Federal Reserve Bank of Minneapolis High and Emerging Risk List

June 30, 2013
(based on data as of December 31, 2012)

Executive Summary

The Reserve Bank currently assesses earnings risk as the only risk with a high level of concern and significant exposure. As reflected in the discussions, the risk to earnings is not one of immediate loss exposure but results from actions banks may be taking in an effort to address the perceived need to enhance earnings. This document discusses earnings-driven actions that are increasing financial institution risk in the discussions related to investment securities, interest rate risk (IRR), vendor management, fraud and internal controls, consumer compliance, and commercial and industrial (C&I) lending.

Process

Development of the Risk List begins with the identification of areas of potential risk faced by Ninth District financial institutions. SRC management then assesses each risk based on the level of concern, level of exposure, and trend, as defined in Table 1. Table 2 lists the risks considered and shows the level of concern and level of exposure for the current period and the prior year-end. The report includes trend data only for the current period. We completed summaries for the risks rated high or elevated, regardless of exposure, for any risk rated moderate with a significant exposure level, and for two risks that warrant continued monitoring despite the current level of concern and exposure.

Table 1

Level of Concern Measures the District's assessment of the risk area considering: (1) prospects that the risk will give rise to an adverse financial impact, (2) immediacy of the risk, and (3) potential for losses. The focus is on inherent risk in the absence of controls or mitigants an institution may have implemented.	High – Current problem area, or one likely to become a problem area in the next one to two years, that if realized would have a significant impact on institutions in terms of operating losses, rating downgrades, or failures. Elevated – Either a current problem area that has a less significant impact on institutions than a high-risk area or an area that is potentially high impact but less likely to develop in the next one to two years. Moderate – A concern that is notable for some reason, but the impact is not likely to be significant in the near term. Low – Little or no risk of a significant impact in the next one to two years.
Level of Exposure Measures the relative percentage of District institutions believed to be affected or potentially affected.	Significant – Affects a substantial number (more than 33%) of state member banks (SMBs) and holding companies (HCs). Moderate – Affects a significant percentage but less than the substantial number (5% to 33%) of SMBs and HCs. Low – Affects only a few (less than 5%) SMBs and HCs.
Trend	Increasing Stable Decreasing

Table 2

Risk	Level of Concern and Exposure		Trend	Discussion Page
	12-31-2012	6-30-2013		
Credit Risk				
Commercial Real Estate	**Elevated** Significant	**Elevated** Significant	Decreasing	7
Commercial and Industrial	Moderate Significant	Moderate Significant	Increasing	15
Agricultural	**Elevated** Significant	**Elevated** Significant	Stable	5
Consumer	Moderate Low	Moderate Low	Stable	N/A
Residential Real Estate	Moderate Low	Moderate Low	Decreasing	N/A
Other Real Estate Owned	**Elevated** Moderate	Moderate Moderate	Decreasing	N/A
Investment Securities	Moderate Moderate	**Elevated** Moderate	Increasing	8
Market and Liquidity Risk				
Liquidity Risk	Low Significant	Low Significant	Stable	N/A
Interest Rate Risk	**Elevated** Moderate	**Elevated** Moderate	Increasing	9
Operational Risk				
Information Security	**Elevated** Moderate	**Elevated** Moderate	Increasing	10
Other Information Technology	Moderate Low	Moderate Low	Stable	N/A
Vendor Management	**Elevated** Moderate	**Elevated** Moderate	Increasing	11
Fraud and Internal Controls	**Elevated** Moderate	**Elevated** Moderate	Increasing	12
Accounting and Auditing	Moderate Moderate	Moderate Moderate	Increasing	16
Legal and Compliance Risk				
BSA/AML/OFAC	**Elevated** Moderate	**Elevated** Moderate	Increasing	13
Consumer Compliance	**Elevated** Moderate	**Elevated** Moderate	Increasing	14
Other				
Capital Risk	Moderate Low	Moderate Low	Stable	N/A
Earnings Risk	**Elevated** Significant	**High** Significant	Increasing	3
Strategic Risk	Moderate Low	Moderate Low	Stable	N/A

