Recent Developments Affecting Depository Institutions

by Lynne Montgomery*

REGULATORY AGENCY ACTIONS

Interagency Actions

New Agreements for Supervision of Foreign Banks

On December 4, 1998, the Conference of State Bank Supervisors announced that federal and state banking regulators have signed two new agreements designed to improve supervision of foreign banks operating across state lines. The first accord, the Nationwide Foreign Banking Organization Supervision and Examination Coordination Agreement, is aimed at helping states coordinate their examination and supervisory responsibilities by sharing information about particular banks. Under this accord, each foreign bank will be assigned one state banking department that will coordinate scheduling and planning of exams and will prepare a single examination report on all the foreign banking firm's U.S. operations. The second agreement, the Nationwide State/Federal Foreign Banking Organization Supervision and Examination Coordination Agreement, creates a similar arrangement between the states, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. Under this agreement, the Federal Reserve Banks and regional FDIC offices will work with the foreign bank's state bank coordinator. *BBR, 12/14/98, p. 909–910.*

Fair Lending Exam Procedures

On January 5, 1999, the Federal Financial Institutions Examination Council (FFIEC) released *Interagency Fair Lending Examination Procedures*, a document which establishes a uniform set of procedures to be used in the Equal Credit Opportunity Act and Fair Housing Act compliance examinations conducted by the FFIEC member agencies. The Equal Credit Opportunity Act prohibits discrimination in any aspect of a credit transaction. The Fair Housing Act prohibits discrimination in all aspects of residential real estate-related transactions. The new fair lending examination procedures are intended to provide a framework for the majority of fair lending examinations, but the procedures may be augmented by each agency. The agencies may also provide their examiners and the institutions they regulate with additional procedures as needed to implement the fair lending examination procedures effectively. The FFIEC member agencies include the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), and the Federal Reserve Board. *BBR, 1/11/99, p. 50.*

New Rating System for Information Technology Systems

On January 19, 1999, the FFIEC issued a revised rating system for banks' and thrifts' data processing

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

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operations. The revised system, called the Uniform Rating System for Information Technology (URSIT), will track more closely the Uniform Financial Institutions Rating System ratings definitions for banks' and thrifts' safety and soundness, referred to as CAMELS ratings. Previously, the FFIEC agencies rated financial institutions and their vendors on the risks posed by information technology systems to the institutions under a system called the "IS" rating system. Under the IS system each provider is given a composite rating from 1 to 5 on: the adequacy of the institution's information technology audit ability; the capability of the institution's information technology management; the adequacy of the institution's development and programming; and the quality, reliability, availability, and integrity of the institution's technology operations. The revised rating system places more emphasis on risk management, and contains four components that examiners will assess: auditing; management; development and acquisitions; and support and delivery. Under the revised system the examiners will evaluate the functions identified within each component to assess the institution's ability to identify, measure, monitor, and control information technology risks. The Exam Council recommends that the agencies implement the revised URSIT by April 1, 1999. *BBR, 1/25/99, p. 135–136.*

New Call Report Form

On January 21, 1999, the federal banking agencies issued a joint notice alerting insured depository institutions to new revisions to the quarterly Reports of Condition and Income (Call Reports). Federally insured banks are required to file quarterly Call Reports detailing their financial condition, and thrifts and credit unions submit similar reports. Most of the Call Report revisions clarify filing instructions and provide additional guidance in certain areas of the Call Report form. In particular, the revised Call Report eliminates the "high-risk securities" items from the securities schedule, and expands the scope of the existing "purchased credit-card relationships" item to include "nonmortgage servicing assets." Further, the updated form adds new items that will apply to banks after they adopt new Financial Accounting Standards Board guidance on financial derivatives accounts. The revisions are effective for the March 31, 1999, filing date. *BBR, 2/1/99, p. 189.*

New Risk-Based Capital Rules

Federal banking and thrift regulators adopted final rules making the treatment of certain loans and other assets for banks' and thrifts' required capital calculations more consistent among the agencies. The final rules cover the capital treatment of construction loans on pre-sold residential properties, real-estate loans secured by junior liens on one- to four-family residential properties, and investments in mutual funds. The rules also set uniform Tier 1 leverage ratios for banks and thrifts. The rules were adopted by the Federal Reserve Board, the FDIC, the OCC, and the OTS, and are effective April 1, 1999. *BBR, 3/8/99, p. 424.*

