Supervisory Insights

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Inside

FDIC

Supervisory Insights

Supervisory Insights is published by the Division of Supervision and Consumer Protection of the Federal Deposit Insurance Corporation to promote sound principles and best practices for bank supervision.

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Letter from the Director

We are pleased to introduce the first issue of ***Supervisory Insights***. The federal banking agencies promote the soundness of U.S. financial institutions in two ways: by implementing detailed laws and regulations and by relying on the professional judgment of bank examiners and supervisors. Yet while legal and regulatory banking updates are in ample supply, published discussion of the art and practice of bank supervision is scarce. This is unfortunate, because the way examiners and supervisors do their jobs, and the issues and challenges they face, can have broad policy implications.

Accordingly, this publication is addressed to those with a professional interest in bank supervision. It will provide a forum for discussion of how bank regulation and policy is put into practice in the field, for sharing of best practices, and for communication about the emerging issues that bank supervisors are facing.

The challenges of supervising a generally healthy banking industry are different, but no less real, than the challenges of supervising during a banking crisis. If a crisis is a time for retrenchment, an expansion can be a time to experiment with new business models and new policy formulas. When the industry is strong, the supervisor's job is to ensure these new formulations are conducted in a sound manner. And at this time, the banking industry does indeed appear strong.

By all measures, the U.S. banking industry continues to set high marks for earnings and profitability. FDIC-insured institutions earned a record $31.9 billion during first quarter 2004—the fifth consecutive quarter that earnings set a new high.[1] Asset quality continues to improve, provisions for loan losses are down, and capital levels remain strong. On-site examinations tell the same story of a strong industry. During the year ending first quarter 2004, the number of institutions on the FDIC's "problem bank" list declined from 136 to 114, and assets held by these institutions fell from $38.9 billion to $29.9 billion.

Despite the general good health of the banking industry, the need for supervisory vigilance remains. Articles featured in this issue of ***Supervisory Insights*** describe a number of areas of current supervisory focus at the FDIC. The Industrial Loan Company (ILC) charter has received considerable attention over the years as part of the ongoing debate about the mixing of banking and commerce, most recently in connection with widely anticipated forays into banking by certain large retail businesses. One important consideration in this debate is how supervisors can prevent an insured institution from being inappropriately influenced or misused by a controlling company. "The FDIC's Supervision of Industrial Loan Companies" discusses this issue in the context of our historical experience with ILCs.

"Compliance Examinations: A Change in Focus" describes the evolution of the FDIC's approach to examining for compliance with consumer protection laws and regulations. Compliance with these laws is critical, both to protect consumers and to preserve the good name and reputations of individual banks. As the laws and regulations have grown in number, detail, and complexity over the years, supervisors have had to confront the issue of how best to promote compliance, given the reality of a finite pool of examination time and resources.

Credit risk always is a key area of supervisory focus, and this issue describes the results of an FDIC attempt to get behind the numbers on bank commercial real estate (CRE) lending. Despite weak CRE fundamentals, a number of FDIC-insured institutions have high and rising expo-

[1] See ***Quarterly Banking Profile***, first quarter 2004, for further details (http://www2.fdic.gov/qbp/2004mar/qbp.pdf).

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sures to CRE loans. This increase in exposure has been pronounced especially in certain metropolitan areas whose CRE markets have weakened considerably in recent years. As described in "Assessing Commercial Real Estate Portfolio Risk," a pilot horizontal review of CRE exposures of Atlanta community banks allayed some of the concern that a top-down look at CRE concentrations identified in financial reports might have suggested. Nevertheless, evaluating the risk of CRE exposures continues to be a supervisory priority.

Community banks traditionally have relied on core deposits as a primary funding source. However, during the past ten years, core deposits have declined as a percentage of total assets as banks have increased their dependence on other borrowings—for example, Federal Home Loan Bank advances. The increasing use of these advances, and the difficulty in evaluating their impact on a bank's risk profile with quarterly financial reports, prompted the FDIC to investigate how the heaviest users of advances were managing the product. "Federal Home Loan Bank Advances: A Supervisory Perspective" describes the results of our review.

Supervisory Insights will also contain a few regular features. "Accounting News" provides an in-depth explanation by the FDIC's Chief Accountant of how to account for purchased impaired loans under guidance recently issued by the American Institute of Certified Public Accountants. "From the Examiner's Desk" gives perspectives on how certain requirements of the USA PATRIOT Act affect banks and examiners.

As we continue to address these and other supervisory challenges, it is our hope that ***Supervisory Insights*** will become a way for examiners and others in the regulatory arena to share best practices and practical approaches and discuss emerging issues. We encourage readers to send comments on the articles, or suggestions for future topics, to SupervisoryJournal@fdic.gov.

Michael J. Zamorski, Director
Division of Supervision and Consumer Protection

The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective

Introduction

Industrial loan companies and industrial banks (collectively, ILCs) are FDIC-supervised financial institutions whose distinct features include the fact that they can be owned by commercial firms that are not regulated by a federal banking agency.[1] Some observers question whether current arrangements for overseeing the relationship between an ILC and its parent would provide sufficient safeguards if more extensive mixing of banking and commerce were permitted. This article describes the FDIC's approach to supervising ILCs and its historical experience with the ILC charter. Because Utah is home to by far the majority of the commercially owned ILCs, we highlight the supervisory practices Utah and the FDIC have employed with respect to the ILC-parent relationship. Our purpose is not to address the broader banking and commerce debate, but to provide a factual and historical context to policy discussions about how supervisors protect FDIC-insured entities that are part of larger organizations.

Strategies to monitor and control a bank's relationship with affiliated and controlling entities are fundamental to effective bank supervision under any organizational form that banks adopt. This principle is enshrined in U.S. banking legislation, bank regulation, and supervisory practice. Stand-alone banks, savings associations, bank and thrift holding company subsidiaries, industrial loan companies, and other FDIC-insured entities are subject to Sections 23A and 23B of the Federal Reserve Act, which limits bank transactions with affiliates, including the parent company.[2] Federal Reserve Regulation O places limitations on loans to bank insiders and applies to all insured banks.[3] The Prompt Corrective Action regulations required under the Federal Deposit Insurance Act (FDI Act) mandate progressively severe sanctions against any insured bank whose owners fail to maintain adequate capitalization in that bank.[4] These and other safeguards described in this article constrain the degree to which a parent company or its subsidiaries can undertake transactions with, or divert capital from, an insured institution.

This array of safeguards reflects the importance Congress and the banking agencies attach to containing the potential cost of bank failures. The bank failures listed in Table 1 were caused by various factors, including weak economic conditions, failed business strategies, insufficient oversight by boards of directors, fraud perpetrated by bank insiders, and the nature of the influence exerted by a holding company or other controlling entity. Table 1 shows that the problems that can cause a bank to fail strike democratically across charter types and

[1]ILCs are state-chartered institutions (currently operating in California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah) that under certain circumstances are not "banks" under the Bank Holding Company Act (BHCA). A company controlling an institution that is not a BHCA bank is not required to register as a bank holding company with the Federal Reserve Board and, therefore, is not subject to regulation and supervision by the Federal Reserve Board. Generally, an ILC will not be a BHCA bank as long as it satisfies at least one of the following conditions: (1) the institution does not accept demand deposits, (2) the institution's total assets are less than $100,000,000, or (3) control of the institution has not been acquired by any company after August 10, 1987.

[2]Sections 23A and 23B, 12 U.S.C. §§ 371c & 371c-1, by their terms, apply only to state member banks and national banks. However, section 18(j) of the Federal Deposit Insurance Act, 12 U.S.C. § 1828(j) makes Sections 23A and 23B applicable to state nonmember banks, and 12 U.S.C. § 1468 makes sections 23A and 23B applicable to savings associations.

[3]Regulation O (loans to insiders), 12 C.F.R. Part 215. FDIC regulations (12 C.F.R. § 337.3) make the Regulation O prohibitions and limitations on loans to insiders applicable to all insured nonmember banks.

[4]See, for example, 12 C.F.R. Part 325 (with respect to nonmember banks).

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regulatory structures. More specifically, the table reinforces the observation that appropriate safeguards over inter-affiliate transactions are important under any charter type.

Table 1

Failed Banks and Thrifts 1985–April 2004

Charter Type		Number of Failures
Thrift institutions		1,129
Bank holding company subsidiaries		813
Stand-alone banks *		579
CEBA banks		1
Industrial loan companies	All ILCs	21
	Utah ILCs	0
Total		2,543

* Figure includes savings banks supervised by the FDIC.

Note: CEBA = Competitive Equality Banking Act.

Depending on the organizational form a banking company adopts, federal oversight of the relationship between an insured bank and its affiliates may occur in two ways: bank supervision and holding company supervision. Bank supervision does not involve extensive federal banking agency oversight of controlling entities and their related interests. For example, if the controlling shareholder of a community bank also owns an automobile dealership, that dealership is not supervised by a federal banking agency. The statutory, regulatory, and supervisory safeguards alluded to at the outset of this article are designed to prevent abuse of the bank by the owner, and the owner may be required to produce documents and financial records that detail the bank's relationship with the dealership.

As of year-end 2003, 7,769 insured commercial banks were in operation. Of these, about 1,370 stand-alone commercial insured banks, 56 ILCs, and 40 Competitive Equality Banking Act (CEBA) credit card banks and other non-BHCA banks interacted with the federal banking agencies primarily by virtue of the agencies' bank supervision powers.[5] Another 6,303 insured institutions were bank holding company subsidiaries. Each of these institutions was directly regulated, as a bank, by the relevant federal banking agency, and the parent companies of these institutions were subject to an additional layer of Federal Reserve supervision.[6]

In addition to supervising bank holding companies, the Federal Reserve, under the Gramm-Leach-Bliley Act of 1999 (GLBA), has umbrella supervision powers with respect to financial holding companies.[7] Where a subsidiary of a bank holding company or financial holding company is regulated directly by another agency, GLBA directs the Federal Reserve to rely on work performed by that agency (the "functional regulator") to the extent practical for purposes of exercising its umbrella supervision responsibilities.

In the context of this regulatory landscape, an ILC is an insured bank operating under a specific charter whose controlling shareholder may be a nonfinancial corporation. The ILC is subject to oversight by federal and state bank regulators; however, the controlling company in many cases is not.[8] Table 2 compares key features of the ILC

[5]The Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 101(a)(1), 101 Stat. 554, 562 redefined "bank" for purposes of the Bank Holding Company Act to include any bank insured by the FDIC but specifically excepted certain classes of banks from the BHCA, including CEBA credit card banks and certain ILCs.

[6]By comparison, both federal savings associations and savings and loan holding companies are regulated by the Office of Thrift Supervision.

[7]Gramm-Leach-Bliley Act of 1999 (GLBA), Pub. L. No. 106-102. Title I, 113 Stat. 1338.

[8]Under a proposed rule, broker-dealers who own ILCs may soon be able to choose consolidated supervision by the Securities and Exchange Commission. See "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," 62 Fed. Reg. 62872 (proposed November 6, 2003, to be codified at 17 C.F.R. Part 240). An ILC can be owned by a bank holding company, in which case the parent company is subject to Federal Reserve supervision.

charter with those of a bank charter. The remainder of this article discusses the supervisory approach and framework that have evolved with respect to ILCs and concludes with a brief chronology of ILC failures.

A Historical Perspective on ILC Supervision

Stepping back, industrial loan companies and industrial banks have existed since the turn of the 20th century. In 1910, Arthur J. Morris established the Fidelity Savings and Trust Company of

Table 2

Comparison of Powers Shows Key Differences between Commercial Bank and ILC Charters

Powers	State Commercial Bank That Is a BHCA Bank	Industrial Loan Company (or Industrial Bank) That Is Not a BHCA Bank
Ability to accept demand deposits	Yes	Varies with the particular state. Where authorized by the state, demand deposits can be offered if either the ILC's assets are less than $100 million or the ILC has not been acquired after August 10, 1987
Ability to export interest rates	Yes	Yes
Ability to branch interstate	Yes	Yes
Ability to offer full range of deposits and loans	Yes	Yes, including NOW accounts, but see the first entry above regarding demand deposit accounts
Authorized in every state	Yes	No. ILCs currently are chartered in seven states*
Examination, supervision, and regulation by federal banking agency	Yes	Yes
FDIC may conduct limited scope exam of affiliates	Yes	Yes
Golden Parachute restrictions apply	Yes	Yes, to the institution; no, to the parent
Cross Guarantee liability applies	Yes	No
23A & 23B, Reg. O, CRA apply	Yes	Yes
Anti-tying restrictions apply	Yes	Yes
Parent** subject to umbrella federal oversight	Yes	No
Parent** activities generally limited to banking and financial activities	Yes	No
Parent** could be prohibited from commencing new activities if a subsidiary depository institution has a CRA rating that falls below satisfactory	Yes	No
Parent** could be ordered by a federal banking agency to divest of a depository institution subsidiary if the subsidiary becomes less than well capitalized	Yes	No
Full range of enforcement actions can be applied to the subsidiary depository institutions if parent fails to maintain adequate capitalization	Yes	Yes
Control owners who have caused a loss to a failed institution may be subject to personal liability	Yes	Yes

*California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah.

**Parent, with respect to a state commercial bank, refers to a bank holding company or financial holding company subject to supervision by the Federal Reserve. Under a proposed rule, broker-dealers who own ILCs may soon be able to choose consolidated supervision by the Securities and Exchange Commission. See "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," 62 Fed. Reg. 62872 (proposed November 6, 2003, to be codified at 17 C.F.R. Part 240).

Note: NOW = negotiable order of withdrawal; CRA = Community Reinvestment Act

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Norfolk, Virginia. This was the first of the Morris Plan Companies, which were also known as industrials, industrial banks (borrowers were industrial workers), or thrift and loans. In the beginning, these entities were not subject to supervision by any federal banking regulator but rather were state-chartered and supervised by the states. These early industrials operated more or less like finance companies, providing loans (at a high interest rate) to wage earners who could not otherwise obtain credit. The loans were not collateralized but were based on endorsements from two creditworthy individuals who knew the borrower. Some ILCs operating today continue to serve as small financing companies; however, they have expanded their operations to include some commercial and collateralized real estate lending.

State law prevented some of the early Morris Plan banks from receiving deposits. Instead, they issued certificates of investment or indebtedness (thrift certificates) and avoided the use of the term "deposit." Because some state laws did not permit these entities to accept deposits, the FDIC determined that they were not eligible for federal deposit insurance.[9] This policy eventually changed, and at least six banks received federal deposit insurance from 1958 through 1979. In addition, as state law permitted industrial banks to include "bank" in their name, these entities applied for and received deposit insurance.

