

# Recent Developments Affecting Depository Institutions

by Lynne Montgomery\*

## REGULATORY AGENCY ACTIONS

### Interagency Actions

#### ***Final Patriot Act Regulations on Customer Identification***

On April 30, 2003, the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the Department of the Treasury and its Financial Crimes Enforcement Network issued final regulations requiring certain financial institutions to establish procedures to verify the identity of new account holders. The regulations implement section 326 of the USA Patriot Act, which mandates that rules be issued requiring financial institutions to implement reasonable procedures to (1) verify the identity of a person opening an account, (2) maintain records of the

information used to verify the person's identity, and (3) determine whether the person appears on any list of known or suspected terrorists or terrorist organizations. The rules apply to banks and trust companies, savings associations, credit unions, securities brokers and dealers, mutual funds, futures commission merchants, and introducing brokers. Institutions subject to the final rules will be required to establish a program for obtaining identifying information from customers who open new accounts. Financial institutions are also required, among other things, to set forth procedures for verifying the identity of customers within a reasonable period of time. Financial institutions must be in full compliance with the new regulations by October 1, 2003.

*PR-FRB, 4/30/03.*

#### ***Guidance on Managing Credit-Card Accounts***

On January 8, 2003, the FRB, the OCC, the OTS, and the FDIC issued guidance on account management and loss-allowance practices for credit-card lending and called for conservative management of credit-line assignments. The guidance outlines the supervisory agencies' expecta-

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

tions for prudent risk-management, income-recognition, and loss-allowance practices. The guidance, which applies to all banks and thrift institutions, requires that lenders justify their credit-management decisions with careful analysis of borrower repayment history, risk scores, and other relevant criteria. The guidance is intended to help financial institutions conduct credit card lending activities in a safe and sound manner while meeting the needs of their customers. The agencies developed the guidance in response to recent examinations that disclosed a number of inappropriate account-management, risk-management, and loss-allowance practices.

*BBR, 1/13/03, p. 40.*

### **Advisory on Mortgage Banking Activities**

The FRB, the OCC, the OTS, and the FDIC on February 24, 2003, issued an advisory letter providing guidance on mortgage banking activities. The guidance, which applies to all banks and thrift institutions, was developed in response to recent examinations and market developments. The guidance details the agencies' expectations regarding risk-management activities, including valuation and modeling processes, hedging activities, management information systems, and internal audits. The guidance also states that the agencies may require additional capital from institutions that fail to incorporate into their risk-management programs the sound practices set forth in the advisory letter. *PR-14-2003, FDIC, 2/25/03.*

## **Federal Deposit Insurance Corporation**

### **Final Rule on Limited Liability Companies**

On January 31, 2003, the FDIC adopted a final rule making banks that are organized as limited liability companies (LLCs) eligible for federal deposit insurance. An LLC offers an optional business organization model that has both the limited liability benefits of a corporation and the "pass-through" taxation benefits of a partnership. Under the new rule, the regulators will retain their bank supervisory powers over banks operating as LLCs, including the power to take prompt correc-

tive action and issue enforcement orders to LLC banks that become critically undercapitalized. *BBR, 2/3/03, pp. 195-96.*

### **Bank Failure**

On February 7, 2003, the California Commissioner of Financial Institutions closed Southern Pacific Bank, Torrance, California, and named the FDIC as receiver. Beal Bank, S.S.B., Plano, Texas, paid the FDIC a premium of \$500,000 to assume approximately \$834.0 million of Southern Pacific's insured deposits and to purchase approximately \$201.5 million of the failed bank's assets. The FDIC estimates that the cost of the failure to the Bank Insurance Fund will be \$134.5 million. This was the first failure of an FDIC-insured institution in 2003 and the first bank failure in California since 2000. *PR-11-2003, FDIC, 2/7/03.*

