Office of the Comptroller of the Currency
September 1998

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Background

The Office of the Comptroller of the Currency (OCC) was established in 1863 as a bureau of the Department of the Treasury. The OCC is headed by the Comptroller, who is appointed by the President, with the advice and consent of the Senate, for a five-year term.

The OCC regulates national banks by its power to:

- Examine the banks;
- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure;
- Take supervisory actions against banks that do not conform to laws and regulations or that otherwise engage in unsound banking practices, including removal of officers, negotiation of agreements to change existing banking practices, and issuance of cease and desist orders; and
- Issue rules and regulations concerning banking practices and governing bank lending and investment practices and corporate structure.

The OCC divides the United States into six geographical districts, with each headed by a deputy comptroller.

The OCC is funded through assessments on the assets of national banks, and federal branches and agencies. Under the International Banking Act of 1978, the OCC regulates federal branches and agencies of foreign banks in the United States.

The Comptroller

Julie L. Williams became acting Comptroller of the Currency on April 6, 1998, succeeding Eugene A. Ludwig whose term of office had ended. She had been chief counsel since 1994 with responsibilities for all of the agency's legal activities. As the Comptroller's top legal advisor, Ms. Williams served as a member of the Executive Committee, providing advice and guidance on major issues and actions. Ms. Williams joined the OCC in 1993 as deputy chief counsel, with responsibility for special legislative and regulatory projects.

Before joining the OCC in 1993, Ms. Williams served in a variety of positions at the Office of Thrift Supervision and its predecessor agency, the Federal Home Loan Bank Board. From 1991 to 1993, she was senior deputy chief counsel, responsible for regulations and legislation, corporate and securities law and general legal issues. She previously served as deputy chief counsel for securities and corporate analysis. In 1983 she joined the Bank Board, after working as an attorney since 1975 with the law firm of Fried, Frank, Harris, Shriver & Kampelman in Washington, D.C.

Ms. Williams is the author of *Savings Institutions: Mergers, Acquisitions and Conversions* (Law Journal Seminars-Press, 1988) and has published numerous articles on the regulation of depository institutions, financial services, securities and corporate law matters. She was awarded a B.A. from Goddard College, Plainfield, Vermont, in 1971, and a J.D. in 1975 from Antioch School of Law, Washington, D.C., where she was first in her class.

The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year in March, June, September, and December. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and congressional testimony, material released in the interpretive letters series, statistical data, and other information of interest to the administration of national banks. Suggestions, comments, or questions on content may be sent to Rebecca W. Miller, Senior Writer-Editor, Communications Division, Comptroller of the Currency, Washington, DC 20219–0001. Subscriptions are available for $100 a year by writing to Publications—QJ, Comptroller of the Currency, P.O. Box 70004, Chicago, IL 60673–0004. You may now view the *Quarterly Journal* on the World Wide Web at http://www.occ.treas.gov.

Quarterly Journal

Office of the Comptroller of the Currency

Julie L. Williams

Acting Comptroller of the Currency

The Administrator of National Banks

Contents

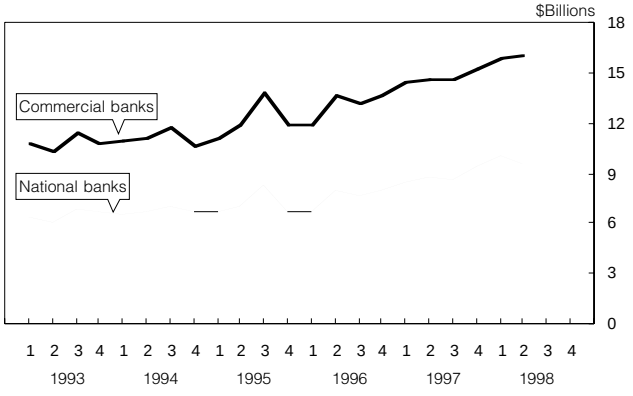
Condition and Performance of Commercial Banks

Commercial banks reported their sixth consecutive quarter of record earnings in the second quarter of 1998. This unprecedented run of record earnings, however, has likely drawn to an end. First, several large banks have already announced large write-offs for trading losses in the third quarter because of deepening of the Asian and Russian crises. Second, although most economists are not forecasting a national recession in the coming year, most forecasts now call for slower growth than previously expected, with a higher risk of a recession. Given the loosening of commercial credit standards over the last four years, a slowdown in U.S. economic growth would likely lead to an increase in problem loans and lower bank earnings. The banking industry is facing this period of possibly slower economic growth and economic uncertainty from a position of generally strong financial health, though there was some moderation in credit quality and earnings growth over the last year.

Earnings Trends

Commercial banks earned a record $16.1 billion in the second quarter of 1998 (see Figure 1). Industry earnings increased 10 percent from the second quarter of 1997 and were 1 percent higher than in the first quarter of 1998. The annualized return on average assets (ROA) for all commercial banks was 1.25 percent, virtually unchanged from both the second quarter a year ago and the first quarter of 1998. The industry's annualized return on average equity (ROE) was 14.72 percent, unchanged from the second quarter a year ago, but down 30 basis points from the first quarter.

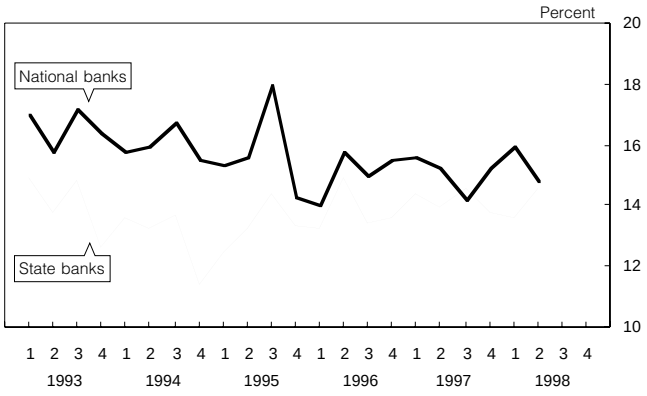
Figure 1—Quarterly net income, 1993–1998



Source: Integrated Banking Information System

National banks earnings increased 9 percent from the second quarter of 1997 to $9.6 billion, but declined 4 percent from the first quarter. National banks experienced year-ago and previous-quarter decreases in ROA and ROE, to 1.29 percent and 14.80 percent, respectively (see Figure 2). National banks out-performed state-chartered banks on an ROA and ROE basis, in the second quarter, but the difference in performance narrowed considerably. National banks earned a higher ROE than state-chartered banks in all but one quarter since 1993.

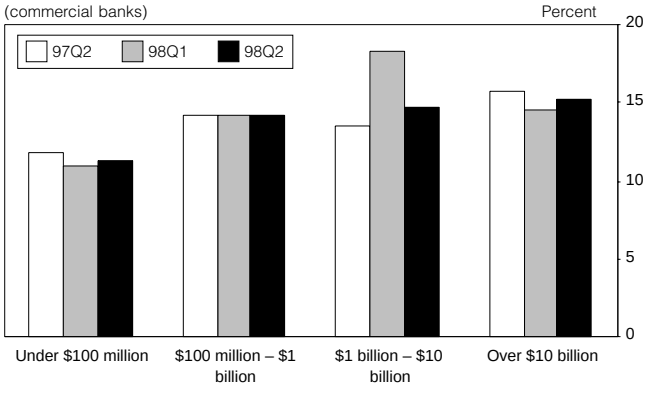
Figure 2—Quarterly return on equity, 1993–1998



Source: Integrated Banking Information System

The ROE for the largest and smallest commercial banks declined from the second quarter of 1997 (see Figure 3). For banks with assets over $10 billion, ROE declined 48 basis points to 15.25 percent, and banks with assets under $100 million saw a 50 basis point decline to 11.27 percent. However, ROE increased compared with the first quarter for both these size groups.

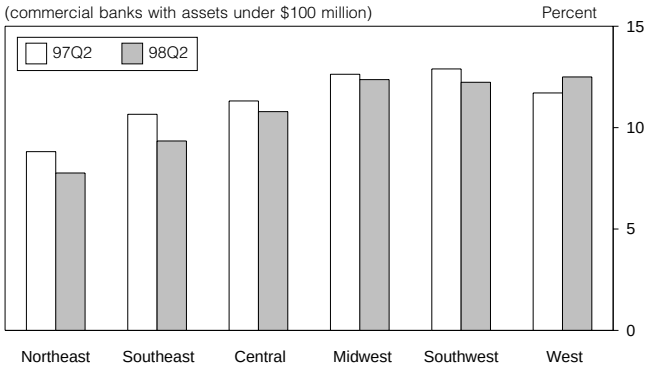
Figure 3—Quarterly return on equity by size of bank, 1997 and 1998



Source: Integrated Banking Information System

There were large differences in the profitability by region for banks with assets under $100 million (see Figure 4). Small bank profitability was considerably lagging in the

Figure 4—Quarterly return on equity by region, for second quarter 1997 and 1998



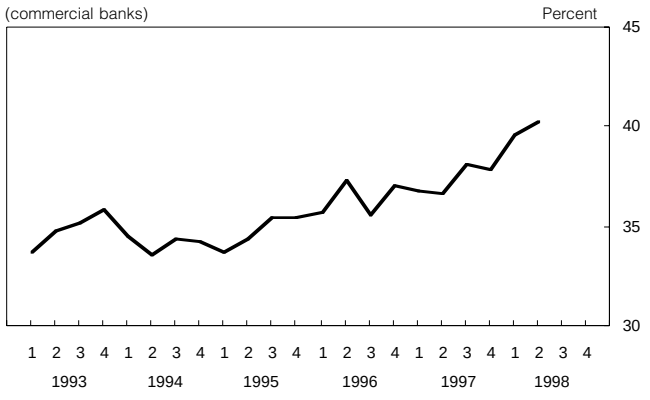
Source: Integrated Banking Information System

Northeast and Southeast, the only regions where ROE was under 10 percent in the second quarter of 1998. Small banks in the West earned the highest average ROE, and the West was the only region where small banks showed an increase in ROE from a year ago.

Although industry earnings generally remained strong in the second quarter, some banks experienced slippage. Sixty-nine percent of all banks earned an ROA over 1 percent in the second quarter, while 72 percent of all banks did so a year ago. Fifty-nine percent of all banks registered year-to-year earnings gains in the second quarter, down from 65 percent of the industry a year ago. Also, the share of banks reporting second quarter losses increased to 4.9 percent from 4.2 percent a year ago.

On the revenue side of the income statement, noninterest income continued to grow faster than net interest income. Noninterest income in the second quarter was 21 percent higher than a year ago, while net interest income was 5 percent higher. Consequently, the share of industry revenues from noninterest income rose to 40 percent in the second quarter, compared with 37 percent a year ago (see Figure 5).

Figure 5—Noninterest income to net operating revenue, 1993–1998



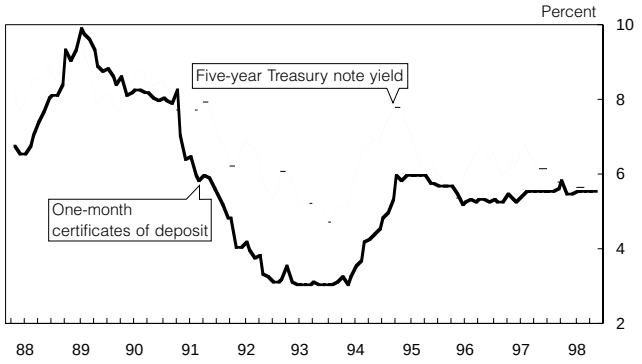
Source: Integrated Banking Information System

Trading revenue was the fastest growing component of noninterest income, increasing 27 percent over the last year. However, trading revenue accounted for only 8 percent of noninterest income for the industry as a whole, with banks over $10 billion in assets accounting for 97 percent of total trading revenue. The share of total noninterest income from fiduciary activities held steady at 15 percent, while the contribution from service charges on deposits declined to 16 percent from 18 percent a year ago.

Net interest income increased modestly even though earning assets grew by 8 percent over the last year, consistent with declining net interest margins. Net interest income to assets in the second quarter declined by 16 basis points over the last year to 3.53 percent.

Interest rate movements and changes in banks' balance sheet composition have both contributed to this decline in average net interest margins. First, as shown in Figure 6, the spread between interest rates on earning assets (represented by the five-year Treasury note rate) and interest rates on deposits (represented by the one-month CD rate) narrowed over the last year as the yield curve has flattened. Second, since credit card loans have higher interest rates than other types of loans, as banks securitize more of their credit card loans they lower their average net interest margin. Over the last year, credit card loans held on-balance-sheet decreased 4 percent, while credit card loans securitized and sold off-balance-sheet increased 42 percent. Third, over the last year interest-bearing deposits increased 8 percent, while noninterest-bearing deposits grew just 3 percent. This greater dependence on interest-bearing deposits also lowers banks' average net interest margin.