Because thrift certificates were exempt from Regulation Q interest rate restrictions, the ILCs tended to pay higher interest rates on their thrift certificates than insured banks paid on their deposits. Even given the high interest rates, some investors were reluctant to purchase the thrift certificates, as they were not federally insured. In 1975, Utah formed an insurance fund, the Industrial Loan Guaranty Corporation (ILGC), to help ILCs remain competitive with federally insured banks. California organized a similar state insurance fund. Both insurance funds were financed not as part of the state budgets but rather built up reserves through modest assessments on ILCs. After only two ILC failures in 1978 and 1980, the Utah ILGC fund was depleted. The California fund also was depleted following a large ILC failure. These problems were compounded in 1980 when Regulation Q was repealed, allowing banks to pay higher interest rates and forcing ILCs to accept narrower margins to remain competitive.

This situation posed significant challenges for the onset of federal supervision in the early 1980s. The FDIC's involvement with industrial loan companies began in earnest in 1982, when the Garn-St Germain Depository Institutions Act authorized federal deposit insurance for thrift certificates, a funding source used by industrial loan companies. Provisions of this legislation allowed ILCs that were regulated in a manner similar to commercial banks to apply for federal deposit insurance. Reinforcing this development, some states changed their laws to require their ILCs to obtain FDIC insurance as a condition of keeping their charters. The determination of eligibility for federal deposit insurance came as ILCs were experiencing significant deterioration in credit quality and the economy was entering a recession. Several ILCs that applied for federal deposit insurance required the infusion of additional capital, and other applications were denied. As a result, those entities had to be sold or liquidated.

The FDIC subsequently amended its *Statement of Policy Concerning Applications for Deposit Insurance* to clarify that ILCs would be eligible for deposit insurance if they met certain requirements. These requirements addressed problems that had characterized the

[9]Where state law permitted the use of "bank" in the name, 45 industrial banks became federally insured before the enactment of the Garn-St Germain Depository Institutions Act of 1982, Pub. L. 97-320, 96 Stat. 1469.

previously uninsured ILCs. If the eligibility requirements were met, the FDIC Board of Directors would then evaluate an applicant based on the factors set forth in Section 6 of the FDI Act: the financial history and condition of the applicant; the adequacy of the applicant's capital structure, future earnings prospects, and character of management; the convenience and needs of the community; and whether the applicant's corporate powers were consistent with the FDI Act.

In the mid-1980s, commercial firms became increasingly interested in nonbank bank charters (including ILCs) because they were exempt from the Bank Holding Company Act.[10] As a result, more than 40 nonbank banks were organized that were owned by commercial firms, and several hundred more applications were anticipated. These applications were not filed, however, because in 1987 CEBA was enacted. CEBA generally made all banks that were insured by the FDIC "banks" under the BHCA. Therefore, with certain exceptions, all existing nonbank banks that were insured became "banks" under the BHCA. CEBA also grandfathered the exclusion from the BHCA of the parent companies of existing nonbank banks, provided they operated within certain restrictions. Interest increased in the ILC charter, and, in 1988, the first commercially owned ILC applied for FDIC insurance. Once the precedent had been set, more applications followed.

Tasked with supervising the ILCs that had obtained federal deposit insurance, the early FDIC and state examinations of those ILCs with commercial parents proved challenging. Examiners encountered management unaccustomed to regulatory oversight and sometimes unwilling to provide information. For example, examiners frequently could not identify local officers with decision-making authority or find records, including loan documentation, on site. These entities operated as an extension of the parent, not as autonomous, federally insured and regulated banks. It became apparent that such ILCs needed to be introduced to and helped to understand the specifics of banking regulation and corporate governance of the separate ILC entity.

Specifically, just as for all other insured banks, ILC management (senior officers and directors) must be held accountable for ensuring that all bank operations and business functions are performed in compliance with banking regulations and in a safe and sound manner. To guarantee sufficient autonomy and insulate the bank from the parent, the state authority, the FDIC, or both typically impose certain controls. One example of proactive state supervision is the Utah Department of Financial Institutions, which imposes conditions for approval of new industrial bank charters, giving considerable weight to the following factors:

> The organizers have solid character, reputation, and financial standing.
>
> The organizers have the resources (source of capital) to support an ILC.
>
> The selection of a board of directors, the majority of whom must be outside, unaffiliated individuals, and some of whom must be Utah residents.
>
> The establishment of a Utah organization where autonomous decision-making authority and responsibilities reside with the board and management such that they are in control of the ILC's activities and direction.

[10]At that time, the BHCA defined a bank as an entity that both made commercial loans and accepted demand deposits. If an entity performed only one of these tasks, it was not a bank under the BHCA. Such an entity became known as a nonbank bank because it was not a bank for BHCA purposes, yet it was a bank for other purposes, including, for example, deposit insurance. As a result, a company that controlled a nonbank bank was not subject to regulation and supervision as a bank holding company.

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Management that has a track record and the knowledge, expertise, and experience in operating a depository institution in a regulated environment.

Management that is independent of the parent; however, the goals and policies of the parent may be carried out if defined in the ILC's business plan.

A bona fide business plan and purpose for the existence of an ILC, in which deposit-taking is an integral component, including three years' pro forma projections and supporting detail.

FDIC deposit insurance.

All ILC lending and activities must comply with Sections 23A and 23B of the Federal Reserve Act (restrictions on transactions with affiliates) and Federal Reserve Regulation O (loans to executive officers, directors, or principal shareholders).[11]

The FDIC has developed conditions that may be imposed when approving deposit insurance applications for institutions that will be owned by or significantly involved in transactions with commercial or financial companies.[12] Some of the nonstandard conditions that may be imposed include the following:

The organizers will appoint a board of directors, the majority of whom will be independent of the bank's parent company and its affiliated entities.

The bank will appoint and retain knowledgeable, experienced, and independent executive officers.

The bank will develop and maintain a current written business plan, adopted by the bank's board of directors, that is appropriate to the nature and complexity of the activities conducted by the bank and separate from the business plan of the affiliated companies.

To the extent management, staff, or other personnel or resources are employed by both the bank and the bank's parent company or any affiliated entities, the bank's board of directors will ensure that such arrangements are governed by written contracts giving the bank authority and control necessary to direct and administer the bank's affairs.

As with any bank-level review of an institution with affiliates, examination procedures include an assessment of the bank's corporate structure and how the bank interacts with the affiliates (including a review of intercompany transactions and interdependencies) as well as an evaluation of any financial risks that may be inherent in the relationship. Examiners review the current written business plan and evaluate any changes. Examiners also review any arrangements involving shared management or employees. In the latter case, referred to as "dual employees," agreements should be in place that define compensation arrangements, specify how to avoid conflicts of interest, establish reporting lines, and assign authority for managing the dual-employee relationship.

All services provided to or purchased from an affiliate must be on the same terms and conditions as would be applied to nonaffiliated entities. All service relationships must be governed by a written agreement, and the bank should have a contingency plan for all critical business functions performed by affiliated companies.

In examining any insured depository institution, the FDIC has the authority

[11]These requirements are outlined in Utah's Department of Financial Institutions website at www.dfi.utah.gov/FinInst.htm.

[12]Regional Director memo, transmittal number 2004-011, "Imposition of Prudential Conditions in Approvals of Applications for Deposit Insurance."

(under Section 10(b) of the FDI Act) to examine any affiliate of the institution, including the parent company, for purposes of determining (i) the relationship between the ILC and its parent and (ii) the effect of such a relationship on the ILC.[13] Further, Section 10(c) of the FDI Act empowers the FDIC, in the course of its supervisory activities, to issue subpoenas and to take and preserve testimony under oath, so long as the documentation or information sought relates to the affairs or ownership of the insured institution.[14] Accordingly, individuals, corporations, partnerships, or other entities that in any way affect the institution's affairs or ownership may be subpoenaed and required to produce documents. In addition, the states of Utah, California, and Nevada have direct authority to conduct examinations of parents and affiliates.[15]

ILC Failures: A Brief Chronology

The narrative above indicates that ILCs' entry into the federal regulatory arena and FDIC insurance was precipitated by financial difficulties the ILCs were experiencing. Recollections of FDIC examination staff are that a number of the newly insured ILCs were essentially small finance company operations that paid high rates to thrift certificate holders and made higher-risk loans. The post-1985 history of ILC failures is dominated by these smaller ILCs.

From 1985 through year-end 2003, 21 ILCs failed (Table 3). Of those, 19 were operated as finance companies, and the average total assets of these 19 failed ILCs were $23 million. Most of the failures were small California Thrift and Loans that did not fare well in the banking crisis of the late 1980s and early 1990s.[16] Eight of the 21 ILC failures occurred within five years of the institutions' receiving FDIC insurance. Another ten failures occurred within six to eight years of receiving insurance.

The two largest ILC failures are also the most recent—Pacific Thrift and Loan and Southern Pacific Bank (SPB). Both were part of a holding company structure when they failed; one, SPB, was a vestige of the old system of uninsured ILCs. SPB, the largest failure, was originally chartered in 1982 as Southern Pacific Thrift and Loan and was insured in 1987 with a name change to Southern Pacific Bank. Pacific Thrift and Loan was chartered and received federal deposit insurance in 1988. Both failures were the result of ineffective risk management and poor credit quality.

[13] 12 U.S.C. § 1820(b).

[14] 12 U.S.C. § 1820(c).

[15] The Utah Department of Financial Institutions ("DFI") requires all parent companies to register with the state under Section 7-8-16 of the Utah Code and has authority to examine such companies under Section 7-1-510. The California DFI has authority to examine parent organizations through Chapter 21, Section 3700 (specifically Section 3704) of the California Financial Code and to require reports and information through Section 3703. In the state of Nevada, holding companies are required to register with the Secretary of State. The Financial Institutions Department for the State of Nevada has the authority to conduct examinations of parent organizations under Section 658.185.

[16] As the operations of industrial banks based in California grew larger and more complex, the California Department of Financial Institutions reorganized and enhanced its oversight of ILCs. In October 2000, California state laws and regulations governing the oversight of ILCs (specific to capital standards, lending authority, loan limits, permissible investments, branching requirements, transactions with affiliates, dividend restriction, and holding company examinations) were revised to parallel those of other charter types.

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It is difficult to make definitive, "all other things equal" comparisons of historical failure rates of ILCs with failure rates for other charter types. Failed ILCs generally were small Thrift and Loan companies (except for Southern Pacific and Pacific Thrift and Loan) and, during a significant part of the period we are considering, were relative newcomers to federal supervision. Also, as noted above, a number of them may have entered the insured arena with an above-average risk profile and, soon after their entry, experienced deteriorating local economic conditions and a severe real estate downturn. These factors contributed to a relatively high incidence of failure.[17]

A review of Table 3 raises an interesting question: Why have no Utah-based

[17]For more general information on the regional banking crises of the 1980s and early 1990s, see FDIC, *History of the Eighties—Lessons for the Future.*

Table 3

Most Failing ILCs Operated as Small Finance Companies: ILC Failures 1985–2003

Institution	Location	Year of Failure	Resolution Assets ($000)	Loss to the Bank	Loss Ratio % Insurance Fund ($000)	Comments
Orange Coast Thrift & Loan	Los Alamitos, CA	1986	13,966	5,352	38.3	Insured 1985
Whittier Thrift & Loan	Whittier, CA	1987	15,206	3,263	21.5	Insured 1985
Colonial Thrift & Loan	Culver City, CA	1988	26,761	4,600	17.2	Insured 1986
First Industrial Bank	Rocky Ford, CO	1988	12,489	6,696	53.6	Insured 1987
Metropolitan Industrial Bank	Denver, CO	1988	12,434	4,729	38.0	Denied 1972 & 1982; insured 1984
Westlake Thrift & Loan	Westlake Village, CA	1988	55,152	7,745	14.0	Insured 1985
Lewis County Savings & Loan	Weston, WV	1989	3,986	405	10.2	Insured 1986
Federal Finance & Mortgage	Honolulu, HI	1991	7,732	878	11.4	Insured 1985
Landmark Thrift & Loan	San Diego, CA	1991	16,638	2,208	13.3	Insured 1984
Assured Thrift & Loan	San Juan Capistrano, CA	1992	48,226	21,028	43.6	Insured 1985
Huntington Pacific Thrift & Loan	Huntington Beach, CA	1992	40,476	17,368	42.9	Insured 1985
North American Thrift & Loan	Corona Del Mar, CA	1992	21,276	0	0	Insured 1989
Statewide Thrift & Loan	Redwood City, CA	1992	9,636	2,341	24.3	Insured 1986
Brentwood Thrift & Loan	Los Angeles, CA	1993	12,920	3,323	25.7	Insured 1987
Century Thrift & Loan	Los Angeles, CA	1993	31,876	9,553	30.0	Insured 1985
City Thrift & Loan	Los Angeles, CA	1993	39,383	17,697	44.9	Insured 1986
Regent Thrift & Loan	San Francisco, CA	1993	35,751	1,450	4.1	Insured 1987
Los Angeles Thrift & Loan	Los Angeles, CA	1995	23,388	6,067	25.9	Insured 1990
Commonwealth Thrift & Loan	Torrance, CA	1996	11,547	5,640	48.8	Insured 1987
Pacific Thrift & Loan	Woodland Hills, CA	1999	127,342	42,049	33.0	Insured 1988
Southern Pacific Bank	Torrance, CA	2003	904,294	90,000	10.0	Estimated figures. Denied 1985; insured 1987
Total ILC Failures 21; by state: CA 17; CO 2; HI 1; WV 1			$1.5 billion	$252 million	17%*	

*Weighted average

insured ILCs failed? One plausible answer is that only eight of the original Utah state-insured ILCs were subsequently insured by the FDIC. The state of Utah tried to either sell or liquidate the poorer-performing ILCs. Recently, an essentially new ILC industry has been born in Utah, with commercial companies either buying ILC charters or organizing de novo institutions. The supervisory strategies and standards the FDIC and the state of Utah applied to this new breed of ILCs, outlined in the preceding section of this article, have been tailored to fit the profiles of individual institutions. While details of supervisory approaches may differ across institutions, the approaches share one overriding principle that permeates both state and federal bank supervision: protection of the insured entity.

Conclusion

Monitoring and controlling the relationship between an insured entity and its parent company is an important part of the banking agencies' approach to supervision. This is true under any organizational form banks adopt, including the limited number of banks now operating as subsidiaries of a commercial firm or other nonbank entity. Because Utah is home to a number of commercially owned ILCs, the evolving supervisory strategies developed by that state and the FDIC provide a window into the processes and procedures that are important to consider in any discussion of insulating an insured entity from potential abuses and conflicts of interest by a nonfederally supervised parent. Cooperation between regulators from the state authorities and the FDIC's San Francisco Region and ILC management has resulted in critical controls, including requirements for local management, boards of directors, and files, as well as definitive business plans for the ILCs. More broadly, experience with the ILC charter reinforces the conclusion derived from other charter types that effective bank-level supervision is a key ingredient in safeguarding insured institutions from risks posed by parent companies.

