

AMERICAN BANKER®

THE FINANCIAL SERVICES DAILY

Volume CLXXI No. 1

www.americanbanker.com

REVIEW 2005/PREVIEW 2006

SUBSCRIPTIONS: 800-221-1809

TUESDAY

JANUARY 3, 2006

FRIDAY'S MARKETS

American Banker 225	▼	1.1%
American Banker 50	▼	0.4%
Dow Jones Industrial Average	▼	0.6%
Standard & Poor's 500	▼	0.5%

10-year Treasury yield 4.393%, up 0.037

Unfinished Business Confronts New Crop of Top Regulators

■ BY TODD DAVENPORT

WASHINGTON — Long-anticipated changes at the top of the banking agencies finally occurred in the second half of last year, but the new leadership probably will have little effect on regulatory priorities.

The breadth of the turnover is impressive — there's a new comptroller of the currency, a new chairman of the Federal Deposit Insurance Corp., and a new director at the Office of Thrift Supervi-

sion. And the Federal Reserve Board is preparing for the departure of a chairman who has held the position since 1987.

At agencies one step removed from the primary banking regulators, the changes have been no less substantial. The Securities and Exchange Commission has a new chairman. The Treasury Department finally got around to selecting a new undersecretary for

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For Agencies, New Leaders, Same Priorities

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domestic finance, and the Office of Federal Housing Enterprise Oversight has an acting chief.

"It's a whole new ball game, but the staffs at all these agencies are very experienced," said Eugene Ludwig, a former comptroller and now the chief executive officer of Promontory Financial Group, a Washington consulting firm. "I don't expect to see any bombs thrown."

Most of the big regulatory topics on the 2005 calendar will be carried into 2006.

Compliance with the Bank Secrecy Act, arguably the dominant regulatory priority of the past year, remains regulators' focus for the coming year. And there's still plenty of work left in defining and implementing the Basel II regulatory capital regime.

Deposit insurance reform is nearing the legislative finish line but will leave in its wake the intricate task of implementing the law. Attempts by the world's largest retailer to secure a depository charter have required regulators to contemplate the boundaries of banking and commerce. Regulators continue to test the limits of preemption, which in turn has triggered a broad-based reassessment of how banks treat their customers.

Underlying all of those initiatives is a broad-based directive to determine what banks must disclose to customers about products, and whether companies must make choices about the suitability of products for some customers. Regulators will do that as they try to balance the occasionally competing priorities of data security and consumer privacy.

The compliance concerns are mounting as a flattening yield curve, untested products, and tight competition — not to mention a national disaster whose effects are only now becoming apparent — have revived regulators' concerns about credit quality.

It's little wonder that banks complain about increasing regulatory burdens, though the industry's tremendous profitability in recent years tends to dull the urgency of pleas for relief.

THE 2006 AGENDA

Failure to comply with anti-money-laundering laws produced the biggest regulatory headaches in 2005, and that's unlikely to change in 2006.

The emphasis is a "derivative of our national focus on terrorism," said Gilbert Schwartz, a partner at

the Washington law firm Schwartz & Ballen LLP. "It's going to ratchet down, and more institutions will feel the pressure — smaller institutions are going to be more highly scrutinized."

Banks can no longer claim that the sharp focus on BSA compliance has been without warning, but that does not mean they are prepared.

"There probably will be more than a few banks that think they have been doing a good job or don't need to do much, and they will be surprised," said Paul Pilecki, a lawyer at Winston & Strawn LLP.

While the burden of BSA compliance has already shifted to bankers, the fight to articulate new capital standards is still largely a problem for policymakers.

The revival of private equity investments and the proliferation of hedge funds have emphasized the role that leverage plays in investing, and for competitive reasons, bankers also want to take advantage of it to the extent possible. Banks forced into the complex, internal-ratings-based approach of the Basel II standards obviously are curious to see what's in it for them.

If the advantages are clear enough, another class of banks will opt into the regime. For the rest — the vast majority of banks that in aggregate account for only a minority share of the industry's assets — regulators are cooking up a modification of current capital standards commonly referred to as Basel IA.

