. The AICPA general *Audit Risk Alert—2001/02* summarizes some of the more significant exposure drafts outstanding.

The following table lists the various standard-setting bodies' Web sites where information—including downloadable copies of the exposure drafts—may be obtained on outstanding exposure drafts.

Standard-Setting Body	*Web Site*
ASB	www.aicpa.org/members/div/auditstd/drafts.htm
AcSEC	www.aicpa.org/members/div/acctstd/edo/index.htm
FASB	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees now publish exposure drafts of proposed professional standards on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if possible, your membership and subscriber number in the message.

Upcoming SOPs and New Audit and Accounting Guide

Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others

At its February 2001 meeting, AcSEC approved a final SOP, *Accounting by Certain Entities (Including Entities With Trade Receivables) that Lend to or Finance the Activities of Others*, pending AcSEC's positive clearance of certain revisions and FASB clearance. AcSEC's positive clearance was obtained and, in August 2001, the FASB did not object to the issuance of a final SOP, subject to final clearance by the FASB staff. AcSEC expects to issue the SOP during the fourth quarter of 2001.

This SOP applies to certain entities that lend to or finance the activities of others. The SOP applies to more entities than banks, savings institutions, credit unions, finance companies, corporate credit unions, and mortgage companies, including manufacturers, retailers, wholesalers, and other business enterprises that provide financing for products and services.

All entities (except those such as investment companies, broker-dealers, and employee benefit plans, which carry loans receivable at fair value and include gains and losses in earnings) that lend to or finance the activities of others are subject to the provisions of the Audit Guide *Audits of Finance Companies*. Although the scope of that Guide explicitly excluded insurance companies, this SOP is intended to include the financing activities of insurance companies.

This SOP also reconciles the specialized accounting and financial reporting guidance established in the existing Auditing Guides *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies* (collectively, the Guides). The yet-to-be-issued SOP eliminates differences in accounting and disclosure established by the respective Guides and carries forward accounting guidance for transactions determined to be unique to certain financial institutions. It is not intended to create new accounting guidance.

This project consists of two parts. First, the chapters from the Guides have been combined and redrafted for consistency in a proposed combined Guide, titled *Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others.* The chapters were posted to the AICPA Web site for comment during the first quarter of 2001 (www.aicpa.org/members/div/acctstd/edo/chapters.htm). AcSEC expects to issue the Combined Guide during May 2002. Second, the SOP reconciles the specialized accounting and financial reporting guidance established in the Guides. The SOP includes guidance for all entities engaged in lending and financing activities (including trade receivables). AcSEC believes this guidance should stand alone in an SOP. AcSEC was concerned that, if such guidance were included only in the combined Guide, preparers and auditors would focus on the organizational structure of an entity rather than the activities of the entity. In other words, auditors and preparers could potentially overlook guidance contained in an industry-specific Guide. Accordingly, the SOP not only will be included in the combined Guide but will provide guidance for *all* entities (including entities with trade receivables) through the issuance of a stand-alone SOP.

Accounting for Purchased Loans and Certain Debt Securities (formerly known as *Discounts Related to Credit Quality*)

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* requires that discounts be recognized as an adjustment of yield over a loan's life. Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans,* further addresses amortization of discounts on certain acquired loans, which involves intertwining issues of amortization of discount, measurement of credit losses, and recognition of interest income. This SOP addresses purchases of loans and debt securities when the purchaser does not expect to collect all contractual cash flows and there has been evidence of credit deterioration.

In March 2000, AcSEC approved a final SOP, *Accounting for Certain Purchased Loans and Debt Securities*, pending AcSEC's positive clearance of certain revisions and FASB clearance. In May 2001, AcSEC submitted a letter to the FASB describing AcSEC's intent to change the scope of the proposed SOP. In June 2001, the FASB did not object to the issuance of a final SOP, subject to final clearance by the FASB staff. AcSEC expects to issue the SOP during the fourth quarter of 2001. This SOP is effective for fiscal years beginning after June 15, 2002.