Earnings Risk

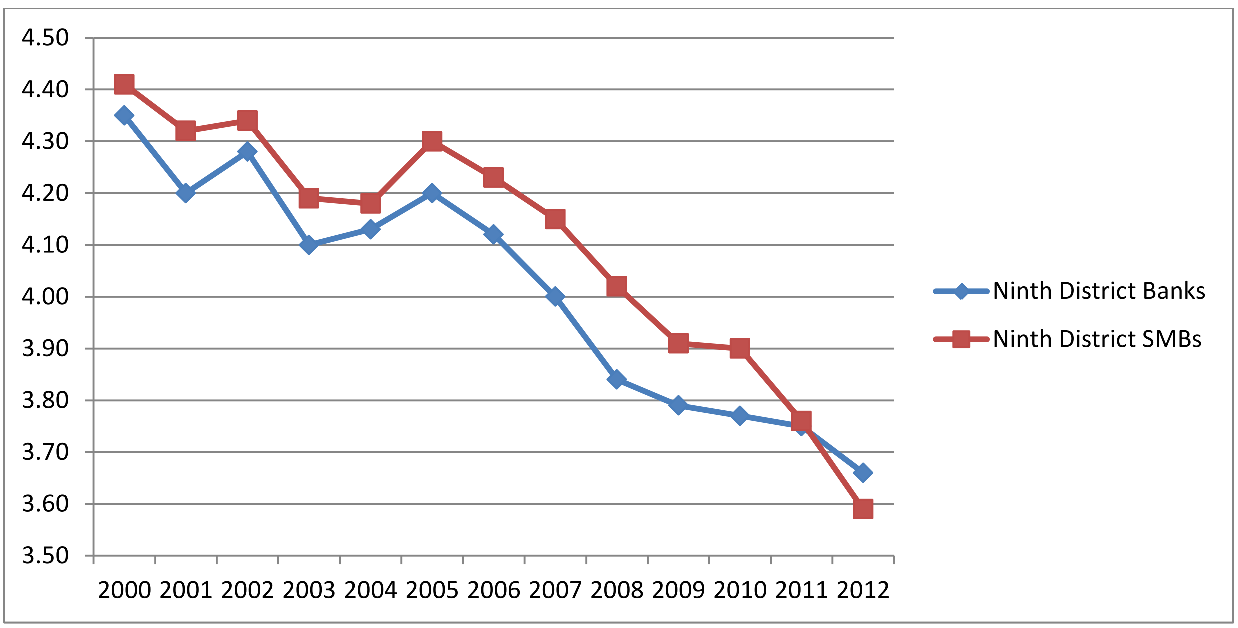
Summary

Earnings risk is considered high and increasing, with exposure being noted at a significant portion of Ninth District institutions. Current low interest rates, low loan demand, declining fee income, and increasing compliance costs are leading to lower than "normal" earnings at many institutions, both nationally and Districtwide. Community banks faced with these pressures view them as a critical challenge. These conditions have led some institutions to "chase" earnings through increasing credit risk and/or IRR in the loan or securities portfolio; cutting support costs such as audit, information technology (IT), compliance, and risk management staff; expanding into new and unfamiliar markets and/or products; or a combination of these approaches.

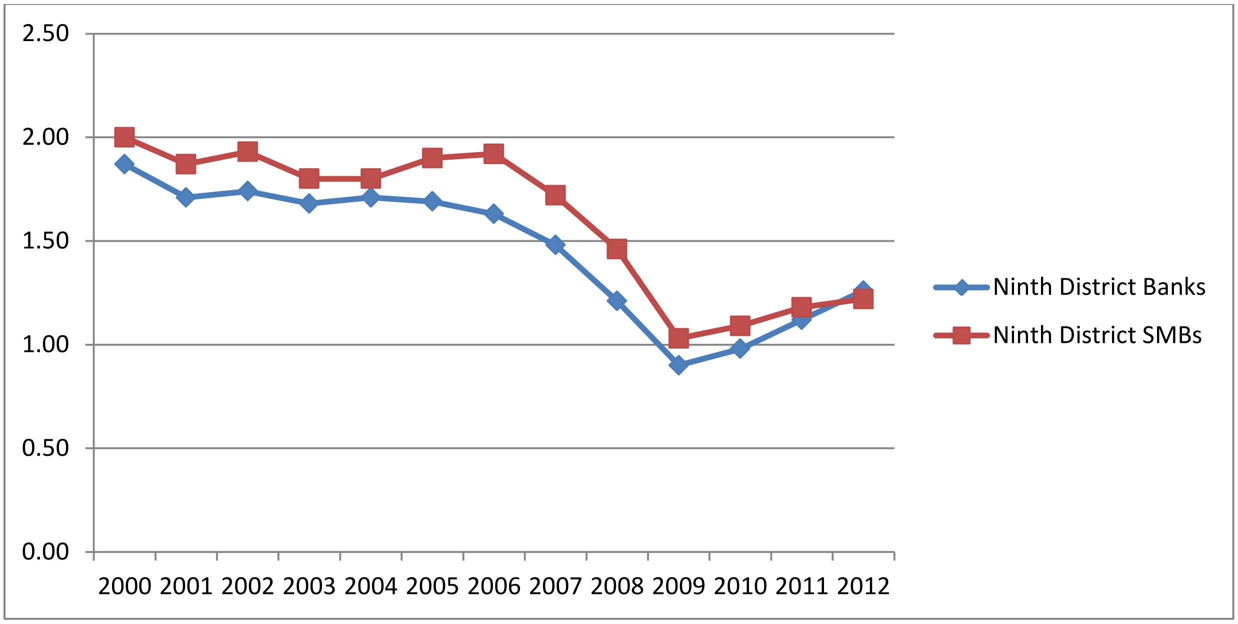
Discussion

As the charts illustrate, net interest income has shown a strongly negative trend over the past several years beginning in 2006. While pretax net operating income has also trended negatively, the drop is less pronounced.