Guidance on Subprime Lending

On March 3, 1999, the FDIC, the Federal Reserve Board, the OCC, and the OTS jointly issued Interagency Guidance on Subprime Lending. The guidelines are intended to remind banks and thrifts of the risks inherent in subprime lending and to outline the types of controls the agencies expect banks to have in place before engaging in subprime lending. *PR-8-99, FDIC, 3/3/99.*

Federal Deposit Insurance Corporation

Real-Estate Survey – January 1999

The January 1999 issue of the *Survey of Real Estate Trends* reported a slowdown in the expansion of the nation's residential and commercial real-estate markets during the late fall and early winter. The January survey contained an increased number of respondents reporting "no change" in market conditions during the quarter. The survey polled 304 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 slipped to 29 percent from 36 percent in October. Sixty-five percent characterized supply and demand as "in balance" compared to 61 percent in October, while 15 percent cited excess supply, down from 17 percent in October. As for local commercial real-estate markets, assessments continued to be positive, but not as positive as in earlier surveys. Twenty-six percent of the survey respondents in January observed better conditions than three months earlier, down from 28 percent in October.

The national composite index used by the FDIC to summarize results for both residential and commercial real-estate markets was 61 in January, compared to 62 in October. Index scores above 50 indicate improving conditions, while index scores below 50 indicate declining conditions. *Survey of Real Estate Trends, FDIC, January 1999.*

Trust-Preferred Stock Rule

On February 19, 1999, the FDIC clarified the authority of state banks to invest in trust-preferred securities. In a letter to bank chief executive officers, the FDIC said that, as long as state law permits it, state banks regulated by the FDIC may buy trust-preferred stock in unlimited quantities. Trust-preferred stock is issued by a trust, or tax-free subsidiary, of a bank holding company. The trust issues common and preferred shares, keeping the former and selling the preferred stock to investors. *AB, 2/22/99.*

Federal Reserve Board

Subpart G of Regulation Y

A final rule, which revises Subpart G of Regulation Y, permits bank holding company securities units to underwrite and deal in mortgage-backed securities without proving that the loans underlying the instruments are supported by appraisals that meet the Federal Reserve Board standards. The final rule applies only to banks' securities units established under Section 20 of the Glass-Steagall Act, which are given limited authority to engage in investment banking activities. The new final rule, which became effective on December 28, 1998, does not affect the appraisal requirements for federally insured depository institutions. *BBR, 12/7/98, p. 864.*

HMDA Data Reporting Exemption Unchanged for 1999

The Federal Reserve Board announced that depository institutions with assets of $29 million or less as of December 31, 1998, would not be required to report data on their housing-related lending activities in 1999. Provisions in the Economic Growth and Regulatory Paperwork Reduction Act of 1996 require the Federal Reserve Board to adjust the asset-size exemption threshold annually on the basis of changes in inflation as measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPIW). The exemption threshold for 1998 was $29 million. The CPIW increase of 1.3 percent for 1998 did not result in an adjustment large enough to trigger a hike in the exemption level for 1999. *BBR, 1/4/99, p. 9.*

Interest Rates Remain Unchanged

After trimming short-term interest rates three times in the fall of 1998, the Federal Reserve Board left rates unchanged when they met in December 1998 and again in February 1999. The federal funds rate remains at 4.75 percent, and the discount rate remains at 4.50 percent. *WSJ, 2/4/99.*

Revised Limits on Use of Securities to Back Loans

A January 21, 1999, legal opinion by the Federal Reserve Board will make it easier for Federal Reserve member banks to make loans backed by securities issued by corporate affiliates. The ruling involved an interpretation of Section 23A of the Federal Reserve Act, which is designed to maintain arm's-length dealings between member banks and affiliates. Since 1984, the Federal Reserve has considered loans backed by securities of an affiliate to be backed entirely by those securities, even if the stock only amounted to a fraction of the loan amount. However, the new ruling permits loans to be valued differently. Now, loans to unrelated third parties (not affiliates) will be valued either at the fair market value of the loan minus the amount of collateral offered by the nonaffiliate, or the fair market value of the affiliate's shares that are used as collateral, whichever is less. In addition, if the nonaffiliate collateral, valued at its fair market rate, is enough to cover the loan amount, then the loan would not be included in the bank's quantitative limits for purposes of Section 23A. *BBR, 2/1/99, p. 192–193.*