## **Federal Reserve Board**

### **Identity Theft Booklet**

On January 16, 2003, the Federal Reserve Bank of Boston released a new booklet designed to help consumers protect themselves against identity theft. The *Identity Theft* booklet describes some common sense precautions consumers should take to protect personal information, shows consumers how to monitor for signs of identity theft, and offers a guide for consumers whose identities have been stolen. The booklet also has contact information for the national credit bureaus, federal agencies, and nonprofit organizations that advise consumers and businesses. The booklet is available online at the Federal Reserve Bank of Boston's Web site: <http://www.bos.frb.org/consumer/identity/index.htm>. *PR-FRB, 1/16/03.*

### **Updated Check-Processing Operations**

The Federal Reserve Banks on February 6, 2003, announced changes to their back-office check-processing operations intended to improve operating efficiency and reduce check-cashing costs to the government. Reflecting the ongoing shift in

consumer and business preferences from checks to electronic payments, the Reserve Banks intend to reduce their check service operating costs through a combination of streamlining their check management structure, reducing staff, and consolidating their check-processing locations. Check payments continue to be the most popular form of noncash retail payment; however, their share of all noncash retail payments has declined from 85 percent in 1979 to 60 percent today. The changes, which are projected to be completed by the end of 2004, are expected to reduce operating costs for check services by approximately \$60 million in 2005 and \$300 million over the subsequent five years. *PR-FRB, 2/6/03; BBR, 2/10/03, p. 242.*

### ***Amendments to Regulation B—Equal Credit Opportunity Act***

On February 19, 2003, the FRB approved a final rule amending Regulation B, which implements the Equal Credit Opportunity Act (ECOA). The ECOA prohibits discrimination on the basis of a credit applicant's national origin, marital status, religion, color, sex, race, age, receipt of public assistance benefits, or the exercise of rights under the Consumer Credit Protection Act. The FRB in 1976 adopted a general prohibition against nonmortgage lenders' inquiring about applicant characteristics. The final rule creates an exception that allows nonmortgage lenders to collect data about borrowers' personal characteristics as long as the lenders keep the data confidential and use the information to assess their own compliance with the ECOA. *PR-FRB, 2/19/03.*

### ***Online Resource Center***

The FRB announced on March 28, 2003, the launch of an online resource for researchers, educators, program directors, and others interested in advancing financial education programs. The resource—the Financial Education Research Center—was developed by the Federal Reserve Bank of Chicago to encourage research and disseminate information through its repository of studies related to financial education and its listing of major financial education programs

throughout the country. The Web site for the Research Center is [www.chicagofed.org/cedric/index.cfm](http://www.chicagofed.org/cedric/index.cfm). *PR-FRB, 3/28/03.*

## **Office of the Comptroller of the Currency**

### ***Simplified Application Process***

The OCC announced on March 21, 2003, a new national bank service that simplifies the corporate application process. National banks can use the new "E-Corp" system to electronically complete and submit branch and relocation applications to the OCC. E-Corp is available on National Banknet, the OCC's secure extranet Web site available exclusively to national banks. E-Corp is one component of the agency's continuing effort to eliminate unnecessary regulatory burden, simplify administrative processes, enhance communications, reduce paperwork, and take full advantage of e-government mandates.

*NR 2003-24, OCC, 3/21/03.*

## **Office of Thrift Supervision**

### ***Appointment of Gilleran as FFIEC Chairman***

OTS Director James E. Gilleran was named Chairman of the Federal Financial Institutions Examination Council (FFIEC) for a two-year term beginning April 1, 2003. Mr. Gilleran succeeds Donald E. Powell, Chairman of the FDIC. Mr. Gilleran was sworn in as director of the OTS on December 7, 2001. Before joining the OTS, he served as chairman and chief executive officer of the Bank of San Francisco from 1994 to 2000 and as superintendent of the California State Banking Department from 1989 to 1994. He also served as chairman of the Conference of State Bank Supervisors (CSBS) from 1993 to 1994 and as a member of the CSBS's Bankers Advisory Council until 2000. From 1991 to 1992, Mr. Gilleran was chairman of the State Liaison Committee of the FFIEC. *OTS 03-14, 4/1/03.*

