First Quarter 2005

SRC

Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

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Volume 9 Issue 3

IN THIS ISSUE

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SVP Commentary on...

Top Ten Topics for Management Attention

While the year is new, many of the issues facing bankers in 2005 will be the same as those in 2004. However, both bankers and regulators are hopeful that much of the uncertainty and many of the open issues will be resolved early in the year. I see ten major areas for continued attention, progress, and/or resolution in 2005: accounting, auditing, and internal control; compliance risk; interest rate risk; expense control; liquidity; credit risk; consumer finance; mergers and acquisitions; fraud mitigation; and Basel II.

Accounting, Auditing, and Internal Control

Accounting, auditing, and internal control issues will remain in the news, as FASB, the SEC, the PCAOB, and others bring closure to many open issues.

The first wave of Sarbanes-Oxley section 404 reporting—management's report on internal control over financial reporting and the related auditor's report on management's assessment—will appear for accelerated filers in the first quarter 2005. Financial institutions will need to promptly

Michael E. Collins, **Senior Vice President**

continued on page 8

The EITF Issue 03-1 Storm: Other-Than-Temporary Impairment of Investments

by Cynthia L. Course, CPA, Enforcement and ISS Officer

At its March 17-18, 2004 meeting, the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) issued EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, to provide guidance for evaluating whether an investment is other-than-temporarily impaired.[1] As originally proposed, this guidance would have been effective for other-than-temporary impairment evaluations made in reporting periods beginning after June 15, 2004. However, despite the rather public nature of EITF discussions and the publication of EITF minutes, it was not until the final consensus was published that financial institution executives and their external auditors began to realize the full implications of this interpretation of existing generally accepted accounting principles (GAAP).

FASB listened to and heard the industry's concerns and, on September 30, 2004, issued FASB Staff Position No. EITF Issue 03-1-1, delaying the implementation of the proposed measurement and recognition paragraphs.[2] However, FASB noted that entities would still be required to recognize other-than-temporary impairments as required by existing authoritative literature and comply with the disclosure guidance in paragraphs 21 and 22 of EITF 03-1.

This article reviews the original EITF 03-1 proposal, the industry's concerns, and the current status of the issue. Management should also monitor the status of any resolution to EITF 03-1 through trade publications, the media, or FASB's EITF web site at <www.fasb.org/eitf/agenda.shtml>.

As proposed, EITF 03-1 would not have changed GAAP accounting for impaired investment securities.

What was the Issue?

As proposed, EITF 03-1 would not have changed GAAP accounting for impaired investment securities. However, at least one major accounting firm interpreted EITF 03-1 to mean that the sale of any impaired available-for-sale security, even one impaired or in an unrealized loss position only because of a change in interest rates, would taint the entire portfolio of available-for-sale securities with unrealized losses, requiring the portfolio's unrealized losses to pass through earnings. In a rising interest rate environment, such as the one existing today, financial institutions could be forced to recognize significant unrealized losses from debt securities due solely to a change in interest rates. At the extreme, institutions could have been forced to choose between never selling an available-for-sale security with an unrealized loss, which would limit liquidity and risk management options, or recognizing any unrealized loss on all available-for-sale securities during each reporting period.

The lack of consistent interpretation of EITF 03-1 by the major accounting firms, coupled with the potential for significant balance sheet and income statement impacts in a rising interest rate environment, caused FASB to take rather swift action. In September 2004, FASB directed staff to issue two FASB Staff Positions (FSPs). Proposed FSP EITF 03-1-a provides guidance for applying paragraph 16 of EITF 03-1 to debt securities that are impaired because of interest rate and/or sector spread increases.[3] FSP EITF 03-1-1 delays the effective date of EITF 03-1 paragraphs 10 – 20 that

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[1]FASB does not make *EITF Abstracts* available on its web site. However, *EITF Abstracts* can be ordered in a loose-leaf or bound edition through FASB's web site at <www.fasb.org/public/>. *EITF Abstracts* is also available through FASB's Financial Accounting Research System (FARS), which is available for purchase at <www.fasb.org/fars/>.

[2]EITF 03-1-1 is available on FASB's web site at <www.fasb.org/fasb_staff_positions/fsp_eitf03-1-1.pdf>.

relate to the measurement and recognition of impairment. Importantly, FSP EITF 03-1-1 did not suspend the requirement to recognize other-than-temporary impairments as required by existing authoritative literature, nor did it delay the disclosure guidance in paragraphs 21 and 22 of EITF 03-1.

Current Accounting for Securities Impairment

Accounting for securities is generally covered by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115).[4] Paragraph 16 of FAS 115 requires that other-than-temporarily impaired securities be written down to fair value with a loss recorded through earnings in the period in which the impairment is determined to be other-than-temporary. Under other FAS 115 paragraphs, the appropriate treatment of temporary unrealized losses on securities depends on the nature of the security. Securities that are classified by management as held-to-maturity remain on the balance sheet at amortized cost, with separate disclosure of their book and fair values. Securities that are classified by management as trading are reported in the balance sheet at fair value, with gains and losses recorded in earnings. Finally, both increases and temporary decreases in the value of securities that are classified as available-for-sale are recorded directly in equity as other comprehensive income. While these rules are fairly straightforward, there is significant diversity in current practice in defining when an impairment is "other-than-temporary."

