

Financial Services Regulatory Highlights

volume 10 no. 2

February 2008

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Federal Reserve Requests Comment on Proposed Changes to Regulations D and I

On February 7, 2008, the Federal Reserve Board issued for comment proposed changes to Regulation D -- Reserve Requirements of Depository Institutions -- and Regulation I -- Issue and Cancellation of Federal Reserve Bank Stock.

These proposed amendments incorporate provisions of the Financial Services Regulatory Relief Act of 2006 and remove certain restrictions on the way depository institutions maintain required reserves and clarify and update other provisions of the regulations.

Depository institutions must maintain required reserves in the form of cash in their vaults or as a balance in an account at a Federal Reserve Bank. Depository institutions may maintain a balance directly with the Federal Reserve Bank or with a correspondent institution that, in turn, holds reserve balances for respondents in a Federal Reserve account on a "pass-through" basis. The Financial Service Regulatory Relief Act of 2006 amended the Federal Reserve Act to permit both banks that are Federal Reserve System members as well as nonmember banks to enter into pass-through correspondent arrangements. Previously, the Federal Reserve Act permitted only nonmember banks to enter into such arrangements.

This proposed rule would implement the revisions to the pass-through rules as well as make other changes to clarify and modernize regulations. The changes include:

- Simplifying the restrictions on certain types of transfers and withdrawals that may be made from savings deposits;
- Clarifying the definitions of "time deposit" and "vault cash" to incorporate the substance of previously issued written staff guidance;
- Reorganizing the provisions relating to deposit reporting and to the calculation and maintenance of required reserves; and
- Making other minor editorial changes for clarity.

GAO Releases Report on Hedge Funds

On February 26, 2008, the Government Accountability Office (GAO) released a report on the systemic risk posed by the growth in hedge funds.

The GAO conducted their study because of concerns about the systemic risks posed by the growth of hedge funds. Not only has the number of hedge funds grown, but hedge funds are now an important source of liquidity and price discovery for the US markets. Additionally, institutional investors now regularly invest their assets in hedge funds. The report describes how federal financial regulators provide oversight of hedge fund-related activities under their existing authorities; examines what measures investors, creditors, and counterparties have taken to impose market discipline on hedge funds; and explores the potential for systemic risk from hedge fund-related activities and actions regulators have taken to address this risk. Below are some of the more important issues noted in the report:

- Regulated entities have the responsibility to practice prudent risk management standards, but prudent standards do not guarantee prudent practices. As such, it will be important for regulators to show continued vigilance in overseeing the hedge fund-related activities of regulated institutions.
- The market discipline imposed by investors, creditors and counterparties is limited in its effectiveness or is not properly exercised. These factors can contribute to conditions that create the potential for systemic risk if breakdowns in market

discipline and the risk controls of creditors and counterparties are sufficiently severe that losses by hedge funds in turn cause significant losses at key intermediaries or in financial markets.

- Regulators questioned whether counterparty risk is effectively managed and factors such as trading behavior can create conditions that contribute to systemic risk. Given certain market conditions, the simultaneous liquidation of similar positions by hedge funds that hold large positions on the same side of a trade could lead to losses or a liquidity crisis that might aggravate financial distress. Recognizing that market discipline cannot eliminate the potential systemic risk posed by hedge funds and others, regulators have been taking steps to better understand the potential for systemic risk and respond more effectively to financial disruptions that can spread across markets.
- The recent actions taken by the President's Working Group (PWG) (see February 2007 edition of the FS Regulatory Highlights) are positive steps to address systemic risk, but it is too soon to evaluate their effectiveness.

Treasury Under Secretary Steel Discusses U.S. Financial Regulation

On February 7, 2008, Department of Treasury Under Secretary Robert K. Steel discussed U.S. financial regulation at a conference of the New York Society of Securities Analysts.

The focal point of Mr. Steel's speech was the Treasury's plan for a new regulatory blueprint for the U.S. financial services regulation.

Treasury Secretary Paulson announced that the Treasury would publish a "regulatory blueprint study," on June 2007. The study would rationalize the current regulatory structure in an effort to maintain a dynamic U.S. market for financial services as well to improve oversight.

Secretary Steel states that the current system is flawed and that the current framework has been a reaction to various crises or innovations in the financial services industry.

"Today we have a series of individual regulations, each designed in response to specific circumstances and lacking an overarching set of guiding principles. Our system has multiple federal and state regulators with unclear and sometimes overlapping boundaries." stated Mr. Steel.

As an example of issues with our current structure, Mr. Steel states: "Within our existing regulatory structure, the regulation of depository institutions may choose from one of three federal charters of state charter. For institutions that are subject to federal oversight, there are five distinct regulators, which have primary regulatory responsibility based on various characteristics of the institution and its membership within the Federal Reserve System. Sound oversight and consumer protections should not be a matter of choice."