### ***Guidance on Third-Party Arrangements***

On March 19, 2003, the OTS issued a bulletin offering guidance to federal thrift institutions on how to monitor the operational and financial performance of third-party firms that provide key business services. The guidance, published in *Thrift Bulletin 82*, cautions institutions to exercise appropriate due diligence before entering into third-party arrangements and to maintain effective oversight and controls for the duration of the arrangement. OTS examiners will review internal controls and management of third-party arrangements when conducting safety-and-soundness examinations. Thrift institutions contract with third-party firms who provide security services, tax services, legal advice, and an array of other services. This guidance complements existing OTS guidance on third-party arrangements in two other prominent areas: information technology and internal audits.

*OTS 03-10, 3/10/03; BBR, 3/24/03, p. 502.*

## **National Credit Union Administration**

### ***Appointment of Johnson as Vice Chair***

On January 15, 2003, the NCUA Board of Directors named board member JoAnn Johnson as the board's vice chair. The three-member board has been without a vice chair since 1997. Before joining the NCUA board in March 2002, Ms. Johnson was a member of the Iowa Senate, having been elected to that body in 1994. She chaired the Senate's Ways and Means Committee from 1996 to 2000 and the Commerce Committee from 2000 until resigning her seat to join the NCUA board. *NR03-0115, NCUA, 1/15/03.*

### ***Broader Access to SBA Loan Program***

A February 14, 2003, legal ruling by the Small Business Administration (SBA) allows all credit unions to seek SBA approval to participate in the SBA's guaranteed business loan program under Section 7(a) of the Small Business Act (the SBA

guarantees up to 85 percent of Section 7(a) loans). When the guaranteed business loan program was first established, the SBA allowed all credit unions to participate. However, ten years ago the SBA reinterpreted its regulations to mean that only credit unions whose members had a geographic common bond were eligible because only those credit unions were considered "open to the public," as required by SBA rules. Other credit unions—such as those bound together on the basis of common occupational relationships—were not considered open to the public and were therefore ineligible. Under the new ruling, all credit unions are once again eligible to seek approval for participation in the program. *BBR, 2/24/03, p. 350.*

### ***Updated Chartering and Membership Rules***

On March 27, 2003, the NCUA adopted a regulation that revises federal credit union chartering and field-of-membership rules by expanding the choices for groups that wish to establish federally chartered credit unions. The regulation allows a proposed field of membership to include a trade, industry, or profession. Another major feature of the regulation is a provision for single-sponsor credit unions that allows a field of membership to be diversified beyond a single employer. The regulation also provides that multiple-group occupational credit unions with fewer than 3,000 members no longer need an economic analysis to determine if each group could sustain a separate credit union. In addition, the regulation assumes that any metropolitan statistical area with a population of up to 1 million can serve as the credit union's local community. *NR03-0327, NCUA, 3/27/03.*

### ***Foreign Branching***

The NCUA adopted a final rule that establishes the requirements for federally insured credit unions to branch outside the United States. The rule requires credit unions to receive approval from the host country and the NCUA. The NCUA recognizes that a host country will have some regulatory authority over a foreign branch office; however, the NCUA retains the right to

examine a foreign branch and take any necessary enforcement actions. The final rule, which becomes effective July 1, 2003, also requires that

credit unions wishing to set up a foreign branch submit a business plan to the NCUA. NCUA, 12 CFR Part 741.

## STATE LEGISLATION AND REGULATION

### Georgia

On January 22, 2003, the OTS announced that federal law preempts provisions of the Georgia Fair Lending Act (GFLA) from applying to federal savings associations and their operating subsidiaries. The GFLA imposes various restrictions on loans based on the annual percentage rate and amount of points and fees charged. The preemption is based on the Home Owners' Loan Act and OTS regulations that comprehensively and exclusively regulate lending by federal savings associations. The OTS also determined that with respect to terms of credit, loan-related fees, disclosures, and the origination or refinancing of a loan, the GFLA conflicts with OTS regulations governing lending operations. *OTS 03-02, 1/22/03.*