EITF Proposal

Because of the diversity in practice for identifying other-than temporary impairment of investment securities, the EITF attempted to clarify the impairment guidance currently existing in FAS 115 and other standards. In EITF 03-1, the EITF proposed a three-step process for evaluating investment securities for impairment.

The **first step** would be to determine whether an investment was impaired. Paragraph six stated that an investment would be impaired if the fair value of the investment was less than its cost, including adjustments made to cost for accretion, amortization, previous other-than-temporary impairments, foreign exchange, and hedging (this is referred to simply as "cost" throughout EITF 03-1). The comparison of fair value and cost generally would be made at each reporting period. If management determined that an investment was impaired, then a second step would be necessary.

The **second step** would be to evaluate whether an impairment was other-than-temporary. The criteria for determining whether an impairment was other-than-temporary would vary with the nature of the security. In general, for equity securities and debt securities that could be contractually prepaid, paragraph ten provided that an impairment would be deemed other-than-temporary unless both of the following conditions were met.

- The investor has the ability and intent to hold an investment for a reasonable period of time sufficient for a forecasted recovery of fair value up to or beyond the cost of the investment.

- Evidence indicating that the cost is recoverable within a reasonable period outweighs evidence to the contrary.

For investment securities not within the scope of paragraph ten (for example, debt securities that could not be contractually prepaid), paragraph 16 provided that an impairment would be deemed other than temporary if the investor did not have the ability and intent to hold an investment until a forecasted recovery of fair value up to or beyond the cost of the investment or it is probable that the investor would be unable to collect all amounts due according to the contractual terms of the debt security.

If the impairment was deemed to be other than temporary, then the **third step** would be to recognize an impairment loss equal to the difference between the investment's cost and its

continued on page 12

There is significant diversity in current practice in defining when an impairment is "other-than-temporary."

[3]EITF 03-1-a is available on FASB's web site at <www.fasb.org/fasb_staff_positions/fsp_eitf03-1-a.pdf>.

[4]FAS 115 is available on FASB's web site at <www.fasb.org/pdf/fas115.pdf>.

The Role of Credit Cards in an Increasingly Indebted World Economy

by Frederick W. Stakelbeck, Training and Development Coordinator

Long viewed as a mere postscript to mortgages and installment loans when considering the country's overall consumer debt picture, credit cards are now recognized by banking industry experts as key contributors to the epidemic of escalating consumer debt. In its capacity as the nation's payment systems regulator with responsibility for ensuring the safety and soundness of the nation's financial system and for containing systemic risk, the Federal Reserve continues to closely monitor fluctuations in consumer debt levels. Statistics released by the Federal Reserve in February 2004 showed that U.S. household debt, excluding home mortgages but including most short and intermediate credit extended to individuals, reached $2 trillion in November 2003.[1] Of this total, credit card debt represented $744 billion.[2] One year later, in November 2004, U.S. household debt had grown another 4.8 percent, reaching $2.1 trillion.[3]

Over the course of the past five years, consumers in Europe and the Far East have joined Americans in embracing the use of electronic payment alternatives such as credit cards to pay for goods and services. Double digit growth in annual credit card receivables in countries such as the United Kingdom, Australia, Taiwan, South Korea, and China have placed pressure on Asian and European consumers unfamiliar with the nuances of managing credit card debt. The growing reliance of American banks and financial services companies on foreign cardholders for sustained income further complicates this situation and merits attention, as credit card issuing giants such as American Express, MBNA, Citigroup, and J.P. Morgan Chase expand their overseas operations.

A new concern for a number of economists is the growth of the nonprime credit card market in the United Kingdom.

This article will provide a brief profile of the credit card market for several European and Far East countries. This can then serve as a point of reference for continued research in the area of global credit card debt and related industry trends.

United Kingdom

On July 29, 2004, the Bank of England, the country's central bank, reported that British consumers were nearing the £1 trillion mark on credit card, mortgage, and other consumer loan debt for the first time.[4] Like their United States counterparts, British consumers have benefited from a low interest rate environment. This favorable borrowing environment allowed total credit card lending to grow by 87 percent for the five-year period ending June 2004, compared with a 54 percent increase for all other consumer loans during the same period. However, these favorable borrowing conditions are quickly changing, placing an increased burden upon consumers. Citizens Advice, a British debt counseling service, reported a 44 percent increase over a six year period in the number of Britons seeking debt counseling—an almost identical correlation with the increase in credit card lending over the same period.[5] The United Kingdom's Treasury Select Committee recently began to study this upward trend in consumer debt. The committee commenced its investigation of the credit card industry, calling on a number of British banks to explain more concisely the exact manner in which credit card charges are presented to consumers.

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[1]Federal Reserve System, *Statistical Release for Consumer Credit*, February 6, 2004, <www.federalreserve.gov/releases/g19/20040206/>.
[2]Ibid.
[3]Federal Reserve System, *Statistical Release for Consumer Credit*, February 7, 2005, <www.federalreserve.gov/releases/g19/20050207/>.

[4]BBC News, *UK Debt Likely to Top £1 Trillion,* July 29, 2004.
[5]Ibid.