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Compliance Examinations: A Change in Focus

The financial safety of U.S. consumers is protected by a broad array of laws that govern the provision of banking services and products. These laws typically have one or more purposes: (1) to protect consumers from harm or abuse; (2) to provide consumers with information that helps them understand a banking transaction; and (3) to ensure fair access to the credit markets for all consumers. In addition to its fundamental mission of contributing to public confidence in the financial system, one of the FDIC's primary goals is to ensure that state nonmember banks comply with consumer protection laws and regulations. The agency does this through the compliance examination process as well as through the processing of consumer complaints.

During the past decade, the FDIC's approach to compliance examinations has evolved. Its original approach was relatively simple and was based almost exclusively on reviewing actual banking transactions for adherence to regulatory and statutory requirements. This approach worked well when consumer laws and regulations were few in number. However, as banks expanded product and service offerings and Congress continued to pass or revise consumer protection laws, the resource demands of implementing an extremely detailed, transaction-oriented approach grew considerably. It became harder to complete examination schedules and write meaningful examination reports. The FDIC recognized that it was impossible, and in many cases unnecessary, to rely so heavily on transaction analysis to evaluate a bank's compliance posture.

An Evolutionary Process

In 1996, the FDIC reengineered and streamlined its compliance examination procedures and incorporated the important step of risk-scoping. Under the risk-focused approach to examinations, the extent of transaction testing depends on assessing a bank's risk of noncompliance in a particular area. Compliance examiners were instructed to focus on regulatory areas that posed the greatest risk to the bank and the greatest potential harm to consumers.

In July 2003, the Corporation built on that progress by initiating top-down, risk-focused compliance examinations. Although the 1996 reengineering effort introduced needed adjustments, additional changes in the marketplace needed to be addressed. In response, the FDIC combined the risk-based examination process with an in-depth evaluation of a bank's compliance management system.

A bank's "system" is the confluence of directorate and management oversight, internal controls, and compliance audits. The examination approach assesses how well a bank identifies emerging risks, remains current on changes to laws and regulations, ensures that employees understand compliance responsibilities, incorporates compliance into business operations, reviews operations to ensure compliance, and takes effective corrective action to address violations of law or regulation and weaknesses in the compliance program. Based on an assessment of the quality of the compliance management system, compliance examiners use transaction testing to pinpoint regulatory areas for further evaluation. The intensity and extent of transaction testing depend on a bank's risk profile.

For example, the intensity and extent of transaction testing in a bank that has a solid history of compliance with the flood insurance regulations, administers a well-constructed training program, conducts periodic reviews to ascertain flood insurance compliance, reports any exceptions to the board of directors, and addresses them promptly and thoroughly, can certainly be tempered. Instead, the examiner can consider these positive indicators and reduce the intensity of any transaction review deemed

necessary to ensure that the bank's system is working properly. In fact, depending on the strength of the bank's overall corporate compliance program, the breadth of the bank's own testing, and the degree of reliance the examiner can place on the results, the examiner has the discretion to forego transaction testing for this subject area. Under the old approach, the examiner likely would have delved into the bank's files without considering these positive indicators.

New Realities, New Challenges

What prompted the FDIC to modify its compliance examination program in 2003? A careful look at the marketplace showed that much had happened in the financial and regulatory communities since 1996, as indicated by the following developments:

- The number and complexity of federal consumer protection laws had significantly increased. Congress had enacted new laws pertaining to privacy, fair credit reporting, identity theft, and securities sales, to name a few.
- Attention to corporate governance compelled banks to review and strengthen internal controls, policies, and practices.
- Agency examination resources were taxed every time a new law was enacted, as were bank resources.
- The industry raised concerns about regulatory burden that prompted regulators to review their practices and consider alternative ways to fulfill examination mandates.

Such factors prompted the FDIC to ask a number of questions about its approach to compliance examinations:

- Was the compliance examination program positioned to absorb and adapt to these and future industry and legislative changes?
- How could we break the cycle of incrementally adding more examination resources every time a new law was passed or an old one was substantially revised?
- Did our examination reports include information that could help bank management design and implement more effective compliance programs?
- Could we modify our internal processes to reduce the resource demands associated with on-site examinations?
- Had we provided our compliance examiners with clear expectations about our examination process?

Upon consideration of these questions, the FDIC concluded that additional regulatory responsibilities were certainly adding to the length of our examinations, placing stress on our examiners and the industry. Our examination reports could add more value if we explained the significance of violations in the context of a bank's operational weaknesses.

In addition, the FDIC had long impressed on bank boards of directors and senior management that they are ultimately responsible for compliance, and that they need to include compliance as a core risk management function. Examination experience told us that the industry was listening, and larger banks in particular were migrating toward a top-down risk management orientation. However, our examination process appeared to be a step behind.

And finally, looking to the presence or absence of violations as the chief determinant of a bank's compliance performance presented an incomplete picture of its overall compliance risk management structure. For example, evaluating a bank's overall compliance posture on violations alone ignores whether new

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products can be successfully implemented from a compliance standpoint, whether the bank is positioned to absorb future regulatory changes, or whether a staff training program is sufficient to facilitate ongoing compliance.

The business case for change was clearly there. A strategy emerged that was based on three components—reorienting the process, changing on-site examination workflow, and revamping examination reports.

Reorienting the process toward a top-down, risk-focused approach to examinations that focuses on a bank's compliance management system was a natural first step. This approach places emphasis on the directorate's and senior management's administration of the bank, which includes identifying, monitoring, and managing risk and ensuring that the bank complies with consumer protection, fair lending, and community reinvestment laws and regulations.

Although the details of a particular bank's system will vary depending on its history and business plan, effective compliance management systems share common characteristics. Senior management sets the tone by supporting compliance and providing resources that will ensure a strong system. The compliance officer has sufficient knowledge and authority and keeps current on regulatory changes, and the compliance officer reviews new products before roll-out to avoid potential problems. The bank has in place, and follows, policies and procedures appropriate to its product lines. Staff is trained commensurate with its responsibilities, and internal monitoring identifies and remedies problems before they multiply. Consumer complaints are treated as an early warning system for potential problems, and the bank's audit program helps management understand the causes of problems so future occurrences can be prevented.

Small banks without a wide variety of products may not have a single dedicated compliance officer or an independent audit function. However, they will have sufficient resources devoted to compliance to enable staff to understand and carry out its responsibilities. Small banks also will have a functioning internal monitoring system.

Changing examination workflow fosters efficiencies and new ways of thinking about how compliance fits into a bank's overall corporate risk management plan. Starting each compliance examination by looking for violations of federal consumer laws and regulations and then drawing conclusions about how a bank manages its compliance responsibilities did little to address operational weaknesses or prevent future violations. Under the new approach, examiners first establish a compliance risk profile that reflects the quality of the bank's compliance management system. Succeeding examination staff will use the risk profile as part of the process of establishing the scope of the examination. This approach can increase efficiency by focusing the examiner's attention on substantive changes to the bank's operations and compliance infrastructure since the previous examination and enabling examiners to direct finite examination staff resources toward areas that present the greatest risks.

Revamping the compliance report of examination to specifically relate violations to what they mean in the context of the bank's compliance management system helps foster meaningful corrective actions. Writing the report in a way that helps management understand where its system works well and where it needs to tighten controls and procedures puts violations in context.

The revised examination report format places comments and conclusions about board and management oversight, the compliance program, and the internal review program on the first page, along

with recommendations for corrective action. Separate subsections for each compliance management system element include summary statements that characterize each element as strong, adequate, or weak. Moreover, the examiner discusses the positive and negative aspects of each element to support the summary, and the recommendations are tied to these comments.

Expected Outcomes of the Top-Down, Risk-Focused Approach

The FDIC's intent is that the new approach will result in a smoother, more efficient examination process as compliance risk profiles are established for each supervised bank. In addition, rather than simply enumerating a list of violations, examination reports will become more meaningful as they will address the quality of the bank's compliance management system and make recommendations for correcting weaknesses.

Any time saved through this new approach will permit examiners to concentrate on the problems of banks with weak compliance management systems and those that require more than a normal level of supervisory attention. Of critical importance, this approach will help move compliance from the back room to the boardroom by establishing a tone and climate that support the incorporation of compliance risk management into the way employees do business, all the way down the line.

Effective compliance program management at a bank starts at the top—with the board of directors and senior management, who are responsible for the bank's management and control. The top-down, risk-focused approach to compliance examinations complements the importance of directorate and senior management accountability for a bank's compliance risk management system. In addition, the new approach helps to ensure that the FDIC's compliance examination program continues to be effective in a dynamic environment. As the industry paradigm has shifted to enterprise-wide compliance risk management, so has the FDIC's approach to supervision.

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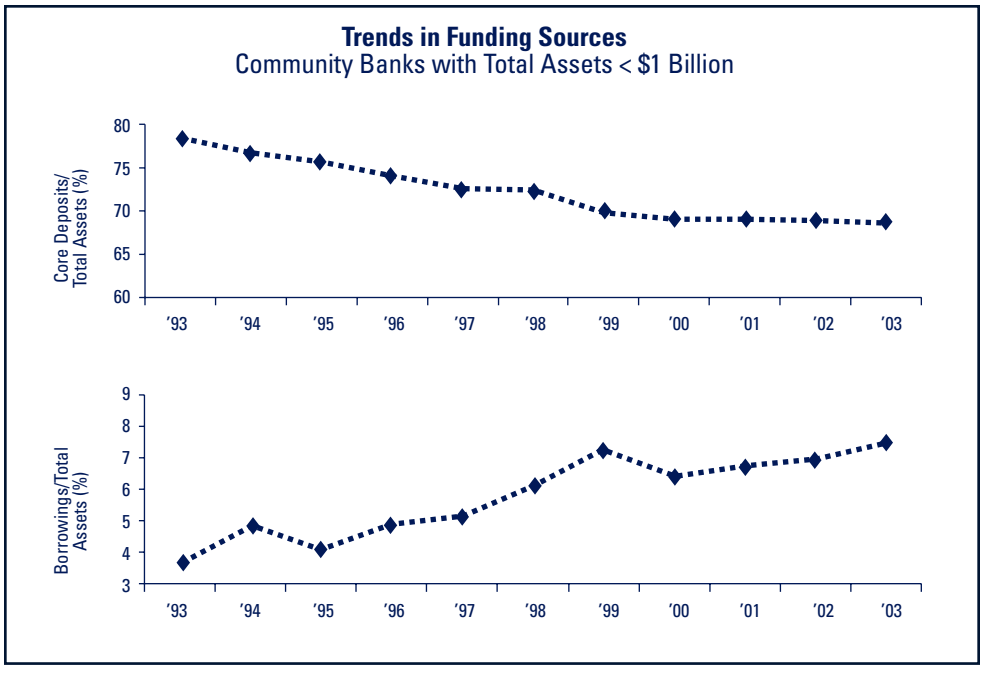
Federal Home Loan Bank Advances: A Supervisory Perspective

The Federal Home Loan Bank (FHLB) System is an increasingly important funding source for community banks. What risks are associated with the growing importance of FHLB advances in banks' funding mix? Such risks could include an unexpected increase in cost or reduction in availability of advances in general and the mismanagement of advances by specific institutions. While there is no immediate systemic threat to the overall cost and availability of advances, individual institutions must be mindful of the risks undue reliance on advances can pose. Examiner review of the heaviest users of advances indicates that most banks manage these products prudently—but the exceptions have given rise to supervisory concern.

Traditionally, community banks have relied on deposits as the primary funding source for earning assets. (In this article, institutions with total assets less than $1 billion are considered community banks.) As shown in Chart 1, core deposits remain the primary source of funding for these institutions.[1] There has been, however, a noteworthy trend in community bank funding patterns during the past ten years. Core deposits have been declining as a percentage of total assets as these institutions have become more dependent on other borrowings to meet funding needs.[2] Core deposit migration is due, in part, to bank deposit accounts losing significant ground to higher-yielding mutual funds and to the euphoria of the stock market during the late 1990s. For instance, during the ten years ending December 31, 2003, mutual fund assets increased 258 percent, while core deposits as a percentage of community bank total assets declined 11.52 percent.[3]

Even with recent negative publicity surrounding mutual fund sales practices,

Chart 1



[1]Core deposits exclude certificates of deposit greater than $100M, brokered deposits, and foreign deposits.

[2]Other borrowings include primarily FHLB advances, fed funds purchased, and repurchase agreements.

[3]Mutual fund asset data for December 2003 were provided by the Investment Company Institute.

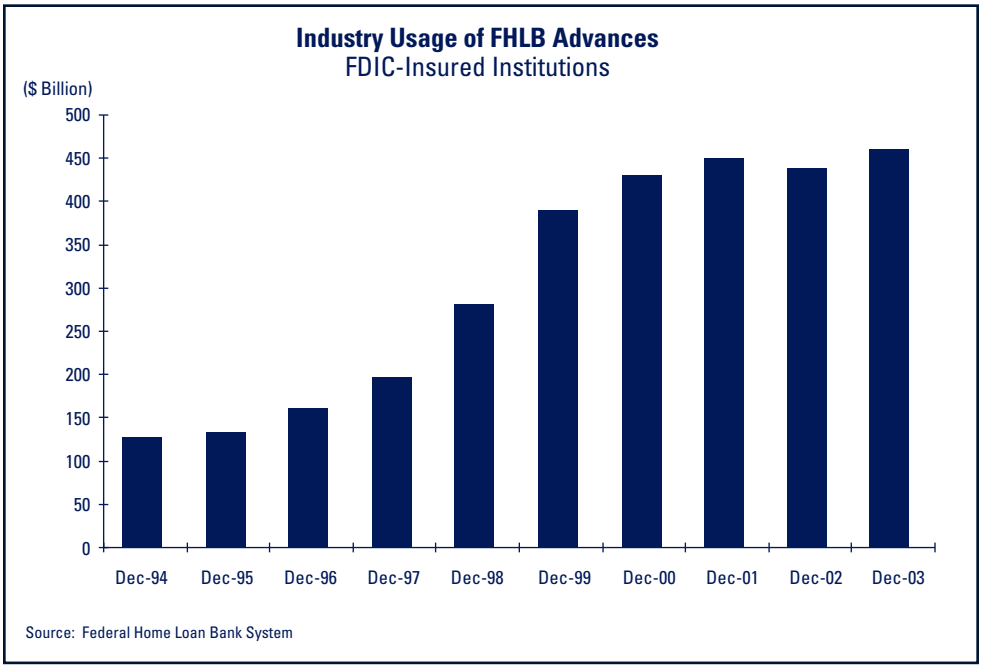
investors have not lost faith in this investment alternative. This observation is supported by the recently reported 2.5 percent growth in mutual fund assets for month-end December 2003. To a large extent, the decline in core deposit funding has been offset by an increase in different types of wholesale funding, such as FHLB advances and brokered certificates of deposit (CDs). In fact, community bank use of other borrowings and brokered CDs increased by 123 percent and 394 percent, respectively, from 1993 to 2003. During this time, FDIC-insured institutions significantly increased their reliance on FHLB advances (see Chart 2).

