Letter from the Director

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

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

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

Problems in the subprime lending market also highlight the importance of proper due diligence when entering into third-party arrangements. In this issue, ***"Third-Party Arrangements: Elevating Risk Awareness"*** addresses both the benefits and potential risks associated with third-party agreements and offers some best practices for avoiding the financial losses and reputation risks that can result from poorly managed third-party arrangements. The article also highlights how, as third-party arrangements become more prevalent in all institutions, they present a broad spectrum of risks crossing all examination disciplines—risk management, compliance, trust, and information technology. As the examples in the arti-

cle point out, the risks in many of these relationships (such as information technology or merchant processing) are well known, but others are often overlooked. Inadequate management and control of third-party risks can result in a significant financial impact on an institution, including legal costs, credit losses, increased operating costs, and loss of business. The problems highlighted in the article might have been avoided if the institutions had conducted thorough risk assessments, conducted proper due diligence on the parties with whom they were partnering, thoroughly reviewed contracts, and ensured that the third-party product or service meshed with the institution's goals and business plan and that those products or services were consistent with applicable supervisory policies. Examiners from all disciplines will continue to review banks' third-party arrangements to ensure that financial institutions understand and mitigate the potential risks.

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

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

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

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

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