

Recent Developments Affecting Depository Institutions

by Lynne Montgomery*

REGULATORY AGENCY ACTION

Interagency Actions

Year 2000 Planning Guidance

Federal banking and thrift regulators issued additional joint guidance on May 7, 1999, in an effort to help answer frequently asked questions on Year 2000 contingency planning. The release, *Additional Questions and Answers Concerning Year 2000 Business Resumption Contingency Planning*, is intended to supplement Year 2000 guidance issued by regulators through the Federal Financial Institutions Examination Council in December 1998. The 1998 guidance said that financial institutions should finish their business resumption contingency plans (which are plans to guide institutions in resuming their core business processes if their computer systems fail) and design methods to test the plans by June 30, 1999. The new guidance states that institutions may conduct these tests after June 30, but early enough to allow ample time to make essential changes and retest, if necessary. *BBR*, 5/17/99, p. 878.

Final Rule on Specific Market Risk

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) adopted a final rule allowing

banks that meet certain criteria to use their own valuation models to determine how much capital must be held to protect against specific market risk in their investment portfolios. In order to determine whether a bank's internal models are adequate to set capital levels, regulators will measure the models against various criteria, such as whether the models measure risk in a way that adequately explains historical price variations in the institution's investment portfolio. The final rule, which contains no substantive changes from the interim rule that was published in the *Federal Register* on December 30, 1997, is intended to reduce banks' regulatory burden by ending the requirement that they use two methods to measure their risk exposure to price fluctuations of stocks and bonds in their trading portfolios. Banks whose internal valuation models fail to meet the rule's minimum adequacy standards will have to continue to hold capital at least equal to half of the specific risk charge calculated under the standardized approach developed by the international Basel Committee on Banking Supervision. *BBR*, 4/5/99, p. 611.

*Lynne Montgomery is a senior financial analyst in the FDIC's Division of Research and Statistics.

Reference sources: *American Banker* (AB); *The Wall Street Journal* (WSJ); *BNA's Banking Report* (BBR); and *Federal Register* (FR).

Joint Working Group to Issue Guidance on Disclosure of Credit Losses

The federal banking and thrift regulators and the Securities and Exchange Commission issued a joint statement on March 10, 1999, announcing plans to work together to issue guidance on the appropriate disclosure of credit losses by banks and thrifts. The agencies plan to set up a Joint Working Group of agency representatives to understand more about the procedures and processes of credit loss allowances. The regulators hope to issue parallel guidance within a year on two issues on credit loss allowances. The first issue relates to the procedures and processes necessary for banks to reasonably assess losses inherent in their portfolios and ways to document the reported loan-loss allowance. The second relates to appropriate disclosures of loan-loss allowances and the credit quality of institutions' loan portfolios. The guidance will also address the need for institutions to disclose changes in risk factors and asset quality that affect allowances for credit losses. *BBR, 3/15/99.*

Federal Deposit Insurance Corporation

New Insurance Rules for Joint Accounts and Payable-on-Death Accounts

On March 23, 1999, the FDIC Board of Directors approved changes that are intended to simplify the deposit insurance rules for joint accounts and payable-on-death accounts. The maximum insurance coverage that a person can obtain for individual interests in joint accounts at one bank or thrift will remain at \$100,000. However, under the new rules, the maximum coverage for any joint account owned by more than one person is expanded from \$100,000 for each joint account to \$100,000 for each individual owner. The new rules for payable-on-death accounts add parents and siblings to the list of "qualifying beneficiaries," which already includes spouses, children, and grandchildren. *BBR, 3/29/99; PR-13-99, FDIC, 3/23/99.*

Bank Failures

On March 26, 1999, the FDIC closed Victory State Bank in Columbia, South Carolina, and took possession of the bank in its capacity as receiver. The

newly chartered South Carolina Community Bank in Columbia, South Carolina, assumed the deposits of Victory State Bank and also purchased \$12.2 million of the failed bank's assets. Victory State Bank's sole office was re-opened on March 29, 1999, as South Carolina Community Bank. The FDIC estimates this will be a no-cost resolution for the Bank Insurance Fund (BIF). *PR-15-99, FDIC, 3/26/99.*

