Letter from the Director

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

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

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

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

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

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

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

[1]See ***Quarterly Banking Profile,*** first quarter 2004, for further details (https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2004mar/qbp.pdf).

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

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

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

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

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