Recent Developments Affecting Depository Institutions

*by Lynne Montgomery**

CONDITION OF THE BANKING INDUSTRY

First-Quarter 2003 Financial Results for Commercial Banks and Savings Institutions

In its *Quarterly Banking Profile* for the first quarter of 2003, the Federal Deposit Insurance Corporation (FDIC) reported that FDIC-insured commercial banks and savings institutions earned a record $29.4 billion, an increase of $4.1 billion from earnings in the first quarter of 2002. Key factors in the higher earnings were gains on sales of securities and lower expenses for delinquent loans. The average return on assets was 1.38 percent, up from 1.29 percent one year earlier. The number of commercial banks and savings institutions on the FDIC's "Problem List" declined from 136 in the fourth quarter of 2002 to 129 in the first quarter of 2003, and assets of "problem" banks fell from $39 billion to $35 billion. The *Quarterly Banking Profile* can be accessed at **http://www2.fdic.gov/qbp**. *FDIC Quarterly Banking Profile, First Quarter 2003.*

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Reference sources: *American Banker* (AB), *BNA's Banking Report* (BBR), and *Federal Register* (FR).

First-Quarter 2003 Financial Results for the Insurance Funds

The FDIC reported that for the first quarter of 2003 the Bank Insurance Fund (BIF) had comprehensive income (net income plus/minus current-period unrealized gains/losses on available-for-sale securities) of $332 million, compared with income of $258 million for the same period in 2002. Although net income was actually $7 million lower than in the first quarter of 2002, unrealized gains on available-for-sale securities increased by $81 million. As of March 31, 2003, the BIF balance was approximately $32.4 billion, up from $32.1 billion at year-end 2002. The BIF reserve ratio rose from 1.27 percent at December 31, 2002, to 1.28 percent at March 31, 2003.

The Savings Association Insurance Fund (SAIF) reported comprehensive income of $159 million for the first quarter of 2003, compared with $114 million for the same period in 2002. The increase in comprehensive income was due primarily to lower estimated losses for future failures and higher unrealized gains on available-for-sale securities. The SAIF balance as of March 31, 2003, was $11.9 billion, up from $11.7 billion at year-end

2002. The SAIF reserve ratio held steady at 1.37 percent between December 31, 2002, and March 31, 2003. *PR-45-2003, FDIC, 5/7/03; FDIC Quarterly Banking Profile, First Quarter 2003.*

Bank Failure

On May 9, 2003, the First National Bank of Blanchardville, Blanchardville, Wisconsin, was closed by the Office of the Comptroller of the Currency (OCC), and the FDIC was named receiver. First National had total assets of approximately $35 million and total deposits of approximately $29 million. The Park Bank, Madison, Wisconsin, acquired First National's insured deposits and purchased the failed bank's cash and cash-equivalent assets. The remaining assets have been retained by the FDIC for later disposition. First National was the second failure of a BIF-insured institution in 2003. *PR-47-2003, FDIC, 5/9/03; PR-48-2003, FDIC, 5/10/03.*

Emerging Risks to the Banking Industry

The summer 2003 edition of the *FDIC Outlook* reports that even as the banking and thrift industries' earnings set new records, U.S. banks and savings institutions continue to face risk-management challenges in several key areas. The report discusses how banks have been addressing their credit, market, and operational risks. The report also discusses potential bank problem areas that FDIC analysts and examiners continue to monitor, including commercial real estate portfolios; subprime consumer lending; net interest margin compressions; interest rate and funding risks related to the unusually low interest-rate environment; exposure to market-sensitive, non-interest income sources; and the adequacy of internal audit and other fraud controls. The *FDIC Outlook* also addresses developments in each of the FDIC's six regions (Atlanta, Chicago, Dallas, Kansas City, New York, and San Francisco). The summer 2003 *FDIC Outlook* can be accessed at **http://www.fdic.gov/bank/analytical/regional/ro20032q/na/index.html**. (Past editions of the FDIC Outlook can be accessed at **http://www.fdic.gov/bank/analytical/regional/index.html**.) *PR-66-2003, FDIC, 6/18/03.*