Task Force Created for Credit Loss Guidance

AcSEC has established a task force whose primary objective is to provide additional guidance on the application of GAAP as it relates to the allowance for credit losses. The task force is expected to develop an SOP that will provide additional guidance on periodic credit loss provisions and the related allowance for credit losses. The project may result in amendment of certain AICPA Audit and Accounting Guides. AcSEC will discuss a revised draft SOP at the December 2001 meeting and plans to issue an exposure draft (subject to FASB clearance) in the first quarter of 2002.

New Framework for the Audit Process

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in late 2001 and 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "expectation gap" standards were issued in 1988.

Some of the more important changes to the standards expected to be proposed are:

- A requirement for a more robust understanding of the entity's business and its environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Auditor Independence and Outsourcing Guidance

The federal banking agencies are currently reviewing the SEC's recently issued independence rules to determine what changes, if any, they need to make to the Interagency Policy Statement on Internal Audit Outsourcing dated December 22, 1997. If an insured depository that is not a SEC registrant is currently outsourcing any of its internal audit duties to the firm that is providing the independent audit of its financial statements, those outsourced services may be subject to whatever revisions the regulators ultimately decide on.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit and Accounting Guide *Audits of Banks and Savings Institutions* (Product No. 012468kk).
- Audit and Accounting Guide *Audits of Credit Unions* (Product No. 012469kk)
- Audit and Accounting Guide *Audits of Finance Companies* (Product No. 012467kk)
- Audit and Accounting Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (Product No. 012520kk)
- Audit and Accounting Guide *Auditing Revenue in Certain Industries* (Product No. 012510kk)
- Audit and Accounting Guide *Audit Sampling* (Product No. 012530kk)
- Audit and Accounting Guide *Analytical Procedures* (Product No. 012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (Product No. 010010kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (Product No. 006701kk)
- *Accounting Trends & Techniques—2001* (Product No. 009893)
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk)
- Audit Risk Alert *E-Business Industry Developments 2001/02*

Audit and Accounting Manual

The *Audit and Accounting Manual* (Product No. 005131kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; and engagement letters, management representation letters, and confirmation letters.

CD-ROM

The AICPA is currently offering a CD-ROM product titled *Resource: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Educational Courses

The AICPA has developed a number of continuing professional education courses that are valuable to CPAs working in the financial institution industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (Product No. 737061 (text) and 187078 (video)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *SFAS 133: Derivative and Hedge Accounting* (Product No. 735180). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.

- *Independence* (Product No. 739035). This interactive CD-ROM course will review the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and Independence Standards Board standards.
- *SEC Reporting* (Product No. 736745). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Internal Control Implications in a Computer Environment* (Product No. 730617). This practical course analyzes the effects of electronic technology on internal controls and provides a comprehensive examination of selected computer environments, from traditional mainframes to popular personal computer set-ups.
- *Banks, Savings Institutions and Credit Unions: An Accounting and Auditing Perspective* (Product No. 736092 (text) and 181791 (video)). This course provides an excellent introduction to the banking, savings institutions, and credit union industries. It will ensure that you are up-to-date and prepared for the continuing changes in this field.
- *E-Commerce: Controls and Audit* (Product No. 731550). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee ($95 for members and $295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

The Practitioner's Update (Product No. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, AICPA Online offers information about AICPA products and services, career resources, and online publications.

CPA2Biz.com

This new Web entity is the product of an independently incorporated joint venture between the AICPA and state societies. It currently offers a broad array of traditional and new products, services, communities, and capabilities so CPAs can better serve their clients and employers. Because it functions as a gateway to various professional and commercial online resources, cpa2biz.com is considered a Web "portal."