On April 23, 1999, New Mexico's Director of Financial Institutions closed Zia New Mexico Bank in Tucumcari, New Mexico, and the FDIC was named as receiver. All the deposits of Zia New Mexico Bank were assumed by the First National Bank of New Mexico in Clayton, New Mexico, which also purchased \$6.0 million of the failed bank's assets. The FDIC estimates this transaction will cost the BIF \$1.6 million. *PR-20-99, FDIC, 4/23/99.*

Real-Estate Survey—April 1999

The April 1999 issue of the *Survey of Real Estate Trends* reported that the nation's real-estate markets rebounded in recent months after a slowdown in the late fall and early winter. The April survey included an increased number of respondents reporting the condition of their local housing market as better than three months earlier. The survey polled 292 examiners and asset managers from federal bank and thrift regulatory agencies about developments in their local markets in the preceding three months. The proportion of respondents reporting that housing markets were on the upswing during the three-month period increased from 29 percent in January to 48 percent in April. Only 13 percent noted excess supply, down from 15 percent in January. As for local commercial real-estate markets, 69 percent of the respondents characterized supply and demand as in balance. Higher sales levels and sale prices were also reported for commercial properties in the April survey.

The national composite index used by the FDIC to summarize results for both residential and commercial real-estate markets was 69 in April, compared to 61 in January. Index scores above 50 indicate improving conditions, while index scores below 50 indicate declining conditions. *Survey of Real Estate Trends, FDIC, April 1999.*

Report on Underwriting Practices

The April 1999 issue of the *Report on Underwriting Practices* reported a decrease in the occurrence of risky loan underwriting practices at FDIC-supervised banks during the six months ending March 31, 1999, compared with the previous six-month period ending September 30, 1998. The FDIC examiners reported a small proportion of banks with high risk in current underwriting practices, loan portfolios, and loan administration. Examiners did note concerns about the level of “carryover debt” at FDIC-supervised banks actively making agricultural loans. Carryover debt refers to loans that are not paid off at the end of the growing season and are subsequently carried over into the next growing season. The survey of loan underwriting practices is aimed at providing early warnings of potential problems in underwriting practices at FDIC-supervised, state-chartered nonmember banks. The focus of the survey is threefold: material changes in underwriting standards for new loans, degree of risk in current practices, and specific aspects of the underwriting standards for new loans. The April report includes surveys from 958 FDIC-supervised banks that were examined during the six months ending March 31, 1999. *Report on Underwriting Practices, FDIC, April 1999.*

Financial Results for 1998 and First-Quarter 1999

The FDIC reported that the Bank Insurance Fund (BIF) earned \$1.3 billion in 1998 and \$244 million in the first quarter of 1999. The Savings Association Insurance Fund (SAIF) earned \$468 million in 1998 and \$99 million in the first three months of 1999. The BIF closed the first quarter of 1999 with a balance of \$29.9 billion. The SAIF closed the quarter with an unrestricted fund balance of \$9.0 billion and \$978 million in the new SAIF Special Reserve, which was established on January 1, 1999, and contains the amount by which the SAIF exceeds the Designated Reserve Ratio of 1.25 percent. Revenue for the BIF totaled \$2 billion for 1998 and \$438 million for the first quarter of 1999. The fund’s investments in U.S. Treasury securities earned \$1.7 billion in interest in 1998 and \$429 million during the first quarter of 1999. Deposit insurance assessments

were \$22 million in 1998 and \$10 million in the first quarter of 1999. The SAIF earned \$584 million in revenue during 1998 and \$141 million in the first quarter of 1999. Almost all revenue for both periods was derived from interest on investments in U.S. Treasury securities. The low numbers of bank and thrift failures contributed to the strong financial results.

During 1998 and the first quarter of 1999, the FSLIC Resolution Fund (FRF) assets in liquidation were reduced by \$1.4 billion to a balance of \$930 million on March 31, 1999. *PR-31-99, FDIC, 6/3/99.*

Semiannual Agenda of Regulations

The FDIC published its semiannual agenda of regulations in the *Federal Register* in May 1999, to inform the public of the Corporation’s regulatory actions and encourage participation in the rulemaking process. Many of the actions are the result of the FDIC Board of Director’s ongoing efforts to reduce the regulatory burden on banks, simplify rules, improve efficiency and comply with the Riegle Community Development and Regulatory Improvement Act of 1994. The agenda contains 22 regulatory actions. Four actions have been completed and the remainder are in various stages of the rule-making process. *PR-23-99, FDIC, 5/11/99.*