A new concern for a number of economists is the growth of the nonprime credit card market in the United Kingdom. In a November 2004 report, PricewaterhouseCoopers stated that the nonprime market, which includes nearly 8 million British adults, will be one of the key sources of growth in the United Kingdom credit card market."[6] The report also noted that the number of credit cards is expected to increase by 3 to 4 million, or 10 percent, over the next several years. Industry penetration will increase to 73 percent of the UK population, compared to 85 percent in the United States. Certainly, developments in UK consumer debt and emerging market dynamics deserve further study.

Australia

Figures released by the Reserve Bank of Australia in December 2004 show that credit and charge card debt reached a record high of A$28.2 billion in October 2004.[7] Supporting these figures were poll results released by the *Sydney Sun-Herald* in August 2004 showing an increasing reliance on credit cards by Australians. The poll showed that 68 percent of Australians polled were "revolvers," rolling over their monthly credit card debt and paying only the minimum payment on credit cards that sometimes charged 15 to 20 percent. The poll also noted that 20 percent of Australians found their credit card debt difficult to manage. Statistics released by the Reserve Bank of Australia show the average debt among the 70 percent of households with a credit card reached A$5,162 in 2004, up from A$1,601 in 1996.[8]

With consumer credit card debt soaring, members of Australia's Labor Party have proposed several measures to address the problem. Options discussed include the following: [9]

Twenty percent of Australians found their credit card debt difficult to manage.

- Allowing a credit card issuer to increase credit limits *only* if requested by the cardholder.
- Prohibiting unsolicited promotional material with pre-approved credit limits.
- Requiring financial "health warnings" to ensure that consumers are made aware of the potential cost of credit card finance.
- Ensuring monthly statements contain warnings about the timeframe required to repay debt if only the minimum payments are made, as well as the total amount of interest that would be paid.

Taiwan

The credit card market in Taiwan has expanded rapidly during the past five years, with the total number of credit cards in circulation as of December 2003 increasing to almost 40 million, or five credit cards per household.[10] Directly related to the increase in credit card circulation has been escalating consumer debt. As of December 2003, total Visa credit card outstanding balances alone stood at NT$376.7 billion, 28 percent over 2002 levels and 41 percent over 2001 levels, even when adjusted for inflation.[11] NT$376.7 billion in total outstanding balances translates into an average balance of NT$17,900 per credit card.[12] Furthermore, according to the Taiwanese Financial Supervisory Commission, the island's population of 48 million residents has approximately US$13.2 billion dollars in cumulative credit card debt.[13]

The *Asia Times* reported on August 18, 2004 that Taiwan is facing rising credit card and cash card debt and a possible default fiasco similar to South Korea's.[14] How did Taiwan consumers get into so much credit card debt? Taiwanese banks, eager to expand into the credit card market, turned a blind eye toward risk controls and gambled that bad loans would be manageable.

continued on page 14

[6]Michel Hennigan, ***Ireland Business News Service***, "UK Credit Card Issuers Lose 1 Billion Pounds Annually on Balance Transfers," November 1, 2004.

[7]The Australian, ***Credit Card Debt at New High,*** December 16, 2004, <www.theaustralian.news.com>.

[8]Greg Ansley, ***The New Zealand Herald***, "Australian Debt Soars with Property Boom and Easy Credit," August 16, 2004.

[9]Senator Kate Lundy's Office, ***We Owe Almost $28 Billion on Our Credit Cards***, November 18, 2004, <www.katelundy.com.au/nov04.htm#18Nov2004>.

[10]Visa, ***The Credit Card Report: Credit Card Use in Taiwan,*** September 2004.

[11]Ibid.

[12]Ibid.

[13]Ibid.

[14]Scott Ridley, ***Asia Times***, "Taiwan Tackles High Credit Card Default Rate," August 18, 2004.

Shhh...Supervisory Ratings and Other Nonpublic Supervisory Information are Confidential

On February 28, 2005, the Federal Reserve, OCC, FDIC, and OTS (the agencies) issued an interagency advisory reminding financial institutions about the confidential nature of supervisory ratings and other nonpublic supervisory information. Except in very limited circumstances, financial institutions are prohibited by law from disclosing their CAMELS rating and other nonpublic supervisory information to non-related third parties without written permission from their appropriate federal banking agency. This includes prohibitions on disclosure to insurers underwriting Directors and Officers Liability coverage.

12 CFR 261.20 addresses disclosure of confidential supervisory information by financial institutions supervised by the Federal Reserve. This section provides that any supervised financial institution lawfully in possession of confidential supervisory information may disclose such information, or portions thereof, to its directors, officers, and employees, and to its parent bank holding company and its directors, officers, and employees. In addition, it may also disclose such information, or portions thereof, to any certified public accountant or legal counsel employed by the supervised financial institution, subject to certain conditions.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to publicly available information in lieu of disclosing any confidential regulatory information. This could include, for example, any of the following:

- Quarterly reports of condition
- Uniform Bank Performance Report (UBPR), which is available on the FFIEC web site at <www.ffiec.gov>
- Publicly available filings, if any, filed with the appropriate federal banking agency or with the SEC
- Reports on or ratings of the institution compiled by private companies that track the performance of financial institutions or issue ratings on public debt issued by an institution
- Information on formal enforcement actions, as reported on the agencies' web sites
- Any reports or other sources of information on institution performance or internal matters created by the institution that does not contain information prohibited from release by law or regulation

The complete interagency advisory is available on the Federal Reserve's web site in SR Letter 05-4, *Interagency Advisory on the Confidentiality of Nonpublic Supervisory Information*, at <www.federalreserve.gov/boarddocs/SRLETTERS/2005/sr0504.htm>. ■

Can I Get Confidential Information on the Institution's...?