Most notably, the rate of advance usage accelerated from 1994 through 2000, before tapering off in response to the recession and the resultant lackluster stock market performance. However, as the economy and the equity markets began to rebound in 2003, FDIC-insured institutions started to increase borrowing levels from the FHLB System. Determining the specific composition of advances in any given bank is difficult without visiting the financial institution, as the amount and nature of advance information reported in the Call Report is extremely limited. Call Report data show that commercial banks were liable for $237 billion in FHLB advances as of September 30, 2003, which is 52 percent of the $456 billion in advances outstanding to FDIC-insured institutions.[4] Savings associations and savings banks held 39 percent and 9 percent of advances, respectively. Accordingly, commercial banks are now a core constituent and borrower of the FHLB System.

In light of community banks' growing use of advances, this article focuses on two areas of supervisory attention:

(1) the impact of the FHLB System's risk profile on FDIC-supervised institutions; and

Chart 2



[4]Commercial banks include national, state member, and state nonmember banks.

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(2) whether the types and degree of advance usage by FDIC-supervised institutions raise any concerns.

The FHLB System

The FHLB System recently has been the focus of negative financial news and increased regulatory scrutiny. In the second half of 2003, FHLB-New York reported a loss of $183 million on its investment portfolio and suspended its third quarter dividend payment. Consequently, Standard & Poor's (S&P) lowered the long-term counterparty credit rating for FHLB–New York to AA+ with a stable outlook because of higher credit exposures and operating losses. Late in third quarter 2003, S&P revised its outlook to negative from stable for FHLB–Pittsburgh and FHLB–Atlanta because of heightened interest rate risk exposure and earnings volatility. S&P also revised its outlook for FHLB–Chicago, –Indianapolis, and –Seattle to negative from stable. In a November 17, 2003, press release, S&P stated that the ratings action reflects its concern regarding the banks' change in risk profile, which has led to a higher degree of interest rate risk exposure and higher demands for risk management. The change in risk profile stems from actively growing fixed-rate residential mortgage portfolios as a part of the mortgage partnership programs developed in the FHLB System. S&P stated that the ratings actions do not affect the AAA rating on the senior debt of the banks in the system based on their status as government-chartered entities.

In addition to rating agency attention, policymakers have expressed concerns regarding the regulation of housing government-sponsored enterprises (GSEs). In the "Analytical Perspectives" portion of the fiscal year 2005 budget of the United States (budget proposal), the Bush administration strongly suggests that regulatory reform is necessary for the housing GSEs, including the FHLB System.[5] The budget proposal includes a detailed analysis that indicates that GSEs do not hold enough capital and outlines problems encountered last year by the FHL Banks and other housing finance GSEs. Furthermore, the analysis warns that because of the large size of these entities, even a small mistake by a GSE could have consequences throughout the economy.

FDIC-supervised institutions could be affected negatively if these recent events result in higher advance rates. FHL Banks can lend money to members at lower rates because, as GSEs, they can borrow at cheaper rates. Traditionally, GSEs benefit from an implied guarantee to the extent investors perceive that they are backed by the federal government. Although highly unlikely, loss of GSE status coupled with negative ratings actions or downgrades would probably result in much higher borrowing costs for FHL Banks and borrowing members, many of which are FDIC-supervised and -insured institutions.

Even though the FHLB System has recently sustained some negative press and closer regulatory scrutiny, these factors do not pose significant negative implications for FDIC-supervised institutions at this time. This finding is evidenced by Moody's third quarter 2003 reaffirmation of its Aaa bank-deposit rating on the FHL Banks, which attests to their profitability, liquidity, and asset quality. However, regulators should continue to monitor FDIC-supervised and -insured institutions' level and use of FHLB advances.

Community Bank Use of FHLB Advances

The upward trend in advance use by FDIC-supervised institutions coupled

[5] "Analytical Perspectives," *Budget of the U.S. Government—Fiscal Year 2005,* pp. 81–85.

with the lack of Call Report information on the composition of FHLB advances prompted the FDIC in 2002 to review the largest users of FHLB advances it supervises. The sample consisted of 79 banks; each bank had advances equal to at least 25 percent of total assets as of June 30, 2002.[6] The sample included the top ten FHLB advance users (as a percentage of assets) in each Region and area office. This supervisory review was conducted primarily to determine the types of advances community banks used (although 10 percent of the sample banks had total assets in excess of $1 billion). Of particular interest was the level of advances containing options, referred to as structured advances. Historically, such advances have been characterized by higher levels of interest rate risk and have required more rigorous risk management techniques.

In 2003, a second supervisory review was conducted to analyze trends in the types of advances community banks used, in the aggregate and among FDIC Regions and area offices. The 2003 review focused on banks with a significant increase in advances year-over-year, not only on banks with a relatively high use of advances. In addition to having a high asset concentration of advances, sample banks displayed at least a 25 percent increase in their use of advances between June 30, 2002, and June 30, 2003. Because both requirements had to be met for inclusion in the sample, the sample cutoff for advances as a percentage of assets was lowered from 25 percent to 15 percent. Although the average asset size of the banks in the sample increased in 2003, the sample population remained essentially community banks.

The survey results indicated that fixed-rate, nonstructured advances were the most popular type of advances used by sample banks in 2003 and 2002. Floating-rate advances showed a significant increase in popularity in the 2003 survey, but they remained a relatively small percentage of total advances. Structured advances accounted for just under one-third of total advances in both years. The relatively heavy use of structured advances by some institutions in the sample would not have been identified through current reporting requirements.

The review captured the dollar amount and types of structured advances

Characteristics of Banks in the Sample	June 30, 2003	June 30, 2002
Total Number of Banks	107	79
Total Assets	$128.5 billion	$41.5 billion
Average Total Assets	$680 million*	$521 million
Average FHLB Advances/Assets**	20 percent	29 percent
Banks With FHLB Advances/Assets > 35 percent	4	16
Composition of FHLB Advances		
Average Fixed-Rate Advances/Total Advances	57 percent	63 percent
Average Floating-Rate Advances/Total Advances	13 percent	5 percent
Average Structured Advances/Total Advances	30 percent	32 percent

*For the 2003 sample, average total assets excludes two large banks with $34 billion and $23 billion in total assets.

**The decline in this ratio from 2002 to 2003 is not attributed to an actual decline in use but rather to a change in the criteria for choosing banks in the sample. In the 2002 sample, each bank had advances equal to at least 25 percent of total assets; however, this ratio was changed to 15 percent for the 2003 sample.

[6]The bank population represented each FDIC Region and area office and was derived using judgmental sampling, with emphasis placed on the banks with high concentration levels and, for the 2003 review, rapid growth over the sample period.

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reported by the sample banks. The most commonly used structured advances were callable, putable, and convertible advances. The FHL Banks use various terms for these structured advance products; but for purposes of the survey, FDIC provided sample banks with the following terminology and definitions to ensure consistency. Callable and convertible advances are very similar in that the borrowing bank has effectively sold an option to the FHLB in return for a relatively low interest rate. The initial interest rates on these products are *lower* than a fixed-rate advance with the same maturity, owing to the embedded option. The interest rate remains fixed for a predetermined amount of time (lockout period), after which the FHLB has the option to call the advance or convert it to a floating-rate advance. These types of borrowings carry risk associated with the uncertainty of the option exercise. Also, when the option is exercised, it will be at a point when it is financially disadvantageous for the borrower. The FHLB charges substantial prepayment penalty fees for early payoff of an advance. Typically, the prepayment fee for an advance with an option includes the FHLB's hedge-unwind cost related to the borrowing plus the present value of the foregone profit on the advance. With a putable advance, the borrowing bank effectively purchases an option from the FHLB that allows the bank to prepay the advance without penalty on a predetermined date or dates. Because the borrowing bank controls the embedded option, the bank must pay a premium for the advance, generally in the form of an above-market interest rate. Therefore, putable advances are offered at a *higher* cost than fixed-rate advances with a similar maturity date. The FHLB System's 2003 financial report indicates that only a little over 2 percent of total advances outstanding at year-end 2003 were putable advances.

Potential supervisory concerns with structured advances include the following: (1) these products can have a significant impact on a bank's interest rate risk profile as they are used in increasing quantities; (2) they often are used as part of leverage programs that tend to focus on short-term enhancement of return on equity with a concomitant increase in the institution's risk profile; (3) several banks have recently paid substantial prepayment penalties to retire costly structured advances before maturity; and, in some instances, (4) bank management did not possess the requisite knowledge and understanding of these products to manage the risks effectively.

The 2003 sample banks appeared to have a preference for convertible advances, whereas the 2002 banks preferred callable advances. The popularity of convertible advances over other structured advances is probably an indication that the sample banks decided to take advantage of the historically low interest rate environment. Almost a year later, convertible advances could still be obtained at a very low interest rate. For example, as of April 6, 2004, several FHL Banks offered five-year convertible advances with a one-year lockout period at an initial interest rate ranging from 1.28 percent to 1.62 percent.[7]

Sample banks in various Regions showed notable differences in terms of advance composition and use.[8] In both reviews, sample banks in the Chicago Region were the heaviest users of FHLB

[7]The range of interest rates for a five-year/one-year convertible advance was obtained from FHLB–Atlanta, –Chicago, –Des Moines, and –Topeka websites as of April 6, 2004.

[8]FDIC Regions are defined as the following geographic areas: Atlanta Region (AL, FL, GA, NC, SC, VA, WV); Chicago Region (IL, IN, KY, MI, OH, WI); Dallas Region (AR, CO, LA, MS, NM, OK, TN, TX); Kansas City Region (IA, KS, MN, MO, ND, NE, SD); New York Region (CT, DC, DE, MA, MD, ME, NH, NJ, NY, PA, PR, RI, VI, VT); San Francisco Region (AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY).

advances, with advances-to-assets ratios of 26 percent in 2003 and 37 percent in 2002. For the 2003 sample banks, the *structured* advances-to-total-advances ratio ranged from a low of 3 percent in the San Francisco Region to a high of 58 percent in the New York Region.[9] In 2002, the San Francisco Region again displayed the lowest use of structured advances at 15 percent; the largest user of structured advances was the Kansas City Region at 57 percent.

In both reviews, sample banks in the San Francisco Region were the most conservative in their choice of advances. They were the heaviest users of fixed-rate advances, with fixed-rate advances-to-total-advances ratios of 77 percent in 2003 and 85 percent in 2002.[10] In 2003, three Regions (Atlanta—42 percent; Chicago—53 percent; and New York—58 percent) reported a higher percentage of structured advances than both fixed- and floating-rate advances. In 2002, four Regions (Atlanta—44 percent; Chicago—44 percent; Memphis—50 percent; and Kansas City—57 percent) reported a higher level of structured advances than all other advance products.[11] Based on the results of both reviews, we can conclude that the sample banks in the Atlanta and Chicago Regions rely heavily on structured advances.

How Community Banks Use Advances

The supervisory review asked three questions designed to gather information about how banks use advances and how well banks manage risks associated with advance use.

(1) What was the primary use of FHLB advances by each bank between June 30, 2002, and June 30, 2003?

The results of the survey indicate that advances were used primarily to fund loan growth and secondarily to buy securities and manage interest rate risk (IRR). Only 4 percent of surveyed banks used advances primarily to replace core deposit runoff.

Fund Loan Growth	34 percent
Purchase Securities	22 percent
Manage IRR	20 percent
Provide Liquidity	12 percent
Replace Core Deposits	4 percent
Pay Down Other Liabilities	4 percent
Other	4 percent
	100 percent

(2) Did the bank have a specific program, designed to enhance earnings, which matches FHLB advances with investments in earning assets (sometimes referred to as leverage or arbitrage programs)?

Forty-three percent of the sample banks used the advances as part of a leverage strategy. These strategies are intended to increase profitability by leveraging the bank's capital by purchasing earning assets using borrowed funds, often FHLB advances. Profitability may be achieved if a positive, stable net interest spread is maintained. Leveraging strategies increase assets and liabilities while decreasing the bank's capital ratios. If improperly managed, these strategies may cause increased IRR and credit risk (depending on the assets purchased) and

[9]One institution in the New York Region skews the percentage because it holds nearly $2 billion in structured advances.

[10]The fixed-rate advances-to-total-advances ratio for 2003 is skewed due to inclusion of Washington Mutual Bank (WAMU); however, WAMU is not included in the 2002 sample group.

[11]The former Memphis Region is now an area office within the FDIC's Dallas Region.

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decreased net interest margin (NIM). Structured advances are often used in leveraging strategies. Survey results indicated that sample banks in both the Atlanta and Chicago Regions were heavy users of structured advances. The two Regions accounted for 22 percent of the reported leverage programs for the 2003 review. Sample banks indicated that advances obtained for leveraging purposes primarily funded securities, such as collateralized mortgage obligations (CMOs) and mortgage pass-throughs.

(3) Did the last FDIC examination identify any weaknesses in the bank's risk management program regarding the use of FHLB advances?

FDIC regional capital markets specialists indicated that 10 percent of the sample banks had risk management weaknesses associated with FHLB advances. Deficient bank policy guidelines were the most frequently identified weakness. Other deficiencies included inadequate information provided to the board of directors on advance use, difficulty tracking the initial use of the funds, lack of a strategic plan for leverage strategies, compression of NIM because of costly advances, and lack of pre-purchase analysis and ongoing performance measurement.

Survey results are in line with recent examination data for FDIC-supervised banks. The use of advances does not play a material role in most examination ratings. Only 3 percent of FDIC-supervised banks with Composite CAMELS ratings of 3, 4, or 5 funded more than 15 percent of assets with advances, and only 7 percent of FDIC-supervised banks with poor ratings on Sensitivity to Market Risk made significant use of advances.

Consequences of Inadequate Risk Management

Is mismanagement of FHLB advances a significant problem for FDIC-supervised institutions? For some of the sampled institutions, the answer is yes. All sample banks with a composite 3 rating and a 3, 4, or 5 rating for earnings, liquidity, or sensitivity were assessed further to determine how FHLB advances factored into the examination rating. Examiner comments relative to earnings, liquidity, and sensitivity provided insight into how these banks managed the risks on both sides of the balance sheet as a result of obtaining FHLB advance funding. For the 2003 and 2002 reviews, FHLB advances contributed to the adverse examination rating for 5 percent and 16 percent, respectively, of the sample banks. The examiners' comments clearly show that improper management of FHLB advances can increase a bank's risk profile and the degree of supervisory scrutiny it may face.