REGULATORY AGENCY ACTIONS

Interagency Actions

Guidance on Sound Practices for Resilience of the Financial System

On April 8, 2003, the Board of Governors of the Federal Reserve System (FRB), the OCC, and the Securities and Exchange Commission (SEC) issued a paper entitled *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*, which identifies sound practices to strengthen the resilience of U.S. financial markets and minimize the immediate systemic effects of wide-scale disruptions. The paper identifies four sound practices for clearing and settlement organizations and firms that play significant roles in critical financial markets. Specifically, the sound practices consist of (1) identifying clearing and settlement activities in support of critical financial markets, (2) determining appropriate recovery and resumption objectives for clearing and settlement activities in support of critical markets, (3) maintaining sufficient geographically dispersed resources to meet recovery and resumption objectives, and (4) routinely using or testing recovery and resumption arrangements. These sound practices are intended to supplement the agencies' own policies and other guidance on business continuity planning by financial institutions. The agencies expect organizations that fall within the scope of the paper to adopt the sound practices within the specified implementation time frames. *PR-FRB, 4/8/03; BBR, 4/14/03, p. 602.*

Guidance on Use of the Discount Window

On July 23, 2003, the FDIC, the FRB, the OCC, the Office of Thrift Supervision (OTS), and the National Credit Union Administration issued guidance on the appropriate use of the Federal Reserve's new discount window program, which was introduced in January 2003. The guidance provides information on the new primary and secondary credit programs. It also reiterates well-established supervisory policies on sound liquidity contingency planning, and discusses sound practices in using primary-credit-program borrowings in liquidity contingency plans. *PR-73-2003, FDIC, 7/23/03.*

New Electronic Filing System for Beneficial Ownership Reports

On July 30, 2003, the FDIC, the FRB, and the OCC unveiled a new interagency electronic filing system that allows faster and easier submission and public retrieval of beneficial ownership reports filed by directors, officers, and principal shareholders ("insiders") of institutions whose equity securities are registered with the FDIC, the FRB, or the OCC. The new electronic system is part of the agencies' ongoing efforts to streamline the submission and retrieval of reports filed with the agencies under the Securities Exchange Act of 1934. The new system will also reduce the burden on insiders, who are required to file these reports within two business days of completing a transaction in equity securities of the institutions. Initially, filing under the new system will be voluntary, although the agencies encourage insiders to use the system as soon as practicable. *PR-74-2003, FDIC, 7/28/03.*

Federal Deposit Insurance Corporation

New Approach to Compliance Exams

The FDIC adopted a new examination process for measuring an institution's compliance with consumer protection laws and regulations. Under the new approach, compliance examinations will combine the risk-based examination process with an in-depth evaluation of an institution's compliance-management system. The new approach was developed to keep pace with the banking industry's compliance responsibilities, which have become more numerous and complex. Past examinations placed too much emphasis on checklists, and on-site examinations often involved reviewing every bank regulation and determining whether a bank was in compliance with each one. The new approach emerges from regulators' belief that bank officials have a common-sense understanding of their compliance responsibilities and therefore do not require the checklist approach during examinations. The new process will be used for on-site examinations occurring after June 30, 2003. *BBR, 6/23/03, p. 1006.*

Exam Guidance for Payday Lending

On July 2, 2003, the FDIC issued examination guidance for FDIC-supervised institutions that engage in payday lending, which typically involves issuing small-dollar, unsecured, short-term advances at high annual percentage rates. Payday lenders will now be subject to special examination procedures to verify and monitor their performance. In addition, the FDIC will hold an institution's board of directors and management responsible for ensuring that all facets of the payday lending operation—including those handled by a third party—are conducted in a safe and sound manner and in compliance with all applicable consumer protection laws, regulations, and policies. Failure to meet the standards will result in enforcement actions, which could require an institution to exit the payday lending business. *PR-70-2003, FDIC, 7/2/03.*

Federal Reserve Board

Home Mortgage Disclosure Act (HMDA) Transition Rules

On May 23, 2003, the FRB released transitional rules that provide lenders with guidance on how to comply with revisions to the Home Mortgage Disclosure Act that become effective January 1, 2004, in cases in which a mortgage application is submitted before the effective date but final action is not taken until after it. The transitional rules provide that (1) lenders will not have to indicate whether an application or loan involved a request for preapproval or was related to a manufactured home; (2) lenders may, at their option, continue to apply the current (instead of the revised) definitions for home improvement loans and for refinancings; and (3) lenders need not report the rate spread for loans in which the rate lock occurs before January 1, 2004. Lenders must report certain information available at the time of final action, such as the purchaser type and whether a loan is subject to the Home Ownership and Equity Protection Act. *PR-FRB, 5/23/03.*