OK to Disclose

- Directors, officers, employees,
- Parent BHC directors, officers, employees
- CPA (subject to limitations)
- Legal counsel (subject to limitations)

Check with Appropriate Agency

- Insurers
- Creditors
- Shareholders
- Customers
- Rating Agencies
- General Public

Interagency Guidance on Overdraft Protection Programs: Managing the Risks

by Joanne M. Branigan, CPA, Senior Examiner

On February 23, 2005, the Federal Reserve, OCC, FDIC and the NCUA issued interagency guidance on overdraft protection programs that are currently being offered by a growing number of financial institutions. Overdraft protection programs, also referred to as bounced-check protection programs, are a credit service offered as an alternative to traditional means of covering overdrafts. The purpose of the guidance is to assist financial institutions in managing the risks associated with these services.

Prior to implementing an overdraft protection program, management should be diligent in measuring the risks associated with the program. These include credit, legal, reputation, compliance, and other risks. Management should develop written policies and procedures to address the risks and regularly monitor the program to ensure compliance. There should also be sufficient management reports created to effectively identify, measure, and manage the risks.

Typically, there is no underwriting associated with the extension of credit in an overdraft protection program, which could result in additional credit risk. Customer accounts should be regularly reviewed so that the related credit risk can be actively managed. Diligent monitoring of customer repayments is necessary to ensure timely charge-offs. Overdraft balances should be charged off when an account is deemed uncollectible, but no later than 60 days from the date when the account was first overdrawn.

Overdraft protection programs are subject to all applicable federal laws and regulations, and some state laws may also be applicable. To manage legal risk, the program should be reviewed by legal counsel for compliance, prior to implementation. In addition, the program should be reviewed as laws and regulations are amended to ensure ongoing compliance. If a third party vendor is selected to implement the program, there should be proper due diligence conducted prior to the signing of the contract.

Overdraft protection programs can also create increased reputation risk. Management should be clear in its marketing and other communications related to its overdraft protection program to avoid including misleading information. The specifics of the program should be evident to the consumer, as well as their responsibilities under the program. An overdraft protection program should not encourage irresponsible financial behavior.

Management should be aware of the correct financial and regulatory reporting of income and loss recognition by following GAAP and Call Report instructions. Overdraft balances should be reported as loans and any loss should be charged to the allowance for loan and lease losses. Management should also ensure the proper risk-based capital treatment as overdraft balances should be risk-weighted according to the obligor.

Overdraft balances should be reported as loans and any loss should be charged to the allowance for loan and lease losses.

The interagency guidance also provides a section on industry best practices related to the both the marketing and communication aspects of an overdraft protection program and to the features and operations aspects.

The complete interagency guidance is available on the Federal Reserve's web site in SR Letter 05-3, *Interagency Guidance on Overdraft Protection Programs,* at <www.federalreserve.gov/boarddocs/SRLETTERS/2005/sr0503.htm>.

Top Ten Topics for Management Attention

continued from page 1

address any identified internal control deficiencies to maintain both investor and supervisory confidence. To help financial institutions respond appropriately to the provisions of section 404 and to ensure consistent supervisory treatment of financial institutions across Federal Reserve districts, the Federal Reserve anticipates issuing supervisory guidance in early 2005. While we continue to hear about the unanticipated burden of section 404 compliance, it is important to remember that the provisions included in the *Sarbanes-Oxley Act of 2002* were needed to reestablish and ensure investor confidence. However, the proper balance and application of Sarbanes-Oxley will remain an important policy issue. In the interim, the workload should ease with experience and more practical assessments by auditors.

FASB continues to consider EITF Issue 03-1, *Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*, and its impact on changes in fair value of debt securities due to changes in interest rates. The proposed recognition and measurement guidance has been deferred indefinitely; however, the disclosure provisions are currently effective.

FASB also continues to review the application of FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, on loan participations and how loan participations can meet FAS 140's requirements for legal isolation and no continued control over transferred assets as conditions of sale treatment. The most significant issue to be resolved is the right of setoff in the event of a financial institution liquidation.

Some other issues that could affect financial institutions include the final FASB statement, FAS 123 (revised) on the valuation of stock options, which becomes effective for many public entities for reporting periods beginning after June 15, 2005 and for nonpublic entities for reporting periods beginning after December 15, 2005; SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, which is effective December 15, 2004; and the continued discussion about fair value accounting.

You can also anticipate expanded supervisory guidance in these and other areas. Bank management and financial institution auditors must be aware of the effects of these and other accounting and auditing issues to ensure that financial statements are prepared according to generally accepted accounting principles and accurately reflect the operations of the company. To fail to do so significantly increases reputational, operational, and legal risks.

Financial institutions will need to promptly address any identified internal control deficiencies to maintain both investor and supervisory confidence.

Compliance Risk

In light of recent changes in legislation and regulation—including HMDA, Check 21, and the *Bank Secrecy Act* and anti-money laundering rules—compliance risk should remain near the center of management's radar.