Survey on Lending Standards

A February 1999 Federal Reserve Board survey of senior loan officers concludes that domestic banks are no longer tightening business lending standards as they had done last fall, but institutions remain concerned about the effect of uncertain economic conditions on their lending activities. Compared to the results of loan officer surveys conducted last September and November, fewer U.S. banks reported stricter lending standards to businesses of all sizes. Institutions continued to report stricter business loan terms, but not as restrictive as the terms granted in November. The survey is based on responses from

55 domestic banks and 23 U.S. branches of foreign banks. *BBR, 2/15/99, p. 287.*

Office of the Comptroller of the Currency

Updated Risk-Management Guidance

On January 25, 1999, the OCC issued supplemental guidance on managing the risks of financial derivatives and securities trading activities. The new guidance applies to a wide range of bank activities, including extensions of credit to hedge funds and other highly leveraged institutions that could threaten the stability of world financial markets if they were to fail. The supplemental guidance highlights existing shortfalls in the risk-management systems within financial institutions, and identifies sound risk-management practices that should be in place for all significant derivatives trading activities. The guidance, which is effective immediately, is intended to help OCC examiners identify weaknesses in the design of national banks' risk-management systems. *BBR, 2/1/99, p. 185.*

Office of Thrift Supervision

Less Restriction on Cash Dividends

Under a final rule issued on January 19, 1999, the OTS will permit well-run, healthy thrift institutions to pay cash dividends without first notifying their federal regulator. Previously, all thrifts had to give the OTS notice or apply to the agency to make a dividend distribution. Under the new rule, institutions that are not subsidiaries of a savings-and-loan holding company can qualify for a capital distribution without a notice or application to OTS if they meet certain conditions, including retaining their well-capitalized designation following the distribution and having CAMELS and compliance ratings of 1 or 2. Other institutions either have to notify the OTS or obtain the agency's approval, depending on the condition of the institution and the amount and nature of the capital distribution, but they may now file a schedule of proposed capital distributions for a year at a time, rather than filing separate notices. The final rule is effective April 1, 1999. *PR-OTS-99-03, 1/19/99.*

National Credit Union Administration

Final Chartering Rule

On December 17, 1998, the National Credit Union Administration approved comprehensive changes to its chartering and field of membership policies for federal credit unions. The new rules implement the requirements of the Credit Union Membership Access Act, which was signed into law on August 7, 1998. The primary revisions concern the NCUA's policy on various types of federal credit union charters, and the criteria necessary to amend a credit union's field of membership. The final rule also clarifies overlap issues, mergers, low-income policies regarding low-income charters and service to underserved areas, the definition of immediate family member or household, and the "once a member, always a member" policy. The new rules are included in the NCUA's revised Chartering and Field of Membership Manual. *PR-NCUA, 12/17/98; BBR, 1/4/98, p. 24.*

On January 8, 1999, the American Bankers Association (ABA) filed a lawsuit, claiming that the Chartering and Field of Membership Manual oversteps the boundaries set by Congress in the Credit Union Membership Access Act. The ABA is asking the court for an injunction against any new credit union approval. The ABA also wants the court to rescind any expanded field of membership approval previously granted. *BBR, 1/25/99, p. 165.*

Loan Rate Ceiling Maintained

The NCUA approved a final rule to maintain the current 18 percent interest-rate ceiling on loans by federal credit unions, instead of allowing the ceiling to revert to 15 percent. The rate ceiling was scheduled to revert to 15 percent on March 9, 1999; however, with the new ruling, the ceiling will remain at 18 percent for the period from March 9, 1999 through September 8, 2000. The NCUA reported that a 15 percent ceiling would restrict certain categories of credit and adversely affect the financial condition of a number of federal credit unions. At the same time, prevailing market rates and economic conditions do not justify a rate higher than the current 18 percent ceiling. The NCUA Board is prepared to reconsider the 18 percent ceiling at any time should changes in economic conditions warrant. *BBR, 2/15/99, p. 308.*