Net Interest Income (Tax Equivalent)/Percent of Average Assets (Medians)



Pretax Net Operating Income (Tax Equivalent)/Percent of Average Assets (Medians)



Pretax net operating income showed a marked decline through the financial crisis and has improved slightly since the 2009 trough. Loan loss provisions increased dramatically during the financial crisis and are largely responsible for the decline in earnings during that time period. Conversely, provisions have declined since 2009, and in 2012 provisions approximated historical lows. This decline is largely responsible for the slight improvement in earnings over this time period. However, aid to earnings from this source will be more limited in the future. Likewise, the benefit from lower cost of funds has diminished as the lower bound of interest rates has been reached.

Community banks do not view themselves as having the ability to make up for the declining trend in net interest margin with other sources of income. They are vocal in their concerns about increasing regulatory costs and the possibility that new regulations will cause them to drop some business lines.

The principal concern about lower earnings is the incentive for institutions to take on additional risk. Examiners have seen some evidence that the current low-interest-rate environment has prompted banks to reach for yields by increasing their investments in higher credit risk securities, more complex structured securities, and/or longer duration securities. (See the Investment Securities Risk and Interest Rate Risk discussions.) Further, offering new products, expanding into new markets, or reducing the resources devoted to critical risk management functions increases the risk of operational losses.

Agricultural Credit Risk

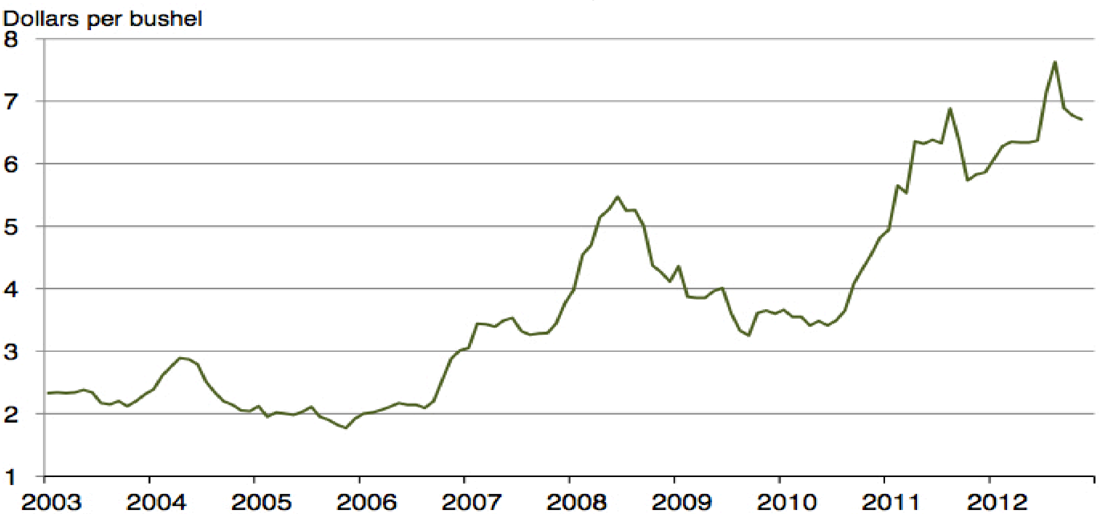
Summary

Agricultural credit risk is elevated and significant with a stable trend. The agricultural economy has traditionally evidenced considerable volatility, with periodic booms and busts. Currently, the agricultural economy has delivered several years of record performance due to a combination of high commodity prices, strong national and international demand, and low interest rates. Continuation of all these strong positive trends without an offsetting increase in supply is unlikely. Consequently, a correction of at least some degree is probable. Risk exposure is significant because 38 of the District's 69 SMBs and 357 of the 662 District institutions have agricultural lending concentrations.[1]

Discussion

There is the potential for some correction in select agricultural asset values given historically high valuations. Indeed, some measures such as agricultural land price to rent ratios are at historical highs. A return to more "normal" levels is a possibility. Crop prices have been near record highs as shown by the graph[2], and Ninth District yields in 2012 were normal or better despite the drought.

Prices Received for Corn by Month – United States



The combination of high crop prices and respectable to above-average yields has resulted in record income for many producers. This has enabled producers to pay down debt and often to use internal working capital for their operating needs, thereby decreasing borrowing needs. The increased income levels have also provided operators the opportunity to pay mostly cash to upgrade their machinery and purchase farmland. Finally, farm equity and borrowing apparently demonstrate a conservative picture for existing farmers.