Some features cpa2biz provides or will provide include:

- Online access to AICPA products, such as Audit and Accounting Guides and Audit Risk Alerts
- News feeds each user can customize
- CPA "communities"
- Online CPE
- Web site development and hosting
- Electronic procurement tools to buy goods and services online
- Electronic recruitment tools to attract potential employees online
- Links to a wider variety of professional literature
- Advanced professional research tools

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

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This Audit Risk Alert replaces the *Lending and Depository Institutions Industry Developments—2000/2001* Audit Risk Alert. The *Banks, Credit Unions and Other Lenders and Depository Institutions Industry Developments* Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to jgould@aicpa.org, or write to:

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APPENDIX A

Equity and Disclosures Regarding Capital Matters for Credit Unions

In early 1998, the U.S. Supreme Court ruled that the National Credit Union Administration (NCUA) had strayed from the original intent of Congress as reflected in the Federal Credit Union Act (FCUA) passed in 1934 relating to common bond affiliation for credit union membership. This ruling had the effect of restricting future membership in federal credit unions. On August 7, 1998, legislation was signed into law that eased membership restrictions on credit unions and allowed them to expand. The legislation, known as the Credit Union Membership Access Act (CUMAA), permits occupation-based credit unions to take in groups of members from unrelated companies under certain circumstances.

CUMAA also establishes three important new requirements with respect to financial statements and audits. First, all federally insured credit unions with assets of $500 million or more must obtain an annual independent audit of their financial statements by a certified public accountant or licensed public accountant. Second, all federally insured credit unions with assets of $10 million or more must follow generally accepted accounting principles (GAAP) for all reports or statements required to be filed with the NCUA board. Third, for any federal credit union with assets of more than $10 million that uses an independent auditor who is compensated for his or her services, the audit is subject to state accounting laws, including licensing requirements.

CUMAA addressed minimum capital requirements and "prompt corrective action" to restore capital. New net worth standards based in a percentage of assets was established for insured credit unions, as well as risk-based capital standards for complex credit unions as defined by the NCUA. The NCUA also developed prompt corrective action regulations, as well as regulations concerning other areas, such as new field of membership rules, and supervisory committee audit rules as required by this legislation.

Natural Person Credit Unions

Capital Adequacy

Title III of CUMAA established a new system of tiered net worth requirements for all insured credit unions other than corporate credit unions. These requirements did not take effect until August 2000. The Act requires that the NCUA establish a net worth standard for insured credit unions as well as risk-based capital standards for complex credit unions as defined by the NCUA. A separate system of prompt corrective action is mandated for "new credit unions." A new credit union is defined as a federally insured credit union that both has been in operation for less than 10 years and has $10,000,000 or less in total assets. A summary of general requirements follows. In 2000, the NCUA published prompt corrective action guidelines in the *Federal Register* effective August 7, 2000. On July 20, 2000, the NCUA published prompt corrective action guidelines with respect to the risk-based net worth requirement in effect January 1, 2001. Specific requirements are set forth in 12 CFR Parts 700, 702, 741, and 747.

A credit union's net worth, the numerator of the net worth ratio, is defined as retained earnings as determined under GAAP. A credit union's total assets, the denominator of the net worth ratio, is calculated in any one of four methods. It may be (1) the average of the quarter-end balances of the four most recent quarters, (2) the monthly average over the quarter, (3) the daily average over the quarter, or (4) the quarter-end balance. A credit union may elect a method from the four options to apply for each quarter. Whatever method is chosen for a quarter must be used consistently for all PCA measures other than the risk-based net worth requirement (RBNWR).

Credit unions with less than 7 percent net worth with respect to total assets and any complex credit union, as defined below, not meeting risk-based standards will be required to increase its net worth quarterly by an amount of earnings equivalent to at least 0.1 percent of its total assets for the current quarter. Earnings are required to be transferred quarterly from current earnings to the statutory reserve.

Prompt Corrective Action

In 1998, Congress amended the FCUA to require the NCUA board to adopt a system of prompt corrective action to be applied to federally insured credit unions that become undercapitalized. The new FCUA provision imposes a series of progressively more stringent restrictions and requirements indexed to five net worth categories. The provision also mandates a separate system for new credit unions and additional RBNWRs for complex credit unions.