Figure 6—Representative interest rates on earning assets and deposits, 1988–1998



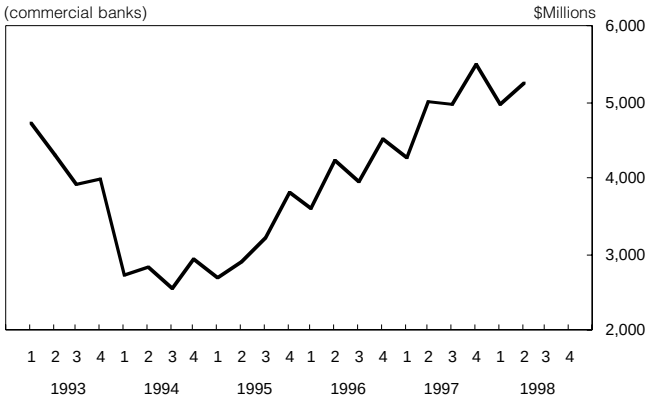
Source: Haver Analytics

Owing to the drop in interest rates over the last year, realized gains on securities nearly doubled from a year ago to $575 million. However, realized securities gains had a relatively minor impact on industry earnings, adding only 4 basis points before taxes to the industry

ROA of 1.25 in the quarter. Also, only 110 banks, or slightly more than 1 percent of the industry, took securities gains that added more than 25 basis points before taxes to their second quarter ROA.

On the cost side of income statement, provisioning for loan and lease losses increased by $235 million, or 5 percent, from a year earlier to $5.3 billion (see Figure 7). The increase was entirely accounted for by provisioning attributable to international operations, which increased to $474 million from $239 million. Provisioning was a 41 basis point drag (before taxes) on ROA, compared with 43 basis points a year ago. Provisions exceeded net charge-offs to loans and leases in each of the last four quarters, resulting in a 3 percent increase in the reserve for losses. Because reserves increased less than loans, however, the loss-reserve-to-loans ratio declined to 1.82 percent, compared with 1.90 percent a year ago and 1.83 percent in the first quarter. For the industry as a whole, the ratio of loss reserves to loans is now at its lowest level since the first quarter of 1987. Note, however, that because of the low level of noncurrent loans, the loss-reserve-to-noncurrent-loans ratio is at a record high of 194 percent.

Figure 7—Provision for loan and lease losses



Source: Integrated Banking Information System

Provisioning had the largest impact on earnings of banks concentrated in credit card lending. Sixty-three credit card banks[1]—which held 64 percent of credit card loans but only 4 percent of total banking assets—accounted for 39 percent of total industry provisions in the second quarter. For these institutions, provisioning represented a 434 basis point pre-tax reduction on second quarter ROA, compared to a 26 basis point reduction for all other banks. Credit card banks, however, continued to earn a higher ROA than the rest of the industry—2.75 percent versus 1.19 percent, respectively—because of their higher net interest margins and noninterest income rates.

[1] Credit card banks defined here as those institutions whose credit card loans constitute at least 50 percent of their loans, and total loans are at least 50 percent of their assets.

Credit Quality Trends

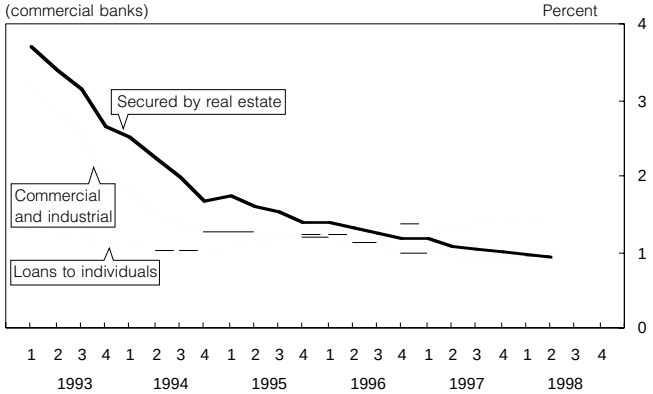
Aggregate call report measures of credit quality continued to signal that credit quality conditions generally remained favorable for the industry as a whole. Total noncurrent loans (90 days past due and nonaccrual) were $505 million higher than in the second quarter a year ago, but decreased by $413 million from the first quarter to $29.1 billion. The noncurrent loan ratio declined to 0.94 percent from 1.0 percent a year earlier and 0.98 percent in the first quarter. Net charge-offs of loans and leases increased 12 percent from the second quarter of 1998 to $4.9 billion. The net charge-off rate for loan and leases was 0.64 percent, up 2 basis points from a year ago, and unchanged from the first quarter.

These aggregate measures of industry credit quality, however, mask negative credit quality developments for particular loan types and sectors of the banking industry.

The net charge-off rate for credit card loans hit a record 5.65 percent in the second quarter, an increase of 43 basis points from a year ago, and 25 basis points from the first quarter. Although the delinquency rate for credit cards declined for the second consecutive quarter to 4.53 percent, it remained historically high and 12 basis points above the level of a year ago. These problems are primarily localized in large credit card issuers and banks that concentrate in credit card lending. The 63 credit card banks identified earlier, along with the 14 other banks with at least $1 billion in outstanding credit cards, account for 89 percent of credit card charge-offs and 90 percent of delinquencies.

Noncurrent commercial and industrial (C&I) loans increased by $120 million in the second quarter to $8.0 billion, and were $817 million above their level one year ago. However, the noncurrent ratio for C&I loans declined 2 basis points (see Figure 8), owing to a combination of strong C&I loan growth and a 12 percent increase in charge-offs of C&I loans.

Figure 8—Noncurrent loan ratios by loan type, 1993–1998



Source: Integrated Banking Information System

The increase in noncurrent C&I loans over the last year is particularly noteworthy because, for more than two years, bank regulators have warned that surveys indicated an easing of terms and weakening of underwriting standards on loans, especially commercial loans. The 1998 OCC Underwriting Survey,[2] showed that examiners at 69 percent of the surveyed banks—compared with 59 percent in 1997—reported eased underwriting standards for one or more types of commercial loans. This trend was most pronounced in national, middle market, and commercial real estate lending. The weakening of underwriting standards for commercial loans is of particular concern because C&I loans and commercial and construction real estate loans have been the fastest growing categories of loans over the last two years. Also, commercial loans are generally larger on average, and thus put more capital at risk, than other types of loans.

The increase in noncurrent C&I loans in the second quarter was entirely attributable to loans to non-U.S. addressees, a direct impact of the Asian crisis on U.S. banks. The noncurrent ratio for C&I loans to non-U.S. addressees rose 8 basis points in the second quarter to 1.31 percent. One year ago, the noncurrent rate for these loans was just 0.7 percent. Commercial and industrial loans to non-U.S. addressees make up 17 percent of total C&I loans, but accounted for 23 percent of noncurrent C&I loans. Slightly less than 200 banks have C&I loans to non-U.S. addressees. Of those banks, 20 have an exposure in excess of their equity capital, and another 30 have an exposure between 100 and 25 percent of equity capital.

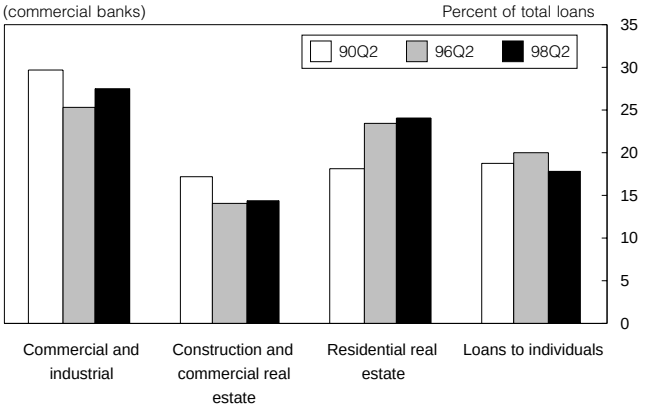
On-Balance-Sheet and Off-Balance-Sheet Activity

As has been the case for over two years, commercial loans continued to be the fastest growing part of banks' loan portfolios in the second quarter. C&I loans grew at a 15 percent annualized rate in the second quarter, and commercial and construction real estate grew at a 6 percent annualized rate. By contrast, loans to individuals and 1–4 family residential real estate loans grew at 4 percent and 2 percent annualized rates, respectively. Over the last year, C&I loans rose 13 percent, commercial and construction loans increased 8 percent, loans to individuals decreased 2 percent, and 1–4 family residential real estate loans grew 7 percent.

The accelerating growth in commercial lending has been an important source of revenues for banks over the last two years. However, there are some indications that this growth may slow. A recent Federal Reserve Board survey of 57 large banks found that overall demand for business credit has begun to slow over the last three months.[3] More than 20 percent of the banks surveyed said that business loan demand had fallen in the past three months. Banks reporting weaker demand outnumbered those reporting stronger demand almost two to one, and this was the first time since early 1996 that more banks reported weaker demand than reported stronger demand. Bankers attributed the weakness to decreased business investment in plant and equipment, lessened merger and acquisition activity, and greater reliance on nonbank lenders.

Despite the over two-year shift towards commercial lending, commercial loans are still a smaller proportion of banks' loan portfolios today than just prior to the last economic downturn in 1990 (see Figure 9). The C&I loan share increased to 27 percent from 25 percent over the last two years, but is still 2 percentage points less than in the second quarter of 1990. Construction and commercial real estate loans currently account for 14 percent of total bank loans, compared with 17 percent in 1990. Residential loans, however, have been an increasing share of banks' portfolios throughout the current expansion, and today account for 24 percent of total loans.

Figure 9—Portfolio share by loan type, for second quarter 1990, 1996, and 1998



Source: Integrated Banking Information System

Increased securitization of credit card loans is partly responsible for the decreased on-balance-sheet exposure to loans to individuals. Credit card loans securitized and sold off-balance-sheet increased to $239 billion in the second quarter, and exceed on-balance-sheet credit card loans for the first time ever. Also, the growth of credit card securitizations has accelerated. Securitized credit cards grew 42 percent over the last four quarters, compared with 20 percent over the previous four quarters. Unused credit card commitments have also been

[2] The survey of examiners at the 77 largest national banks was conducted during the second quarter of 1998.

[3] August 1998 Senior Loan Officer Opinion Survey on Bank Lending Practices, Board of Governors of the Federal Reserve System. The sample is selected from among the largest banks in each Federal Reserve District.

growing at an accelerating pace over the last two years. Consequently, unused credit card commitments are now almost nine times credit card loans, compared with six times loans two years ago.

Banks also continue to increase their use of off-balance-sheet derivatives. The notional amount of derivatives at commercial banks grew 21 percent over the last year, and increased by 8 percent in the second quarter to $28.2 trillion.[4] Eight years ago, the notional value of derivatives at commercial banks was $6.5 trillion. Currently, interest rate contracts account for 71 percent of total derivatives held by banks, compared with 26 percent for foreign exchange contracts, and 2 percent for equity, commodity, and other contracts.

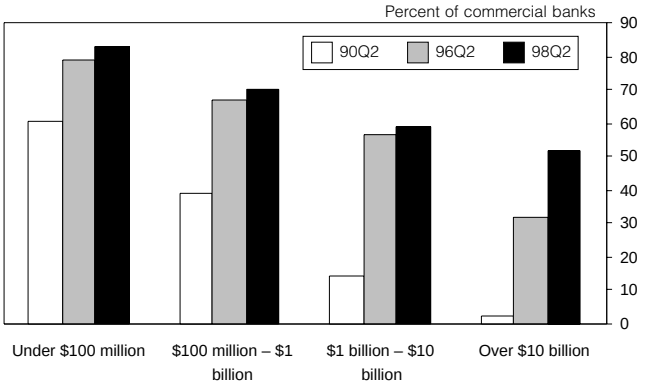
Holdings of off-balance-sheet derivatives continue to be concentrated in the largest banks. Eight institutions account for 95 percent of all derivatives held by banks, with 99 percent held by the 25 largest holders. In total, 461 banks held derivatives as of the second quarter, nine more than in the first quarter. The preponderance of derivatives held for trading activities, including both customer transactions and proprietary positions, is concentrated in the 25 largest holders of derivatives. Smaller banks, on the other hand, tend to limit their use of derivatives to risk management purposes.

While the banking industry's business mix has changed and off-balance-sheet activity has increased, the banking industry is also substantially better capitalized than eight years ago. The equity capital ratio for the industry has increased to 8.6 percent from 6.4 percent in the second quarter of 1990. Currently, 78 percent of all banks have an equity capital ratio greater than 8 percent. In the second quarter of 1990, just 54 percent of the banking industry had a capital ratio greater than 8 percent. Both large and small banks have increased their capital ratios, with the capitalization of the largest banks showing the most improvement. Currently, over half of the banks with assets over $10 billion have an equity capital ratio in excess of 8 percent, compared with just 2 percent of the largest banks eight years ago, and 32 percent two years ago (see Figure 10).