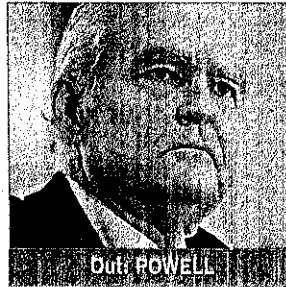
It is a hugely important topic, said Timothy McTaggart, a former Delaware banking commissioner who is now a partner with the Washington law firm Willkie Farr & Gallagher LLP, but its complexity presents unique problems.

"It's a dull subject, but from a policy standpoint, you have to get it right," he said. "The problem is, like most things, it's not being decided strictly in policy laboratory conditions."

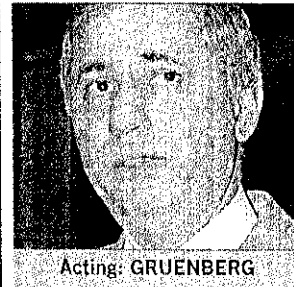
The debate pits large banks against small ones and, as a consequence, has occasionally put regulators at cross-purposes.

Bankers want to avoid a "sausage-making process, because that implies that there are compromises and political decisions, as opposed to the business decision of what's the right way to measure bank capital," Mr. Pilecki said. "There are all these nuances and different ways businesses are run; markets change, products change, and out of necessity it

FDIC Chairman



Duff POWELL

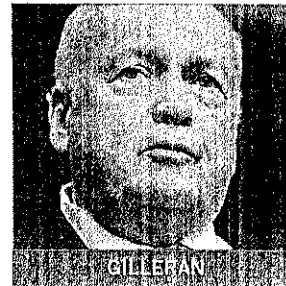


Acting: GRUENBERG



Hilary TAYLOR expected

OTS Director



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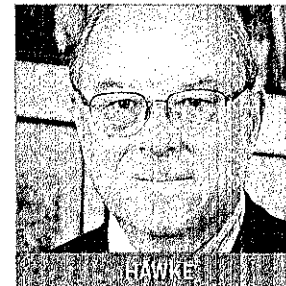


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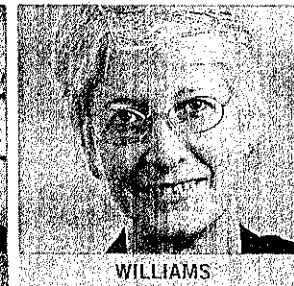


REICH

Comptroller of the Currency



HAWKE



WILLIAMS



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becomes a moving target."

The industry's long flirtation with reforming deposit insurance became a priority over the past year as it became clear that banks might actually have to pay for the government's backing. Lobbying efforts appear to have borne fruit: The reform measure is tied to a budget-reconciliation measure that awaits Congress when it returns at the end of January.

If the legislation passes, it means more work for the FDIC. "It's a big change to the insurance coverage. It will rationalize the insurance funds, address some of the premium issues, and rebates," Mr. McTaggart said. "The implementation associated with that will clearly be front and center."

The FDIC is also considering Wal-Mart Stores Inc.'s application to form an industrial loan company, and the simple question of whether the huge retailer ought to have direct access to payment networks has mushroomed into a debate over fundamental princi-

ples of American business.

"Policymakers have wrestled for decades over the extent to which commercial firms should be in the banking business," said Kenneth Ehrlich, a lawyer in Boston with Nutter McClennen & Fish LLP. "The only loophole that is left for a commercial firm trying to get into the banking business is the industrial loan company."

The policy question is complicated by competitive concerns. Other nontraditional players quietly secured ILC charters, but Wal-Mart's reputation as a threat to the fabric of American retailing has raised the stakes.

"The mix of banking and commerce and the whole ILC issue has been out there for a long time, but it took a Wal-Mart to draw attention to it," said John Ryan, the executive vice president of the Conference of State Bank Supervisors.

The Fed and the FDIC are jockeying for turf as they — and lawmakers — consider the

appropriate regulation of ILCs. The substantive question facing the FDIC is what kind of limits it might be able to put on Wal-Mart, which continues to assert a lack of interest in launching a retail-banking operation. Whether it could change its mind at some point is what troubles community bankers.

"It's an interesting legal question, and it's Wal-Mart as the behemoth, but it's also an especially vulnerable time for all the people that would have to compete against Wal-Mart if it got into the banking business," Mr. Ehrlich said. Wal-Mart, "has a place unto itself in terms of the threat it poses to different business models."