The following are the most common weaknesses examiners identified for the 2003 sample banks with composite or component ratings of 3 or worse:

- repricing mismatch between advance and investment (IRR);
- expensive long-term advances relative to the cost of core deposits;
- low liquidity;
- advances used as the primary source of funding; and
- inadequate bank policies and monitoring practices.

The examiner findings for the 2002 sample banks with composite or component ratings of 3 or worse mirror those of the 2003 sample group. However,

several risk management weaknesses were unique to the 2002 sample banks:

- Leverage strategies were not evaluated to determine the impact of interest rate volatility on earnings and capital.
- IRR exposure was not maintained within established policy guidelines, resulting in a contravention to the Joint Agency Policy Statement on IRR.[12]
- IRR position was exacerbated by leverage programs.

Conclusion

The intent of this article was to draw a conclusion regarding community banks' increasing reliance on the FHLB System via FHLB advances and whether this relationship poses a supervisory concern. We examined the availability of FHLB advance data through the Call Report system, evaluating how the financial condition of the FHLB System affects financial institutions and, finally, surveying the types and degree of advance usage by community banks that are the most active users.

Based on our research and supervisory review results, we can generally assert the following:

- FHLB advances are a secondary, but growing, source of funding for community banks.
- Limitations of available reported financial information highlight the need for on-site review of potential risks associated with inappropriate use of FHLB advances.
- As indicated by a recent Moody's report, the FHLB System is in sound financial condition despite operating losses and earnings volatility experienced by several FHL Banks in 2003. However, bank regulators should continue to monitor the financial condition of the FHLB System and the outcome of regulatory reform for GSEs.
- There is steady but not excessive use of structured advances among community banks.
- Community banks are actively using FHLB borrowings to fund leverage programs.
- Most banks with a high concentration of FHLB advances (≥ 15 percent advances to assets) do not have a high level of risk management deficiencies.
- Management must continue to demonstrate a thorough knowledge of FHLB advance products, their risks, and enterprise-wide implications.

All of these observations lead us to the conclusion that FHLB advances are an important funding source for community banks when properly managed. Bank management needs to understand the terms of the advances, the risks they pose, and their impact on banks' financial condition. Our examiners will continue to ensure compliance with these sound principles.[13]

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[12]FIL-52-1996: Interest Rate Risk.

[13]Examiner guidance on FHLB advances:
- Wholesale Funding—Transmittal #2002-039, dated August 28, 2002.
- Revised Examination Guidance for Liquidity and Funds Management—Transmittal #2002-0001, dated November 19, 2001.
- Federal Home Loan Bank Advances—Transmittal #2000-046, dated August 22, 2000.

Assessing Commercial Real Estate Portfolio Risk

Introduction

Insured financial institutions have increased their exposures to commercial real estate (CRE) lending at a time when CRE market fundamentals remain weak. To understand the potential portfolio risk, bank supervisors must "get behind the numbers" and review CRE lending practices to determine the nature and extent of the exposure. A horizontal review of selected community banks in the Atlanta metropolitan statistical area (MSA) shows that their CRE exposures are concentrated in residential construction and owner-occupied commercial real estate. CRE lending practices at the selected banks were stronger than those prevailing in the early 1990s.

The Atlanta CRE review was a pilot program the FDIC is replicating in other markets on the basis of perceived risks. For a relatively modest investment by the FDIC and the selected banks, the program provides a rapid assessment of issues that may need to be addressed in this traditionally higher-risk lending segment. The program also reinforces the need for banks to engage in sound CRE lending practices. This article identifies elements that are critical to a strong, well-managed lending program.

CRE Market Conditions

Following several quarters of deterioration nationwide, CRE conditions stabilized in late 2003, with vacancy rates peaking or retreating slightly in many metropolitan markets. Office markets weakened precipitously after 2000 owing to the loss of white-collar jobs during the economic downturn and subsequent weak recovery. Continued weak employment growth during the economic recovery has forestalled greater absorption of CRE space.

Tepid economic growth following the recession, combined with anxiety about travel following the 9/11 attacks, contributed to prolonged weakness in revenue per available room in several hotel markets. Retail markets have been comparatively resilient, as consumer spending remained remarkably robust in contrast to previous economic downturns. Industrial and warehouse market conditions have suffered from prolonged losses in manufacturing employment and a low inventory-to-sales ratio stemming from strong consumer sales. Multifamily housing has been hurt by an increase in the number of new homeowners, in part due to low interest rates. Although it appears that deterioration in CRE markets may have bottomed out, sustained economic growth and more rapid gains in employment and wages will be necessary to foster a recovery.

Key developments have changed the dynamics of the CRE sector. Public markets now play a much larger role in CRE financing. Greater public involvement began with the development of the commercial mortgage-backed securities (CMBS) market in the early 1990s. The success of the CMBS market then contributed to tremendous growth in the secondary market for distressed properties. The CMBS market has grown to more than $550 billion. In the mid-1990s, real estate investment trusts (REITs) also became a major force in financing CRE, with more than a sevenfold increase in market size in the past ten years. It also appears that the CMBS and REIT markets have taken on a larger share of the traditionally higher-risk types of loans.

The quality, availability, and timeliness of market information and data have improved significantly. The CRE market also has benefited from the recent prolonged low interest rate environment. Cash-strapped property owners have

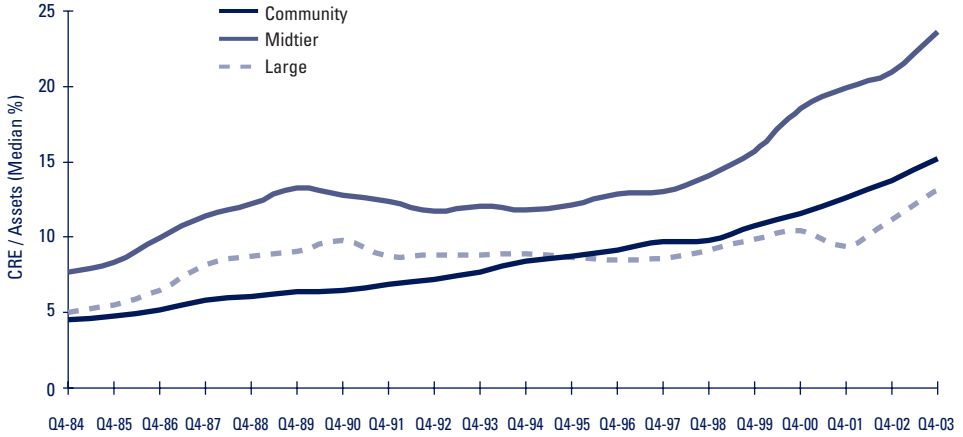
been able to lower debt service burdens through refinancing or a contractual variable rate. The combination of these factors has constrained wide cyclical swings in the performance of the CRE sector.[1]

Trends in Bank CRE Portfolio Exposures

During the past 20 years, and more particularly during the past 5 years, insured institution CRE loan exposures have increased considerably. CRE lending growth has been greatest among midtier commercial banks.[2] The median exposure level of these institutions has consistently exceeded that of community and large-sized banks, with the difference among these groups widening during the past five years.[3] At year-end 2003, the median ratio of CRE loans to assets at midtier institutions was 24 percent, compared with 15 and 13 percent at community and large banks, respectively (see Chart 1).

Despite increased exposure to CRE lending and weak market fundamentals, insured institutions have not reported any significant deterioration in credit quality. Although office vacancy rates have climbed to levels seen during the early 1990s, insured institutions are reporting lower delinquencies and

Chart 1



Source: Bank Call Reports, December 31.
Note: Includes all commercial banks nationwide and excludes de novos. Community bank assets: < $1 billion; midtier bank assets: $1 – $10 billion; large bank assets: $10 – $100 billion.

[1]For more detailed information on the CRE sector, see "The Changing Paradigm in Commercial Real Estate" (proceedings of a September 12, 2003, roundtable of industry experts convened by the FDIC), ***FYI,*** October 28, 2003 (http://www.fdic.gov/bank/analytical/fyi/2003/102803fyi.html), and Thomas Murray, "How Long Can Bank Portfolios Withstand Problems in Commercial Real Estate?" ***FYI,*** June 23, 2003 (http://www.fdic.gov/bank/analytical/fyi/2003/062303fyi.html). Analysis of the CRE sector in the FDIC's Atlanta Region was presented in "A Recovery in Some Commercial Real Estate Markets Remains Constrained by Weak Economic Growth," *Atlanta Regional Perspectives,* ***Regional Outlook,*** Fall 2003 (http://www.fdic.gov/bank/analytical/regional/ro20033q/na/index.html).

[2]Midtier commercial banks hold assets of $1 billion to $10 billion.

[3]Community banks hold assets of less than $1 billion, and large banks hold assets of at least $10 billion.

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charge-offs now than during that time (see Chart 2).

CRE loans are reported on Call Reports in broad categories and may be reported with limited descriptions in other publicly available financial reports. Off-site financial data are of little help in identifying the types of construction and CRE loans being financed (office, hotel, retail, industrial, residential construction), whether the project is speculative or under contract, or whether the property is owner occupied. Evaluating the risks inherent in CRE loan portfolios requires understanding portfolio composition, specific institution business strategies, and the types of risk management controls that are in place.

The Atlanta CRE Lending Pilot Program

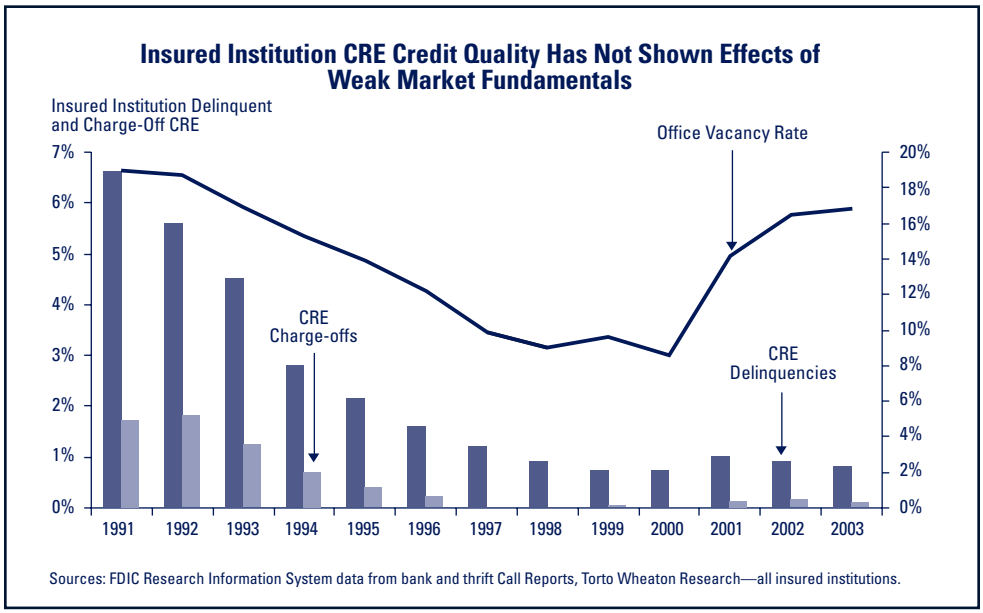
Why the Atlanta Metro Area?

The decision to launch the CRE lending pilot program in Atlanta was driven by a consideration of the weak local market conditions in tandem with the fact that a relatively high number of banks based in this area were reporting significant levels of CRE exposures.

Nationally, the percentage of banks that report CRE loans exceeding 300 percent of Tier 1 capital (traditionally a threshold that represents a relatively high concentration of CRE loans) has more than doubled in the past six years—from 14 percent in 1997 to 31 percent at year-end 2003. More than half the institutions supervised by the FDIC's Atlanta Field Office report CRE exposures that exceed this threshold. Banks in this area have reported an increase in CRE loan exposures of roughly 197 percent since fourth quarter 1999, to 453 percent of Tier 1 capital at year-end 2003. This compares to a national median of approximately 188 percent.

In addition, the softness in the CRE market is more pronounced in the Atlanta MSA, where employment has declined and vacancy rates are high. The current vacancy rate of 22 percent for office space and 15.8 percent for industrial space significantly exceeds the national averages of 16.8 percent and 11.6 percent, respectively. High vacancy rates in the Atlanta MSA increase the vulnerability of insured institutions to a potential decline in CRE property values.

Chart 2



Sources: FDIC Research Information System data from bank and thrift Call Reports, Torto Wheaton Research—all insured institutions.

An Overview of the Pilot Program

Given increasing exposures, weak market fundamentals, and lack of detailed off-site financial data, in 2003 the FDIC developed and implemented a pilot program to better assess the risk in insured institution CRE loan portfolios and evaluate the adequacy of risk management practices and controls. Another goal of the program is to more thoroughly understand how banks with relatively high levels of CRE exposures identify concentrations and what techniques they use to monitor market conditions.

FDIC staff explained the pilot project to the sample banks and asked them to report detailed CRE data on a worksheet. The worksheet breaks down broad CRE loan categories into smaller, more specific loan types (e.g., existing retail, office development) and assigns them to risk groupings.

Site visits were conducted at 67 banks determined to have elevated levels of CRE exposures to verify data and review policies and practices. On the basis of the composition of the CRE loan portfolio and a review of lending practices and procedures, each bank in the sample was assigned a risk management profile of Strong, Satisfactory, Fair, or Unsatisfactory (see text box).

Risk Management Profiles

Strong

- Higher levels of owner-occupied CRE and residential construction under contract loans
- Strong underwriting and credit administration procedures
- Loan review and board reporting are usually thorough and timely
- Demonstrate the strongest identification, measuring, monitoring, and control of risks
- Low volume of past-due loans
- Exhibit the highest level of regulatory compliance

Satisfactory

- Higher percentage of development CRE loans and speculative residential construction loans
- Overall risk management is sound and risks are mitigated and controlled
- Satisfactory identification, measuring, monitoring, and control of risks
- Adequate board reporting

Fair

- Higher concentration of CRE development loans
- Loan policy risk limits and management's identification, measuring, monitoring, and control of risks warrant improvement
- Generally high volume of technical exceptions and past-due loans

Unsatisfactory

- Larger volume of higher-risk loan types
- Significant weaknesses in risk management
- May have high levels of adversely classified assets and past-due loans
- Banks are of significant regulatory concern

Results of the Pilot Program

Results show that area bankers are generally knowledgeable about CRE market conditions in the Atlanta MSA. In addition, insured institution risk controls and monitoring programs have improved significantly since the early 1990s. Overall, bank management has implemented more effective grading systems, improved control and approval limits, and adequate loan review procedures. Bankers understand current conditions and issues in submarkets and have access to a broader range of market information.

The pilot project showed that insured institution CRE exposures were centered in one- to four-family residential real estate development projects and owner-occupied commercial real estate—with limited involvement in speculative retail and office building construction loans. (See Chart 3 for an aggregate portfolio breakout.)