Federal Reserve Board

Vice Chairman Resigns

Federal Reserve Board Vice Chair Alice Rivlin announced that she plans to resign from the Federal Reserve Board, effective July 16, 1999. Ms. Rivlin, who joined the Federal Reserve Board in June 1996, plans to return to the Brookings Institution and spend more time with her family. With Ms. Rivlin’s resignation, the seven-member Federal Reserve Board of Governors now has two vacancies. *FRB-PR, 6/3/99; BBR, 6/7/99, p. 1017.*

Regulation CC

On March 23, 1999, the Federal Reserve Board announced rule changes that will give banks involved in mergers more time to make software changes so that the banks can focus on correcting Year 2000 computer-related problems. The amend-

ments to Regulation CC affect banks that consummate mergers between July 1, 1998, and March 1, 2000. Banks involved in mergers during this period will be treated as separate banks for purposes of Regulation CC until March 1, 2001. Banks involved in mergers after March 1, 2000, will be subject to the regulation's normal one-year transition period for merging banks. *FRB-PR, 3/23/99; BBR, 3/29/99.*

Office of the Comptroller of the Currency

Information-Sharing Accord

On June 7, 1999, the OCC announced that it had reached an agreement with insurance commissioners from eight states to exchange information related to customer complaints about bank sales of insurance products. The agreement calls for the OCC and state authorities to send copies of complaints to each other and also to communicate on other matters, including regulatory and policy initiatives. The OCC and state commissioners have worked together over the years on matters of common concern, including consumer protection. In December 1998, the OCC signed an agreement to share information with the Oklahoma Insurance Department. The eight states involved in the new agreement are Delaware, Kansas, Kentucky, Louisiana, Maine, North Carolina, North Dakota, and Pennsylvania. *BBR, 6/14/99, p. 1067.*

Federal Housing Finance Board

Mortgage Financing Program

On March 10, 1999, the Federal Home Loan Bank of Atlanta announced that it is joining the FHLBanks of Chicago and Dallas in participating in the Mortgage Partnership Finance (MPF) program. The MPF program, which was started as a pilot by the Chicago FHLBank, provides new competition in the secondary mortgage market by permitting FHLBank members to sell loans to the FHLBank rather than to Fannie Mae or Freddie Mac. *BBR, 3/15/99.*

Fees Prohibited in Lieu of Stock Redemption

The Federal Housing Finance Board adopted an interim final rule on March 19, 1999, which prohibits

the Federal Home Loan Banks from charging or accepting a fee instead of redeeming a member's excess capital stock. The rule was adopted to eliminate a practice under which a FHLBank gave members the option to pay a fee to the FHLBank in lieu of redeeming each member's capital stock exceeding 115 percent of a member's minimum capital stock as set by statute. The Finance Board stated that the FHLBanks are more than adequately capitalized and they do not need the excess capital stock. In addition, the Finance Board believes that allowing the payment of such fees would detract from the agency's ongoing efforts and initiative to ensure that the FHLBanks carry out their housing and community investment mission. *BBR, 3/29/99.*

Federal Home Loan Banks' Investments Limited

On May 28, 1999, the Federal Housing Finance Board passed a resolution that would limit the Federal Home Loan Banks to make only investments that are tied to the system's housing-related mission. The Federal Home Loan Banks would no longer be permitted to invest in mortgage-backed securities purchased on the secondary market. The resolution was introduced because critics feel that Federal Home Loan Bank activities have extended beyond the mission of funding housing and community development. *AB, 6/1/99.*

National Credit Union Administration

Small-Credit-Union Program

On March 18, 1999, the board members of the National Credit Union Administration (NCUA) agreed to launch a small-credit-union program. The program covers federal credit unions in three categories: small credit unions, newly chartered credit unions, and low-income designated credit unions. The program also allows for regional directors to offer assistance to federally insured state credit unions after consultation with state supervisors. The program provides a flexible framework for providing financial and technical support to those credit unions that may need some additional assistance to better serve their members, expand their membership base,

and build capital. Further, the program works toward future goals by meeting some prompt corrective action requirements. *BBR, 3/22/99, p. 538.*