National Bank Supervisory Ratings

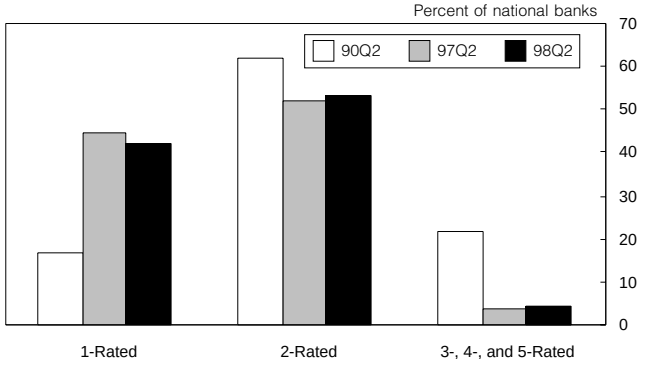
The analysis of earnings, credit quality, and on- and off-balance-sheet activity above shows that even with record industry earnings in each of the last six quarters, there has been some slippage in bank performance and condition over the last year. This is also reflected in changes in the distribution of composite CAMELS ratings for national banks over the last year.[5] As of the second quarter of 1998, 42 percent of all national banks were 1-rated (the best possible rating), down from 44 percent a year ago (see Figure 11). There was movement into both the 2-rated and 3-, 4-, and 5- rated categories. The share of national banks 2-rated rose from 52 percent to 53 percent, and the share of national banks with a rating of 3, 4, or 5 increased from 3 percent to 4 percent. Note, however, that national banks are generally in much better financial health today than eight years ago. As of the second quarter of 1980, only 16 percent of national banks were 1-rated and 22 percent had a composite CAMELS rating of 3, 4, or 5.

Figure 10—Banks with equity capital ratio over 8 percent by size of bank, for second quarter 1990, 1996, and 1998



Source: Integrated Banking Information System

Figure 11—National banks by composite CAMELS rating, for second quarter 1990, 1997, and 1998



Source: Integrated Banking Information System

[4] Notional amounts are helpful in measuring the level and trend of derivative activity, but are not a good indicator of risk exposure.

[5] The Uniform Financial Institutions Rating System rates six components of a bank's performance: capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS) in a combined composite rating. The sixth component—sensitivity to market risk—was added in 1997.

Conclusions

The commercial banking industry's unprecedented run of six consecutive quarters of record earnings is likely at an end. The economic crises in Asia and Russia led to third quarter trading losses for several large banks, and increases the risk that the crisis will spread to Latin America and have an even more adverse effect on the U.S. economy. While a recession in the United States may still not be imminent, most forecasts are now calling for slower growth in 1999 than previously expected, with a higher risk of a recession. Slower economic growth and increased economic uncertainty would probably cut into banks' net interest income because of weaker loan demand, and could likely lead to higher provisioning for loan losses because of deteriorating credit quality. The loosening of commercial credit standards over the last four years particularly heightens concerns over deterioration in credit quality.

U.S. banks are facing this period of possibly slower economic growth and increased uncertainty in generally strong financial health. Earnings, credit quality, and capitalization are all stronger going into this period of economic uncertainty than prior to the last recession. Over the last year, however, there has been some slippage in earnings growth and credit quality.

Key indicators, FDIC-insured national banks
Annual 1994–1997, year-to-date through June 30, 1998, second quarter 1997, and second quarter 1998
(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q2	Preliminary 1998Q2
Number of institutions reporting	3,075	2,858	2,726	2,597	2,546	2,657	2,546
Total employees (FTEs)	851,311	840,699	850,737	912,463	952,354	886,291	952,354
Selected Income Data ($)							
Net income	$26,803	$28,583	$30,497	$35,784	$19,558	$8,784	$9,581
Net interest income	83,958	87,080	94,564	106,641	54,533	25,941	27,615
Provision for loan losses	5,500	6,335	9,598	13,064	7,044	3,179	3,725
Noninterest income	45,906	51,080	56,100	65,429	37,682	15,508	19,274
Noninterest expense	83,941	87,591	93,690	104,681	56,408	24,813	28,459
Net operating income	27,027	28,540	30,096	34,995	18,335	8,630	9,296
Cash dividends declared	17,669	20,516	25,279	28,572	11,528	6,058	3,855
Net charge-offs to loan and lease reserve	5,994	6,459	9,968	12,661	6,813	2,979	3,485
Selected Condition Data ($)							
Total assets	2,256,008	2,401,017	2,528,057	2,893,908	2,978,601	2,688,361	2,978,601
Total loans and leases	1,382,855	1,522,677	1,641,464	1,840,485	1,923,469	1,746,937	1,923,469
Reserve for losses	30,990	31,142	31,992	34,864	36,340	34,021	36,340
Securities	414,264	390,549	380,615	452,119	474,122	408,280	474,122
Other real estate owned	5,709	3,396	2,761	2,112	1,982	2,449	1,982
Noncurrent loans and leases	17,852	17,595	17,223	17,877	17,776	17,211	17,776
Total deposits	1,630,171	1,695,817	1,801,043	2,004,867	2,035,448	1,879,289	2,035,448
Domestic deposits	1,350,658	1,406,312	1,525,565	1,685,316	1,708,326	1,580,898	1,708,326
Equity capital	172,655	189,714	207,167	244,967	263,687	232,656	263,687
Off-balance-sheet derivatives	7,570,283	7,914,818	7,488,663	8,704,481	9,815,132	7,900,454	9,815,132
Performance Ratios (annualized %)							
Return on equity	15.99	15.76	15.28	15.00	15.35	15.26	14.80
Return on assets	1.24	1.24	1.25	1.29	1.32	1.32	1.29
Net interest income to assets	3.87	3.78	3.88	3.83	3.69	3.88	3.71
Loss provision to assets	0.25	0.27	0.39	0.47	0.48	0.48	0.50
Net operating income to assets	1.25	1.24	1.24	1.26	1.24	1.29	1.25
Noninterest income to assets	2.12	2.22	2.30	2.35	2.55	2.32	2.59
Noninterest expense to assets	3.87	3.80	3.85	3.76	3.82	3.72	3.82
Loss provision to loans and leases	0.42	0.44	0.61	0.73	0.75	0.74	0.78
Net charge-offs to loans and leases	0.46	0.45	0.63	0.71	0.72	0.69	0.73
Loss provision to net charge-offs	91.75	98.09	96.29	103.18	103.36	106.72	106.90
Performance Ratios (%)							
Percent of institutions unprofitable	4.13	3.32	4.77	4.85	4.83	4.25	5.34
Percent of institutions with earnings gains	52.59	66.83	67.83	68.04	63.59	63.87	59.70
Noninterest income to net operating revenue	35.35	36.97	37.24	38.02	40.86	37.41	41.11
Noninterest expense to net operating revenue	64.64	63.40	62.18	60.84	61.17	59.86	60.70
Condition Ratios (%)							
Nonperforming assets to assets	1.05	0.88	0.80	0.70	0.67	0.74	0.67
Noncurrent loans to loans	1.29	1.16	1.05	0.97	0.92	0.99	0.92
Loss reserve to noncurrent loans	173.59	176.99	185.75	195.02	204.43	197.67	204.43
Loss reserve to loans	2.24	2.05	1.95	1.89	1.89	1.95	1.89
Equity capital to assets	7.65	7.90	8.19	8.46	8.85	8.65	8.85
Leverage ratio	7.39	7.31	7.40	7.42	7.50	7.61	7.50
Risk-based capital ratio	12.47	12.09	11.97	11.87	11.92	12.08	11.92
Net loans and leases to assets	59.92	62.12	63.66	62.39	63.36	63.72	63.36
Securities to assets	18.36	16.27	15.06	15.62	15.92	15.19	15.92
Appreciation in securities (% of par)	–3.84	0.86	0.50	1.11	0.99	0.51	0.99
Residential mortgage assets to assets	20.43	20.13	19.81	20.10	20.44	19.91	20.44
Total deposits to assets	72.26	70.63	71.24	69.28	68.34	69.90	68.34
Core deposits to assets	55.16	53.28	54.08	51.59	50.80	52.64	50.80
Volatile liabilities to assets	29.90	30.29	29.83	31.42	31.55	30.84	31.55

Loan performance, FDIC-insured national banks
Annual 1994–1997, year-to-date through June 30, 1998, second quarter 1997, and second quarter 1998
(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q2	Preliminary 1998Q2
Percent of Loans Past Due 30–89 Days							
Total loans and leases	1.14	1.26	1.39	1.32	1.12	1.21	1.12
Loans secured by real estate (RE)	1.28	1.38	1.45	1.39	1.14	1.21	1.14
1–4 family residential mortgages	1.28	1.44	1.63	1.65	1.36	1.50	1.36
Home equity loans	0.87	1.19	1.04	0.93	0.78	0.86	0.78
Multifamily residential mortgages	1.45	1.15	1.28	1.33	0.80	0.79	0.80
Commercial RE loans	1.26	1.26	1.25	0.95	0.80	0.82	0.80
Construction RE loans	1.67	1.42	1.63	1.63	1.33	1.17	1.33
Commercial and industrial loans*	0.76	0.77	0.89	0.76	0.72	0.81	0.72
Loans to individuals	1.77	2.16	2.46	2.52	2.20	2.20	2.20
Credit cards	2.08	2.35	2.70	2.75	2.43	2.40	2.43
Installment loans	1.59	2.04	2.26	2.34	2.02	2.04	2.02
All other loans and leases	0.34	0.40	0.41	0.46	0.40	0.43	0.40
Percent of Loans Noncurrent							
Total loans and leases	1.29	1.16	1.05	0.97	0.92	0.99	0.92
Loans secured by real estate (RE)	1.83	1.46	1.27	1.07	1.00	1.12	1.00
1–4 family residential mortgages	0.96	0.90	1.10	1.01	0.92	0.99	0.92
Home equity loans	0.56	0.52	0.47	0.43	0.41	0.41	0.41
Multifamily residential mortgages	3.19	2.21	1.47	1.01	0.87	1.14	0.87
Commercial RE loans	2.81	2.18	1.71	1.27	1.16	1.46	1.16
Construction RE loans	4.93	3.17	1.31	1.00	1.00	0.99	1.00
Commercial and industrial loans*	1.04	1.06	0.87	0.78	0.84	0.88	0.84
Loans to individuals	1.01	1.18	1.34	1.49	1.36	1.30	1.36
Credit cards	1.09	1.34	1.70	2.03	1.77	1.73	1.77
Installment loans	0.97	1.06	1.04	1.04	1.04	0.97	1.04
All other loans and leases	0.47	0.32	0.25	0.27	0.28	0.28	0.28
Percent of Loans Charged-Off, Net							
Total loans and leases	0.46	0.45	0.63	0.71	0.72	0.69	0.73
Loans secured by real estate (RE)	0.29	0.13	0.09	0.06	0.04	0.05	0.03
1–4 family residential mortgages	0.14	0.10	0.08	0.08	0.06	0.10	0.06
Home equity loans	0.25	0.23	0.24	0.18	0.18	0.19	0.15
Multifamily residential mortgages	0.39	0.20	0.09	0.01	0.03	–0.07	0.09
Commercial RE loans	0.47	0.18	0.02	–0.01	–0.05	–0.03	–0.08
Construction RE loans	0.82	–0.01	0.16	–0.10	–0.01	–0.10	–0.02
Commercial and industrial loans*	0.16	0.10	0.22	0.27	0.27	0.21	0.32
Loans to individuals	1.49	1.80	2.45	2.86	3.11	2.85	3.15
Credit cards	3.06	3.40	4.25	4.95	5.56	5.14	5.82
Installment loans	0.59	0.76	1.04	1.20	1.19	1.06	1.12
All other loans and leases	–0.15	–0.14	0.17	0.15	0.19	0.09	0.21
Loans Outstanding ($)							
Total loans and leases	$1,382,855	$1,522,677	$1,641,464	$1,840,485	$1,923,469	$1,746,937	$1,923,469
Loans secured by real estate (RE)	562,005	610,405	646,570	725,287	742,042	693,489	742,042
1–4 family residential mortgages	282,000	317,521	329,031	363,327	373,928	349,323	373,928
Home equity loans	46,044	48,836	55,022	67,670	66,922	62,318	66,922
Multifamily residential mortgages	17,081	18,161	20,480	23,346	23,543	22,366	23,543
Commercial RE loans	151,514	157,638	170,359	190,072	190,752	181,330	190,752
Construction RE loans	33,571	34,736	38,839	47,388	51,936	44,093	51,936
Farmland loans	8,310	8,734	9,046	10,177	10,570	9,617	10,570
RE loans from foreign offices	23,484	24,779	23,794	23,306	24,392	24,442	24,392
Commercial and industrial loans	370,094	405,630	425,148	508,564	552,144	465,262	552,144
Loans to individuals	291,799	320,009	356,067	371,516	365,339	364,204	365,339
Credit cards	111,109	131,228	161,104	168,257	159,452	160,053	159,452
Installment loans	180,690	188,781	194,963	203,258	205,888	204,151	205,888
All other loans and leases	162,135	189,490	216,194	237,330	266,084	226,615	266,084
Less: Unearned income	3,178	2,857	2,515	2,212	2,141	2,634	2,141

* Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured national banks by asset size
Second quarter 1997 and second quarter 1998

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1997Q2	1998Q2	1997Q2	1998Q2	1997Q2	1998Q2	1997Q2	1998Q2
Number of institutions reporting	1,428	1,329	1,036	1,030	151	147	42	40
Total employees (FTEs)	37,788	33,485	115,441	113,237	161,410	160,337	571,652	645,295
Selected Income Data ($)								
Net income	$223	$211	$933	$899	$1,491	$1,726	$6,137	$6,745
Net interest income	763	699	2,911	2,815	5,291	5,254	16,975	18,847
Provision for loan losses	42	36	220	192	1,285	1,285	1,632	2,213
Noninterest income	378	398	1,224	1,203	2,855	3,953	11,052	13,721
Noninterest expense	781	768	2,537	2,500	4,533	5,210	16,962	19,980
Net operating income	223	209	927	890	1,479	1,700	6,001	6,496
Cash dividends declared	106	143	506	452	1,017	1,128	4,429	2,133
Net charge-offs to loan and lease reserve	24	26	185	174	1,015	1,299	1,754	1,986
Selected Condition Data ($)								
Total assets	70,595	65,899	267,731	270,371	488,853	482,286	1,861,181	2,160,046
Total loans and leases	40,451	38,136	163,712	164,093	324,352	313,150	1,218,422	1,408,091
Reserve for losses	545	513	2,564	2,412	7,749	7,987	23,164	25,429
Securities	20,933	17,864	72,064	71,382	90,413	89,737	224,870	295,140
Other real estate owned	100	85	274	236	317	205	1,757	1,456
Noncurrent loans and leases	468	414	1,477	1,380	3,378	3,124	11,888	12,858
Total deposits	60,553	56,402	217,708	220,196	330,497	315,617	1,270,531	1,443,233
Domestic deposits	60,553	56,402	217,293	219,676	323,646	309,905	979,407	1,122,343
Equity capital	7,508	7,121	26,293	26,276	45,834	49,069	153,022	181,220
Off-balance-sheet derivatives	701	535	7,837	4,095	56,713	68,162	8,047,587	10,022,927
Performance Ratios (annualized %)								
Return on equity	12.05	11.91	14.40	13.84	13.14	14.56	16.20	15.12
Return on assets	1.27	1.29	1.41	1.34	1.22	1.45	1.33	1.24
Net interest income to assets	4.36	4.27	4.40	4.19	4.34	4.42	3.67	3.48
Loss provision to assets	0.24	0.22	0.33	0.29	1.05	1.08	0.35	0.41
Net operating income to assets	1.27	1.28	1.40	1.32	1.21	1.43	1.30	1.20
Noninterest income to assets	2.16	2.43	1.85	1.79	2.34	3.33	2.39	2.53
Noninterest expense to assets	4.46	4.70	3.83	3.72	3.71	4.38	3.67	3.69
Loss provision to loans and leases	0.42	0.38	0.55	0.47	1.59	1.66	0.54	0.64
Net charge-offs to loans and leases	0.25	0.28	0.46	0.43	1.26	1.68	0.58	0.57
Loss provision to net charge-offs	172.83	135.67	118.81	110.46	126.58	98.97	93.03	111.40
Performance Ratios (%)								
Percent of institutions unprofitable	6.58	7.45	1.16	2.72	4.64	6.12	0.00	0.00
Percent of institutions with earnings gains	59.66	53.65	69.59	65.63	62.91	67.35	69.05	80.00
Noninterest income to net operating revenue	33.09	36.27	29.60	29.94	35.04	42.93	39.43	42.13
Noninterest expense to net operating revenue	68.42	70.11	61.35	62.23	55.65	56.59	60.52	61.35
Condition Ratios (%)								
Nonperforming assets to assets	0.81	0.76	0.66	0.60	0.76	0.69	0.74	0.67
Noncurrent loans to loans	1.16	1.08	0.90	0.84	1.04	1.00	0.98	0.91
Loss reserve to noncurrent loans	116.37	124.02	173.54	174.73	229.39	255.66	194.85	197.76
Loss reserve to loans	1.35	1.35	1.57	1.47	2.39	2.55	1.90	1.81
Equity capital to assets	10.63	10.81	9.82	9.72	9.38	10.17	8.22	8.39
Leverage ratio	10.48	10.57	9.40	9.21	8.23	8.66	7.08	6.92
Risk-based capital ratio	18.01	17.97	15.25	15.20	12.66	13.48	11.41	11.18
Net loans and leases to assets	56.53	57.09	60.19	59.80	64.76	63.27	64.22	64.01
Securities to assets	29.65	27.11	26.92	26.40	18.49	18.61	12.08	13.66
Appreciation in securities (% of par)	0.13	0.65	0.23	0.85	0.40	1.03	0.69	1.03
Residential mortgage assets to assets	22.69	21.98	25.94	25.84	22.78	22.34	18.18	19.30
Total deposits to assets	85.77	85.59	81.32	81.44	67.61	65.44	68.26	66.81
Core deposits to assets	75.31	74.31	71.07	70.34	58.58	56.55	47.56	46.36
Volatile liabilities to assets	12.56	12.78	16.74	16.70	27.33	26.77	34.49	35.04

Loan performance, FDIC-insured national banks by asset size
Second quarter 1997 and second quarter 1998

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1997Q2	1998Q2	1997Q2	1998Q2	1997Q2	1998Q2	1997Q2	1998Q2
Percent of Loans Past Due 30–89 Days								
Total loans and leases	1.48	1.43	1.27	1.23	1.57	1.61	1.10	0.99
Loans secured by real estate (RE)	1.29	1.21	0.99	1.00	1.23	1.10	1.24	1.17
1–4 family residential mortgages	1.56	1.49	1.18	1.17	1.34	1.09	1.61	1.46
Home equity loans	1.25	0.86	0.78	0.89	0.84	0.91	0.87	0.74
Multifamily residential mortgages	0.97	0.70	0.87	0.75	0.80	0.99	0.75	0.75
Commercial RE loans	0.96	0.94	0.75	0.76	1.02	1.02	0.76	0.74
Construction RE loans	1.42	1.28	1.11	1.15	1.87	1.64	0.91	1.27
Commercial and industrial loans*	2.45	2.45	1.65	1.71	1.47	1.52	0.59	0.52
Loans to individuals	2.20	2.19	2.02	1.86	2.19	2.33	2.22	2.18
Credit cards	2.73	5.00	2.65	2.75	2.36	2.41	2.40	2.41
Installment loans	2.17	2.03	1.83	1.66	1.97	2.21	2.09	2.03
All other loans and leases	N/A	N/A	N/A	N/A	0.92	1.32	0.39	0.33
Percent of Loans Noncurrent								
Total loans and leases	1.16	1.08	0.90	0.84	1.04	1.00	0.98	0.91
Loans secured by real estate (RE)	0.95	0.91	0.78	0.70	1.01	0.82	1.23	1.11
1–4 family residential mortgages	0.81	0.80	0.68	0.65	1.11	0.67	1.04	1.04
Home equity loans	0.50	0.61	0.36	0.35	0.42	0.53	0.42	0.39
Multifamily residential mortgages	0.69	0.29	0.87	0.52	0.82	0.75	1.33	1.00
Commercial RE loans	1.10	0.96	0.93	0.78	1.03	1.11	1.80	1.29
Construction RE loans	0.71	0.89	0.78	0.72	0.93	0.85	1.08	1.12
Commercial and industrial loans*	2.89	2.60	1.57	1.49	0.88	0.82	0.79	0.78
Loans to individuals	0.84	0.81	0.83	0.77	1.28	1.40	1.39	1.42
Credit cards	2.04	2.73	1.94	2.02	1.76	1.83	1.69	1.71
Installment loans	0.76	0.70	0.48	0.49	0.63	0.70	1.18	1.24
All other loans and leases	N/A	N/A	N/A	N/A	0.54	0.52	0.26	0.25
Percent of Loans Charged-Off, Net								
Total loans and leases	0.25	0.28	0.46	0.43	1.26	1.68	0.58	0.57
Loans secured by real estate (RE)	0.04	0.03	0.06	0.05	0.00	0.07	0.07	0.02
1–4 family residential mortgages	0.03	0.03	0.09	0.05	0.05	0.08	0.12	0.06
Home equity loans	0.21	0.02	0.02	0.08	0.25	0.12	0.19	0.17
Multifamily residential mortgages	0.02	0.09	0.04	0.32	–0.10	–0.06	–0.09	0.09
Commercial RE loans	0.05	0.03	0.03	0.01	–0.10	0.06	–0.03	–0.14
Construction RE loans	–0.01	0.11	0.05	0.03	–0.19	0.04	–0.12	–0.06
Commercial and industrial loans*	0.60	0.84	0.42	0.57	0.18	0.28	0.20	0.30
Loans to individuals	0.76	0.79	1.82	1.70	3.70	4.69	2.65	2.68
Credit cards	2.86	6.37	5.57	5.67	5.74	6.96	4.71	4.98
Installment loans	0.60	0.46	0.63	0.58	0.86	0.99	1.22	1.26
All other loans and leases	N/A	N/A	N/A	N/A	0.16	0.27	0.09	0.22
Loans Outstanding ($)								
Total loans and leases	$40,451	$38,136	$163,712	$164,093	$324,352	$313,150	$1,218,422	$1,408,091
Loans secured by real estate (RE)	22,698	21,205	96,170	97,802	131,539	125,379	443,081	497,655
1–4 family residential mortgages	11,509	10,566	47,484	47,178	64,309	62,416	226,021	253,767
Home equity loans	548	486	5,028	4,524	11,103	10,271	45,640	51,641
Multifamily residential mortgages	518	488	3,084	3,244	4,844	4,606	13,920	15,204
Commercial RE loans	6,142	5,908	30,396	31,699	40,030	35,886	104,761	117,259
Construction RE loans	1,550	1,417	6,788	7,418	9,509	10,349	26,245	32,752
Farmland loans	2,431	2,340	3,381	3,717	1,624	1,711	2,180	2,802
RE loans from foreign offices	0	0	9	22	120	140	24,314	24,230
Commercial and industrial loans	6,848	6,515	28,323	29,164	67,523	62,200	362,569	454,265
Loans to individuals	6,255	5,767	30,495	26,918	105,090	105,745	222,364	226,910
Credit cards	397	321	7,158	4,951	60,549	66,215	91,950	87,965
Installment loans	5,858	5,446	23,337	21,966	44,541	39,531	130,414	138,945
All other loans and leases	4,843	4,804	9,161	10,587	20,386	19,994	192,224	230,700
Less: Unearned income	194	155	438	378	185	168	1,817	1,440

* Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured national banks by region
Second quarter 1998
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Number of institutions reporting	287	335	531	498	633	262	2,546
Total employees (FTEs)	251,499	246,457	153,883	71,364	73,628	155,523	952,354
Selected Income Data ($)							
Net income	$2,562	$2,269	$1,654	$808	$505	$1,783	$9,581
Net interest income	7,372	6,760	4,364	2,230	1,926	4,964	27,615
Provision for loan losses	1,421	593	404	374	115	818	3,725
Noninterest income	6,579	3,847	2,438	1,780	785	3,845	19,274
Noninterest expense	8,671	6,497	3,980	2,316	1,884	5,112	28,459
Net operating income	2,424	2,187	1,621	816	482	1,765	9,296
Cash dividends declared	759	(687)	988	660	493	1,641	3,855
Net charge-offs to loan and lease reserve	1,398	517	371	358	132	709	3,485
Selected Condition Data ($)							
Total assets	820,713	763,497	498,317	211,744	198,045	486,285	2,978,601
Total loans and leases	507,854	498,748	328,264	148,452	111,877	328,275	1,923,469
Reserve for losses	11,803	7,605	5,246	2,775	1,569	7,342	36,340
Securities	126,510	133,632	85,355	32,221	49,858	46,547	474,122
Other real estate owned	699	487	204	73	110	410	1,982
Noncurrent loans and leases	6,656	3,746	2,658	1,227	975	2,513	17,776
Total deposits	540,309	493,526	339,064	149,635	160,914	352,001	2,035,448
Domestic deposits	330,964	466,063	312,623	144,793	158,289	295,594	1,708,326
Equity capital	65,645	71,611	42,480	18,536	17,666	47,748	263,687
Off-balance-sheet derivatives	3,909,128	2,630,971	1,376,781	34,800	33,819	1,829,634	9,815,132
Performance Ratios (annualized %)							
Return on equity	15.82	13.27	15.87	17.52	11.46	14.86	14.80
Return on assets	1.26	1.16	1.35	1.53	1.02	1.46	1.29
Net interest income to assets	3.64	3.47	3.56	4.21	3.91	4.07	3.71
Loss provision to assets	0.70	0.30	0.33	0.71	0.23	0.67	0.50
Net operating income to assets	1.20	1.12	1.32	1.54	0.98	1.45	1.25
Noninterest income to assets	3.25	1.97	1.99	3.36	1.59	3.15	2.59
Noninterest expense to assets	4.28	3.33	3.25	4.38	3.82	4.19	3.82
Loss provision to loans and leases	1.14	0.48	0.50	1.01	0.42	1.00	0.78
Net charge-offs to loans and leases	1.12	0.42	0.46	0.97	0.48	0.87	0.73
Loss provision to net charge-offs	101.61	114.77	108.99	104.38	87.47	115.40	106.90
Performance Ratios (%)							
Percent of institutions unprofitable	3.48	7.46	3.01	3.41	6.48	10.31	5.34
Percent of institutions with earnings gains	60.28	65.37	60.08	59.84	56.08	59.54	59.70
Noninterest income to net operating revenue	47.16	36.27	35.85	44.39	28.95	43.65	41.11
Noninterest expense to net operating revenue	62.16	61.25	58.51	57.76	69.48	58.04	60.70
Condition Ratios (%)							
Nonperforming assets to assets	0.92	0.55	0.57	0.61	0.55	0.60	0.67
Noncurrent loans to loans	1.31	0.75	0.81	0.83	0.87	0.77	0.92
Loss reserve to noncurrent loans	177.31	203.00	197.34	226.13	160.89	292.21	204.43
Loss reserve to loans	2.32	1.52	1.60	1.87	1.40	2.24	1.89
Equity capital to assets	8.00	9.38	8.52	8.75	8.92	9.82	8.85
Leverage ratio	7.18	7.32	7.67	8.04	7.86	7.73	7.50
Risk-based capital ratio	11.97	11.53	11.83	12.44	13.39	11.85	11.92
Net loans and leases to assets	60.44	64.33	64.82	68.80	55.70	66.00	63.36
Securities to assets	15.41	17.50	17.13	15.22	25.18	9.57	15.92
Appreciation in securities (% of par)	0.76	1.27	1.07	1.16	0.82	0.75	0.99
Residential mortgage assets to assets	15.93	27.44	21.76	20.01	21.57	15.46	20.44
Total deposits to assets	65.83	64.64	68.04	70.67	81.25	72.39	68.34
Core deposits to assets	35.16	53.59	55.35	62.62	70.08	55.16	50.80
Volatile liabilities to assets	45.35	29.78	28.09	19.66	17.96	25.28	31.55

Loan performance, FDIC-insured national banks by region
Second quarter 1998
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Percent of Loans Past Due 30–89 Days							
Total loans and leases	1.19	0.98	1.34	1.34	1.21	0.87	1.12
Loans secured by real estate (RE)	1.23	1.09	1.31	0.85	1.20	1.01	1.14
1–4 family residential mortgages	1.50	1.33	1.39	0.86	1.39	1.44	1.36
Home equity loans	1.00	0.54	0.86	0.89	0.89	0.79	0.78
Multifamily residential mortgages	0.65	0.55	1.18	0.79	0.56	0.95	0.80
Commercial RE loans	0.66	0.76	1.10	0.71	0.89	0.64	0.80
Construction RE loans	0.78	1.17	2.42	1.04	1.62	0.60	1.33
Commercial and industrial loans*	0.47	0.55	1.12	1.60	1.14	0.53	0.72
Loans to individuals	2.53	2.02	2.11	2.16	1.66	2.02	2.20
Credit cards	2.48	2.70	1.96	2.30	2.24	2.35	2.43
Installment loans	2.62	1.73	2.14	2.00	1.60	1.71	2.02
All other loans and leases	0.35	0.28	0.79	0.84	0.44	0.22	0.40
Percent of Loans Noncurrent							
Total loans and leases	1.31	0.75	0.81	0.83	0.87	0.77	0.92
Loans secured by real estate (RE)	1.43	0.94	0.84	0.65	1.01	0.93	1.00
1–4 family residential mortgages	1.09	0.99	0.79	0.55	0.81	0.96	0.92
Home equity loans	0.58	0.38	0.37	0.25	0.20	0.41	0.41
Multifamily residential mortgages	1.36	0.77	0.85	0.60	0.49	0.70	0.87
Commercial RE loans	1.77	1.01	1.09	0.63	1.29	1.15	1.16
Construction RE loans	1.85	0.99	0.86	1.06	0.93	0.78	1.00
Commercial and industrial loans*	0.92	0.64	0.89	1.04	1.07	0.79	0.84
Loans to individuals	2.23	0.85	0.84	1.11	0.62	1.03	1.36
Credit cards	1.92	1.59	1.48	1.55	1.83	1.73	1.77
Installment loans	2.77	0.54	0.70	0.57	0.49	0.35	1.04
All other loans and leases	0.31	0.17	0.42	0.45	0.27	0.22	0.28
Percent of Loans Charged-Off, Net							
Total loans and leases	1.12	0.42	0.46	0.97	0.48	0.87	0.73
Loans secured by real estate (RE)	–0.06	0.06	0.05	0.06	0.02	0.06	0.03
1–4 family residential mortgages	0.09	0.05	0.07	0.06	0.02	0.07	0.06
Home equity loans	0.16	0.19	0.15	0.14	0.40	0.10	0.15
Multifamily residential mortgages	–0.02	0.06	–0.17	0.26	–0.08	0.60	0.09
Commercial RE loans	–0.61	0.04	0.06	0.03	0.00	–0.02	–0.08
Construction RE loans	–0.23	0.02	–0.13	0.11	0.03	0.01	–0.02
Commercial and industrial loans*	0.29	0.21	0.24	0.51	0.49	0.46	0.32
Loans to individuals	4.21	2.19	1.68	3.28	1.45	4.29	3.15
Credit cards	5.68	5.47	5.42	5.20	5.10	7.21	5.82
Installment loans	1.68	0.93	0.80	0.86	1.03	1.32	1.12
All other loans and leases	0.12	0.19	0.64	0.22	0.12	0.11	0.21
Loans Outstanding ($)							
Total loans and leases	$507,854	$498,748	$328,264	$148,452	$111,877	$328,275	$1,923,469
Loans secured by real estate (RE)	152,190	227,050	142,474	58,687	44,954	116,688	742,042
1–4 family residential mortgages	78,333	128,000	67,075	29,570	20,166	50,784	373,928
Home equity loans	12,024	19,239	16,229	3,417	698	15,315	66,922
Multifamily residential mortgages	5,029	6,066	5,032	2,045	1,395	3,975	23,543
Commercial RE loans	30,343	53,925	41,098	15,940	15,691	33,756	190,752
Construction RE loans	4,620	17,458	10,529	4,928	5,516	8,883	51,936
Farmland loans	437	2,204	2,493	2,787	1,488	1,162	10,570
RE loans from foreign offices	21,403	159	18	0	0	2,813	24,392
Commercial and industrial loans	159,992	137,756	90,614	35,315	31,524	96,943	552,144
Loans to individuals	125,435	71,690	58,416	35,418	24,427	49,954	365,339
Credit cards	80,411	21,502	10,963	19,491	2,501	24,583	159,452
Installment loans	45,024	50,188	47,453	15,927	21,926	25,371	205,888
All other loans and leases	71,354	62,524	36,986	19,057	11,223	64,939	266,084
Less: Unearned income	1,118	272	226	24	251	249	2,141

* Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks
Annual 1994–1997, year-to-date through June 30, 1998, second quarter 1997, and second quarter 1998
(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q2	Preliminary 1998Q2
Number of institutions reporting	10,451	9,940	9,528	9,143	8,984	9,309	8,984
Total employees (FTEs)	1,489,171	1,484,421	1,489,193	1,538,416	1,593,873	1,513,911	1,593,873
Selected Income Data ($)							
Net income	$44,622	$48,746	$52,352	$59,167	$32,036	$14,638	$16,128
Net interest income	146,551	154,210	162,755	174,509	89,839	43,479	45,504
Provision for loan losses	10,965	12,602	16,284	19,845	10,236	5,030	5,265
Noninterest income	76,276	82,426	93,569	104,498	59,810	25,276	30,651
Noninterest expense	144,234	149,729	160,699	169,981	92,107	41,422	46,392
Net operating income	45,029	48,397	51,511	57,938	30,615	14,419	15,763
Cash dividends declared	28,089	31,053	38,787	42,514	18,600	9,475	7,764
Net charge-offs to loan and lease reserve	11,248	12,202	15,500	18,314	9,696	4,393	4,900
Selected Condition Data ($)							
Total assets	4,010,517	4,312,677	4,578,322	5,014,959	5,182,759	4,771,367	5,182,759
Total loans and leases	2,358,212	2,602,963	2,811,282	2,970,761	3,091,664	2,865,748	3,091,664
Reserve for losses	52,132	52,837	53,456	54,682	56,379	54,522	56,379
Securities	823,024	810,872	800,648	871,865	894,496	820,458	894,496
Other real estate owned	9,567	6,063	4,780	3,794	3,530	4,377	3,530
Noncurrent loans and leases	30,708	30,351	29,130	28,547	29,084	28,579	29,084
Total deposits	2,874,439	3,027,574	3,197,139	3,421,745	3,506,574	3,279,852	3,506,574
Domestic deposits	2,442,523	2,573,480	2,723,559	2,895,550	2,957,538	2,775,654	2,957,538
Equity capital	312,089	349,575	375,280	417,963	445,974	402,860	445,974
Off-balance-sheet derivatives	15,773,018	16,860,614	20,035,444	25,063,799	28,175,900	23,324,836	28,175,900
Performance Ratios (annualized %)							
Return on equity	14.61	14.66	14.45	14.69	14.84	14.72	14.72
Return on assets	1.15	1.17	1.19	1.23	1.25	1.24	1.25
Net interest income to assets	3.78	3.71	3.70	3.64	3.52	3.69	3.53
Loss provision to assets	0.28	0.30	0.37	0.41	0.40	0.43	0.41
Net operating income to assets	1.16	1.16	1.17	1.21	1.20	1.22	1.22
Noninterest income to assets	1.97	1.98	2.13	2.18	2.34	2.14	2.38
Noninterest expense to assets	3.72	3.60	3.65	3.54	3.61	3.51	3.60
Loss provision to loans and leases	0.49	0.51	0.61	0.69	0.68	0.71	0.69
Net charge-offs to loans and leases	0.50	0.49	0.58	0.64	0.64	0.62	0.64
Loss provision to net charge-offs	97.48	103.28	105.06	108.36	104.31	114.51	105.31
Performance Ratios (%)							
Percent of institutions unprofitable	3.98	3.55	4.28	4.80	4.44	4.23	4.90
Percent of institutions with earnings gains	53.99	67.54	70.74	68.47	63.39	65.10	59.46
Noninterest income to net operating revenue	34.23	34.83	36.50	37.45	39.97	36.76	40.25
Noninterest expense to net operating revenue	64.73	63.27	62.69	60.92	61.55	60.25	60.92
Condition Ratios (%)							
Nonperforming assets to assets	1.01	0.85	0.75	0.66	0.65	0.69	0.65
Noncurrent loans to loans	1.30	1.17	1.04	0.96	0.94	1.00	0.94
Loss reserve to noncurrent loans	169.77	174.09	183.51	191.55	193.85	190.78	193.85
Loss reserve to loans	2.21	2.03	1.90	1.84	1.82	1.90	1.82
Equity capital to assets	7.78	8.11	8.20	8.33	8.60	8.44	8.60
Leverage ratio	7.64	7.61	7.64	7.56	7.64	7.76	7.64
Risk-based capital ratio	13.01	12.68	12.54	12.26	12.37	12.47	12.37
Net loans and leases to assets	57.50	59.13	60.24	58.15	58.57	58.92	58.57
Securities to assets	20.52	18.80	17.49	17.39	17.26	17.20	17.26
Appreciation in securities (% of par)	–3.42	1.01	0.51	1.10	1.10	0.56	1.10
Residential mortgage assets to assets	20.45	20.31	19.79	20.03	20.01	19.78	20.01
Total deposits to assets	71.67	70.20	69.83	68.23	67.66	68.74	67.66
Core deposits to assets	55.31	53.47	52.45	50.06	49.37	50.97	49.37
Volatile liabilities to assets	29.28	29.68	30.71	31.92	32.25	31.86	32.25

Loan performance, FDIC-insured commercial banks
Annual 1994–1997, year-to-date through June 30, 1998, second quarter 1997, and second quarter 1998