The new regulation, Mr. Steel states, should state who should be protected, which participants should be regulated, and how should that regulation be developed and applied.

The regulatory structure should balance policies that allow for efficient movement of capital while also promoting a safe and stable environment. The blueprint that the Treasury is working on will give the consumers and institutions on differing sides of the continuum the appropriate protections.

The Treasury expects to release the regulatory blueprint within the first quarter of 2008. In developing the model, the Treasury is focusing on:

- Soundness;
- Consumer and investor protection regulations; and
- Overall market stability regulation.

The report will also include recommendations for how to put the U.S. on the path toward the optimal structure of the financial services regulation.

Comptroller of the Currency Discusses the Mortgage Foreclosure Crisis

[On February 12, 2008, the Comptroller of the Currency, John C. Dugan, spoke at the National Association of Affordable Housing Lenders and stressed the need for an amendment to the Community Reinvestment Act \(CRA\) regulation.](#)

The Comptroller suggests a change in the regulation to provide CRA consideration for community development investments in middle-income communities that are distressed because of mortgage foreclosures.

In the 2006 amendments to the federal law authorizing national banks to make "public welfare" investments, the aggregate amount of investments permissible for national banks was increased, but the types of investments that can be made was decreased to include only those investments that "primarily benefit low- and moderate-income areas and people."

"While that limitation sounds sensible at first blush, the reality is quite different because the new standard precludes permissible investments that clearly promote the public welfare," Mr. Dugan said.

The Comptroller also raised questions about whether the CRA should be broadened to cover non-banks that provide so many of the same financial services as banks, and played a significant role in the subprime crisis.

Mr. Dugan said that non-banks, with all their financial resources, could bring billions of additional community reinvestment dollars to local communities. Non-banks could build on and enhance the substantial contributions already being made by banks for CRA purposes.

"Banks, often in conjunction with community partners, have made loans and investments that have dramatically transformed distressed communities and helped build the personal assets of

lower-income households," he added. "CRA lending and investment by banks has worked."

OCC Issues Bulletin on Flood Hazard Determination Practices

[On February 25, 2008, the Office of the Comptroller of the Currency \(OCC\) issued OCC Bulletin 2008-4 regarding certain practices relating to flood hazard determinations.](#)

Through its examination and other supervisory activities, the OCC has identified two concerns regarding certain practices related to flood hazard determinations that may expose national banks to compliance and operational risks.

The OCC recently discovered that some companies are not using the Community Status Book (CSB) when making their flood determinations. Instead, they are using the Flood Map Status Information Service (FMSIS), the Federal Emergency Management Agency's (FEMA) electronic flood data. FEMA has indicated that CSB is the final authority for community status information; because the FMSIS may be out of date. The OCC encourages national banks to review their third-party vendor relationships and their practices and procedures to ensure that they are using the appropriate data.

The OCC also discovered that some flood determination companies do not note on the Standard Flood Hazard Determination Form that they have revised or updated a determination. This also may be a problem for a national bank that is performing determinations for its own portfolio. If the entity revising or updating the form does not record the revised or updated date, the bank may not be able to determine or track compliance with the regulation. The OCC is also recommending that flood determination companies and national banks note the date that flood determinations have been updated or revised in the "comments" section of the Standard Flood Insurance Determination Form, when a revision or update occurs.

Comptroller of the Currency Discusses Losses by Banks and Investors Holding Tranches of Highly-Rated Securities

[In a speech to the Global Association of Risk Professionals, Comptroller of the Currency John C. Dugan outlined steps that should be considered in response to the very large losses incurred by banks and other investors who held tranches of securities that were considered to be relatively safe from loss.](#)

"These better-than-triple A tranches were supposed to be the least risky parts of the subprime securities pyramid," Mr. Dugan said. "Instead they have generated the clear majority of reported subprime writedowns in capital markets, which in turn have been at the core of several of the worst episodes of the market's disruptions."

The losses came from so-called "super senior" tranches of collateralized debt obligations consisting of securities backed by

subprime mortgages, or "subprime ABS CDOs." Because these CDO tranches carried triple A ratings, even risk averse and regulated firms, like banks, insurance companies, and money market mutual funds, felt comfortable investing in these securities, either directly or indirectly through conduits, and some of the firms involved in structuring the securities apparently felt safer in keeping very large concentrations of these assets on their books.

But the systematic weakening in subprime underwriting standards, combined with a significant decline in house price appreciation throughout the country, resulted in a sharp spike

in defaults and delinquencies. And that in turn led to rating downgrades and exceptionally large mark-to-market losses on the super-senior tranches of ABS CDOs.