New Insurance Rules for Joint Accounts

On April 15, 1999, following the action taken by the FDIC, the NCUA voted to adopt an interim final rule to simplify insurance regulations on joint ownership accounts. Under the new rule, the maximum coverage for any joint account owned by more than one person is expanded from \$100,000 for each joint account to \$100,000 for each individual owner. However, the maximum insurance coverage that a person can obtain for individual interests in joint accounts at one bank or thrift will remain at \$100,000. *BBR, 4/19/99, p. 715.*

Member Business Loan Rule

On May 19, 1999, the NCUA approved a member business loan final rule, incorporating loan-limit

provisions required under the Credit Union Membership Access Act (CUMAA). The CUMAA laid out the definition of a member business loan as “any loan, line of credit, or letter of credit, the properties of which will be used for a commercial, corporate or other business investment property or venture or agricultural purpose.” In addition, the CUMAA imposed an aggregate limit on a federally insured credit union’s outstanding member business loans of \$50,000. Under the CUMAA and the NCUA’s final rule, loans under \$50,000 to credit union members are not counted as member business loans, with a few specific exceptions. The final rule states that a federally insured credit union may not grant a member business loan that would result in an amount outstanding that is higher than 1.75 times the actual net worth of the credit union or 12.75 percent of the credit union’s assets, whichever is less. *BBR, 5/24/99, p. 944.*

STATE LEGISLATION AND REGULATION

New York

On April 8, 1999, the New York State Banking Board approved regulations to remove the ceiling on the fee that state-chartered banks may charge customers for “bounced” checks. The regulations, which went into effect on April 28, 1999, remove the current \$15 limit on fees for checks written against insufficient funds. The state Banking Department said the regulations were necessary to keep state-chartered banks competitive with federal banks, which have no limits on the amount they can charge for insufficient funds. *BBR, 4/19/99, p. 707.*

Pennsylvania

On May 27, 1999, Pennsylvania Governor Tom Ridge nominated former banker David E. Zuern as the state’s top banking regulator. Mr. Zuern would succeed Banking Secretary Richard C. Rishel. Mr. Zuern retired last year after a 28-year banking career.

Most recently he was president and chief executive officer of PNC Bank’s northwestern Pennsylvania operations. Mr. Zuern also headed Governor Ridge’s transition team for banking and insurance in 1994. *AB, 5/28/99.*

Texas

On May 21, 1999, Texas Governor George W. Bush signed a bill that requires all banks and savings and loans doing business in Texas but domiciled in other states to pay corporate franchise taxes in the same manner as financial institutions domiciled in Texas. The bill, which becomes effective on January 1, 2000, is aimed at the growing number of banking corporations doing business in Texas that have not been paying franchise taxes on revenues earned in Texas because they are domiciled elsewhere. *BBR, 6/14/99, p. 1071.*

BANK AND THRIFT PERFORMANCE

First-Quarter 1999 Results for Commercial Banks and Savings Institutions

FDIC-insured commercial banks earned a record \$18.0 billion in the first quarter of 1999, which is \$2.1 billion higher than in the first quarter of 1998. The first quarter was marked by an absence of major merger-related restructuring expenses at large banks, which had depressed industry earnings in recent periods. Large-bank earnings also were boosted by improvements in international operations and a record quarter for trading income. Banks' annualized return on assets (ROA) rose to 1.32 percent, compared to 1.11 percent in the fourth quarter of 1998 and 1.26 percent one year previously. The number of problem banks dropped from 69 in the fourth quarter of 1998 to 64 in the first quar-

ter of 1999, and assets of problem banks were approximately \$4.7 billion at March 31, 1999. There was one bank failure during the quarter.

FDIC BIF-insured mutual savings institutions reported profits of \$2.7 billion in the first quarter, which is the third-highest quarterly total in the industry's history. The higher earnings were made possible by low expenses for credit losses and strong growth in interest-earning assets. The industry's ROA for the first quarter was 0.98 percent, slightly below the 1.01 percent average in the first quarter of 1998. For the tenth consecutive quarter, no federally insured savings institutions failed. The number of problem thrifts increased by one institution to 16 at the end of the first quarter. *FDIC Quarterly Banking Profile, First Quarter 1999.*

RECENT ARTICLES AND STUDIES

On April 16, 1999, the Federal Reserve Bank of Cleveland released a report stating that traditional financial institutions need to realize specifically what unbanked low-income individuals need in a financial institution in order to promote the advantages of banks compared to nonbank payment-service providers such as check cashers. The report, entitled *Bringing the Unbanked Onboard*, states that "community organizations need to get involved in promoting the advantages for building a financial and credit history, as well as in teaching the unbanked how to use and manage a checking or other transaction account." Barbara A. Good, a former payments system specialist for the Federal Reserve, authored the report. *BBR, 4/26/99, p. 752.*