Regulation Y

On June 30, 2003, the FRB adopted a final rule amending Regulation Y, which outlines permissible derivative activities of bank holding companies. The amendment permits bank holding companies to (1) take and make delivery of title to commodities underlying commodity derivative contracts on an instantaneous, pass-through basis; and (2) enter into certain commodity derivative contracts that do not require cash settlement or do not specifically provide for assignment, termination, or offset before delivery. The final rule became effective August 4, 2003. *PR-FRB, 6/30/03.*

Survey on Bank Lending Practices

In its April 2003 issue of the quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices, the FRB reported that since the January 2003 survey, both domestic and foreign banks had continued to tighten business lending practices. However, the percentage of domestic banks that reported tightened lending standards for commercial and industrial (C&I) loans to large and middle-market firms during the period dropped significantly—from 20 percent in the January 2003 survey to 9 percent. The percentage of domestic banks that tightened their standards for business loans to small firms during the period dropped from 20 percent in the January survey to 13 percent. Both foreign and domestic institutions indicated that the most important reason for tightening standards and terms on C&I loans was a less-favorable economic outlook: the institutions reported that the demand for C&I and commercial real estate loans weakened between the January and April surveys. Domestic banks attributed the reduced demand to a decline in customers' needs for bank loans to finance capital expenditures, reduced needs to finance inventories and account receivables, and reduced merger and acquisition business. Foreign institutions attributed the reduced demand to a decline in merger and acquisition activity and reduced customer investment in plant and equipment. For the report, the Federal Reserve surveyed loan officers from 56 large domestic banks and 18 foreign banking institutions. The survey focused on changes during the preceding three months in the supply of and demand for bank loans to households and businesses. A copy of the survey can be obtained at **http://www.federalreserve.gov/boarddocs/SnLoanSurvey/**. *Senior Loan Officer Opinion Survey on Bank Lending Practices, FRB, April 2003.*

STATE LEGISLATION AND REGULATION

New Jersey

On July 23, 2003, the OTS announced that federal law preempts provisions of New Jersey's recently enacted anti-predatory-lending law, the New Jersey Home Ownership Security Act of 2002, preventing these state provisions from applying to federal savings associations and their operating subsidiaries. Federal preemption of the New Jersey law is based on the Home Owners' Loan Act and the OTS regulations that comprehensively and exclusively regulate lending by federal savings associations. The OTS says that federal law authorizes the OTS to provide federal savings associations with a uniform national regulatory environment for their lending operations, and requiring federal savings associations to treat customers in New Jersey differently would impose increased costs and an undue regulatory burden. *OTS 03-22, 7/23/03.*

Texas

The Texas Finance Commission adopted a rule, 7 Texas Administrative Code Section 12.33, that authorizes state-chartered banks to offer and sell debt cancellation contracts (DCC) and debt suspension agreements (DSA) to consumer-loan borrowers. DCCs and DSAs are offered to borrowers to cancel or suspend payments in the event of death, medical disability, or unemployment. The new rule establishes standards for state banks when they issue DCCs and DSAs, and it addresses consumer protections, fees, disclosures, and affirmative elections the customer must make to purchase the products. Because the sale of DCCs and DSAs transfers to the bank a risk that formerly was assumed by third parties, Texas Department of Banking managers advise banks to give priority to establishing a methodology to calculate reserve adequacy for potential losses. The new rule became effective on May 1, 2003. *BBR, 5/5/03, pp. 723–24.*

RECENT ARTICLES AND STUDIES

In a paper released on April 21, 2003, the FDIC reported that new capital rules being considered by the Basel Committee on Banking Supervision are expected to reduce the risk-based capital requirements for syndicated loans held by the largest U.S. banks. The risk characteristics of rated syndicated bank loans suggest a reduction in risk-based capital requirements for such loans on the order of 10 percent to 40 percent, with the magnitude of the decrease largely dependent on the approach used to estimate one of the key risk parameters: loss given default (LGD). A number of factors would limit the extent to which overall capital might decline under the new capital rules (known as "Basel II"), including the continued existence of Prompt Corrective Action capital tripwires, pressures from market participants, and Basel II's new capital charge for operational risk. However, meaningful changes in risk-based capital requirements for selected portfolios at the largest U.S. banks still remain possible. The report, entitled "Risk-Based Capital Requirements for Commercial Lending: The Impact of Basel II," was released through the FDIC's FYI series, which addresses emerging issues in banking. A copy of the paper can be obtained at **http://www.fdic.gov/bank/analytical/fyi/2003/042103fyi.html**.