A credit union is defined as "complex" and a risk-based net worth requirement is applicable only if the credit union meets both of the following criteria as reflected in its most recent Call Report:

- The credit union's quarter end total assets exceed $10 million.
- The credit union's RBNWR exceeds 6 percent.

Determining the net worth category of a credit union (other than a "new" credit union) is a multiple-step process. In the first step, an initial net worth category is determined by calculating the ratio of the credit union's net worth (under GAAP, excluding such factors as "accumulated other comprehensive income") to total assets (computed under any of the four methods described above). This ratio determines an initial category based on the following:

1. *Well capitalized* if it has a net worth ratio of 7 percent or greater.
2. *Adequately capitalized* if it has a net worth ratio of 6 percent or more but less than 7 percent.

3. *Undercapitalized* if it has a net worth ratio of 4 percent or more but less than 6 percent.
4. *Significantly undercapitalized* if:
   - It has a net worth ratio of two percent or more but less than 4 percent; or
   - It has a net worth ratio of 4 percent or more but less than 5 percent and either (1) fails to submit an acceptable net worth restoration plan within the time prescribed or (2) materially fails to implement a net worth restoration plan approved by the NCUA board.
5. *Critically undercapitalized* if it has a net worth ratio of less than 2 percent.

In the second step, the credit union (other than credit unions with less than $10 million in total assets at quarter end) determines its RBNWR. If the RBNWR is less than 6 percent, the credit union does not have to meet a RBNWR and the credit union's initial net worth category would become its net worth classification under the PCA regulations. If the RBNWR is greater than 6 percent, but less than the credit union's actual net worth ratio, the credit union would meet its RBNWR and the credit union's initial net worth category would become its net worth classification under the PCA regulations. However, a credit union's net worth category may be downgraded if there exist any supervisory or safety and soundness issues between the credit union and the NCUA or any applicable state regulatory authority.

For a credit union with an initial net worth category of either "well capitalized" or "adequately capitalized," but with a RBNWR that is greater than the initial net worth calculation if not met, the actual net worth classification under PCA regulations would be reduced to the first tier of "undercapitalized." For a credit union with an initial net worth category of "undercapitalized" or lower, any net worth restoration plan submitted by the credit union would have to consider the RBNWR if that requirement were greater than 6 percent.

The RBNWR is computed by multiplying the end-of-quarter balances of the credit union's risk-portfolio components (as defined in the regulations) by prescribed percentages (the "standard calculation"). If the standard calculation produces a RBNWR that is larger than the credit union's net worth ratio, the credit union can recalculate its RBNWR using some or all of the "alternative components approach." In the alternative components approach, the maturities of several of the risk-portfolio components are used to produce a more detailed set of calculations, again each with a prescribed risk percentage. If the alternative components approach produces a RBNWR that is less than the credit union's net worth ratio, the credit union would have met its RBNWR. If the alternative components approach produces a RBNWR that is larger than the credit union's net worth ratio, the credit union may apply to the NCUA for a "risk mitigation credit" to reduce its calculated RBNWR. If the credit union fails to obtain an adequate amount of "risk mitigation credit" to reduce its RBNWR below its net worth ratio, it would have failed its RBNWR. An example of the calculation for a single risk category is as follows. The RBNW ratio is the sum of all components for each category at the calculation date.

Disclosures About Regulatory Capital Matters by Natural Person Credit Unions

Noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the footnotes to the financial statements:[1]

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) mandated by the prompt corrective action provisions of the Credit Union Membership Access Act of 1998.

1. Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements.

2. The actual or possible material effects of noncompliance with such requirements.

3. Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented,[2] the following with respect to quantitative measures:[3]

   a. The institution's required and actual ratios and amounts of net worth and any applicable RBNWR and the basis for computation. There are four alternative total asset computation options.

   b. Factors that may significantly affect capital adequacy, such as potentially volatile components of capital, qualitative factors, and regulatory mandates.