Despite a crammed agenda, the FDIC may be reluctant to abandon its efforts to stake out its own preemption regulation, given the Office of the Comptroller of the Currency's success over the past year in litigating its powers. The OCC won substantial preemption victories before the U.S. Courts of

Appeals for the Second, Sixth, and Ninth Circuits.

OCC preemption is not yet impregnable. The agency is still facing a challenge in the appeals court for the Fourth Circuit, and the Supreme Court asked the Solicitor General's Office to weigh in on the extent to which jurists should extend deference to agencies in interpreting their implementing statutes.

The request "sends a signal" that the Supreme Court may want to look more closely "when federal agencies just announce by fiat that they are going to expand their jurisdiction," said Patricia McCoy, a professor at the University of Connecticut School of Law.

National lenders are as keen as ever to draw distinct boundaries around the laws with which they must comply and the investigations to which they must submit. New data disclosures under the Home Mortgage Disclosure Act have made them vulnerable to accusations of discriminatory lending.

The Justice Department launched an investigation in November, and as many as 100

banks are under scrutiny. Prof. McCoy is skeptical that the department has the will or the manpower to prosecute instances of lending discrimination, but she said that won't shut the door on HMDA-related inquiries.

"We can't make sense of the HMDA pricing data without credit scores," she said. "The drumbeat will grow for disclosure of credit scores" in a manner that does not tread on privacy concerns.

Mr. Schwartz said the HMDA issue is ripening as investigators interpret the data, but it probably will not emerge as a big issue for banks until 2007. In the meantime, the OCC continues to examine the lending records.

"By the end of 2006 we will be done with or well engaged in the various examination activities" related to the HMDA data, said Julie Williams, the agency's chief counsel. "Whether anything comes out of that is impossible to know right now."

CONSUMER PROTECTION

The HMDA probe is part of a pervasive reexamination of how banks treat existing and potential

retail customers, which itself is intimately associated with preemption efforts. The more state laws and regulators are knocked out of the box, the more the federal agencies that remain will be pressured to prove they can adequately protect consumers.

The chief component of the protection effort is based on disclosures, in keeping with free-market principles. The strategy assumes consumers armed with the right information can make intelligent decisions about which financial products and providers are appropriate for them.

An ancillary part of that debate is what responsibilities banks bear following data-security breaches. All the ingredients for a robust conversation about identity theft have been in place for a couple of years, but a wave of breach disclosures early last year — triggered by a California law and a monumental gaffe at ChoicePoint Inc. — pushed the issue before lawmakers and regulators.

Never mind that ID thefts resulting from the high-profile breaches have been tenuous to this point.

Breaches are "spectacular because they affect people personally," Mr. Schwartz said. "What financial institutions will have to do to protect consumer information won't change dramatically, because the systems are pretty good, and the banking agencies have required them to be more careful about it. But people are going to get more and more nervous about it."

Regulators have been scrutinizing privacy notices mandated by the Gramm-Leach-Bliley Act, and this year they could complete a rule first proposed two years ago. The intent of the notices was to make consumers aware of their bank's policy regarding the distribution and sale of personal information. The reality has been increased legal and mailing costs for banks, and several pages of small-font legal language for consumers to throw away every year.

Ms. Williams has taken a personal interest in improving the notices.

"There is a lot of consumer disclosure in the financial services arena, but there generally is very little consumer testing done before we promulgate it," she said.

This time regulators have "retained communications experts to test various models and formats for disclosure before we mandate particular things or change our regulations."

The Fed is amending its Regulation Z, which implements the Truth-in-Lending Act, to accommodate credit card disclosure

requirements imposed by the bankruptcy law that took effect Oct. 17. The agency will make the changes as part of a broad look at card disclosures in an effort that is itself only the first step in what will likely be a multi-year effort to reform Truth-in-Lending disclosures for most retail lending products.

Proposed interagency guidelines for nontraditional mortgages, particularly interest-only and payment option mortgages, laid out underwriting and risk-management practices but also included more thorough disclosure to consumers about the costs of the products.

CREDIT QUALITY

The consumer disclosures required by regulators' guidance on exotic mortgages may be largely an afterthought to lenders. Of greater importance are the underwriting standards that regulators laid out, as well as the risk-management process required of lenders that offer such loans.