Banking necessarily involves the willingness to accept and manage risks, and this review provided insights into what CRE risks Atlanta community banks have accepted and how they are managing those risks. Active involvement in the financing of owner-occupied CRE involves a bet on the health of the local

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economy. The performance of exposures to residential construction depends on the financial health of local builders and developers, which in turn depends on Atlanta house price trends and indirectly on the behavior of interest rates. For both types of exposures, important risk mitigants include portfolio diversification and appropriate loan underwriting strategies. For the most part, the sampled banks appeared to be making effective use of such risk mitigants.

However, the pilot program also identified weaknesses in CRE lending programs among some insured institutions, including the following:

- Lack of adequate cash flow analysis
- Weak real estate appraisal review processes
- Inconsistent compliance with board reporting requirements and regulatory loan-to-value guidelines
- Inadequate management information systems regarding loan stratifications and risk designations
- Miscoded loan data and Call Report errors
- Limits for speculative loans that often were not established on an aggregate basis, but only by individual borrower

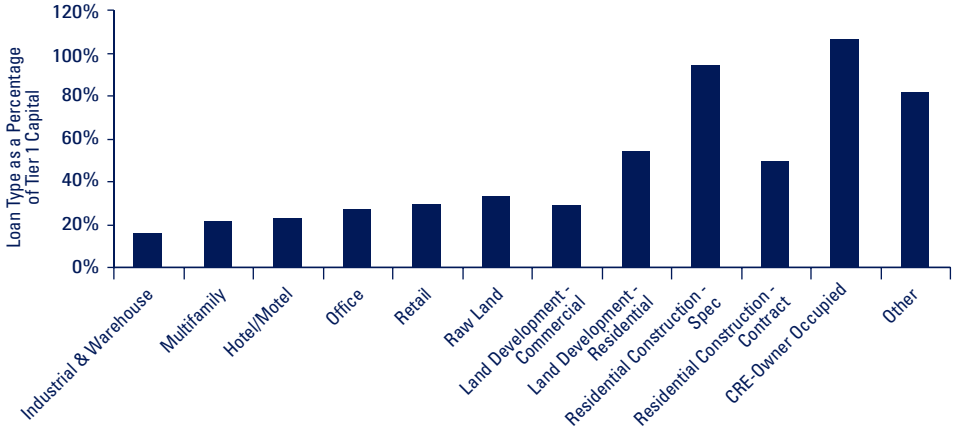
The results reinforced the need for enhanced identification of concentration risk and tools to monitor market conditions. The insights gained from the pilot program helped examiners allocate resources more efficiently in the risk-scoping and examination-scheduling processes. In addition, the program promoted communication between examiners and bankers about CRE market conditions and loan exposures, lending practices, and regulatory policies and priorities. Bankers were generally supportive of the project; some indicated that they intended to use the CRE worksheet for internal reporting and monitoring. The Atlanta Region is now planning to implement a similar review in selected markets, including parts of Florida and North Carolina, and the program also has been adopted in other Regions.

Results of the Pilot Program Reinforce the Importance of Sound CRE Lending Practices

The weaknesses identified through the pilot program confirm the need for bank management to develop and implement lending programs that incorporate certain key components. A sound CRE lending program begins with board of directors and senior management direction and

Chart 3

Composition of Atlanta Community Bank Portfolios Is Focused on Traditionally Lower Risk CRE Credits



Source: Data provided by banks included in the Atlanta CRE Pilot Program.

oversight. Developing and adhering to a comprehensive loan policy that establishes clear and measurable standards for production, underwriting, diversification, risk review, reporting, and monitoring are critical. Within this context, certain elements are integral to strong, well-managed CRE lending programs:

Well-defined Underwriting Standards: Clear limits, expectations, and monitoring systems should be established.

Effective Due Diligence: Obtaining financial statements, market analysis, borrower background information, project schedules, and detailed property information is imperative.

Established Concentration Limits: Diversification standards by portfolio, property type, market area/submarkets, builder(s), and risk grades need to be established and enforced.

Strong Appraisal Review Process: An independent review that evaluates appraiser qualifications and the impact on assessed values under stressed scenarios is critical.

Formal Approval Process and Loan Administration Procedures: Comprehensive loan presentations that include the strengths and weaknesses of the credit should be submitted to the appropriate committees for approval. Insured institutions also should implement procedures to ensure adequate segregation of loan administration duties.

Comprehensive Risk Measurement and Monitoring: Segmenting CRE portfolios by product, geographic location, office, officer, and risk grade enhances the early identification of potential weaknesses and aids in the development of proactive risk mitigation strategies. More sophisticated CRE risk management programs include the ability to analyze the impact of changing interest rates or market fundamentals on debt service and collateral valuations at the portfolio level.

Conclusion

CRE lending programs consist of a broad array of products that present a range of risks. Although softness may exist in many CRE markets, financial reporting limitations may have contributed at times to overly negative assessments of the potential risks to insured financial institutions. The type of lending products insured institutions offer and their risk management practices may mitigate the potential risk. Most of the sampled banks appeared to be doing a good job of managing the risks associated with their most important exposure categories—residential construction and owner-occupied CRE.

Growth in CRE portfolios during a time of weak market fundamentals warrants a careful and complete risk assessment that reaches beyond financial statement presentations. The types of loans institutions make can vary widely from area to area and from bank to bank. Therefore, particularly in an environment of weak CRE fundamentals when interest rates could rise, supervisors must "get behind the numbers" to assess the extent of portfolio risk. The results of the Atlanta pilot program show that greater understanding of a bank's CRE lending risk profile, as well as the controls and monitoring programs, can improve examiners' ability to risk-focus examinations.

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From the Examiner's Desk...

This regular feature focuses on developments that affect the bank examination function. We welcome ideas for future columns, and readers can e-mail suggestions to ***SupervisoryJournal@fdic.gov.***

More than two-and-a-half years have passed since President Bush signed the USA PATRIOT Act into law in October 2001.[1] The USA PATRIOT Act strengthened measures to prevent, detect, and prosecute terrorism and international money laundering activities. The banking agencies have issued new anti–money laundering (AML) regulations during the past year. This article surveys some of the issues these regulations have raised for bankers and examiners.

Information Sharing and Customer Identification Programs Are Key Components of Bank Compliance

Two sections of the USA PATRIOT Act have generated the greatest volume of inquiries from banks and industry trade groups—Section 314 (Information Sharing) and Section 326 (Customer Identification Program).[2] As part of its compliance with Section 314, the Financial Crimes Enforcement Network (FinCEN) fields law enforcement requests for searches of names believed to be involved in money laundering or terrorist financing activity. Twice a month, FinCEN forwards a list of these names to all insured institutions and asks them to try to match these names with certain records covering a particular period of time.

During the past 15 months, FinCEN has consulted with financial institution regulatory agencies, the banking industry, trade groups, and federal law enforcement personnel and is now prioritizing the names subject to Section 314(a) requests. Law enforcement has benefited significantly from this program (see inset box). Many of the banks' positive responses have resulted in the identification of new criminal accounts and transactions and have helped law enforcement allocate scarce resources. Examples of initial successes include identification of the following: a Hawala operation involving a blocked country, arms and drug traffickers, alien smuggling resulting in fatalities, an international criminal network involved in identity theft and wire fraud, and a nationwide investment fraud scheme.[3] Although the government is in the early stages of prosecuting these cases, the Information Sharing program has contributed to law enforcement success in these areas.

Section 326 of the USA PATRIOT Act modifies the Bank Secrecy Act (BSA) and requires banks to develop a Customer Identification Program (CIP) that verifies customer identity, compares names with terrorist lists, and maintains appropriate recordkeeping. The CIP final rule took effect on June 8, 2003; however, financial institutions had until October 1, 2003, to implement a customer identification program. The design and implementation

Initial Results from the Information Sharing System

The Section 314(a) system has processed 188 law enforcement requests submitted from February 18, 2003, through November 25, 2003. Of these cases, 124 were related to money laundering and 64 cases were related to terrorism or terrorist financing. There were 1,256 subjects of interest in these investigations. Of these, financial institutions responded with 8,880 matches, resulting in the discovery or issuance of the following:

795	New accounts identified
35	New transactions
407	Grand jury subpoenas
11	Search warrants
29	Administrative subpoenas/summons
3	Indictments

[1]The complete title of this legislation is "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001." Sections 314 and 326 (included in Title III of the Act) are not subject to the sunset provisions that apply to other subtitles of the USA PATRIOT Act. Section 324 of the USA PATRIOT Act requires the Secretary of the Treasury, along with the Attorney General, the banking agencies, the NCUA, and the SEC to evaluate the operations of the provisions of Title III of the Act and make recommendations to Congress as to any legislative action, if deemed necessary or advisable.

[2] The implementing rules for Section 314 of the USA PATRIOT Act are the Department of the Treasury's Financial Recordkeeping and Reporting Regulations, Sections 103.100 and 103.110. The implementing rules for Section 326 of the Act are the Department of the Treasury's Financial Recordkeeping and Reporting Regulations, Section 103.121 and the FDIC Rules and Regulations, Section 326.8(b)(2).

[3]Hawala (also known as hundi) is a money transfer system without formal recordkeeping procedures that is used primarily in the Middle East, Africa, and Asia.

of a CIP vary from bank to bank. Small, community-based banks tend to know virtually all their customers; however, these institutions must document their programs in writing. On the other hand, larger banks have a greater client base and must implement tighter controls to verify customers' identities. Banks must formally consider what risks they will accept. For example, what documents will they accept as identification? When developing their CIP, bankers may raise questions about how thoroughly some foreign governments check the identities of individuals requesting foreign identification documents. In these cases, bank management must determine which foreign identification forms are acceptable.

Bankers also are keenly interested in CIP requirements for trust accounts, an evolving compliance area. Key issues that must be addressed include identifying the customer, trustee, and source of funds, as well as determining how the bank should verify identities on trust accounts. These issues have been discussed on an interagency basis, and guidance is expected to be issued in the near term. Given the newness of the CIP requirements, examiners should be aware that many bankers will need additional training and guidance.

Changes in the BSA Affecting Nonbank Entities

Provisions of the USA PATRIOT Act require all financial institutions, including money service businesses (MSBs) such as currency exchanges and money transmitters, to comply with the BSA and anti–money laundering requirements. All MSBs, as defined in the USA PATRIOT Act, were required to register with FinCEN by December 1, 2003. These businesses are licensed by the state but are examined for compliance by the Internal Revenue Service (IRS). The IRS is responsible for more than 160,000 MSBs and approximately 600 casinos or other gaming organizations in some 30 states, territories, and tribal lands. The CIP requires that MSBs perform due diligence on MSB customers just as the CIP requires banks to perform due diligence on bank customers. In addition, if a bank has an MSB customer, bank management must understand the MSB's business operations and its normal volume of cash transactions.[4]

Supervisory Strategies Differ among Banks

Supervisory strategies depend greatly on the nature of a specific bank's activities. For example, many community banks have very few foreign correspondent or payable-through accounts. For institutions with the potential for higher-risk transactions and activities, an examiner would be expected to expand the examination procedures appropriately. Examples include the following: reviewing cash transactions by sub-account holders, reviewing the audit of the foreign bank's operations, evaluating the institution's process for identifying foreign correspondent account holders, and determining the adequacy of the account approval process if the institution has an international correspondent relationship with a bank in a bank secrecy or money laundering haven.[5]

[4]The CIP is a "gatekeeper rule" in that it relates to the responsibility of financial institutions to know with whom they are doing business. As a means of reporting suspicious activities, the FDIC and other agencies encourage banks to perform due diligence and account monitoring for high-risk customers, such as MSBs.

[5]FDIC BSA guidelines have expanded procedures that identify steps to be taken when a financial institution is involved in activities that have a greater risk potential. The guidance was released publicly on October 17, 2003, and can be found at www.fdic.gov/news/news/financial/2003/fil0379.html.

From the Examiner's Desk...

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Cooperation among Federal Bank Regulatory Agencies Is Critical

To strengthen the enforcement provisions of the USA PATRIOT Act, representatives from the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision meet monthly to share information and best practices. Bank regulators also are working with federal law enforcement organizations (see inset box). This high level of commitment to national and global working groups that deal with USA PATRIOT Act issues and initiatives is notable.

Bankers and Regulators Work Together to Ensure Compliance

Compliance with provisions of the USA PATRIOT Act has received a great deal of attention during banker outreach meetings. A key issue raised by bankers is the lack of prompt feedback related to the filing of Currency Transaction Reports (CTRs). Approximately 12 million CTRs are filed annually, and, although it is not evident in all instances, federal and local law enforcement officials report that the data are extremely useful. However, understanding the need for CTR feedback, FinCEN, in consultation with the bank regulatory agencies, is evaluating options for

Interagency Groups

National BSA Advisory Group

- Meets twice a year
- Addresses anti–money laundering issues and initiatives
- Includes representatives from the FDIC, Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), Conference of State Bank Supervisors (CSBS), bank trade groups, some large banks, the gaming industry, auto dealers associations, and the U.S. Securities and Exchange Commission (SEC)

Federal Bank Fraud Working Group

- Meets monthly
- Addresses current and emerging fraud issues
- Includes representatives from the Federal Bureau of Investigation (FBI), Internal Revenue Service (IRS), U.S. Department of Justice, FDIC, Federal Reserve, National Credit Union Administration (NCUA), FinCEN, OCC, OTS, U.S. Postal Inspection Service, Bureau of Public Debt, and the U.S. Secret Service

Financial Systems Assessment Team (FSAT)

- Meets biweekly
- Works with countries that may be vulnerable to money laundering or terrorist financing. FSAT works with the judicial system, law enforcement personnel, and financial regulators in these countries to identify any potential problem areas, and provides training and technical assistance
- Sponsored by the U.S. State Department and includes representatives from FinCEN, U.S. Customs and Border Protection, OCC, Federal Reserve, FDIC, FBI, and other representatives from the Treasury and State Departments

providing input to the industry. FinCEN provides feedback on Suspicious Activity Reports (SARs) through SAR Activity Reviews (see links to recent reviews in the inset box). The SAR Activity Reviews are products of close collaboration among financial institutions, federal law enforcement officials, and federal regulatory agencies. The SAR Activity Reviews provide meaningful information about the preparation, use, and value of SARs filed by financial institutions.

As bankers implement and refine compliance programs, they are asking for guidance about what works and what doesn't work. They are concerned about relationships with foreign accounts, particularly those in the Caribbean. Guidance on these and other issues related to the USA PATRIOT Act exists in the form of Financial Institution Letters (FILs) and Frequently Asked Questions (FAQs) available on the FDIC's external website, www.fdic.gov. The FDIC has a website that is devoted specifically to issues related to BSA compliance and anti–money laundering activities (www.fdic.gov/regulations/examinations/bsa/). Overall, bankers are doing a good job of complying with provisions of the USA PATRIOT Act. However, bankers should remain vigilant, as they serve a vital role in the fight against money laundering and terrorist financing.