(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q2	Preliminary 1998Q2
Percent of Loans Past Due 30–89 Days							
Total loans and leases	1.19	1.29	1.37	1.31	1.16	1.23	1.16
Loans secured by real estate (RE)	1.31	1.38	1.41	1.33	1.11	1.20	1.11
1–4 family residential mortgages	1.33	1.53	1.57	1.59	1.30	1.43	1.30
Home equity loans	0.85	1.09	1.06	0.96	0.82	0.87	0.82
Multifamily residential mortgages	1.65	0.99	1.19	1.11	0.80	0.83	0.80
Commercial RE loans	1.27	1.21	1.24	0.97	0.84	0.92	0.84
Construction RE loans	1.64	1.41	1.58	1.42	1.31	1.19	1.31
Commercial and industrial loans*	0.89	0.86	0.95	0.83	0.82	0.90	0.82
Loans to individuals	1.82	2.21	2.50	2.50	2.24	2.24	2.24
Credit cards	2.08	2.40	2.76	2.73	2.51	2.48	2.51
Installment loans	1.66	2.08	2.31	2.33	2.07	2.08	2.07
All other loans and leases	0.30	0.37	0.37	0.51	0.52	0.43	0.52
Percent of Loans Noncurrent							
Total loans and leases	1.30	1.17	1.04	0.96	0.94	1.00	0.94
Loans secured by real estate (RE)	1.70	1.39	1.20	1.01	0.96	1.08	0.96
1–4 family residential mortgages	0.91	0.88	0.99	0.94	0.88	0.92	0.88
Home equity loans	0.54	0.52	0.48	0.44	0.42	0.42	0.42
Multifamily residential mortgages	2.73	1.99	1.35	0.95	0.84	1.11	0.84
Commercial RE loans	2.61	2.02	1.61	1.21	1.10	1.44	1.10
Construction RE loans	4.14	2.75	1.38	0.97	1.00	1.14	1.00
Commercial and industrial loans*	1.27	1.19	0.98	0.85	0.94	0.96	0.94
Loans to individuals	1.01	1.22	1.36	1.47	1.39	1.34	1.39
Credit cards	1.23	1.58	1.91	2.17	2.02	1.93	2.02
Installment loans	0.87	0.97	0.97	0.98	0.99	0.94	0.99
All other loans and leases	0.46	0.30	0.22	0.25	0.28	0.26	0.28
Percent of Loans Charged-Off, Net							
Total loans and leases	0.50	0.49	0.58	0.64	0.64	0.62	0.64
Loans secured by real estate (RE)	0.32	0.18	0.10	0.06	0.04	0.06	0.03
1–4 family residential mortgages	0.14	0.11	0.08	0.08	0.06	0.09	0.06
Home equity loans	0.21	0.20	0.20	0.16	0.15	0.17	0.14
Multifamily residential mortgages	0.51	0.32	0.15	0.04	0.02	0.01	0.05
Commercial RE loans	0.53	0.32	0.09	0.01	–0.02	0.00	–0.04
Construction RE loans	0.87	0.22	0.19	–0.02	0.00	0.00	–0.01
Commercial and industrial loans*	0.27	0.25	0.26	0.28	0.32	0.23	0.35
Loans to individuals	1.43	1.73	2.28	2.70	2.79	2.67	2.80
Credit cards	3.00	3.40	4.35	5.11	5.47	5.22	5.65
Installment loans	0.50	0.66	0.89	1.04	1.01	0.95	0.96
All other loans and leases	0.21	–0.04	0.13	0.16	0.24	0.09	0.25
Loans Outstanding ($)							
Total loans and leases	$2,358,212	$2,602,963	$2,811,282	$2,970,761	$3,091,664	$2,865,748	$3,091,664.
Loans secured by real estate (RE)	997,704	1,080,116	1,139,020	1,243,808	1,284,564	1,194,707	1,284,564
1–4 family residential mortgages	493,137	546,808	570,124	620,611	643,873	597,949	643,873
Home equity loans	75,818	79,182	85,300	98,165	97,178	92,511	97,178
Multifamily residential mortgages	31,928	35,788	38,162	41,224	42,179	39,703	42,179
Commercial RE loans	283,208	298,533	315,998	340,382	348,144	327,294	348,144
Construction RE loans	64,506	68,696	76,390	88,207	95,693	82,463	95,693
Farmland loans	22,649	23,907	24,964	27,062	28,407	26,144	28,407
RE loans from foreign offices	26,457	27,202	28,083	28,157	29,090	28,642	29,090
Commercial and industrial loans	589,090	661,417	709,600	796,128	850,388	755,170	850,388
Loans to individuals	487,104	535,348	562,291	561,449	547,880	557,628	547,880
Credit cards	186,755	216,016	231,664	231,174	216,954	225,159	216,954
Installment loans	300,348	319,332	330,627	330,275	330,925	332,469	330,925
All other loans and leases	290,659	331,934	405,678	373,900	413,158	363,389	413,158
Less: Unearned income	6,344	5,853	5,308	4,525	4,326	5,145	4,326

* Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks by asset size
Second quarter 1997 and second quarter 1998

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1997Q2	1998Q2	1997Q2	1998Q2	1997Q2	1998Q2	1997Q2	1998Q2
Number of institutions reporting	6,048	5,647	2,888	2,963	306	310	67	64
Total employees (FTEs)	134,836	123,017	311,762	313,460	302,639	306,632	764,674	850,764
Selected Income Data ($)								
Net income	$859	$795	$2,405	$2,505	$2,811	$3,245	$8,563	$9,583
Net interest income	2,950	2,728	7,679	7,720	9,714	9,655	23,136	25,401
Provision for loan losses	156	136	523	479	1,925	1,721	2,427	2,929
Noninterest income	857	877	2,590	2,865	4,913	6,498	16,915	20,411
Noninterest expense	2,436	2,375	6,202	6,458	8,338	9,419	24,446	28,140
Net operating income	856	790	2,390	2,480	2,788	3,204	8,384	9,289
Cash dividends declared	335	417	1,238	1,153	2,430	2,498	5,472	3,697
Net charge-offs to loan and lease reserve	96	88	404	385	1,502	1,679	2,391	2,747
Selected Condition Data ($)								
Total assets	273,489	259,076	711,271	734,031	916,015	928,995	2,870,593	3,260,657
Total loans and leases	160,660	153,795	438,980	449,051	602,059	605,467	1,664,048	1,883,351
Reserve for losses	2,370	2,226	6,747	6,754	12,755	12,928	32,650	34,470
Securities	80,057	69,392	189,409	193,134	185,661	186,552	365,331	445,417
Other real estate owned	406	321	945	789	784	588	2,243	1,832
Noncurrent loans and leases	1,751	1,659	4,149	3,950	6,714	6,191	15,965	17,284
Total deposits	234,633	221,686	587,361	605,950	631,453	627,253	1,826,405	2,051,684
Domestic deposits	234,599	221,616	584,988	603,932	610,791	610,816	1,345,277	1,521,173
Equity capital	29,635	28,482	68,943	71,278	83,738	90,533	220,543	255,681
Off-balance-sheet derivatives	901	873	12,008	10,257	129,111	133,709	23,689,365	28,692,855
Performance Ratios (annualized %)								
Return on equity	11.77	11.27	14.19	14.23	13.56	14.70	15.73	15.25
Return on assets	1.27	1.24	1.37	1.38	1.24	1.41	1.21	1.18
Net interest income to assets	4.36	4.25	4.37	4.24	4.27	4.21	3.26	3.13
Loss provision to assets	0.23	0.21	0.30	0.26	0.85	0.75	0.34	0.36
Net operating income to assets	1.26	1.23	1.36	1.36	1.23	1.40	1.18	1.14
Noninterest income to assets	1.27	1.37	1.48	1.57	2.16	2.83	2.39	2.51
Noninterest expense to assets	3.60	3.70	3.53	3.55	3.67	4.11	3.45	3.47
Loss provision to loans and leases	0.40	0.36	0.49	0.43	1.29	1.15	0.59	0.63
Net charge-offs to loans and leases	0.25	0.23	0.38	0.35	1.01	1.12	0.58	0.59
Loss provision to net charge-offs	161.79	153.63	129.31	124.42	128.19	102.27	101.50	103.01
Performance Ratios (%)								
Percent of institutions unprofitable	5.67	6.55	1.35	1.89	3.92	4.52	0.00	0.00
Percent of institutions with earnings gains	61.82	54.52	71.43	67.40	68.63	69.03	71.64	81.25
Noninterest income to net operating revenue	22.52	24.34	25.22	27.07	33.59	40.23	42.23	44.55
Noninterest expense to net operating revenue	63.98	65.86	60.39	61.01	57.01	58.31	61.04	61.43
Condition Ratios (%)								
Nonperforming assets to assets	0.79	0.77	0.72	0.65	0.82	0.73	0.64	0.62
Noncurrent loans to loans	1.09	1.08	0.95	0.88	1.12	1.02	0.96	0.92
Loss reserve to noncurrent loans	135.36	134.15	162.64	170.98	189.98	208.84	204.50	199.43
Loss reserve to loans	1.48	1.45	1.54	1.50	2.12	2.14	1.96	1.83
Equity capital to assets	10.84	10.99	9.69	9.71	9.14	9.75	7.68	7.84
Leverage ratio	10.74	10.79	9.35	9.28	8.35	8.62	6.89	6.73
Risk-based capital ratio	18.16	17.99	15.11	15.08	12.95	13.34	11.37	11.29
Net loans and leases to assets	57.88	58.50	60.77	60.26	64.33	63.78	56.83	56.70
Securities to assets	29.27	26.78	26.63	26.31	20.27	20.08	12.73	13.66
Appreciation in securities (% of par)	0.14	0.69	0.32	0.93	0.30	0.87	0.91	1.34
Residential mortgage assets to assets	21.97	21.29	24.56	24.37	24.40	24.22	16.91	17.72
Total deposits to assets	85.79	85.57	82.58	82.55	68.93	67.52	63.62	62.92
Core deposits to assets	75.35	74.48	71.90	71.25	57.49	56.54	41.38	40.41
Volatile liabilities to assets	12.36	12.51	16.02	15.93	27.98	26.45	38.89	39.14

Loan performance, FDIC-insured commercial banks by asset size
Second quarter 1997 and second quarter 1998

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1996Q4	1997Q4	1996Q4	1997Q4	1996Q4	1997Q4	1996Q4	1997Q4
Percent of Loans Past Due 30–89 Days								
Total loans and leases	1.58	1.57	1.31	1.27	1.50	1.47	1.07	0.99
Loans secured by real estate (RE)	1.37	1.34	1.07	1.05	1.17	1.07	1.25	1.13
1–4 family residential mortgages	1.70	1.67	1.29	1.26	1.25	1.12	1.53	1.35
Home equity loans	0.94	1.07	0.83	0.91	0.88	0.87	0.87	0.77
Multifamily residential mortgages	1.09	0.69	0.80	0.66	0.89	0.85	0.78	0.84
Commercial RE loans	1.05	1.04	0.84	0.81	1.02	0.98	0.88	0.75
Construction RE loans	1.31	1.20	1.14	1.20	1.52	1.44	1.00	1.32
Commercial and industrial loans*	1.55	1.60	1.44	1.43	1.34	1.31	0.57	0.51
Loans to individuals	2.34	2.33	2.01	1.95	2.25	2.32	2.28	2.26
Credit cards	3.03	3.56	2.44	2.87	2.45	2.47	2.50	2.51
Installment loans	2.30	2.27	1.92	1.79	2.05	2.15	2.12	2.10
All other loans and leases	N/A	N/A	N/A	N/A	1.04	1.15	0.37	0.48
Percent of Loans Noncurrent								
Total loans and leases	1.09	1.08	0.95	0.88	1.12	1.02	0.96	0.92
Loans secured by real estate (RE)	0.92	0.91	0.85	0.75	1.08	0.89	1.22	1.07
1–4 family residential mortgages	0.80	0.80	0.72	0.70	1.01	0.77	0.97	0.99
Home equity loans	0.49	0.57	0.41	0.36	0.42	0.49	0.42	0.41
Multifamily residential mortgages	0.98	0.62	1.02	0.74	0.99	0.81	1.23	0.93
Commercial RE loans	1.05	0.96	1.02	0.83	1.30	1.16	1.88	1.26
Construction RE loans	0.85	0.79	0.87	0.79	1.29	0.91	1.30	1.20
Commercial and industrial loans*	1.51	1.46	1.32	1.28	0.97	0.90	0.77	0.80
Loans to individuals	0.86	0.90	0.75	0.76	1.43	1.45	1.47	1.55
Credit cards	1.88	2.15	1.61	1.84	1.95	1.90	1.94	2.12
Installment loans	0.80	0.84	0.57	0.57	0.88	0.93	1.11	1.16
All other loans and leases	N/A	N/A	N/A	N/A	0.48	0.49	0.24	0.25
Percent of Loans Charged-Off, Net								
Total loans and leases	0.25	0.23	0.38	0.35	1.01	1.12	0.58	0.59
Loans secured by real estate (RE)	0.05	0.04	0.07	0.05	0.03	0.05	0.07	0.02
1–4 family residential mortgages	0.03	0.05	0.06	0.06	0.07	0.06	0.11	0.06
Home equity loans	0.27	0.03	0.08	0.07	0.18	0.15	0.17	0.15
Multifamily residential mortgages	0.21	0.04	0.14	0.13	0.01	–0.06	–0.08	0.07
Commercial RE loans	0.07	0.04	0.07	0.02	–0.06	0.03	–0.01	–0.14
Construction RE loans	0.04	0.05	0.17	0.04	–0.06	0.01	–0.08	–0.06
Commercial and industrial loans*	0.38	0.36	0.40	0.47	0.20	0.30	0.18	0.32
Loans to individuals	0.69	0.71	1.44	1.38	3.34	3.70	2.76	2.78
Credit cards	3.03	3.75	4.71	5.39	5.69	6.22	4.97	5.27
Installment loans	0.55	0.56	0.73	0.62	0.86	0.91	1.13	1.13
All other loans and leases	N/A	N/A	N/A	N/A	0.19	0.30	0.07	0.27
Loans Outstanding ($)								
Total loans and leases	$160,660	$153,795	$438,980	$449,051	$602,059	$605,467	$1,664,048	$1,883,351
Loans secured by real estate (RE)	89,729	85,466	267,538	277,513	263,658	272,767	573,781	648,819
1–4 family residential mortgages	44,828	41,829	122,487	123,964	128,435	133,130	302,198	344,950
Home equity loans	2,141	1,972	13,262	12,900	20,982	19,715	56,127	62,590
Multifamily residential mortgages	1,971	1,834	8,743	9,191	10,653	11,554	18,337	19,600
Commercial RE loans	23,750	23,044	90,779	95,538	79,540	81,041	133,224	148,521
Construction RE loans	6,174	5,993	22,537	25,076	20,737	23,562	33,016	41,061
Farmland loans	10,858	10,783	9,666	10,806	3,068	3,450	2,551	3,368
RE loans from foreign offices	7	10	63	37	243	315	28,329	28,728
Commercial and industrial loans	26,508	25,715	77,326	81,430	129,681	125,991	521,655	617,252
Loans to individuals	24,446	22,495	72,095	65,650	167,660	166,871	293,427	292,863
Credit cards	1,337	1,062	12,656	9,450	85,728	88,742	125,438	117,700
Installment loans	23,108	21,433	59,438	56,200	81,932	78,129	167,990	175,163
All other loans and leases	20,662	20,686	23,389	25,691	42,016	40,602	277,321	326,179
Less: Unearned income	685	567	1,367	1,233	956	764	2,137	1,762

* Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks by region
Second quarter 1998

(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Number of institutions reporting	704	1,473	1,962	2,307	1,570	968	8,984
Total employees (FTEs)	463,471	384,697	273,402	123,207	121,074	228,022	1,593,873
Selected Income Data ($)							
Net income	$5,391	$3,448	$2,707	$1,255	$843	$2,484	$16,128
Net interest income	13,809	10,201	7,458	3,570	3,032	7,435	45,504
Provision for loan losses	1,955	868	669	448	177	1,148	5,265
Noninterest income	13,505	5,478	3,809	2,074	1,060	4,725	30,651
Noninterest expense	17,157	9,536	6,666	3,251	2,734	7,049	46,392
Net operating income	5,199	3,359	2,666	1,260	818	2,461	15,763
Cash dividends declared	2,043	450	1,615	903	683	2,070	7,764
Net charge-offs to loan and lease reserve	1,960	766	563	414	175	1,022	4,900
Selected Condition Data ($)							
Total assets	1,908,473	1,102,730	845,261	338,954	302,586	684,756	5,182,759
Total loans and leases	959,459	722,767	552,391	230,938	168,922	457,187	3,091,664
Reserve for losses	20,500	10,865	8,561	4,103	2,380	9,971	56,379
Securities	287,904	209,971	162,148	64,517	83,113	86,843	894,496
Other real estate owned	1,175	846	388	191	241	689	3,530
Noncurrent loans and leases	11,690	5,474	4,383	1,983	1,535	4,019	29,084
Total deposits	1,151,441	748,837	593,095	256,638	249,444	507,119	3,506,574
Domestic deposits	739,099	718,120	556,703	251,796	246,819	445,002	2,957,538
Equity capital	143,072	103,867	72,543	31,178	27,712	67,602	445,974
Off-balance-sheet derivatives	22,151,905	2,675,550	1,433,135	35,399	34,518	1,845,393	28,175,900
Performance Ratios (annualized %)							
Return on equity	15.36	13.77	15.15	16.21	12.23	14.68	14.72
Return on assets	1.15	1.24	1.30	1.48	1.12	1.45	1.25
Net interest income to assets	2.94	3.66	3.59	4.22	4.03	4.35	3.53
Loss provision to assets	0.42	0.31	0.32	0.53	0.24	0.67	0.41
Net operating income to assets	1.11	1.20	1.28	1.49	1.09	1.44	1.22
Noninterest income to assets	2.88	1.96	1.83	2.45	1.41	2.76	2.38
Noninterest expense to assets	3.65	3.42	3.21	3.84	3.63	4.12	3.60
Loss provision to loans and leases	0.83	0.48	0.49	0.78	0.43	1.01	0.69
Net charge-offs to loans and leases	0.83	0.43	0.41	0.72	0.42	0.90	0.64
Loss provision to net charge-offs	95.08	113.29	118.01	108.24	101.38	112.34	105.31
Performance Ratios (%)							
Percent of institutions unprofitable	5.68	6.25	3.57	2.95	5.29	8.99	4.90
Percent of institutions with earnings gains	62.93	58.93	59.68	59.08	56.75	62.60	59.46
Nonint. income to net operating revenue	49.44	34.94	33.80	36.75	25.90	38.86	40.25
Nonint. expense to net operating revenue	62.81	60.82	59.16	57.60	66.81	57.97	60.92
Condition Ratios (%)							
Nonperforming assets to assets	0.74	0.57	0.56	0.64	0.59	0.69	0.65
Noncurrent loans to loans	1.22	0.76	0.79	0.86	0.91	0.88	0.94
Loss reserve to noncurrent loans	175.36	198.48	195.30	206.91	155.06	248.07	193.85
Loss reserve to loans	2.14	1.50	1.55	1.78	1.41	2.18	1.82
Equity capital to assets	7.50	9.42	8.58	9.20	9.16	9.87	8.60
Leverage ratio	6.92	7.77	7.97	8.65	8.29	8.24	7.64
Risk-based capital ratio	12.22	12.08	12.20	13.36	14.20	12.31	12.37
Net loans and leases to assets	49.20	64.56	64.34	66.92	55.04	65.31	58.57
Securities to assets	15.09	19.04	19.18	19.03	27.47	12.68	17.26
Appreciation in securities (% of par)	0.64	2.14	0.96	1.01	0.75	0.81	1.10
Residential mortgage assets to assets	15.68	27.39	22.49	20.20	22.75	15.79	20.01
Total deposits to assets	60.33	67.91	70.17	75.71	82.44	74.06	67.66
Core deposits to assets	31.90	56.83	57.76	67.51	70.48	57.38	49.37
Volatile liabilities to assets	45.63	26.71	26.66	16.78	17.61	24.88	32.25

Loan performance, FDIC-insured commercial banks by region
Second quarter 1998

(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Percent of Loans Past Due 30–89 Days							
Total loans and leases	1.14	1.08	1.34	1.35	1.28	0.92	1.16
Loans secured by real estate (RE)	1.15	1.10	1.24	0.97	1.23	0.94	1.11
1–4 family residential mortgages	1.32	1.31	1.30	1.10	1.48	1.31	1.30
Home equity loans	0.99	0.61	0.92	0.87	0.92	0.79	0.82
Multifamily residential mortgages	0.66	0.82	1.09	0.56	0.55	0.81	0.80
Commercial RE loans	0.86	0.80	1.07	0.75	0.95	0.61	0.84
Construction RE loans	0.94	1.19	2.04	1.18	1.39	0.97	1.31
Commercial and industrial loans*	0.50	0.72	1.20	1.86	1.31	0.69	0.82
Loans to individuals	2.59	2.08	2.12	2.22	1.74	1.98	2.24
Credit cards	2.59	2.77	2.18	2.57	2.18	2.22	2.51
Installment loans	2.58	1.81	2.11	1.92	1.69	1.72	2.07
All other loans and leases	0.54	0.34	1.01	0.57	0.37	0.24	0.52
Percent of Loans Noncurrent							
Total loans and leases	1.22	0.76	0.79	0.86	0.91	0.88	0.94
Loans secured by real estate (RE)	1.30	0.85	0.79	0.67	0.95	0.98	0.96
1–4 family residential mortgages	1.02	0.88	0.73	0.56	0.83	0.98	0.88
Home equity loans	0.61	0.35	0.38	0.26	0.23	0.43	0.42
Multifamily residential mortgages	1.00	0.77	0.82	0.65	0.43	0.92	0.84
Commercial RE loans	1.66	0.90	0.98	0.64	1.12	1.13	1.10
Construction RE loans	2.00	0.86	0.84	0.96	0.83	0.92	1.00
Commercial and industrial loans*	0.99	0.69	0.92	1.37	1.27	0.94	0.94
Loans to individuals	2.19	0.93	0.86	1.11	0.65	1.16	1.39
Credit cards	2.32	1.68	1.63	1.73	1.75	1.82	2.02
Installment loans	2.04	0.63	0.67	0.56	0.55	0.46	0.99
All other loans and leases	0.30	0.19	0.38	0.32	0.25	0.23	0.28
Percent of Loans Charged-Off, Net							
Total loans and leases	0.83	0.43	0.41	0.72	0.42	0.90	0.64
Loans secured by real estate (RE)	–0.01	0.05	0.04	0.01	0.03	0.06	0.03
1–4 family residential mortgages	0.08	0.05	0.05	0.04	0.03	0.09	0.06
Home equity loans	0.12	0.15	0.17	0.12	0.47	0.09	0.14
Multifamily residential mortgages	0.01	0.05	–0.10	0.16	–0.05	0.26	0.05
Commercial RE loans	–0.30	0.04	0.03	–0.09	0.01	0.02	–0.04
Construction RE loans	–0.13	0.02	–0.05	0.08	0.03	–0.01	–0.01
Commercial and industrial loans*	0.28	0.25	0.31	0.46	0.53	0.58	0.35
Loans to individuals	3.47	2.09	1.61	2.94	1.24	4.16	2.80
Credit cards	5.41	5.58	4.96	5.42	4.78	6.83	5.65
Installment loans	1.22	0.81	0.76	0.70	0.91	1.23	0.96
All other loans and leases	0.26	0.20	0.48	0.13	0.15	0.16	0.25
Loans Outstanding ($)							
Total loans and leases	$959,459	$722,767	$552,391	$230,938	$168,922	$457,187	$3,091,664
Loans secured by real estate (RE)	308,813	361,792	253,178	102,185	75,193	183,402	1,284,564
1–4 family residential mortgages	172,729	194,451	122,946	48,901	33,356	71,491	643,873
Home equity loans	21,104	28,335	23,970	4,538	856	18,375	97,178
Multifamily residential mortgages	11,276	9,493	8,634	3,293	2,180	7,303	42,179
Commercial RE loans	66,687	91,583	71,860	27,821	26,387	63,806	348,144
Construction RE loans	10,416	32,594	18,721	8,304	9,275	16,383	95,693
Farmland loans	1,103	5,178	7,029	9,328	3,139	2,630	28,407
RE loans from foreign offices	25,497	159	19	0	0	3,415	29,090
Commercial and industrial loans	299,001	176,186	153,034	49,412	43,553	129,202	850,388
Loans to individuals	194,808	112,132	87,008	46,347	34,992	72,593	547,880
Credit cards	105,680	31,759	17,709	21,717	2,939	37,150	216,954
Installment loans	89,129	80,373	69,298	24,629	32,053	35,443	330,925
All other loans and leases	158,769	73,357	59,653	33,064	15,739	72,577	413,158
Less: Unearned income	1,932	700	483	70	556	587	4,326

* Includes "All other loans" for institutions under $1 billion in asset size.

Glossary

Data Sources

Data are from the Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (call reports) submitted by all FDIC-insured, national-chartered and state-chartered commercial banks and trust companies in the United States and its territories. Uninsured banks, savings banks, savings associations, and U.S. branches and agencies of foreign banks are excluded from these tables. All data are collected and presented based on the location of each reporting institution's main office. Reported data may include assets and liabilities located outside of the reporting institution's home state.

The data are stored on and retrieved from the OCC's Integrated Banking Information System (IBIS), which is obtained from the FDIC's Research Information System (RIS) database.

Computation Methodology

For performance ratios constructed by dividing an income statement (flow) item by a balance sheet (stock) item, the income item for the period was annualized (multiplied by the number of periods in a year) and divided by the average balance sheet item for the period (beginning-of-period amount plus end-of-period amount plus any interim periods, divided by the total number of periods). For "pooling-of-interest" mergers, prior period(s) balance sheet items of "acquired" institution(s) are included in balance sheet averages because the year-to-date income reported by the "acquirer" includes the year-to-date results of "acquired" institutions. No adjustments are made for "purchase accounting" mergers because the year-to-date income reported by the "acquirer" does not include the prior-to-merger results of "acquired" institutions.