Both bank management and consumer activists are awaiting the release of the expanded HMDA data in the third quarter 2005. The data for 2004, which must be submitted in the March 2005 HMDA filings, will include disclosure of pricing data on higher cost loans, expansion of the number of non-depository institutions subject to reporting, and revisions to certain definitions to provide for more uniformity of reporting. These changes, which were approved in 2002, are discussed in more detail in the Third Quarter 2003 issue of

continued on page 9

Top Ten Topics for Management Attention *continued from page 8*

Compliance Corner, and tools to aid in compliance appear in this issue of *Compliance Corner*.

Now that the October 28, 2004 effective date of Check 21 has passed, attention is turning from the operational aspects of implementing Check 21 to the compliance aspects of the Act, including the consumer awareness disclosure and the provisions for expedited recredit to consumer accounts. Consumer groups are also concerned about new disparities between the faster check clearing available through electronic means and the current funds availability rules in Regulation CC, *Availability of Funds and Collection of Checks*. On December 7, 2004, U.S. Representative Carolyn Maloney (D-N.Y.) introduced H.R. 5410, *Consumer Checking Account Fairness Act*, which is intended to address imbalances between the speed of funds collection under Check 21 and the slower pace of funds availability. While passage of the bill is not certain, the issue bears watching and banks should proactively assess their check clearing and funds availability processes.

Compliance risk encompasses more than just consumer compliance; it includes the failure to comply with all laws and regulations. As some bankers have already learned, failure to comply with the provisions of the *Bank Secrecy Act* and the anti-money laundering (BSA/AML) provisions of the *USA PATRIOT Act* might carry one of the heavier burdens—formal enforcement actions and significant civil money penalties. Banks doing business with money transfer companies, including so-called check cashers, have been under additional scrutiny, both to ensure that they are complying with BSA/AML laws and regulations and to ensure that they are not discriminating against check cashers to mitigate exposure in this area. The federal banking supervisory agencies plan to release BSA/AML examination guidance in 2005. These procedures, while ensuring that BSA/AML examinations conducted by the various federal banking supervisors are more consistent, will also be a valuable tool for financial institution self-assessment.

Interest Rate Risk

Short-term interest rates rose sharply in 2004 and early 2005, as the Federal Open Market Committee (FOMC) raised its target for the fed funds rate by 25 basis points six times between June 2004 and February 2005. However, during this period, middle-term rates rose only moderately and longer-term rates declined, resulting in a flatter yield curve. Accordingly, the most recent rises in short-term interest rates did not have the anticipated significant negative effect on portfolio valuations or mortgage volume. In fact, despite the rise in short-term interest rates, adjustable rate mortgages held a steady one-third share of application volume.

Nevertheless, due to heightened competition, loan pricing is not keeping pace with existing funding costs, resulting in declining margins for some banks. Organizations with a high proportion of earning assets in securities and those that have funded expansion through borrowing will likely experience margin challenges. In addition, the increasing volume of options across the balance sheet has made it more important for banks to measure interest rate risk from an economic value perspective.

Bank management should still resist the temptation to chase yields, whether through portfolio extension, which provides even less benefit with a flatter yield curve, or through greater credit risk; should focus on long-term performance and sustainability; and should remain vigilant about interest rate risk management practices.

The federal banking supervisory agencies plan to release BSA/AML examination guidance in 2005.

Expense Control

Curtailing expense growth will be a focal point in 2005. Bankers will continue to evaluate branching strategies, which traditionally come with significant overhead costs, as they assess the dynamics of old and new distribution channels. The ultimate goal, in addition to providing stellar customer service, is to avoid negative operating leverage, where expense growth exceeds revenue growth.

Liquidity

The pressure to increase profits as margins compress has resulted in some institutions lending longer and funding those loans with short-maturity deposits. While creating interest rate risk, this also increases liquidity risk. Accordingly, bankers should sharpen their focus on liquidity. This might entail building a diversified and reliable base of lower cost funding and restructuring the balance sheet to minimize asset/liability mismatches.

It is possible that we have reached or are near the peak in asset quality as part of the normal credit cycle.

Credit Risk

Achieving satisfactory loan growth is one of the top challenges for commercial banks. Increased competition from alternative sources of credit—such as credit unions, captive lending subsidiaries of nonbanks, finance companies, securities companies, and nationwide institutions—coupled with increased competition from peer banks, could, if not managed appropriately, lead to unprofitable or unsustainable pricing and term concessions and declining portfolio quality. Furthermore, the volume of refinancing activity in 2004, by both consumers and many investment grade companies, might place significant pressure on loan volume in 2005. In this environment, lenders should make sure that lending standards remain sound and that loans are priced for the long-term to fully account for risks.

Further exacerbating the competitive challenges are the challenges of attracting and retaining experienced commercial lenders. As many attendees at a recent Bankers' Forum remarked, it is increasingly difficult for community banks to attract mid-level lenders, those who have credit analysis experience but are not demanding top wages. Inexperienced lenders, without the benefit of lending through a full economic cycle, might not recognize what to a more experienced lender would be a marginal loan or might, again through inexperience, overlook operational safeguards.

Finally, the economic cycle has not been revoked. It is possible that we have reached or are near the peak in asset quality as part of the normal credit cycle, and bankers may need to begin to take higher loan loss provisions as loans season and deteriorate and to account for continued portfolio growth.

Because of these challenges, banks are increasingly under pressure to have a portfolio-wide set of early warning indicators. In 2005 and beyond, regulators will be looking for objective leading indicators of credit risk in addition to traditional lagging indicators to gain better assurance about management's ability to effectively manage credit risk.