Key Issues for Examiners

Compliance with provisions of the USA PATRIOT Act is of significant concern to examiners as well as bankers. Examiners must ensure that the scope of review is appropriate. Examiners need to understand the risk attributes of the specific bank and should also review workpapers, CTR filings, and SAR activity since the last examination to determine the appropriate level of exam resources. As bankers must understand their frontline role, examiners must be knowledgeable about BSA and AML compliance requirements and be prepared to communicate and explain these requirements to bankers.

Because of its importance to national security, BSA and AML will continue to receive significant attention. Expectations are that more effective use of exemptions from CTR filings will help ensure that valuable resources are not diverted from investigations of threats and actual crimes. As new money laundering techniques are identified by law enforcement personnel, compliance and enforcement procedures will continue to change. For example, FinCEN recently released information about how jewels and precious metals are being used to launder money and support terrorist financing.[6]

Conclusion

Overall, the new BSA requirements have broadened the banking industry and regulatory approach to include measures designed to detect terrorist funding, an unfamiliar concept to most before September 11, 2001. However, failure to comply carries with it costs, such as enforcement actions, including civil money penalties, heightened reputation risk, and the significant social costs associated with money laundering or terrorist financing activities. Working together, examiners and bankers can successfully navigate this new chapter in bank compliance.

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Lisa D. Arquette, Chief, Special Activities Section, contributed significantly to the writing of this article.

Links to Recent FinCEN SAR Activity Reviews

SAR Activity Review Issue 6 (November 2003)
http://www.fincen.gov/sarreviewissue6.pdf

SAR Activity Review Issue 5 (February 2003)
http://www.fincen.gov/sarreviewissue5.pdf

[6] "FinCEN Urges Cooperation Against Use of Diamond and Precious Metals Trade to Support Terrorist Financing," March 29, 2004. http://www.fincen.gov/dubaipressstmnt.pdf and Remarks by FinCEN Director William Fox before the World Diamond Council, March 30, 2004, Dubai, United Arab Emirates. http://www.fincen.gov/dubaiconferenceaddress.pdf.

Accounting News...

This regular feature focuses on topics of critical importance to the bank accounting function. Comments on this column and suggestions for future columns can be e-mailed to ***SupervisoryJournal@fdic.gov.***

Implications of New Guidance on Accounting for Purchased Impaired Loans

Introduction

In response to recent accounting guidance from the American Institute of Certified Public Accountants (AICPA), beginning in 2005 banks and examiners must take a new approach to the accounting for, and evaluation of loss allowances on, purchased impaired loans. AICPA Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer,* was issued in December 2003. When it takes effect next year, it will supersede AICPA Practice Bulletin (PB) 6, *Amortization of Discounts on Certain Acquired Loans,* which was issued in 1989. Four years later, the Financial Accounting Standards Board (FASB) released Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), which treats impairment differently than PB 6. SOP 03-3 will eliminate this inconsistency by providing updated guidance on the accounting for purchased loans that show evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the purchaser will be unable to collect all "contractually required payments receivable." Loans meeting these two criteria can be acquired individually, in a group of loans, or in a purchase business combination. However, SOP 03-3 does not apply to purchased loans that are held for trading or to purchased mortgage loans that are designated as held for sale. It also does not cover loans that a bank has originated.

Key Provisions of the New Guidance

A key principle of SOP 03-3 is a prohibition on the "carrying over" or creation of an allowance for loan losses when initially accounting for the purchase of an impaired loan.[1] The price that the purchaser is willing to pay for an impaired loan reflects the purchaser's estimate of the credit losses over the life of the loan. In the AICPA's view, using a loan loss allowance to address the collectibility of the cash flows that the purchaser does not expect to receive and, therefore, was not willing to pay for would not properly reflect the substance of the loan purchase. Thus, the AICPA concluded that loan loss allowances recorded by the purchaser of impaired loans should reflect only those losses incurred by the purchaser after acquisition and not losses incurred by the seller of the loan prior to the sale.

The SOP will change banks' current practices in accounting for purchased impaired loans. In purchase business combinations, the acquiring bank normally "carries over" the acquired institution's allowance for loan losses when it records the acquired loan portfolio at fair value. In other words, the acquiring bank typically combines the acquired institution's loan loss allowance with its own allowance as of the date of the business combination. This practice was sanctioned by the Securities and Exchange Commission in *Staff Accounting Bulletin No. 61* and has been accepted by the banking agencies for Call Report purposes. This carryover practice has also been extended, by analogy, to purchases of pools of loans where

[1]The SOP uses the terms "allowance for loan losses" and "allowance" rather than "allowance for loan and lease losses" and "ALLL."

a specifically identifiable portion of the selling institution's loan loss allowance has been allocated to the loan pool. Once SOP 03-3 takes effect, the portion of the acquired or selling institution's allowance attributable to the purchased impaired loans should no longer be carried over and added to the acquiring bank's allowance.[2]

SOP Introduces New Terminology to the Accounting Literature

Under SOP 03-3, a purchased impaired loan is initially recorded at its fair value, which normally is the purchase price (see Example 1). In a purchase business combination, such a loan would be recorded at its allocated fair value (i.e., the present value of amounts to be received determined at an appropriate current interest rate). The SOP limits the yield that may be accreted on the loan, "the accretable yield," to the excess of the bank's estimate of the undiscounted principal, interest, and other cash flows expected at acquisition to be collected on the loan over the bank's initial investment in the loan. The excess of "contractually required payments receivable" over the cash flows expected to be collected on the loan, referred to as the "nonaccretable difference," must not be recognized as an adjustment of yield, a loss accrual, or a loan loss allowance. The "contractually required payments receivable" is the total undiscounted amount of all uncollected contractual principal and interest payments, and includes payments that are past due as well as those that are scheduled for the future. Neither the "accretable yield" nor the "nonaccretable difference" may be shown on the balance sheet.

Example 1: Purchased Impaired Loan at Acquisition Date under SOP 03-3

On December 31, 20x0, Bank A purchases a loan with a principal balance of $100,000 for $63,000. The contractual interest rate on the loan is 10 percent, and annual payments of $26,380 are required each December 31. Because the December 31, 20x0, payment has not been made, accrued interest of $10,000 is delinquent. Bank A purchases this loan at a discount because of concerns about the borrower's credit quality that have arisen since the origination of the loan. Bank A determines that it is probable that it will be unable to collect all of the contractually required payments on the loan. Instead, based on its analysis of the borrower's financial condition, Bank A expects to collect $18,000 at the end of each of the next five years, which would produce an effective interest rate of 13.2 percent on the loan. Bank A would report its initial investment in the loan on its balance sheet at $63,000 on December 31, 20x0, and it would not be permitted to establish an allowance for loan losses for this loan as of that date. Other information presented in the following table, such as the outstanding balance, contractually required payments receivable, and accretable yield, would be incorporated into the disclosures in the footnotes to Bank A's financial statements.

Principal balance	$100,000
Accrued delinquent interest	10,000
Outstanding balance	110,000
Contractual interest not yet earned	21,899
Contractually required payments receivable	131,899
Nonaccretable difference	(41,899)
Cash flows expected to be collected	90,000
Accretable yield	(27,000)
Initial investment (Initial carrying amount of loan receivable)	63,000
Allowance for loan losses	0
Net loan receivable	$ 63,000

However, because these loans are impaired when they are acquired, the purchasing bank must determine whether it is appropriate to recognize the "accretable yield" as income over the life of the loan. According to the SOP, in order to apply the interest method of income recognition for a purchased impaired loan, the bank must have sufficient information to reasonably estimate the amount and timing of the cash flows expected to be collected (see Example 2). When that is not the case, the bank

[2]The FASB is developing additional guidance on procedures to follow in applying the purchase method of accounting for business combinations. As one of its tentative decisions, the FASB would prohibit the carrying over of loan loss allowances for all loans acquired in such transactions, not just purchased impaired loans. The FASB expects to issue its "purchase method procedures" proposal in the third quarter of 2004.

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should place the loan on nonaccrual status at acquisition and then apply the cost recovery method or cash basis income recognition to the loan. Under the cost recovery method, any payments received are first applied to reduce the carrying amount of the loan. Once the carrying amount has been reduced to zero, any additional amounts received are recognized as income.

Cash Flow Estimates Take on Added Importance

After the purchase of an impaired loan, the purchaser will need to regularly estimate the cash flows expected to be collected over the life of the loan based on current information and events (see Example 3). In general, a probable decrease in the cash flows that the purchaser reasonably expected to collect when the loan was acquired should be recognized as an impairment through the recording of an allowance for loan losses. Consistent with the general rule in FAS 114, this post-acquisition impairment would be measured based on the present value of expected future cash flows discounted at the purchased loan's effective interest rate.[3] On the other hand, if there is a probable significant increase in the cash flows compared with those that previously were reasonably expected to be collected, or if actual

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[3]However, as is customary for accounting standards addressing loan impairment, the SOP does not address when a loan, or a portion of a loan, should be charged off.

Example 2: Actual Cash Flows Equal Expected Cash Flows on a Purchased Impaired Loan

Bank A has determined that it has sufficient information to reasonably estimate the amount and timing of the cash flows expected to be collected on the purchased impaired loan. Thus, if Bank A were to receive the $18,000 per year that it expects to receive at the end of each of the five years of the life of the loan, this expected repayment activity would be reflected as shown in the following table. Unless one of Bank A's periodic evaluations over the life of the purchased impaired loan indicates that, based on current information and events, it is probable that the bank will be unable to collect all cash flows expected at the acquisition of the loan (see Example 3), no loan loss allowance should be established for this loan under SOP 03-3. If the actual cash flows on the loan equal the expected cash flows, Bank A's accounting for the loan over its five-year life will be consistent with the amounts in the table.

	A	B	C	D	E	F	G	H	I	J
	Contractually Required Payments Receivable	Cash Expected to Be Collected	Nonaccretable Difference (A–B)	Accretable Yield	Gross Carrying Amount of Loan Receivable (B–D)	Loan Loss Allowance	Net Loan Receivable (E–F)	Provision for Loan Losses	Cash	Interest Income
Dec. 31, 20x0	$131,899	$ 90,000	$ 41,899	$ 27,000	$ 63,000		$ 63,000		$ (63,000)	
20x1 Collections	(18,000)	(18,000)		(8,316)	(9,684)		(9,684)		18,000	$ 8,316
Balance, Dec. 31, 20x1	113,899	72,000	41,899	18,684	53,316		53,316			
20x2 Collections	(18,000)	(18,000)		(7,039)	(10,961)		(10,961)		18,000	7,039
Balance, Dec. 31, 20x2	95,899	54,000	41,899	11,645	42,355		42,355			
20x3 Collections	(18,000)	(18,000)		(5,592)	(12,408)		(12,408)		18,000	5,592
Balance, Dec. 31, 20x3	77,899	36,000	41,899	6,053	29,947		29,947			
20x4 Collections	(18,000)	(18,000)		(3,954)	(14,046)		(14,046)		18,000	3,954
Balance, Dec. 31, 20x4	59,899	18,000	41,899	2,099	15,901		15,901			
20x5 Collections	(18,000)	(18,000)		(2,099)	(15,901)		(15,901)		18,000	2,099
Balance, Dec. 31, 20x5	41,899	$ 0	41,899	$ 0	$ 0		$ 0			
Close-out	(41,899)		(41,899)							
Total	**$ 0**		**$ 0**						**$ 27,000**	**$ 27,000**

Example 3: Decrease in Cash Flows Expected After Two Years

Bank A receives the expected $18,000 at the end of each of the first two years. However, based on current information and events affecting the borrower and the loan, Bank A determines on December 31, 20x2, that the cash flows it expects to collect in each of the next three years will be reduced by $6,000 annually to $12,000 per year. Using the loan's effective interest rate of 13.2 percent, the present value of the remaining cash flows expected to be collected on December 31, 20x2, is $28,238.[4] From Example 2, the carrying amount of the loan receivable on that date before considering the reduced estimate of the cash flows expected to be collected was $42,355. Thus, the measurement of impairment on this loan on December 31, 20x2, is as follows:

Carrying amount of loan receivable	$ 42,355
Less: Present value of cash flows expected to be collected	(28,238)
Measure of impairment on December 31, 20x2	$ 14,117

Under the SOP, this impairment would be recognized through the establishment of a loan loss allowance for the loan. However, SOP 03-3 does not address when a charge-off should be taken. This example shows the allowance for this loan being maintained until the end of the loan's expected term, at which time Bank A charged off the uncollectible balance of the loan receivable (i.e., $14,117). Alternatively, Bank A could have charged off this uncollectible amount on December 31, 20x2, after establishing the allowance for the loan.

After the recognition of the impairment on the loan, the accretable yield on the loan must be recalculated to determine the amount of the adjustment to be made to this account for the future accretable yield no longer expected to be earned. The amount of the adjustment is calculated, and can be verified, as follows:

Remaining cash flows expected to be collected, December 31, 20x2		$ 36,000
Less the sum of:		
Initial investment in the loan	$ 63,000	
Less: Cash collected to date	(36,000)	
Less: Allowance and/or charge-offs	(14,117)	
Plus: Yield accreted to date	15,355	
		28,238
Remaining accretable yield as recalculated		7,762
Less: Balance of accretable yield before adjustment, December 31, 20x2		(11,645)
Adjustment needed to accretable yield		$ (3,883)

Proof of calculation:	
Total decrease in cash flows expected to be collected	$ 18,000
Present value of total decrease in cash flows (measure of impairment)	(14,117)
Adjustment needed to accretable yield (future accretable yield no longer expected to be earned)	$ 3,883

The effect of the impairment and the adjustment to reduce the accretable yield on the purchased impaired loan on December 31, 20x2, are reflected in the following table. The reduction in the accretable yield arising from the impairment will result in a decrease in the amount of interest income recognized on the loan in Bank A's earnings over the life of the loan (i.e., $23,117 in interest income in Example 3 compared to $27,000 in Example 2).

If the actual cash flows on the loan over the remaining three years of the life of the loan equal the expected cash flows and Bank A's evaluations over this period indicate no further impairment is probable, Bank A's accounting for the loan over its five-year life will be consistent with the amounts in the table.

continued next page

[4]The present value of the expected cash flows of $12,000 for each of the next three years discounted at 13.2 percent equals $28,238.