Among the steps that should be considered, Comptroller Dugan said, are improvements in underwriting standards for subprime mortgages.

“While national banks were not the primary originators of subprime mortgages that have gone bust – they originated just 10 percent of such mortgages in 2006, for example, with lower delinquency rates than the national average – the OCC has joined other regulators in raising standards across the board for all banking organizations,” the Comptroller said. “The challenge will be to extend these standards in a meaningful way to nonbank lenders and brokers regulated exclusively by the states.”

The Comptroller also urged changes in the approach rating agencies take to rating subprime ABS CDOs. “At a minimum, I believe that the credit rating agencies need to do a much better job in disclosing the distinctions between the likely performance of triple A-rated structured securities and triple A-rated corporate securities,” Mr. Dugan said. “If triple A means different things in different contexts, then we all need to know that.”

However, he said, neither investors nor regulators should rely exclusively on credit ratings when evaluating the credit risk in a highly rated tranche of an ABS CDO. “This may seem obvious to everyone now, but exclusive reliance on ratings has been all too common a practice,” he added. “There is really no excuse for institutions that specialize in credit risk assessment – like large

commercial banks – to rely solely on credit ratings in assessing credit risk.”

The Comptroller also said that packagers of ABS CDOs should not retain large concentrations of super-senior tranches on their balance sheet, no matter how low they perceive the risk to be. “What most differentiated the companies sustaining the biggest losses from the rest was their willingness to hold exceptionally large positions on their balance sheets – which in turn led to exceptionally large losses,” Mr. Dugan said.

Finally, Mr. Dugan said that regulators should reconsider the part of the Basel II capital rules that apply to senior tranches of restructured structured credit such as subprime ABS CDOs. “For example, should the securitization provisions of Basel II establish a unique set of higher risk weights for ABS CDOs and other re-securitizations, reflecting the higher vulnerability to systemic risk as evidenced by recent events?” he asked.

The Comptroller said that policy makers and market participants should actively consider whether these and other steps might be necessary to avoid future market disruptions.

OTS Issues Thrift Bulletin on Referral Fees for Trust Business

On February 20, 2008, the Office of Thrift Supervision (OTS) issued Bulletin 76-1a on the payment of referral fees for trust business. The OTS permits savings associations to pay referral fees to persons or entities that refer trust business to the institution. The OTS does not arbitrarily impose limitations on the size of referral fees paid. However, savings associations should be aware that OTS will assess the impact of the referral fee payments on the trust department’s income and the savings association’s overall financial condition.

Trust account customers impacted by the referral fee program should receive a referral fee disclosure from the savings association prior to payment of the referral fee. The referral fee disclosure must be in writing and at a minimum contain certain information, including the name of the referring party, the nature of the relationship, including any affiliation, and a statement that the referral fee will not result in any increased charge to the customer, among other guidelines.

The bulletin also advises that when establishing a referral fee program, a savings association should determine, among other requirements, that:

- The referral fee agreement is in writing;
- The referral fee program is approved by the board of directors and annually reviewed by senior management;
- Fee arrangements with affiliates or subsidiaries are in compliance with the restrictions with affiliates or subsidiaries set forth in 12 U.S.C. 1468 and OTS's transactions with affiliates regulations at 12 C.F.R. 563.41; and
- Fee arrangements for employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") do not violate any ERISA provisions, particularly as addressed in ERISA Section 406 – Prohibited Transactions; and

- Savings associations with existing trust customer accounts that are generating on-going referral fee payments (i.e., the referring party is continuing to receive a periodic referral fee for the existing account) should make a good faith effort to meet the oversight and disclosure conditions with regard to those customer accounts if the on-going fee payment will be affected by a new or revised referral fee program. Referral programs affecting new trust customers or accounts should meet the conditions immediately.

OTS Director Reich Addresses National Association of Mortgage Brokers

[OTS Director John Reich addressed the National Association of Mortgage Brokers on February 6, 2008 during its Legislative & Regulatory Conference in Washington.](#)

In his prepared remarks, the Director said 2008 is beginning an era of reform by the federal sector and the states to set standards for mortgage originators and to weed out the minority of originators who have engaged in predatory, improper practices.

Director Reich said reform is necessary to protect consumers as well as financial markets by ensuring a level playing field for

mortgage originators to compete without feeling pressure to lower their standards to capture market share.

We believe that there may be two potential areas where OTS could play a role in achieving this goal – (1) licensing and registration of mortgage originators, and (2) joint state and federal oversight of state regulated mortgage banking companies, Director Reich said.