A Federal Reserve study released in May 2003 suggests that mortgage lenders are more risk averse in states where tough foreclosure laws require lengthy court proceedings to evict a delinquent homeowner. The study, conducted by Federal Reserve economist Karen Pence, looked at Home Mortgage Disclosure Act data from 55 communities that cross state lines, such as the New York City, Washington, D.C., and Kansas City metropolitan areas. The study reports that consumers have a more difficult time getting credit in states with a more time-consuming foreclosure process. Consumers may appreciate the extra protection against foreclosure, but they should be aware that they are paying for the protection. Laws that benefit consumers in foreclosure also lead to higher interest rates, which make mortgages more expensive for consumers who do repay their loans. *Dow Jones Newswires, 5/14/03.*

On June 23, 2003, the FDIC released a report entitled "How Long Can Bank Portfolios Withstand Problems in Commercial Real Estate?" which states that bank loans secured by commercial real estate and construction projects continue to perform well, despite declining fundamentals in most commercial property types. The report discusses factors that have helped buffer banks' commercial real estate portfolios against the effects of declining market fundamentals, including historically low interest rates, more-conservative underwriting practices, and greater financial market involvement in the industry. Although these factors offer significant reassurance that the present downturn will not lead to credit problems on the same scale as those experienced in the real estate cycle of the late 1980s and early 1990s, in coming quarters bank commercial real estate loan losses seem likely to rise from their current low levels, as more borrowers experience problems servicing their debt. The report was released as part of the FDIC's FYI series. A copy of the full report may be viewed at **http://www.fdic.gov/bank/analytical/fyi/2003/062303fyi.html**.

INTERNATIONAL DEVELOPMENTS

Argentina

On May 8, 2003, Argentina's Congress passed a law forcing foreign banks to inform the public whether their headquarters would use their homeland assets to honor their commitments in Argentina in the event of a new financial crisis. The legislation is in response to the behavior of foreign banks during the December 2001 banking disaster, when some foreign banks lacked the funds to pay off depositors. The new legislation seeks to ensure that customers are not misled into thinking that money deposited at a major foreign institution will be protected during a crisis. Argentina's Superintendent of Financial and Exchange Institutions will monitor enforcement of the new law. *BBR, 5/19/03, pp. 834–35.*

Basel Committee

On July 17, 2003, the Basel Committee on Banking Supervision issued two papers setting international guidelines on risk-management principles, one for electronic banking and the other for the management and supervision of cross-border electronic banking activities. The first paper, "Risk Management Principles for Electronic Banking," lays out 14 principles aimed at helping banking institutions expand their existing risk oversight policies and processes to cover their electronic banking activities. The principles focus on the oversight responsibilities of the board of directors and management, the need for appropriate security controls, and the management of legal and reputational risk associated with electronic banking activities. The second paper, "Management and Supervision of Cross-Border Electronic Banking Activities," identifies additional risk-management principles specific to cross-border electronic banking activities. *BBR, 7/21/03, p. 120.*

Japan

The Industrial Revitalization Corporation (IRC), the Japanese governmental company responsible for the reconstruction of troubled borrowers, announced on May 12, 2003, that it had reached an agreement with the National Tax Administration to extend tax privileges to banks that assist corporate reconstruction. The agreement provides that a bank that writes off part of its loans to borrowers in cooperation with the IRC can treat the write-off as a loss and deduct it from taxable income. Previously such losses and deductions were allowed only with National Tax Administration approval. The tax measure is expected to encourage distressed companies and banks to take advantage of this opportunity for prompt turnaround and a return to healthy operations. *BBR, 5/19/03, p. 835.*