However, as noted in the following chart, the major portion of the increase in farmland value is reflected in the increase in equity for the nation's farmers. Although the level of farm debt appears low in relation to farm equity, equity would be eroded by a decline in land values from current record highs. Further, the

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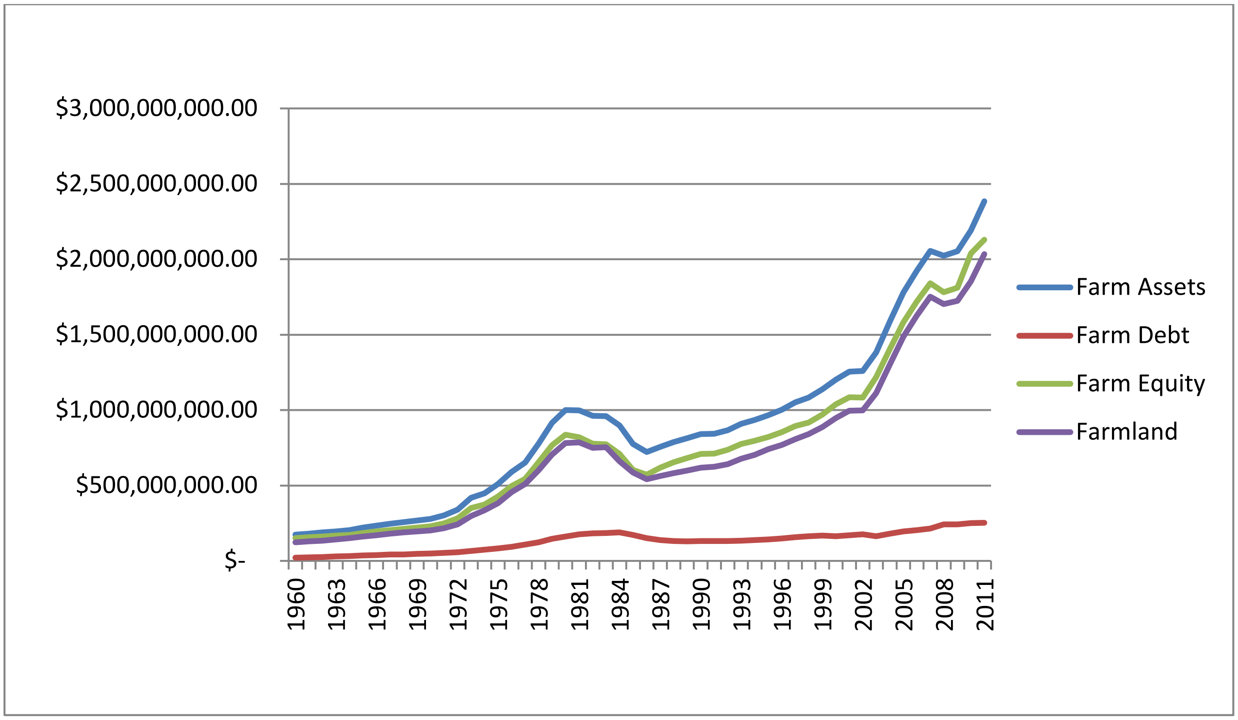
[1]Banks have a concentration in agricultural lending when the sum of loans to finance agricultural production and loans secured by agricultural real estate exceeds either 25% of total loans or 100% of tier 1 capital plus the allowance for loan and lease losses.
[2]Data from the U.S. Department of Agriculture.

estimated debt levels exclude some sources of farm borrowing such as debt to suppliers and farm equipment manufacturers.

Key Farm Balance Sheet Components - Aggregate



Agricultural projections for 2013 indicate declining crop prices, which depending on yields, may decrease cash flow generated from crop production. If decreased cash flow becomes a new "normal," demand declines, or interest rates increase, land values would likely start to fall. The combination of lower revenues and declining collateral values could have a significant effect on farmers and the banks that lend to them.