Consumer Finance

Banks will continue to expand consumer lending efforts in 2005 in search of the best growth opportunities. Home equity products are often cited as areas of emphasis. Bankers should ensure risk management efforts in consumer finance keep pace with rapid growth. Lenders with significant high loan-to-value activity in low score buckets should actively monitor risk exposures. Other areas of consumer risk include overall consumer debt levels, regulatory risk, phishing, and low savings rates.

Mergers and Acquisition

Earnings growth is likely to slow as short-term rates rise and the yield curve flattens. Banks already lean from cost cutting may look to mergers and acquisitions to provide the next profit surge. As this activity picks up, executives should focus intently on the top-line revenue synergies, customer defections, and problems stemming from existing service arrangements.

Although we have seen some recent evidence of divestitures related to one-stop-shopping business models, corporate governance related to diversified banking organizations remains key. For acquisitions outside of core banking activities, banks should make sure that business models fit into the banking compliance model to mitigate reputational and legal risk.

Fraud Mitigation

The flood of recent fines, criminal investigations, and prosecutions related to fraud is raising questions about the ability of banking as an industry to be a frontline defense against financial impropriety. In response, financial institutions are adding to their internal compliance staffs, educating consumers about identify theft, and investing in software to identify suspicious transactions. Continued vigilance against fraud, whether internal or external, should be a standard operating procedure, not only in 2005 but well beyond.

> **Continued vigilance against fraud, whether internal or external, should be a standard operating procedure.**

Basel II

Finally, in 2005, we will see continued progress toward the implementation of the Basel II capital framework. In January 2005, the U.S. banking agencies conducted the Quantitative Impact Study 4 (QIS-4).[1] The purpose of this study is to solicit information to help the banking agencies better understand the likely effect of the proposed international capital standards on the minimum regulatory capital requirements of large U.S. banking organizations. Feedback from this survey will guide the agencies in adopting and implementing such standards in the United States.

Also in January, regulators released interagency standards on the qualification process for Basel II implementation.[2] As part of this process, banking agencies expect that implementation plans, along with evidence of budgeted resources to meet requirements, would be approved by the institution's board of directors and that institutions would make formal notification to the primary regulator of intent to comply with the framework.

More relevant for many Third District banks, however, could be possible proposed changes to the original Basel capital standards for banks that will not use Basel II. Of course, any changes to the original framework for small and regional banks would be subject to a public comment period, and regulators would carefully consider the burden of implementing changes against the benefits of clearer or more streamlined capital calculations.

While managing all of these risks, banking executives must also pay attention to operational capabilities, their institution's ability to execute strategies, and talent shortages. This will require carefully balancing short-term and long-term performance objectives. Banking organizations that instill a longer-term mindset into their culture will be successful at managing current opportunities while laying the foundation for long-term growth. ■

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[1] FFIEC, *Quantitative Impact Study 4* (QIS-4), <www.ffiec.gov/qis4/default.htm>.

[2] Board of Governors of the Federal Reserve System, *Agencies Issue Statement on Implementation of Basel II Framework*, <www.federalreserve.gov/boarddocs/press/bcreg/2005/20050127/default.htm>.

Serving Money Service Businesses: The FinCEN Plan

Combating money laundering has been high on congressional and regulatory agendas since the passage of the USA PATRIOT Act in 2001. For some financial institutions, recent anti-money laundering initiatives have made serving money service businesses—such as check cashers and wire-transfer companies—a high risk, and therefore expensive, activity. As a result, many banks are severing ties with their money service business customers, causing hundreds of such businesses to bank elsewhere.

On March 8, 2005, the Financial Crimes Enforcement Network (FinCEN) conducted a fact-finding meeting to identify issues surrounding the ability of money services businesses to obtain banking services. That meeting confirmed that prompt action is needed. To respond to the findings, FinCEN will take steps to develop guidance, provide education, and strengthen regulation. Additional information on these three initiatives is available in FinCEN's press release at <www.fincen.gov/msbfinalpress.pdf>.

"Other-Than-Temporary Impairment" *continued from page 3*

fair value. The impairment loss would be taken through earnings in the period in which the impairment was determined to be other-than-temporary. In addition, such an impairment loss would create a new cost basis for the investment, and the investment could not be adjusted for subsequent recoveries in fair value.

To Taint or Not to Taint?

Perhaps the most significant issue arising from EITF 03-1 was whether the sale of even one available-for-sale security with an unrealized loss would taint the entire available-for-sale portfolio. Proposed EITF 03-1-a would provide clarification on when such a sale would not taint other available-for-sale securities, drawing an analogy to the circumstances under which a sale of a held-to-maturity security would not taint the entire held-to-maturity portfolio.

For debt securities that were impaired because of interest rate and/or sector spread increases and that would be analyzed for impairment under paragraph 16 of EITF 03-1, the proposal suggested that the following circumstances would not necessarily call into question the investor's ability or intent to hold other securities to recovery.

- Unexpected and significant changes in liquidity needs.
- Unexpected and significant increases in interest rates and/or sector spreads that significantly extend the period that a security would need to be held by the investor.
- A de minimis volume of sales of securities.