On March 7, 2003, Georgia Governor Sonny Perdue signed legislation (SB 53) that eases burdens on lenders and others under the Georgia Fair Lending Act. The GFLA is one of the nation's most controversial and criticized anti-predatory-lending statutes. In February 2003, Standard & Poor's and Moody's Investors Service refused to rate Georgia mortgage-backed securities because of worries that loan assignees and other parties could be liable under the GFLA; after SB 53 was signed, however, both credit agencies agreed to rate the mortgage-backed securities. Under SB 53 assignee liability applies only to high-cost loans, which are defined as loans on which the interest charged is 8 percentage points above the interest rate on comparable U.S. Treasury bills. SB 53 also changed the reasonable tangible net benefit test—which required lenders to determine whether a refinanced loan presents a tangible net benefit to the borrower—so that it applies only to high-cost loans. In addition, SB 53 removed a provision in the GFLA that included mortgage insurance pre-

miums and Veteran Administration funding fees in the cap on points and fees. The new legislation also removed a state fee from the point-and-fee cap. *BBR, 3/10/03, p. 421.*

### New York

The OTS announced on January 30, 2003, that federal law preempts provisions of the New York predatory lending law from applying to federal savings associations and their operating subsidiaries. The New York law restricts loans based on the annual percentage rate and amount of points and fees charged. The preemption is based on the Home Owners' Loan Act and OTS regulations that comprehensively and exclusively regulate lending by federal savings associations. The OTS also determined that, with respect to terms of credit, loan-related fees, disclosures, advertising, and the origination, refinancing, or servicing of a loan, the New York statute conflicts with OTS regulations governing lending operations. *OTS 03-04, 1/30/03.*

New York Attorney General Eliot Spitzer announced on February 11, 2003, that ten banks had signed agreements to block customers from using their credit cards for online gambling. It is illegal in New York to promote or facilitate unauthorized betting or gambling, online or off. The agreements apply to lending activities arising in New York or affecting New York residents, but the attorney general expects that the banks will block all gambling transactions across their entire systems. The ten banks involved are: Cayuga Bank, Chemung Canal Trust Company, First Consumers National Bank, First Premier Bank, Merrick Bank, Peoples Bank, Trustco Bank, USAA Federal Savings Bank, US Bank NA, and Wells Fargo

Financial Bank. Eight months earlier Citibank signed a similar agreement. *BBR*, 2/17/03, p. 300.

On March 28, 2003, New York State Banking Superintendent Elizabeth McCaul resigned, citing personal reasons for her departure. Ms. McCaul had been the state's longest-serving superintendent, spending six years in the position. On April 2, 2003, New York Governor George Pataki named Barbara Kent the state's acting banking superintendent. Ms. Kent joined the New York Banking Department in 1988 and has been the department's deputy for consumer affairs for the past four years. *AB*, 4/2/03.

### Tennessee

On April 17, 2003, Tennessee Governor Phil Bredesen signed legislation (P.A. 03-32) that makes it easier for branches of Tennessee banks to be acquired. Previous law required branches of Tennessee banks to have been opened and engaged in the banking business for at least five years before being acquired. The new legislation reduces the length of business from five years to three years. *BBR*, 4/28/03, p. 687.

## RECENT ARTICLES AND STUDIES

The percentage of community banks selling mortgages into the secondary market has jumped from less than one-half in 2000 to approximately 72 percent in 2002, according to findings of the America's Community Bankers 10th annual Real Estate Lending Survey. The upward trend can be explained by an overall increase in mortgage originations, as well as a favorable environment for sales into the secondary market. The dollar volume of mortgage sales into the secondary market

has increased even more dramatically, rising from 17 percent of total mortgage originations in 2000 to 41 percent in 2001 and to 45 percent in 2002. Nearly 33 percent of the survey respondents said they anticipate selling more loans into the secondary market in 2003, and 43 percent expected to sell about the same level of loans in 2003 as in 2002. The findings are based on survey responses from 320 community banks. *BBR*, 2/10/03, pp. 257-58.