Commercial Real Estate Risk

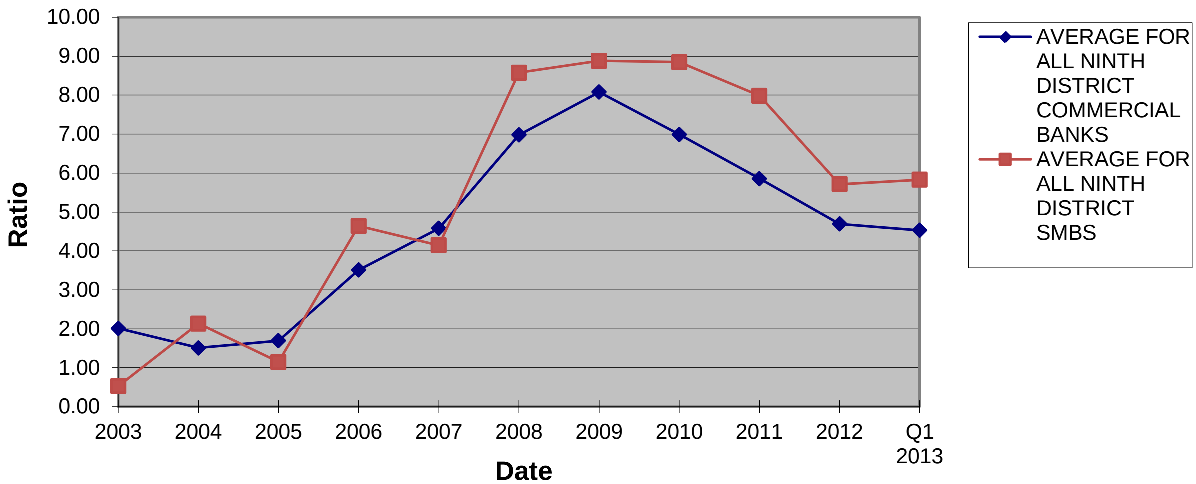
Summary

Commercial real estate (CRE) lending remains an elevated risk with significant exposure but a decreasing trend. Some of the continued concern stems from prior CRE concentrations and losses that banks in the Ninth District, including SMBs, experienced during the past four years. However, quality indicators have shown general improvement in CRE portfolios because most problem loans have been identified and are in the process of resolution. Concentrations have been falling as banks have taken losses and booked few new CRE loans to replace existing loans.

Discussion

Nonperforming CRE loans as a percentage of total CRE loans outstanding decreased for 25 of 68 SMBs in 2012. Delinquent CRE loans peaked in 2009, and although falling since then, remain well above the average pre-crisis levels.

Delinquent CRE Loans/Total CRE Loans (medians)



While some banks continue to work through resolving problem CRE loans and disposing of related other real estate owned (OREO), most banks are seeing a general improvement in asset quality indicators (e.g., past-due loans, noncurrent loans, and net losses) and are becoming positioned to resume more normal lending activities.

There has not been any significant growth in new CRE lending for Ninth District community banks. Overall volume steadily declined between 2009 and 2011; however, total CRE loans at District community banks increased to slightly above the 2009 level by year-end 2012. Growth was driven by North Dakota banks, which experienced CRE lending increases over 10% in both 2011 and 2012. As of December 31, 2012, total CRE volume at SMBs is down 15% compared to 2009.

Investment Securities Risk

Summary

Investment securities risk is elevated with moderate exposure and an increasing trend. The elevated status is assigned for two reasons. The first concern is the change in the information necessary to confirm the investment grade status of investments. The second concern is that banks faced with earnings pressure may be tempted to take additional interest rate and credit risk in the investment portfolio. (This comment deals exclusively with credit risk concerns in the investment portfolio; see the discussions on Earnings and Interest Rate Risk for further comments.)

Discussion

The first concern is an offshoot of the Dodd-Frank Act (DFA), which requires that banks no longer look solely to the ratings assigned to bond issues by nationally recognized rating agencies to demonstrate that investments are of investment grade. Many banks, particularly small community banks, may not have the expertise or infrastructure needed to complete the credit analysis necessary to ensure securities, particularly structured instruments, are of investment grade. While the banks have always had the responsibility to conduct appropriate due diligence, as a practical matter, many small community banks depended almost entirely on rating agency scores to support the creditworthiness of investments. The legislation and implementing regulations and guidance require that banks perform their own more complete and thorough credit analysis to justify all non-Treasury or U.S. Government Agency issued investments. This change will require community banks to devote resources to finding and analyzing financial information on municipal and corporate bond issuers and private label asset-backed instruments. Credit information on municipalities, particularly smaller ones, is often out-of-date.

As noted in the Earnings Risk discussion, there is increasing concern that banks will take on additional credit risk in the investment portfolio in an effort to improve yields. This concern is caused by the low-interest-rate environment, the lack of loan growth, and the low yield on most investment securities. Examiners are seeing a marked move to increasing riskiness in banks' investment choices. During a time when CRE exposure has been reduced and C&I lending is increasing at a relatively slow rate, the SMBs' investment in municipal securities rose almost 20% a year from 2010 through 2012. Further, a few banks are expanding their investment in corporate bonds. While municipal securities are generally of high credit quality, the number of municipal bankruptcies is increasing, and concerns exist about the impact of unfunded pension obligations. Many banks have yet to develop expanded due diligence processes and the policies and procedures needed to conduct their new investment activities.

Interest Rate Risk

Summary

IRR is elevated with a moderate exposure and increasing trend. The prolonged period of low interest rates and the current low-interest-rate environment contribute to the elevated nature of this concern. A continuing worry is that earnings pressure will prompt banks to take on additional IRR.

Discussion

Call Report data indicates that the duration of securities held in District bank portfolios has increased significantly. Specifically, there has been a significant increase in the volume of securities in the greater than 3-year and less than 15-year categories for both repricing and maturity dates as a percentage of total assets, as shown below.

Debt Securities with a Remaining Maturity or Repricing Frequency Divided by Total Assets

	12-31-2007	12-31-2012
Over 3 Years Through 5 Years	2.86%	4.29%
Over 5 Years Through 15 Years	5.32%	8.94%
Over 15 Years	1.63%	1.48%

The lengthening term of bank security portfolios suggests that banks are taking on IRR within the securities portfolio.