In addition, proposed EITF 03-1-a would provide that a sale of an available-for-sale security subject to paragraph 16 for which the investor had *not* previously asserted its ability and intent to hold to recovery would *not* call into question the investor's ability and intent to hold the securities for which the investor *had* previously asserted its ability and intent to hold to recovery. However, other-than-temporary impairments on securities for which the investor had not asserted its ability and intent to hold to recovery would need to be recognized currently in earnings.

Financial institutions will likely experience additional scrutiny of available-for-sale securities with unrealized losses.

If adopted, this latter proposed staff position could lead to, in effect, a bifurcation of the securities in the available-for-sale portfolio that are subject to paragraph 16 into two "subportfolios." A sale from the subportfolio for which the investor had asserted its ability and intent to hold to recovery (importantly, not maturity) could risk taint, subject to the FAS 115 analogy exceptions noted above. A sale from the subportfolio for which the investor had not asserted its ability and intent to hold to recovery would not risk taint, but any other-than-temporary impairments of those securities would need to be reflected in earnings.

The Future?

EITF 03-1-1 does provide some implementation relief, while proposed FSP EITF 03-1-a would provide additional implementation guidance. However, neither FSP changes the fact that financial institutions will likely experience additional scrutiny of available-for-sale securities with unrealized losses, particularly since EITF 03-1 requires that such securities be disclosed in the financial statements whether or not an impairment loss is taken.

While EITF 03-1-1 delays the effective date of the measurement and recognition guidance contained in EITF 03-1 paragraphs 10 – 20, it does not suspend the requirement to recognize other-than-temporary impairments as required by existing authoritative literature. During this interim period, financial institutions should continue to follow applicable guidance, such as the following.

- Paragraph 16 of FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*
- EITF D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security*

Whose Cost Exceeds Fair Value

- Question 47 of FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*

- Paragraph 16 of APB 18, *The Equity Method of Accounting for Investments in Common Stock*

- EITF 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*

- Paragraphs 21 and 22 of EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*

- SEC Staff Accounting Bulletin Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*

Until additional guidance is issued, financial institution management should ensure that measurement and recognition practices are consistent with GAAP and that their disclosure practices are in accordance with paragraphs 21 and 22 of EITF 03-1 and other relevant literature. ■

Whom To Call?

Financial institution management may need to contact an officer, manager, or staff in the Supervision, Regulation & Credit Department but not know whom to call. The following list should help management identify to whom to raise their questions. Financial institutions that have an appointed central point of contact should generally contact that individual directly.

Contact names appearing in **bold** are the primary contacts for their areas.

Community, Regional, and Global Supervision

John J. Deibel, VP	574-4141
Elisabeth V. Levins, AVP	574-3438
James D. DePowell, Manager	**574-4153**
William T. Wisser, Manager	**574-7267**
Eric A. Sonnheim, AVP	574-4116
Glenn A. Fuir, Manager	**574-7286**

Capital Markets

John J. Deibel, VP	574-4141
Elisabeth V. Levins, AVP	574-3438
Avi Peled, Manager	**574-6268**

Consumer Compliance & CRA Examinations

John J. Deibel, VP	574-4141
Constance H. Wallgren, AVP	574-6217
Robin P. Myers, Manager	**574-4182**

Consumer Complaints

John J. Deibel, VP	574-4141
Constance H. Wallgren, AVP	574-6217
John D. Fields	574-6044
Denise E. Mosley	**574-3729**

Regulations Assistance

Regulations Assistance Line	**574-6568**

Enforcement

A. Reed Raymond, VP	574-6483
Cynthia L. Course, Enforcement Officer	**574-3760**

Regulatory Applications

A. Reed Raymond, VP	574-6483
William L. Gaunt, AVP	**574-6167**

Retail Risk Analysis

William W. Lang, VP	574-7225
Todd Vermilyea, Manager	574-4125

Discount Window and Reserve Analysis

Vish P. Viswanathan, VP	574-6403
Gail L. Todd, Manager	**574-3886**

"The Role of Credit Cards" continued from page 5

It didn't happen, and large commercial banks such as Chinatrust FHC, Fubon FHC, and Taishin Financial Holdings Co. saw charge-off rates soar. At Taishin, chargeoffs reached 6.7 percent as recently as July 2004. Recognizing the immediate danger of these developments to the country's budding economy, Taiwan's Finance Ministry reacted by implementing measures to restrict future credit card growth. In March 2004, the Taiwanese government announced plans to curb delinquencies on household debt by rescheduling payments for nearly 400,000 Taiwanese consumers.[15]

South Korea

South Korean household debt has skyrocketed over the past six years. Largely debt-free as recently as 1997, South Korean households now are an average of US$27,000 in debt. A government-fostered stimulus program instituted in 1999, designed to change the historically conservative spending habits of Koreans, has been blamed as the major contributor to the country's current financial condition. Under the plan, any South Korean citizen who spent 10 percent of their annual income on credit cards was given a 20 percent tax deduction. As a result, credit cards, which were hardly in use before 2000, became the payment method of choice for many Korean households. As of December 2003, the average South Korean consumer had four credit cards. Total debt on these credit cards totaled a mind-boggling US$97 billion,[16] an alarming 14 percent of GDP in 2003.[17]

Nearly 4 million South Korean households have forfeited on credit card and other loans.

Nearly 4 million South Korean households have forfeited on credit card and other loans—an astounding 10 percent of the country's total population. Adding to the country's default woes is an industry-driven lender policy that does not allow revolving accounts.