## BANK AND THRIFT PERFORMANCE

### *Fourth-Quarter 2002 Results for Commercial Banks and Savings Institutions*

FDIC-insured commercial banks and savings institutions earned \$25.6 billion during the fourth quarter of 2002, an increase of \$3.5 billion from earnings in the fourth quarter of 2001. Key factors in the higher earnings were gains on sales of securities and other assets, an increase in service charges, a decrease in expenses for credit losses, and strong growth in interest-earning assets. The average return on assets (ROA) was 1.23 percent

in the fourth quarter, up from 1.12 percent one year earlier. The number of commercial banks and savings institutions on the FDIC's "Problem List" declined from 142 in the third quarter of 2002 to 136 in the fourth quarter, and assets of "problem" banks fell from \$42 billion to \$39 billion. Eleven FDIC-insured institutions failed during 2002, and two of those failures occurred in the fourth quarter.

*FDIC Quarterly Banking Profile, Fourth Quarter 2002.*

**INTERNATIONAL DEVELOPMENTS****Argentina**

Under an agreement with the International Monetary Fund signed on January 24, 2003, the Argentine government pledged to pay banks \$5.3 billion in compensation for major losses they sustained following the country's financial crisis in late 2001 and the devaluation of the peso in January 2002. The government also agreed to a major restructuring of Argentina's three large public banks—Banco de la Nacion Argentina, Banco de la Provincia de Buenos Aires, and Banco de la Ciudad de Buenos Aires. *BBR*, 2/3/03, p. 230.

On March 28, 2003, Argentine President Eduardo Duhalde signed a decree to lift all the restrictions on bank withdrawals that had been in place since the financial crisis of 2001. Under the decree, savers will receive approximately two-thirds of their term deposits in cash and the remainder in a ten-year government bond. *BBR*, 3/31/03, p. 552.

**Basel Committee**

On February 25, 2003, the Basel Committee on Banking Supervision issued guidelines for managing and supervising operational risk. The guidelines discuss what banks will be expected to do to protect themselves from operational risk and also provide a framework of ten core principles for effective management of such risk. Institutions are expected to establish and maintain systems for the "identification, assessment, monitoring, and mitigation/control" of operational risk. The guidelines also recommend public disclosure of these systems "to allow market participants to assess their approach to operational risk management." For regulators, the guidelines recommend assessing existing risk controls at supervised banks and establishing systems that allow timely communication of changes in an institution's risk position. *AB*, 2/26/03.

**Canada**

A final package of regulations under Canada's Bank Act eases restrictions on the ability of for-

eign and domestic banks to undertake information technology (IT) activities. The regulations follow the implementation of the Financial Consumer Agency of Canada Act, which is a new financial services framework that permits banks to engage in IT activities in a financial context. The regulations ease existing restrictions by reducing the "primarily financial" standard to a new "materially related" standard. The regulations also provide financial institutions with added flexibility to invest in entities that do not necessarily meet the materially related standard, provided that the size of the investments falls below a certain threshold. *BBR*, 3/3/03, p. 399.

The Office of the Superintendent of Financial Institutions issued a new guideline outlining the policies and procedures that banks operating in Canada are expected to have in place to deter and detect money laundering and terrorist financing activities. The updated Guideline B-8 on Detering and Detecting Money Laundering incorporates legislative changes made since the release of the original guideline in September 1996. The updated guideline omits much of the material related to transaction identification and reporting and shifts the focus to identifying and mitigating risks related to money laundering. *BBR*, 4/14/03, pp. 627-28.

**China**

China's banking industry regulator, the People's Bank of China, issued new rules to combat money laundering. The new rules require financial institutions and their employees to participate in the fight against money laundering and cooperate with law enforcement officials in anti-money-laundering efforts. Financial institutions that fail to comply with the new rules will be subject to prosecution. The new rules, which became effective March 1, 2003, are part of a broader campaign to stop illegal capital flows and to bring the industry regulations into compliance with international standards. *BBR*, 1/20/03, p. 120.