STATE LEGISLATION AND REGULATION

Oklahoma

On December 1, 1998, the OCC announced that it has entered into an agreement with the Oklahoma Insurance Department to share information about complaints arising from national banks selling insurance products in Oklahoma. The agreement also calls for the agencies to communicate with each other on matters of common interest, such as regulatory and policy initiatives. The agreement is the first agreement between the OCC and a state insurance department on these issues. *BBR, 12/7/98, p. 861.*

Utah

On November 5, 1998, the Utah District Court ruled that new membership in geographically-based credit unions is limited under Utah law to identifiable areas, and Utah credit unions are prohibited from soliciting or accepting members beyond those geographic areas. The ruling resulted from a legal case in which the Utah Bankers Association sued Utah credit unions, seeking to stop them from adding new members from outside their fields of membership. Judge William A. Thorne ruled in favor of the Utah Bankers Association and stated that Utah legislation limits membership in a geographically-based credit union to an identifiable neighborhood, community, rural district or county. He also stated that no exception exists to extend that geographic limitation beyond a single county. *BBR, 12/7/98, p. 879.*

BANK AND THRIFT PERFORMANCE

Fourth-Quarter 1998 Results for Commercial Banks and Savings Institutions

The banking industry earned a record $61.9 billion in 1998, setting an earnings record for the seventh year in a row. However, the fourth-quarter 1998 earnings of $14.9 billion for commercial banks were lower than the third-quarter earnings by $148 million. The earnings decline was caused by weaknesses in international operations and rising overhead costs and other expenses related to merger and restructuring of a few large banks. Banks' annualized return on assets (ROA) was 1.11 percent in the fourth quarter, compared to 1.15 percent in the third quarter of 1998 and 1.24 percent in the fourth quarter of 1997. The number of problem banks dropped from 70 in the third quarter to 69 in the fourth quarter, and assets of problem banks were approximately $5.4 billion at the end of 1998. Although three insured commercial banks failed in 1998, there were not any bank failures during the fourth quarter.

FDIC-insured savings institutions posted record profits of $10.2 billion in 1998, despite a decline in earnings in the fourth quarter. Savings institutions earned $2.0 billion in the fourth quarter of 1998, $921 million less than in the third quarter. The industry's average annualized ROA declined from 1.14 percent in the third quarter to 0.76 percent in the fourth quarter. Despite the fourth-quarter decline, the industry's ROA for the full year rose to 1.01 percent in 1998 from 0.93 percent in 1997. For the second consecutive year, no federally insured savings institutions failed. The number of problem thrifts fell to 15 from 18 in the third quarter, but the assets of problem thrifts rose from $2.9 billion in the third quarter to $5.9 billion in the fourth quarter. *FDIC Quarterly Banking Profile, Fourth Quarter 1998.*

RECENT ARTICLES AND STUDIES

State-chartered credit unions are as safe and sound as federally chartered credit unions, according to a study conducted by The Filene Research Institution, a credit union research group at the University of Wisconsin in Madison, Wisconsin. The researchers examined 4,546 state-chartered credit unions and compared them to 7,149 federally chartered credit unions over a ten-year period from 1986 to 1996. The researchers found many similarities between state-chartered and federally chartered credit unions, including similarities in: median numbers of members; assets; capital; delinquency; charge-off ratios; net income ratios; loan-to-savings ratios; and safety and soundness. The report is entitled *Financial Strength: A Comparison of State and Federal Credit Unions*. *BBR, 1/4/99, p. 27.*

A study, conducted by Allen N. Berger of the Federal Reserve Board and Rebecca S. Demsetz and Philip E. Strahan of the Federal Reserve Bank of New York, shows that bank mergers improve the effi-

ciency of the payments system while allowing banks to earn profits more efficiently and diversify their loan portfolios. On the downside, consolidation increases the risk that a bank failure could cause systemic problems and that the government would expand the safety net to keep a really large institution from failing. The report is entitled *The Consolidation of the Financial Services Industry: Causes, Consequences, and Implications for the Future*. *AB, 1/8/99.*