FDIC Chairman Sheila Bair Issues Letter to Stakeholders for 2007

[Among the significant activities and accomplishments reported in 2007 edition of the FDIC's Letter to Stakeholders were the following:](#)

- FDIC-insured commercial banks and savings institutions reported net income of \$28.7 billion in the third quarter of 2007.
- Estimated insured deposits increased by \$9.7 billion in the third quarter of 2007. The Deposit Insurance Fund (DIF) balance increased by \$527 million to \$51.8 billion.

- The FDIC, along with the other banking regulators, approved the final rule implementing the Advanced Approaches of the Basel II Capital Accord.
- In the current issue of *FDIC Quarterly*, the FDIC outlines the analytical case for a systematic and streamlined loan modification process and common misconceptions about this approach.

The FDIC and the Korea Deposit Insurance Corporation (KDIC) signed a Memorandum of Understanding (MOU), which provides the

framework for KDIC employees to gain an overview of the FDIC's operations.

State Foreclosure Working Group Issues Analysis of Subprime Mortgage Servicer Performance

In the summer of 2007, the state attorneys general and state banking regulators formed the State Foreclosure Prevention Working Group to work with servicers of subprime mortgage loans to identify ways to work together to prevent unnecessary foreclosures.

The touchstone of the State Working Group is to work to prevent those foreclosures where the homeowner has the desire and reasonable ability to make payments on a mortgage loan and the investors that own the mortgage loan have a financial incentive to modify the loan rather than incurring the significant costs and likely greater losses from foreclosing on the loan. In the States' experience with homeowners, unnecessary foreclosures had been occurring all too often because the system for servicing subprime mortgage loans was not designed to conduct large numbers of loan modifications or other work-outs for homeowners in distress.

The State Working Group collaborated with industry and federal regulators to develop a uniform data reporting format to collect data to measure the extent of the foreclosure problem and the servicers' efforts to respond to it. The key findings identified are:

1. Seven out of ten seriously delinquent borrowers are not on track for any loss mitigation option. The lack of interaction between mortgage servicers and homeowners remains a major problem. While servicers have developed creative outreach efforts and increased staffing, the data shows a large gap between the number of homeowners needing loss mitigation and the number currently receiving assistance. Our data suggests that a rising number of loan delinquencies are outpacing the increase in loss mitigation efforts.

2. Servicers have increased their use of loan modifications and other home retention options. For those delinquent homeowners in contact with servicers, almost half (45%) are working toward a loan modification. Servicers are increasing their use of longer-term changes to the mortgage loan versus their earlier reliance on short-term repayment or forbearance agreements.

3. Payment resets on hybrid ARMs have not yet been a driving force in foreclosures. A significant percentage of subprime adjustable rate loans are delinquent before they experience payment shock from their first adjustment, reflecting weak underwriting or fraud in the origination of the loan.

With so many homeowners struggling to stay afloat prior to rate resets, we need to act quickly to address these hybrid ARM loans before the payment shock due to the rate reset triggers further foreclosures.

4. Homeowners are helping themselves. Most delinquent loans resolved in October 2007 occurred due to the homeowner catching up on back payments. As of October, actions by homeowners, not servicers, have prevented the most foreclosures.

5. The refinance option has nearly evaporated. Historically, serial refinancing was the primary way that the mortgage industry and homeowners managed delinquencies in subprime loans. Despite recent interest rate cuts, the mortgage industry will not be able to refinance its way out of this crisis absent dramatic changes in available loan products or a reversal in home price declines.

The Working Group noted these preliminary conclusions were based on somewhat limited data.

FinCEN Releases the Ninth Issue of *SAR Activity Review -- By the Numbers*

On February 11, 2008, FinCEN issued the latest edition of the *SAR Activity Review - By the Numbers*.

This report presents a compilation of numerical data gathered from Suspicious Activity Reports (SARs) filed through the first six months of the year. While this report does not analyze specific trends, changes in the reporting of some suspicious activities are of note and will be of interest to financial institutions, regulatory, and law enforcement agencies. For example, the suspicious activity

characterization "Mortgage Loan Fraud" increased 35% from the corresponding six-month period in 2006.

By the Numbers further categorizes this data by and state and by year so that users can compare numbers which are relevant to their areas of interest.

OCC Issues Bulletin on Notary and Bank Seals

On February 8, 2008, the OCC issued guidance in OCC Bulletin 2008-2, on notary or bank seal requirements.

The OCC recently reviewed its requirements for a notary or bank seal. Following the review of statutes and regulations applicable to all corporate applications, documents, and notices, the OCC

removed all notary and seal requirements not supported by federal banking code or regulation.

This change has been implemented to facilitate broader use of e-Corp, an electronic application system for submitting corporate applications and notices.

Additional Information

If you would like additional information about the topics discussed in this newsletter, or about PwC's Financial Services Regulatory Advisory Services, please call:

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