Example 3: Decrease in Cash Flows Expected After Two Years
(continued)

	A	B	C	D	E	F	G	H	I	J
	Contractually Required Payments Receivable	Cash Expected to Be Collected	Nonacc-retable Difference (A–B)	Accretable Yield	Gross Carrying Amount of Loan Receivable	Loan Loss Allowance	Net Loan Receivable (E–F)	Provision for Loan Losses	Cash	Interest Income
Dec . 31, 20x0	$ 131,899	$ 90,000	$ 41,899	$ 27,000	$ 63,000		$ 63,000		$ (63,000)	
20x1 Collections	(18,000)	(18,000)	—	(8,316)	(9,684)		(9,684)		18,000	$ 8,316
Balance, Dec. 31, 20x1	113,899	72,000	41,899	18,684	53,316		53,316			
20x2 Collections	(18,000)	(18,000)	—	(7,039)	(10,961)		(10,961)		18,000	7,039
Impairment		(18,000)	18,000	(3,883)		$ (14,117)	(14,117)	$ 14,117		
Balance, Dec. 31, 20x2	95,899	36,000	59,899	7,762	42,355	(14,117)	28,238			
20x3 Collections	(12,000)	(12,000)	—	(3,727)	(8,273)		(8,273)		12,000	3,727
Balance, Dec. 31, 20x3	83,899	24,000	59,899	4,035	34,082	(14,117)	19,965			
20x4 Collections	(12,000)	(12,000)	—	(2,635)	(9,365)		(9,365)		12,000	2,635
Balance, Dec. 31, 20x4	71,899	12,000	59,899	1,400	24,717	(14,117)	10,600			
20x5 Collections	(12,000)	(12,000)	—	(1,400)	(10,600)		(10,600)		12,000	1,400
Balance, Dec. 31, 20x5	59,899	$ 0	59,899	$ 0	14,117	(14,117)	$ 0	$ 14,117	$ 9,000	$ 23,117
Close-out	(59,899)		(59,899)		(14,117)	14,117				
	$ 0		$ 0		$ 0	$ 0				

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cash flows are significantly greater than those previously reasonably expected, the purchaser should reduce any post-acquisition loan loss allowance and adjust the amount of the "accretable yield," which should be recognized prospectively as an adjustment of the loan's yield over its remaining life.

Although the determination as to whether a loan that a bank acquires is a purchased impaired loan is to be made on an individual loan basis, the SOP permits the aggregation of individual impaired loans acquired in the same fiscal quarter that have common risk characteristics. The bank would then be able to use a composite effective interest rate and a combined set of cash flows expected to be collected for the pooled loans to simplify the ongoing accounting. The integrity of the pool should be maintained once it has been established. The bank should remove an individual loan from a pool only in the event of a foreclosure on, or a sale or charge-off of, that individual loan.

SOP 03-3 will take effect for loans purchased in fiscal years beginning after December 15, 2004. At that time, the SOP's provisions relating to the treatment of decreases in cash flows expected to be collected are to be applied prospectively to previously purchased loans that were subject to PB 6.

A Bank's Policies and Procedures Must Adequately Address the Provisions of the SOP

The banking agencies' 2001 *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations* states that the board of directors is responsible for ensuring that its institution has controls in place to

consistently determine the allowance for loan and lease losses in accordance with the institution's stated policies and procedures, generally accepted accounting principles, and applicable supervisory guidance. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio. The policy statement further notes that an institution's written policies and procedures in this area should address the institution's accounting policies for loans and loan losses and should describe its systematic allowance methodology, which should be consistent with its accounting policies for determining the allowance.

Accordingly, a bank that acquires impaired loans, including a bank that does so in purchase business combinations, should establish policies and procedures appropriate to the volume of its loan purchases and the complexity of the credits involved to ensure compliance with this new SOP. The bank's procedures should include documentation standards for the contractually required payments receivable, the cash flows expected to be collected, and the fair value (initial investment) at the acquisition date for each impaired loan because these amounts drive the accounting under SOP 03-3. The bank also should have adequate support for its assessment of whether the amount and timing of the cash flows expected to be collected are reasonably estimable. For allowance calculation purposes, the bank will need to segregate the purchased impaired loans. In addition, to satisfy the disclosure requirements of the SOP, the bank must maintain other information about its purchased impaired loans, including their outstanding balance and the related carrying amount, accretable yield, and associated post-acquisition loan loss allowance.

New Accounting Guidance Affects the Focus of Examinations

From an examination standpoint, when a bank is a purchaser of impaired loans, its policies and procedures for implementing SOP 03-3 and the related documentation should be reviewed for reasonableness and sufficiency.[5] Furthermore, when evaluating the risk and possible adverse classification of a purchased impaired loan, the examiner should focus on the recoverability of the carrying amount of the loan rather than the outstanding balance of the loan itself. If a portion of the loan's carrying amount is classified Loss, the examiner should recommend that it be charged off.

In the assessment of the bank's loan loss allowance, the purchased impaired loans should be considered separately from the bank's other loans. The examiner should review the bank's cash flow estimation process and ensure that current information and events affecting the borrower and the loan are being satisfactorily factored into the impairment analysis called for by SOP 03-3. This analysis considers whether it is probable that the bank will be unable to collect all cash flows expected at acquisition plus additional expected cash flows arising from changes in this estimate after acquisition. Significant differences between the bank's and the examiner's determination of the amount of any cash flow shortfalls on purchased impaired loans should lead to recommendations for appropriate adjustments to the loss allowances for these loans, measured in accordance with the SOP, and the charge-off of any amounts deemed uncollectible.

Robert F. Storch
Chief Accountant

[5]Until the effective date of the SOP, an examiner should verify that a bank that is a purchaser of impaired loans is or will be developing appropriate policies and procedures to implement the SOP.

Regulatory and Supervisory Roundup

This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release or Financial Institution Letter designations are included so the reader may obtain more information.

Subject	Summary
Federal Banking Agencies Issue New Guidance on Retail Payment Systems (FIL-48-2004, May 3, 2004)	The Federal Financial Institutions Examination Council issued revised guidance for examiners, financial institutions, and technology service providers regarding retail payment systems. The *Retail Payment Systems Booklet* provides guidance on the risks and risk management practices applicable to checks, card-based electronic payments, and other electronic payment media.
Federal Banking Agencies Publish Proposed Rulemaking Regarding Medical Privacy (FIL-47-2004, April 28, 2004)	The FDIC and other financial institution regulatory agencies are soliciting comment on proposed rules (Part 334 of the FDIC's Rules and Regulations) that implement Section 411 of the Fair and Accurate Credit Transactions Act of 2003 (Fact Act). Section 411 prohibits creditors from obtaining or using medical information to make credit decisions. The proposed rules contain the exceptions to Section 411 that would be permitted by the regulatory agencies. Comments were due May 28, 2004.
Federal Banking Agencies Are Designing a Shared Repository for Call Report Data (FIL-30-2004, March 18, 2004)	Under the auspices of the Federal Financial Institutions Examination Council, the federal banking agencies have collaborated on a conceptual design for a Central Data Repository to modernize the collection, validation, management, and distribution of Call Report information. October 2004 is the target date for implementation, using September 2004 Call Report data.
FDIC Proposes a New Part 324 That Would Interpret Restrictions on Affiliate Transactions (FIL-29-2004, March 17, 2004)	The FDIC's Board of Directors has proposed a new Part 324 that would interpret, for state nonmember banks, the restrictions on affiliate transactions contained in Sections 23A and 23B of the Federal Reserve Act. The proposed new rule would cross-reference the Federal Reserve Board's (FRB) Regulation W, which is the first FRB regulation to deal comprehensively with the laws that govern bank transactions with affiliates.
Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) Releases a New Currency Transaction Report (CTR) Form (FIL-28-2004, March 16, 2004)	FinCEN released a new CTR form—FinCEN Form 104—that replaces Internal Revenue Service CTR Form 4789. The new form may be used immediately; however, banks may continue to use the old form until August 31, 2004. Each financial institution must file a CTR for each deposit, withdrawal, exchange of currency, or other payment or transfer that involves a transaction in currency of more than $10,000.
FDIC Alerts Banks to the Increasing Prevalence of E-Mail- and Internet-Related Fraud (FIL-27-2004, March 12, 2004)	The FDIC issued guidance to assist financial institutions in helping their customers avoid becoming victims of the recent flood of e-mail- and Internet-related fraudulent schemes. Many of the schemes have targeted financial institution customers.
Update on Accounting for Loan and Lease Losses Is Released (FIL-22-2004, March 1, 2004)	The federal banking agencies issued guidance that addresses recent developments in accounting for loan and lease losses, specifically the status of the proposed Statement of Position, *Accounting for Credit Losses,* issued by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants. The Committee has decided to proceed only with guidance related to improving disclosures. The interagency guidance also identifies the current sources of generally accepted accounting principles and supervisory guidance regarding allowances for loan and lease losses that institutions should continue to apply.
FDIC Releases *Community Development Investment Guide* (FIL-19-2004, February 19, 2004)	The ***FDIC Community Development Investment Guide*** is designed to assist banks that are considering community development investment opportunities within the context of compliance with the Community Reinvestment Act.

Subject	Summary
Bank Agencies Announce Launch of Website on Call Report Modernization Initiative (PR-12-2004, February 12, 2004)	The federal bank regulatory agencies announced the availability of a website that provides information on the Federal Financial Institutions Examination Council's Call Report Modernization initiative. The FFIEC Call Report agencies (the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency) are building a central data repository to modernize and streamline how the agencies collect, process, and distribute bank financial data. The FIND (Financial Institutions Data—Bank Call Reports) website features a timeline, progress reports, frequently asked questions and answers, and highlights of future process changes. It provides details about project participants and how financial institutions and software vendors can participate in the initiative. The website can be accessed at www.FFIEC.gov/find.
Interagency Advisory Issued on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance (FIL-16-2004, February 11, 2004)	The federal banking agencies issued an advisory letter that discusses the appropriate accounting and reporting for deferred compensation agreements, many of which are linked to investments in bank-owned life insurance.
Bank and Thrift Agencies Publish Proposed Rulemaking Regarding the Community Reinvestment Act (FIL-15-2004, February 6, 2004)	The federal bank and thrift regulatory agencies published in the ***Federal Register*** a joint interagency notice of proposed rulemaking regarding the Community Reinvestment Act (CRA). The agencies are proposing amendments to the CRA regulations in two areas: (1) To amend the definition of "small institution" to mean an institution with total assets of less than $500 million, without regard to any holding company assets. The proposal would increase the number of institutions that are eligible for evaluation under the small institution performance standards, while only slightly reducing the portion of the nation's bank and thrift assets that is subject to evaluation under the large retail institution performance standards. (2) To amend the regulations to provide explicitly that an institution's CRA evaluation will be affected adversely by evidence of specified discriminatory, illegal, or abusive practices by the institution or by an affiliate whose loans were considered in the evaluation as part of the institution's own CRA record. Comments were due April 6, 2004.
FDIC Simplifies Deposit Insurance Rules for Living Trust Accounts (FIL-14-2004, February 4, 2004)	The FDIC issued simplified insurance rules for deposits held in connection with a living trust. The new rules became effective April 1, 2004. Under the new rules, if a bank fails, the FDIC will provide insurance coverage of up to $100,000 for each "qualifying" beneficiary entitled to a living trust account's assets upon the death of the account owner. As with the current rules, a qualifying beneficiary is defined as the account owner's spouse, children, grandchildren, parents, and siblings. However, unlike the current rules, the new rules will not limit FDIC insurance coverage if there are defeating contingencies in the trust agreement. The new rules also eliminate the requirement that beneficiaries of living trust accounts be named in the records of the depository institution.
FDIC Broadens Use of Streamlined "Merit" Examination Program (FIL-13-2004, February 4, 2004)	The FDIC has expanded the use of its streamlined examination program called "MERIT" (for **M**aximum **E**fficiency, **R**isk-**F**ocused, **I**nstitution-**T**argeted Examinations). Well-rated insured banks with total assets of $1 billion or less (up from $250 million or less) are now eligible for examination under the streamlined program. During a MERIT examination, examiners focus on the overall assessment of the institution's risk management processes and tailor the extent of transaction testing to the specific risk profile of each bank.
Banking Agencies Solicit Comments on Reducing Regulatory Burden from Lending-Related Consumer Protection Rules (FIL-10-2004, January 22, 2004)	In accordance with the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the federal banking agencies are seeking comments on any lending-related consumer protection rules that bankers believe are outdated, unnecessary, or unduly burdensome. Comments and suggestions were due April 20, 2004.

Regulatory and Supervisory Roundup

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Subject	Summary
FDIC Expands Fair Lending Examination Specialist Program Nationwide (PR-4-2004, January 15, 2004)	The FDIC announced that it has expanded its fair lending examination program nationwide by appointing examination specialists in each of its six Regions. The fair lending examination specialists in each Region will help ensure implementation of fair lending examination requirements, provide consultation and guidance to compliance examiners during examinations, conduct or participate in large or complex fair lending examinations, coordinate fair lending consumer complaint investigations, and coordinate ongoing fair lending communications and training within each Region.
Federal Regulators Seek Public Comment on Ways to Improve Privacy Notices (FIL-8-2004, January 15, 2004)	Eight federal regulators issued an advance notice of proposed rulemaking (ANPR) requesting public comment on ways to improve the privacy notices financial institutions provide to consumers under the Gramm-Leach-Bliley Act. The ANPR (published in the ***Federal Register*** on December 30, 2003) describes various approaches that the agencies could pursue to allow or require financial institutions to provide alternative types of privacy notices that would be more readable and useful to consumers. It also seeks comment on whether differences between federal and state laws pose any special issues for developing a short privacy notice. The ANPR was developed jointly by the Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Trade Commission, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Securities and Exchange Commission. Written comments were due by March 29, 2004.
FDIC Issues Guidance on Spousal Signature Provisions of Regulation B (FIL-6-2004, January 13, 2004)	The FDIC issued guidance to help financial institutions comply with the marital status and spousal signature provisions of the Equal Credit Opportunity Act and Regulation B.
Interagency Guidance Released on the Application of the "Customer Identification Program" (FIL-4-2004, January 9, 2004)	The federal banking, thrift and credit union regulatory agencies, the Financial Crimes Enforcement Network and the Department of Treasury issued guidance in the form of Frequently Asked Questions on how institutions should implement a written risk-based Customer Identification Program as required by Section 326 of the USA PATRIOT Act.
Policy Statement Issued on Financial Institutions Providing Financial Support to Advised Investment Funds (FIL-1-2004, January 5, 2004)	The federal banking and thrift supervisory agencies issued a Policy Statement alerting financial institutions to the safety and soundness and legal issues involved in providing financial support to investment funds advised by the institution or its subsidiaries or affiliates. The Policy Statement makes clear that a financial institution should *not* inappropriately place its resources and reputation at risk for the benefit of the fund's investors and creditors; violate the limits and requirements contained in applicable laws or regulations or in any special conditions imposed by the supervisory agencies; or create an expectation that it will prop up an advised fund. The Statement sets forth the agencies' expectations regarding the nature of controls that financial institutions should have in place over investment advisory activities and further provides that financial institutions should notify and consult with their primary federal regulator before or, in the event of an emergency, immediately after providing financial support to an advised fund.

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