A paper entitled *An Overview and Analysis of Community Bank Mergers* states that community banks that undertake mergers often become more profitable and operate more efficiently. Joe Van Walleghem and Paul Willis of the Federal Reserve Bank of Kansas City conducted a case study of 19 community banks. They find community banks cut costs by consolidating back-office operations, rather than by closing branches. After mergers, the banks are also able to make larger loans and use personnel more efficiently. *AB, 1/29/99.*

In a paper titled *Bank Industry Consolidation: What's a Small Business to Do?*, Loretta J. Mester, an economist at the Federal Reserve Bank of Philadelphia, concludes that small businesses should not fear consolidation of the banking industry. Ms. Mester finds that businesses with hard-to-evaluate financial conditions will be drawn to community banks, which will continue to offer flexible loan terms. However, these businesses will pay above-market rates for credit. Larger companies with easy-to-evaluate financial conditions will increasingly turn to big banks, which use credit scoring and automated loan applications to keep loan rates down. *AB, 2/12/99.*

James T. Moser, an economics adviser to the Federal Reserve Bank of Chicago, writes that credit derivatives offer banks a low-cost alternative for managing risk. In his paper titled *Credit Derivatives: Just-in-Time Provisioning for Loan Losses*, Mr. Moser compares credit derivatives to loan-loss provisioning and finds that their risk-reduction benefits are approximately equal. However, credit derivatives may also be used to reduce a bank's capital requirements, a cost saving not available with traditional loan-loss provisioning. *AB, 2/12/99.*

INTERNATIONAL DEVELOPMENTS

Basle Committee

The Basle Committee on Banking Supervision issued a report titled *Banks' Interactions with Highly Leveraged Institutions*, which provides guidance on the way banks deal with hedge funds and other highly leveraged institutions (HLIs). Among other things, the Basle Committee's guidance encourages banks to set meaningful credit limits for HLIs, develop more accurate measures of exposures to HLIs, and employ sound due-diligence practices. *Dow Jones Capital Markets Report, 1/29/99.*

Euro Launched

On January 1, 1999, the Euro was launched into world financial markets. The Euro is a common currency that will replace the national currencies of eleven countries, including Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. With the introduction of the Euro, the bilateral exchange rates between the 11 countries as well as against the Euro were permanently locked, but the common currency only came into being in electronic form. Euro bills and coins will not start circulating until 2002. *WSJ, 1/4/99; BNA, 1/18/99, p. 119.*

Mexico

In December 1998, both houses of Mexico's Congress approved reform of the financial-services sector, resolving an eight-month dispute over a $60 billion bank bailout plan. As part of the bailout package, lawmakers voted to lift remaining restrictions on foreign ownership of large Mexican banks and to give lenders an opportunity to swap illiquid bad-debt paper off their books for bonds that should be easier to trade. The result will allow Mexican banks to restructure their balance sheets and strengthen their capital base. *WSJ, 12/15/98.*

Japan

On December 15, 1998, the Japanese government inaugurated the Financial Reconstruction Commission, a new administrative office created to speed the cleanup of commercial banks' bad-loan portfolios. The Commission is an independent government body that will provide stronger administrative powers to dispose of bad loans and prevent intervention from the Ministry of Finance and other administrative offices. It is also responsible for formulating long-term analysis and policies regarding the Japanese financial industry and markets. One of the

first tasks of the Commission is managing two troubled banks, Long-Term Credit Bank of Japan, which was nationalized in October 1998, and Nippon Credit Bank, which was put under temporary nationalization on December 13, 1998.

On February 15, 1999, the Commission granted approval for a 7.45 trillion yen ($65 billion) bailout of 15 of the nation's largest banks. Under the bailout plan, the government will buy preferred shares and subordinated debt to rebuild capital in the banks. In return, the banks will be required to cut costs and improve businesses. *BBR, 12/21/98; AB, 3/5/99.*