Bad credit card accounts, an unheard of phenomenon only five years ago, mounted so quickly that South Korea's largest card issuer, LG Card Co., was forced to suspend its cash advance ATM services because it ran out of money. On December 31, 2004, LG Card Co. announced that it had reached an agreement with LG Group, its previous owner, on a bailout package worth US$966 million, easing fears of a company collapse.[18] "We are glad to say we will be able to give a New Year's gift to the financial markets," said Yoo Ji-Chang, governor of Korea Development Bank, LG Card's main creditor.[19]

Consumer credit card delinquencies have soared, due in large part to ineffective bank credit risk management policies and internal controls. In their desire to gain a significant foothold in a potentially lucrative market and secure a cadre of loyal credit card customers, banks ignored applicant credit histories and approved almost all credit card applications. This lack of bank oversight in both the credit review and application processes facilitated the development of structural inadequacies within the country's financial system and contributed greatly to the 1997-1998 Korean financial crisis and the 2003 credit card crisis. The existence of these unsound lending practices was confirmed in early 2004 when the Korean Board of Audit and Inspection reported that irregularities in the credit card industry allowed 1.8 million individuals with negligible credit histories to obtain 4.3 million credit cards.[20]

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[15]Ibid.

[16]Shanghai Star, *South Korea's Love Affair With Plastic on the Rocks*, May 29, 2003, <app1.chinadaily.com.cn/star/2003/0529/fe22-2.html >.

[17]InfoShop, *Financial Cards in South Korea*, July 2004.

[18]Asia News, *Creditors Agree to Bail Out South Korean Credit Card Company LG Card*, December 31, 2004, <asia.news.yahoo.com/041231/ap/d87acrc80.html>.

[19]Ibid.

[20]David Scofield, *Asia Times Online*, "Behind the Crisis in South Korea's Economy," July 20, 2004, <www.atimes.com/atimes/Korea/FG20Dg04.html >.

As a result, credit card issuers are now faced with finding a more favorable balance between price and risk. Credit card issuers have taken deliberate steps to rectify problems associated with the credit card market, reducing cash advance limits, revising credit approval processes, and modifying risk management practices. The Bank of Korea, the country's central bank, has also taken measures to control consumer credit growth. The central bank plans to establish a new "Paper Company" to handle bad debts and charge card delinquencies, although this concept has been questioned by some industry analysts.

No one knows for sure when the country's credit card market will recover entirely from its early mistakes. However, most industry experts agree that the business model employed by South Korean banks, coupled with unwise, ill-timed government intervention, did incalculable, long-term damage to the country's credit card industry.

China

A majority of Chinese consumers still use cash for all transactions; however, major changes are on the horizon. China, with the largest potential credit card market in the world, presents an attractive opportunity for credit card issuers determined to gain as many of the country's billion-plus consumers as possible before competition increases, customer's attitudes mature, and regulation from the China Banking Regulatory Commission (CBRC) intensifies. Issuers such as American Express, Citigroup, Standard Chartered and American International Group (AIG) are preparing to target the Chinese credit card market, using partnerships to work with local banks until restrictions on international lenders are lifted in 2006. "As soon as China opens up, we want to go in," said AIG vice-president Edmund Tse.[21]

"Both domestic and foreign banks have been eyeing with great interest the credit card market in China for years—and for good reason," said Glen Murphy, Managing Director of ACNielsen China, a marketing information company.[22] Credit card penetration in provincial areas and cities such as Beijing, Shanghai, and Guangzhou has increased from 18 percent in 2003 to 22 percent in 2004.[23] A recent survey of Chinese consumers between the ages of 25 and 34 found 35 percent hold one or more credit cards.[24] According to MasterCard, China could see the number of credit cards in circulation rise from approximately 3 million today to as many as 75 million by 2010.[25]

A majority of Chinese consumers still use cash for all transactions; however, major changes are on the horizon.

Given China's desire for the rapid transformation of its economy from a state-run communist economy to a more diverse, westernized economy; a rise in urban income levels, which have led to increased consumer spending; and the entry of foreign banks into the domestic Chinese market, it may be only a matter of time before Chinese consumers of all ages succumb to the allure of credit cards. To avoid familiar problems associated with market expansion and risk containment in a maturing market, it will be important for Chinese banks to prevent unnecessary risks by educating young consumers on the intricacies of credit. Chinese banks entering this new market will also need to establish the reliable propriety and shared network capabilities that are the pillars of sound controls.

Conclusion

Escalating consumer credit card debt will ultimately have a profound impact on a developing world economy. Increasing consumer debt levels, coupled with any deterioration in the world economy due to unforeseen economic, political, or national security events, could portend a crisis for the global credit card industry. These developments deserve U.S. attention as American credit card issuers increase their presence overseas and explore new markets for growth opportunities. ■

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[21] China Daily, *AIG Eyes Credit Card Market in China,* January 8, 2004.
[22] ACNielsen, *From Cash to Credit: China Offers Cash Cow Opportunities for Banks,* August 12, 2004.
[23] People's Daily OnLine, *China Steps into Credit Card Era,* August 9, 2004.
[24] Ibid.
[25] Samuel Shen, *International Herald Tribune*, "Citigroup Adds China Card Market," December 24, 2004.

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