In addition, current bank balance sheets reflect a substantial volume of nonmaturity deposits, which IRR models risk weight favorably due to historically reduced sensitivity to interest rate changes. However, many of these nonmaturity deposits originated during the financial crisis and may be more susceptible to runoff or conversion into interest-bearing time deposits as interest rates increase.

Concerns related to IRR include the possibility that excess deposit liquidity, low interest rates, and low loan demand have led firms to implement higher-risk investment strategies. This concern is somewhat evident in Ninth District banks. (See the Investment Securities Risk discussion.) Some of the elevated risk strategies could include yield chasing, moving down the yield curve, and taking on more structured investments to pick up incremental yield. These strategies would expose financial institutions to elevated levels of IRR during a period when excessive risk could be masked if the institution does not have the appropriate risk management controls in place. Banks need to ensure that IRR models consider: (1) the potential that deposit bases will revert to historical mixes of nonmaturity and time deposits and (2) the source of deposit increases when estimating decay rates. Finally, national risk reports note concerns that banks are entering this rate cycle with lower levels of earnings and appear less equipped to buffer the impact of IRR than during other rate cycles.

Information Security/Cyber Security Risk

Summary

Information security risk is elevated with a moderate exposure and an increasing trend. The risk of losses due to an information security breach remains a key concern as banks continue to expand their reliance on technology. The principal threat has focused on larger institutions in the form of massive distributed denial of service (DDoS) attacks being launched by "hacktivist" groups specifically targeting the U.S. banking and finance industry. However, small banks are also exposed to fraud and operational losses involving compromised security of their or their customers' information.

Discussion

The DDoS attacks are meant to disrupt public web sites by flooding networks and servers with traffic, either delaying or preventing legitimate customer traffic. The attacks could also disrupt business operations, since links between public and internal web applications may also be affected. The first quarter 2013 Prolexic Quarterly Global DDoS Attack Report indicates the total number of attacks increased 21% compared to the same quarter in 2012. The average attack bandwidth increased from 6.1 gigabits per second (Gbps) to 48.25 Gbps, an increase of 691%.

The initial attacks began in late 2012 and targeted mainly large banking organizations. However, the group leading the effort changed the scope of its attacks in late March 2013. Attacks have now begun to target credit card issuers, financial service suppliers, broker/dealers, investment advisors, and smaller financial institutions.

In addition to the possibility of DDoS attacks moving to smaller banks, community banks continue to be exposed to threats of loss related to identity theft and wire fraud that targets bank customers. As IT becomes a vital part of bank operations, not surprisingly, identity theft and fraud schemes increasingly rely on access to the banks' systems through technology interfaces. Suspicious activity report (SAR) filings increasingly report identity theft from customers as the first step in fraudulently transferring funds from customer accounts.

Further, in an effort to enhance the availability of information and functionality to bank directors, employees, and staff, some banks may be offering new technologies without a full assessment of the associated risks (e.g., storing customer information in "the cloud").

Vendor Management Risk

Summary

Vendor management risk is elevated with a moderate exposure and an increasing trend. To offset continued earnings pressure and increase efficiency, banks have steadily expanded the volume and types of activities outsourced to third parties. Consequently, there is a greater likelihood that management may enter into third-party relationships without fully understanding or mitigating the existing and/or resulting risks.

Discussion

Outsourcing activities may result in increased risk to the institution in a number of ways. A bank may incur legal, reputational, and operational risks (and possibly losses) if a service provider fails to adequately provide contracted services. Concentration or systemic risks arise if multiple firms rely on a limited number of service providers or if the providers are in limited locations. This could have a significant impact on business resiliency. Third-party service providers may themselves outsource some functions to subcontractors who may not have adequate controls and risk management in place. Additional risks arise if bank management chooses to use a foreign-based service provider, since the financial institution needs to ensure the provider complies with applicable U.S. laws, regulations, and guidance.

A specific driver of elevated risk is the growing trend of outsourcing non-IT services; these relationships have not traditionally received the same level of due diligence, risk assessment, or ongoing monitoring as have IT relationships. Outsourced non-IT services may include loan servicing, IRR modeling, loan portfolio analysis, payment processing, wealth management, and risk management, among others. Bank management needs to ensure appropriate management of all critical vendors. Service providers should have risk management processes and controls in place that are comparable to what the bank would have implemented if performing the same function in house.

In addition, some institutions have relied on nonregulated third parties to manage new or expanded businesses in areas such as remote deposit capture and ACH transaction processing. Others have entered into relationships with mortgage brokers or auto dealers as a means of generating loan volume. At times, these banks have not had a complete understanding of the operational, legal, compliance, and reputational risks associated with the new activities and as a result have not developed appropriate risk management practices for the activities.