Regulators are also working on guidance regarding commercial real estate, which has historically been a touchy subject for banks. Notwithstanding the flare-up in corporate lending at the end of 1999 and into 2000, the commercial real estate meltdown in the early 1990s was at the heart of the industry's last lethal credit cycle.

Early this year regulators are expected to release guidelines that will elucidate risk-monitoring standards for banks with substantial concentrations in commercial real estate.

"Next year the focus is going to be back on assets," said Nicholas Ketcha, a managing director at FinPro Inc. and a former director of supervision at the FDIC. "Prices are leveling off, homes are staying on the market longer, rates continue to go up, and income levels for the borrowers aren't going up as fast. The examiners and the agencies are going to be looking closely at real estate," and banks "that have gone out a little further to qualify people and are keeping the loans on the books are probably going to have a little bit more of a hassle."

Mr. Ludwig said banks are "moving into an era when credit examination will be more stringent than it has been in the last several years," but that the focus will not move to the top of the regulatory agenda until losses are more real than imagined.

Mr. Ryan said the nontraditional mortgage guidelines are "just the beginning of the discussion" on lending practices and products. "We are getting close to when some of these products

reprice, and you are starting to see some evidence of some of the weaknesses in the marketplace."

The renewed focus on credit quality is an acknowledgment that times may be getting tougher for banks. Spreads are thin, interest rates are going up, and the residential real estate market is looking shaky. Add to that the ravages of Hurricane Katrina that will test consumers, banks, and regulators alike.

"There's a Katrina effect on a consumer level, in terms of dealing with mortgages, prepayment penalties, the temporary abeyance of mortgage payments, and the lack of flood insurance for many of the properties," Mr. McTaggart said.

Regulators will also have to determine whether banks operating in the affected areas "can continue to function without having the commercial enterprise that had been there," he said. "All those nitty-gritty headaches will be lurking over regulators."

Mr. Ludwig said there are clearly some "knotty problems" presented by Katrina. "For some of these institutions, all the good risk management in the world could not have protected them. Nobody would have believed that their whole physical plant would be blown down or, in other cases, whole communities would be destroyed."

ODDS AND ENDS

There's more, of course.

The SEC continues to work on its Regulation B proposal, a 6-year-old statutory requirement that would push some securities activities out of banks and into brokerage subsidiaries. Bank regulators leveled sharp criticism at two earlier proposals by the securities regulator. The SEC is also working with bank regulators on guidance for complex structured financial activities.

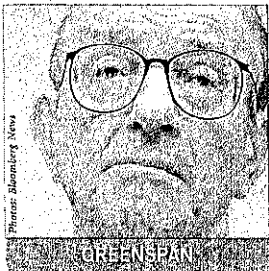
Agencies are still working on regulations required by the Fair and Accurate Credit Transactions Act, particularly provisions governing risk-based pricing and affiliate marketing.

While the rest of the world debates the future of the USA Patriot Act, the Treasury is finally getting around to completing its implementation. The Financial Crimes Enforcement Network reissued a proposal in December seeking more comment on Section 312 of the USA Patriot Act, as officials try to determine which countries and banks should trigger "enhanced due diligence" from U.S. banks.

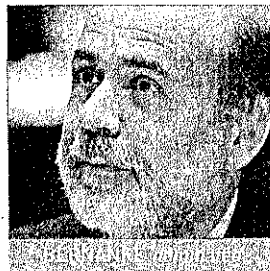
Regulation, by design, does not move quickly.

Prediction: Most of the big items that dominate 2006 will remain in play in 2007. ■

Fed Chairman



BERNANKE

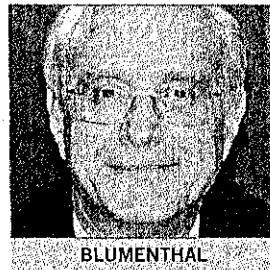


GREENSPAN

OFHEO Director

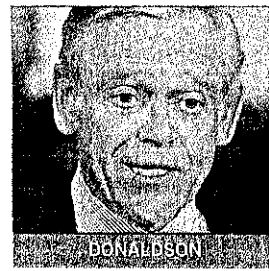


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