4. As of each balance sheet date presented, the net worth category in which the institution was classified as of its most recent Call Report.[4]

5. As of the most recent balance sheet date, whether management believes any conditions or events since notification have changed the institution's category.

If, as of the most recent balance sheet date presented, the institution is either (*a*) not in compliance with capital adequacy requirements, (*b*) considered less than "well capitalized" under the prompt corrective action provisions, or (*c*) both, the possible material effects of such conditions and events on amounts and

2. For adequately capitalized or undercapitalized institutions, this should present the minimum amounts and ratios the institution must have to be categorized as *well capitalized* under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive. Credit unions subject to a separate RBNW determination may employ alternative total asset ratios, which may differ from the financial statement totals. If alternative ratios are used, they should be disclosed in the notes to the financial statements.

3. These amounts may be presented in either narrative or tabular form.

4. A credit union is (under federal regulations) deemed to be within a given capital category as of the most recent date of the following: (*a*) the last day of the calendar month following the end of the calendar quarter, (*b*) the date the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination, or (*c*) the date the credit union received written notice from NCUA or, if State-chartered, the appropriate State official, of reclassification on safety and soundness grounds.

disclosures in the financial statements should be disclosed.[5] Further, noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the institution's ability to continue as a going concern for a reasonable period. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period.
- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.
- The existence of a net worth restoration plan.
- Supervisory actions imposed as a result of net worth category classification.

Illustrative Disclosures

The example disclosures that follow are for illustrative purposes only. Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself "*well capitalized*" under the prompt corrective action framework.

5. The institution should consider also making such disclosures when the institution's actual ratio is nearing noncompliance.

The credit union is subject to various regulatory capital requirements administered by the National Credit Union Administration (NCUA). Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the credit union's financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the credit union must meet specific capital regulations that involve quantitative measures of the credit union's assets, liabilities, and certain off-balance-sheet items as calculated under generally accepted accounting practices. The credit union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the credit union to maintain minimum amounts and ratios (set forth in the following table) of net worth (as defined) to total assets (as defined). Credit unions are also required to calculate a risk-based net worth requirement (RBNWR) that establishes whether the credit union will be considered "complex" under the regulatory framework. The credit union's RBNW ratio as of December 31, 200X was ___ percent. The minimum ratio to be considered complex under the regulatory framework is 6 percent.[6] Management believes, as of December 31, 200X, that the credit union meets all capital adequacy requirements to which it is subject.

As of December 31, 200X, and December 31, 200W, the most recent call reporting period, the NCUA categorized the credit union as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized" the credit union must maintain a minimum net worth ratio of 7 percent of assets.[7] There are no conditions or events

6. These amounts may be presented in either narrative or tabular form.

7. For some institutions, the calculation of required amounts and ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

since that notification that management believes have changed the institution's category.

The credit union's actual capital amounts and ratios are also presented in the table.

	Actual	*To Be Adequately Capitalized Under Prompt Corrective Action Provisions*[8]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*	
	Amount	**Amount**	**Ratio**	**Amount**	**Ratio**
Net worth	$2,000,000	$1,600,000	6.0%	$1,800,000	7.0%
Risk-based net worth requirement	$1,700,000	Less than $2,000,000	Less than 7.5%	N/A	N/A

Because the RBNWR, 6.5 percent, is less than the net worth ratio, 7.5 percent, the credit union retains its original category. Further, in performing its calculation of total assets, the credit union used the [*select one: average of the quarter-end balances of the four most recent quarters, monthly average over the quarter, daily average over the quarter, or quarter-end balance*] option, as permitted by regulation.

Following is an illustrative paragraph to be added in place of the third illustrative paragraph in the example above for an institution that is in compliance with capital adequacy requirements and considers itself "adequately capitalized" under the prompt corrective action framework.