A paper written by Joanna Stavins of the Federal Reserve Bank of Boston states that banks could boost revenue by reducing or eliminating some fees imposed on checking accounts. Consumers tend to

reduce the amount of cash in their checking accounts if banks impose per-item fees, charge for the return of checks, limit the use of tellers, or assess ATM surcharges. The paper, entitled *Checking Accounts: What Do Banks Offer and What Do Consumers Value?*, concludes that fees seem to deter bank customers and induce them to deposit their money elsewhere. As a result, banks have fewer accounts on which they can assess fees, leading to lower revenues. *AB, 5/28/99.*

Nicholas Leung, Jean-Marc Poullet, and Timothy Savers of McKinsey & Co. write that half of all Asian banks will be involved in mergers within two years. The analysts claim that Asian governments are forcing banks to recapitalize quickly, which will force them to look for outside investors and will lead to mergers. In their paper, entitled *Asian Banking: After the Storm*, they state that when the current Asian crisis has passed, a handful of banks will have emerged in each market as the leaders. *AB, 5/28/99.*

INTERNATIONAL DEVELOPMENTS

European Union

In order to help European Union banking institutions ensure a smooth transition into Year 2000, the European Union finance ministers declared that December 31, 1999, will be a banking holiday for all Euro transactions in the 15 European Union member states. The finance ministers believe that the shutdown is necessary in order give the financial industry sufficient time to complete a full back up of all systems before midnight on December 31, 1999. *BBR*, 4/26/99, p. 769.

The European Commission released a report on April 13, 1999, stating that the European Union should not move up the introduction date for Euro notes and coins to a date earlier than January 1, 2002, as requested by some member states. Some member states believe that setting the introduction date earlier than January 1, 2002 would help solidify public acceptance of the single currency. However, the Commission concluded that moving the introduction to an earlier date would pose numerous legal and technical problems. *BBR*, 4/19/99, p. 723.

Canada

Effective March 31, 1999, the Canada Deposit Insurance Corporation (CDIC) adopted a risk-based premium system that replaced the single premium rate that has traditionally been charged on deposits. The new, four-level system is based on assessment of a deposit-taking institution's risk profile and is expected to produce substantial premium reductions for many financial institutions operating in Canada. The new system establishes four categories of premium rates to be applied to an institution's insured deposits. The institutions are assigned to a category on the basis of their rating on the following criteria: capital adequacy, profitability and asset concentration, regulatory ratings, and adherence to CDIC's Standards of Sound Business and Financial Practices. *BBR*, 3/29/99.

Japan

Under a new approach scheduled to begin in July 1999, Japan's Financial Supervisory Agency (FSA) will establish a more regular schedule for inspecting financial institutions, and auditing foreign banks, brokerages, and insurers. Japanese banks generally would be inspected every year, but banks that are in a healthy financial and management condition could be inspected less frequently, possibly every two or three years. In addition, the FSA will cooperate far more closely with the public prosecutors and the Nation Tax Administration in auditing Japanese and foreign banks, brokerages, insurers, and other financial-service providers. *BBR*, 6/7/99, p. 1037.

On May 14, 1999, Japan's FSA took prompt corrective action against Japanese regional bank Kofuku Bank Ltd. in response to a sharp drop in the bank's capital ratio. It was the first time that the FSA has imposed the tough legal measure on a bank since the prompt corrective action system was established in April 1998. The FSA's order requires Kofuku to reinforce its paid-up capital, slash its operations substantially, or terminate its banking business. *BBR*, 5/24/99, p. 957.

Mexico

Mexico's bank bailout agency, the Instituto para la Proteccion al Ahorro Bancario (IPAB), began operations on May 21, 1999. The main functions of the IPAB will be to administer Mexico's bank protection fund, conclude efforts to improve the Mexican banking system, and sell nonperforming assets. The IPAB was established by the Mexican Congress in December 1998 as an agency designed to replace FOBAPROA, an emergency federal deposit insurance fund that was established after the collapse of the peso at the end of 1994 and early 1995. *BBR*, 5/17/99, p. 907.