Fraud and Internal Controls Risk

Summary

Fraud risk is elevated with a moderate exposure and an increasing trend. Continued incidents of internal control breakdowns and reported fraud across the country suggest that some institutions may be bypassing, ignoring, or failing to enforce basic preventive controls. Prolonged earnings pressure increases the possibility that financial institutions may reduce funding for staff, delay control reviews, or enter into new products/business lines without proper due diligence or understanding of risks. Effectiveness of control systems could be further degraded if funding is cut for technology investments or IT projects involving information security, business continuity, or critical IT infrastructure. The resulting weaknesses in internal controls raise the risk of fraud and other operational costs/losses.

Discussion

For Ninth District financial institutions, the average total assets per employee has increased from a mean of $3.6 million as of December 31, 2007, to $4.58 million as of December 31, 2012. The increase in assets per employee suggests that time devoted to non-revenue function, including fraud prevention and detection, may not be keeping pace with asset size. Similarly, declining staff levels could impact banks' ability to maintain key controls, such as separation of duties, that are essential to detection and prevention of internal fraud.

Nationwide SAR filings by depository institutions relating to fraud have increased from 193,000 in 2007 to 253,000 in 2011. The largest increases in filings were related to consumer, mortgage, and wire transfer fraud. Financial institutions in Ninth District states filed an average of more than 20,000 fraud-related SARs annually from 2007 through 2011 (the average includes all of Wisconsin and Michigan, as SAR data is not available by Federal Reserve District).

In 2010 and 2012, the Information Security Media Group (ISMG) conducted a Faces of Fraud survey of banks and credit unions across the country, which indicated that institutions have been slashing budgets and deferring expenses since the beginning of 2008 (see http://www.bankinfosecurity.com/p-survey-fraud-2012). Although the majority of respondents in 2012 indicated they expect an increase in antifraud resources in the next year, 57% of respondents still cited insufficient resources (budget and/or personnel) as one of the biggest challenges to fraud prevention in their organization. Inadequate fraud detection tools and technologies were cited by 47% of the firms. Of the 2012 respondents, 82% say fraud threats have increased in the past year, due primarily to evolving online threats, poor economic conditions, and the complexity of the IT infrastructure (more points of attack). Ninth District-specific information on fraud losses or antifraud spending is not available.

Bank Secrecy Act (BSA)/Anti-Money Laundering (AML)/ Office of Foreign Assets Control (OFAC) Risk

Summary

BSA risk is elevated with a moderate exposure and increasing trend primarily due to recent cases against major financial institutions that resulted in enforcement actions and multimillion dollar assessments. Fines have also been assessed against smaller institutions.

Discussion

Recent enforcement actions and resultant congressional hearings related to BSA/AML/OFAC supervision have prompted additional regulatory scrutiny of BSA/AML compliance at banks of all sizes, both during examinations and in the applications process. Further, FinCEN has implemented an initiative to enforce the BSA more effectively, and its current director is focusing on enhancing the bureau's enforcement and compliance functions.

FinCEN intends to aggressively use tools, such as imposing special measures under section 311 of the USA PATRIOT Act against entities determined to be primary money-laundering concerns, to enhance its ability to hold individuals and institutions involved in money laundering and terrorism financing accountable.

In addition to increased BSA/AML oversight, on February 16, 2012, FinCEN released an Advance Notice of Proposed Rulemaking and a Request for Comment pertaining to the expansion of customer due diligence (CDD) obligations for financial institutions. Specifically, FinCEN proposes to enhance CDD requirements for determining beneficial ownership of accounts. Financial institutions expressed a number of concerns related to the proposal, and a final Notice of Proposed Rulemaking is expected in the near term. It is widely expected that the new rule will create additional expectations for financial institutions at account opening and in monitoring for suspicious activity, which will further strain resources, particularly at community banks.

Consumer Compliance Risk

Summary

Consumer compliance risk is elevated with a moderate level of exposure and an increasing trend. The new residential real estate loan rules issued in January 2013 present significant compliance challenges for banks, which must devote substantial time to understanding the new requirements, analyzing risks, implementing policies and procedures, and modifying compliance risk management programs. In some instances, the new rules may also require extensive system or other costly changes that could lead some smaller community banks to consider discontinuing certain product and service offerings.

Discussion

In early 2013, the Consumer Financial Protection Bureau (CFPB) issued seven new regulations relating to residential real estate loans as part of its implementation of the DFA. Most of the new regulations require compliance by January 2014. The new regulations address issues revealed during the mortgage crisis and relate to almost every aspect of mortgage loan origination and servicing. In addition, the CFPB plans to consolidate the mortgage disclosures, and the banking agencies must adopt credit risk retention requirements for these types of loans. The DFA also increases data collection requirements by establishing Regulation B data collection rules for small business loans and expanding the number of Home Mortgage Disclosure Act data fields that must be reported for mortgage loans.[3]

Other areas where CFPB rule changes have a potential impact on supervised institutions include the following:

- **Compliance Management Program.** Given the expanded regulatory requirements, compliance management program resources may be stressed. Some banks might have to add staff to compliance management programs; however, banks are concerned with the impact such an action will have on earnings. This increase in staffing constitutes a further challenge for community banks, especially those in rural areas, as they seek to attract personnel with the skill sets to manage compliance with the expanded regulatory requirements.
- **New Products, Services, and Business Lines.** Due to earnings pressure, banks might engage in new activities without adapting compliance management programs to reflect new or changed risks. These risks could stem from new products, services, processes, or business lines. In addition, some banks have used external third parties to assist with or manage new products without fully understanding the risks associated with the new activity. (See the Vendor Management Risk discussion.)
- **Fairness and Consumer Impact.** Banks might not adapt compliance management programs to be more proactive and to assess risks relating to fairness and consumer harm potentially caused by the bank's products, services, and processes, including the use of third parties. Also, banks might fail to incorporate an evaluation of consumer complaints and customer service issues into the analysis of fairness and consumer harm.

[3]The CFPB has issued one final and substantive regulation not linked to residential real estate loans; this regulation relates to foreign remittances. The CFPB and other regulatory agencies might issue new or amended regulations linked to other types of products or services during 2013.

Commercial and Industrial Lending Risk

Summary

C&I lending risk is a moderate concern with moderate exposure and an increasing trend. This area requires additional monitoring for future developments, given national concerns about banks expanding C&I lending activity in potentially inappropriate ways as noted below. This concern is partially reflected in the increasing trend. The national trend has also noted an increasing level of C&I lending, and a number of banks have expressed an interest in expanding their C&I portfolios.

The large, multinational banks have experienced nearly 30% growth in C&I volume over the past two years. Most of this increase results from large banks refinancing C&I loans previously held by foreign banks that exited the U.S. markets during the credit crisis.

Banks in the Ninth District, and SMBs in particular, generally have not experienced a significant increase in C&I volume to date. From 2011 to 2012, the District C&I volume increased by just 3%. As discussed in the CRE Risk discussion, a general lack of loan demand is the primary concern for District banks at this time, rather than any specific type of lending activity.

A significant concern is the possibility that banks may take aggressive steps to attract and retain commercial credits. In some cases, banks may loosen underwriting standards, extend credit out of area, and/or resume purchased loan activity. In addition, banks may explore other more risky types of lending, such as asset-based lending, that they lack the expertise to manage. Another concern is that a shift to a greater volume of C&I lending may require different skills than banks' current lenders possess.

Accounting and Auditing Risk

Summary

Accounting risk is moderate with a moderate exposure and an increasing trend. Accounting and the associated risk are rapidly evolving, however, and will be subject to ongoing monitoring. Current concerns focus on the emergence of reserve releases or negative provisions for loan losses and continued questions regarding accounting for troubled debt restructurings (TDRs). Proposed changes in reporting related to financial instruments are the primary longer-term concerns.

Discussion

- **Current Accounting Issues:** As credit quality indicators and collateral values have improved, some institutions have recorded zero or negative provisions for loan losses (reserve releases), which have contributed to earnings growth. There is some concern that institutions may have made overly optimistic assumptions about continued improvement in credit quality and, as a result, may be underestimating loan losses. In addition, many banks continue to struggle with accounting for TDRs.
- **Longer-Term Accounting Issues – Financial Instruments:** The Financial Accounting Standards Board (FASB) continues to deliberate on its classification and measurement model for financial instruments. FASB is also working with the International Accounting Standards Board to achieve a greater level of convergence with the new International Financial Reporting Standard model. New FASB proposals will significantly alter both the accounting for the investment securities portfolio and the allowance for loan and lease losses (ALLL).
    - One proposed change is the accounting for held-to-maturity (HTM) securities, which are currently measured at amortized cost and are subject to the inference of “tainting” if sold early. Under the proposed model, a large portion of HTM securities could be measured at fair value, which could increase volatility in shareholders’ equity.
    - FASB has issued for comment a proposed change in the reserving methodology, which would shift the standard for ALLL adequacy from being sufficient to cover “incurred losses” to being sufficient to cover “expected losses.” The proposal would, in FASB’s view, make the ALLL more forward looking and result in earlier recognition of deteriorating credit conditions. The overall effect of the change to an expected loss model is not clear. Banks have commented negatively on the FASB proposal, stating that the proposal would result in “Day 1 losses” being recorded when the loan is put on the books as part of the estimate of total credit losses over the life of the loan. Banks believe a more realistic method is to recognize losses over the full life of the loan and match them against the interest revenue the loans produce. Estimates prepared by major banking companies indicate that the switch from incurred to expected loss would require an increase in the ALLL of approximately 50%, with a corresponding decrease in earnings. The greater concern for community banks is the need to change the modeling process at a time when they are just getting experience with the current model.
    - Another change in accounting under the new FASB impairment proposal is that a credit reserve would become necessary for all securities, and the reserve would be established based on expected losses. FASB proposes doing away with the Other Than Temporary Impairment accounting and using this reserve to book declines in market value.