As of December 31, 200X, and December 31, 200W, the most recent call reporting period, the NCUA categorized the credit union as "adequately capitalized" under the regulatory framework for prompt corrective action. To be categorized as "adequately capitalized" the credit union must maintain a minimum net worth ratio of 6 percent of assets and, if applicable, must maintain adequate net worth to meet the credit

8. For "adequacy capitalized" or "undercapitalized institutions," this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any mandatory or discretionary supervisory actions.

union's risk-based net worth requirement of X percent as set forth in the table.[9] As an "adequately capitalized" credit union, the NCUA's prompt corrective action regulations require that the credit union increase its net worth quarterly by an amount equivalent to at least 0.1 percent of its total assets for the current quarter, and must transfer that amount (or more by choice) from undivided earnings to its regular reserve account until it is "well capitalized," while continuing to meet its RBNWR. There are no conditions or events since that filing date that management believes have changed the institution's category.

Following are illustrative paragraphs to be added to the disclosures illustrated above when a credit union considers itself undercapitalized (for existing credit unions).

The credit union may not increase assets and must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions.*]

Under the regulatory framework for prompt corrective action, the credit union's net worth classification requires that a net worth restoration plan (NWRP) be filed with and accepted by the National Credit Union Administration (NCUA). The plan outlines the credit union's steps for attaining the adequately capitalized levels of net worth. Management believes, at this time, that the credit union will implement the steps and meet all the targets of the plan and all the regulatory net worth requirements by December 31, 200X (or earlier if stated in the restoration plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA.*]

Following are illustrative paragraphs to be added to the disclosures illustrated above when a new credit union considers itself *moderately, marginally, minimally, or undercapitalized* (for new credit unions).

The credit union must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions.*]

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9. For some institutions, the calculation of required amounts and net worth ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

Under the regulatory framework for prompt corrective action, a revised business plan has been filed, as required, with and accepted by the National Credit Union Administration (NCUA). The plan outlines the credit union's steps for attaining the required levels of net worth. Management believes, at this time, that the credit union will implement the steps and meet all the targets of the plan and all the regulatory net worth requirements by December 31, 200Y (or earlier if stated in the revised business plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA.*]

INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.cpa2biz.com	*AcSEC Telephone Line* (212) 596-6008
Bank for International Settlements	Centralbahnplatz 2, Basel, Switzerland (+41-61) 280 80 80	(+41-61) 280 91 00 and (+41-61) 280 81 00	www.bis.org	
Department of Housing and Urban Development	451 7th Street SW Washington, D.C. 20410 (202) 708-1422		www.hud.gov	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)

Federal Financial Institutions Examination Council	Washington, D.C.		www.ffiec.gov	
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE		www.fhlmc.org	
Federal Deposit Insurance Corporation	*Public Information Center* 801 17th Street, NW Room 100 Washington, D.C. 20434 (800) 276-6003 (202) 416-6940	*Facsimile Bulletin Board System* (804) 642-0003/2036	www.fdic.gov	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	*U.S. Department of Commerce STAT-USA/FAX* Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	www.frb.gov	*Federal Reserve Board Highlights* (202) 452-3206

(continued)

INFORMATION SOURCES—*(continued)*

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 909-6222.	www.mbaa.org	
National Credit Union Administration	*Office of Public and Congressional Affairs* 1775 Duke Street Alexandria, VA 22314		*NCUA Bulletin Board* All information is available to guest users (703) 518-6480 *NCUA World Wide Web home page* www.ncua.gov	*Newsline* (800) 755-1030 (703) 518-6339 (Washington, DC area)
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*Publications Control* P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-5000	*OCC Information Line* (202) 479-0141	www.ustreas.gov	

U.S. Department of the Treasury—Office of Thrift Supervision	*OTS Dissemination Branch* 1700 G Street, NW Washington, DC 20552-0001 (202) 906-5900	*PublicFax* (202) 906-5660	www.ots.treas.gov	
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243		www.ed.gov	
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	*Information Line* (202) 512-2250	www.gpo.gov	
United States Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)