Definitions

Commercial real estate loans—loans secured by nonfarm nonresidential properties.

Construction real estate loans—includes loans for all property types under construction, as well as loans for land acquisition and development.

Core deposits—the sum of transaction deposits plus savings deposits plus small time deposits (under $100,000).

IBIS—OCC's Integrated Banking Information System

Leverage ratio—Tier 1 capital divided by adjusted tangible total assets.

Loans to individuals—includes outstanding credit card balances and other secured and unsecured installment loans.

Net charge-offs to loan and lease reserve—total loans and leases charged off (removed from balance sheet because of uncollectibility), less amounts recovered on loans and leases previously charged off.

Net loans and leases to assets—total loans and leases net of the reserve for losses.

Net operating income—income excluding discretionary transactions such as gains (or losses) on the sale of investment securities and extraordinary items. Income taxes subtracted from operating income have been adjusted to exclude the portion applicable to securities gains (or losses).

Net operating revenue—the sum of net interest income plus noninterest income.

Noncurrent loans and leases—the sum of loans and leases 90 days or more past due plus loans and leases in nonaccrual status.

Nonperforming assets—the sum of noncurrent loans and leases plus noncurrent debt securities and other assets plus other real estate owned.

Number of institutions reporting—the number of institutions that actually filed a financial report.

Off-balance-sheet derivatives—the notional value of futures and forwards, swaps, and options contracts; beginning March 31, 1995, new reporting detail permits the exclusion of spot foreign exchange contracts. For March 31, 1984 through December 31, 1985, only foreign exchange futures and forwards contracts were reported; beginning March 31, 1986, interest rate swaps contracts were reported; beginning March 31, 1990, banks began to report interest rate and other futures and forwards contracts, foreign exchange and other swaps contracts, and all types of option contracts.

Other real estate owned—primarily foreclosed property. Direct and indirect investments in real estate ventures are excluded. The amount is reflected net of valuation allowances.

Percent of institutions unprofitable—the percent of institutions with negative net income for the respective period.

Percent of institutions with earnings gains—the percent of institutions that increased their net income (or decreased their losses) compared to the same period a year earlier.

Reserve for losses—the sum of the allowance for loan and lease losses plus the allocated transfer risk reserve.

Residential mortgage assets—the sum of 1 4 family residential mortgages plus mortgage-backed securities.

Return on assets (ROA)—net income (including gains or losses on securities and extraordinary items) as a percentage of average total assets.

Return on equity (ROE)—net income (including gains or losses on securities and extraordinary items) as a percentage of average total equity capital.

Risk-based capital ratio—total capital divided by risk weighted assets.

Risk-weighted assets—assets adjusted for risk-based capital definitions which include on-balance-sheet as well as off-balance-sheet items multiplied by risk weights that range from zero to 100 percent.

Securities—excludes securities held in trading accounts. Effective March 31, 1994 with the full implementation of Financial Accounting Standard (FAS) 115, securities classified by banks as "held-to-maturity" are reported at their amortized cost, and securities classified a "available-for-sale" are reported at their current fair (market) values.

Securities gains (losses)—net pre-tax realized gains (losses) on held-to-maturity and available-for-sale securities.

Total capital—the sum of Tier 1 and Tier 2 capital. Tier 1 capital consists of common equity capital plus noncumulative perpetual preferred stock plus minority interest in consolidated subsidiaries less goodwill and other ineligible intangible assets. Tier 2 capital consists of subordinated debt plus intermediate-term preferred stock plus cumulative long-term preferred stock plus a portion of a bank's allowance for loan and lease losses. The amount of eligible intangibles (including mortgage servicing rights) included in Tier 1 capital and the amount of the allowance included in Tier 2 capital are limited in accordance with supervisory capital regulations.

Volatile liabilities—the sum of large-denomination time deposits plus foreign-office deposits plus federal funds purchased plus securities sold under agreements to repurchase plus other borrowings. Beginning March 31, 1994, new reporting detail permits the exclusion of other borrowed money with original maturity of more than one year; previously, all other borrowed money was included. Also beginning March 31, 1994, the newly reported "trading liabilities less revaluation losses on assets held in trading accounts" is included.

Special Studies on Technology and Banking

Technological Innovation in Banking and Payments: Industry Trends and Implications for Banks

by Karen Furst, William W. Lang, and Daniel E. Nolle[1]

Introduction

The revolution in information and communication technologies has become central to developments in the banking and financial services industry. Most banking industry analysts include technological change on the short list of important factors underlying the dynamics in banking industry structure and performance. For example, improvements in information management are playing a key role in enabling banks to take advantage of expanded powers and reductions in geographic restrictions. More complete and speedier access to customer information is allowing banks to more effectively manage complex customer relationships and to "cross-sell" additional financial services. In addition, technology has been a motivating factor for many of the recent large bank mergers, as institutions with less efficient technology management seek out merger partners with better technology management.

In recent years, technology has become increasingly important to the evolution of bank retail delivery systems and the development of new electronic retail products. The ability to deliver new advanced technology products reliably has become a central theme in the marketing strategies of a growing number of banks. Most institutions see introducing new products and services such as PC (personal computer) banking as a necessary step for retaining highly valued customers, and for positioning themselves strategically for the future. As this trend continues, the nature and magnitude of risks posed by technology will continue to change, and these changes will pose significant challenges for banks and banking supervisors.

A key to responding to these challenges is having a clear picture of the changing banking and payments landscape. This article describes that landscape, focusing in particular on changes in "retail" payments (i.e., business-to-business and consumer-to-business payments). We begin with a brief description of the significant shift in the United States toward electronic means of payment in retail transactions. The article then addresses important developments taking place in the nature and pattern of electronic payments processes. Some of these developments involve the adoption of new processes, while others reflect a recent surge in the use of technologies that have existed for a number of years. In both cases, these processes combine the electronic transfer of payment related information with the actual payment instructions. While much attention has centered on the shifts away from paper-based payment media, the development and adoption of processes that broaden the scope of information transferred electronically in the course of a payment transaction will likely have a greater long-term impact on electronic commerce and banking.

We discuss the response of banks to these technological developments, and the challenges arising for bank management in the fourth section of the article. Banks are substantially increasing their investments in technology, and we present information on the composition and magnitude of those investments. Our analysis indicates that banks are feeling strong competitive pressures to avoid being left behind in the technology area. This sense of urgency could lead to heightened technology-related risk exposures for banks if they fail to implement appropriate technology risk management practices. We then briefly discuss the steps taken by bank regulators to help institutions develop sound risk management measures. The article concludes with a summary of our key observations.

Developments in Electronic Payment Media

Analysts divide payments into "wholesale" and "retail" payments. Wholesale payments consist of very large value payments, especially interbank payments related to banks' clearing and settlement role.[2] Retail payments

[1] The authors are grateful to Kori Egland for excellent research assistance, James Kamihachi and David Nebhut for helpful comments, and Rebecca Miller for editorial assistance.

[2] The terms "wholesale payments" and "retail payments," while not precise, are commonly used, even in official descriptions of payment systems. See, e.g., the section describing the U.S. payment system in detail in Committee on Payment and Settlement Systems (1993). For a recent description of advances in wholesale payment systems see Emmons (1997).

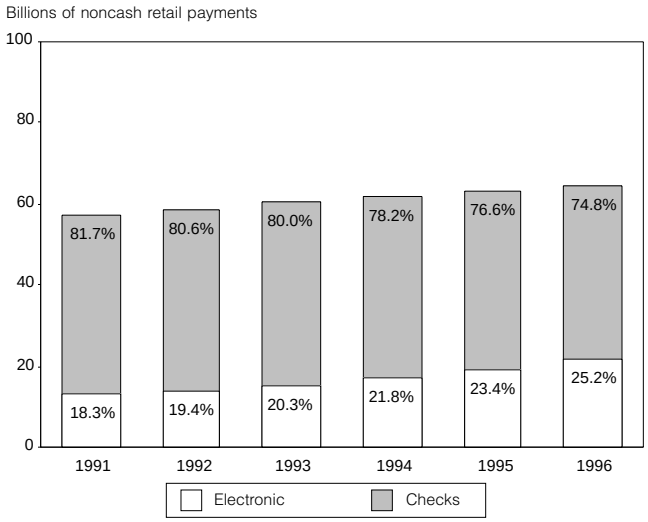
The average value of a wholesale payment in 1996 was $4.3 million. Thus, while wholesale payments account for less than 1 percent of the number of payments in the United States, they account for almost 90 percent of the value of all payments. The average value of a retail transaction varies by payment medium. In 1996, the average check transaction was $1,158; the average credit card purchase was $61; the average debit card transaction was $37; and the average automated clearing house (ACH) payment was $3,283.

include consumer-to-business and business-to-business payments. Wholesale payments have long been electronic, though technological advances are continually being made. Technological advances in retail payments have also been continual, but recent rapid increases in the pace and scope of such changes has drawn much attention in the financial community, the business press, and among the public at large.

In the United States, retail payments are heavily paper-based. Recent Bank for International Settlements (BIS) and National Automated Clearing House Association (NACHA) data show that approximately 97 percent of retail payments in the United States are made with either cash (about 87 percent) or checks (about 10 percent), with less than 4 percent of retail payments being made electronically. While it is difficult to estimate precisely the use of cash in an economy, it is clear that cash is the overwhelming choice for conducting small-value transactions.[3] However, in terms of dollar-value, NACHA estimates that cash accounts for less than 3 percent of retail payments. The data also show significant growth in the use of electronic payment media—credit cards, debit cards, and automated clearing house (ACH) payments, including ACH credit transfers such as direct deposit of payrolls, and ACH direct debits such as automatic mortgage payments.[4]

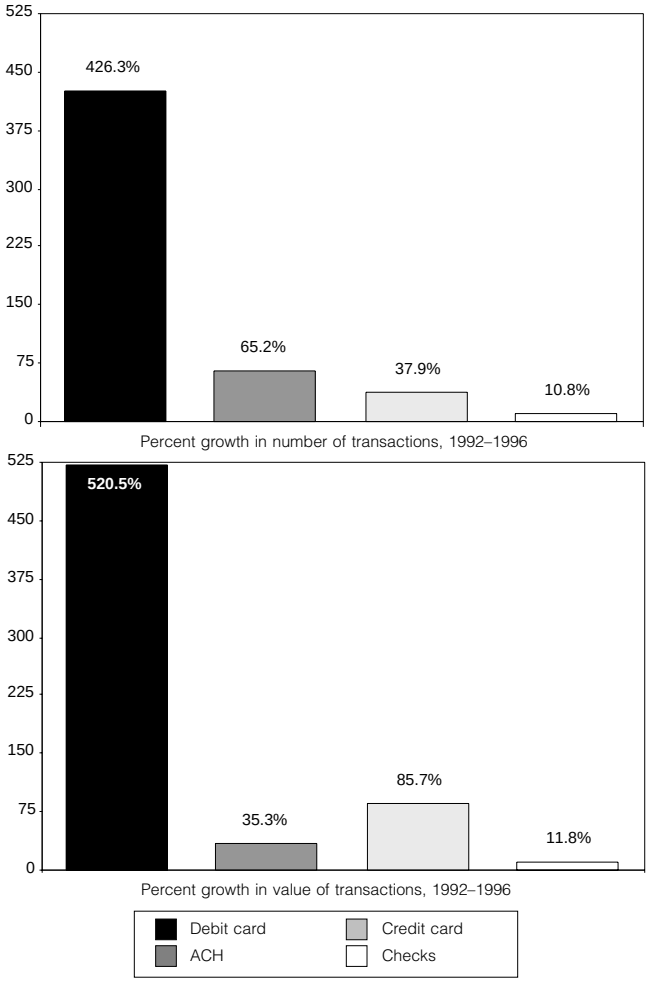
In 1996 (the latest available BIS data), payment with electronic media accounted for over 25 percent of noncash retail payments, up from 18 percent at the beginning of the decade, as Figure 1 illustrates. In terms of number of transactions, credit cards are ahead of both ACH transactions and debit cards, accounting for almost three-quarters of all electronic retail payments in the United States. Hence, the nearly 40 percent increase in credit card transactions over the 1992-to-1996 period contributed substantially to the overall shift toward electronic retail payments. However, the most startling growth was in debit card use, as Figure 2

Figure 1—Electronic retail payments growing in importance



Source: Office of the Comptroller of the Currency, using data from Committee on Payment and Settlement Systems (1997), *Statistics on Payment Systems in the Group of Ten Countries: Figures for 1996,* Bank for International Settlements, and from the National Automated Clearing House Association (NACHA).

Figure 2—Debit card use explodes



Source: Office of the Comptroller of the Currency, using data from Committee on Payment and Settlement Systems (1997), *Statistics on Payment Systems in the Group of Ten Countries: Figures for 1996,* Bank for International Settlements, and from the National Automated Clearing House Association (NACHA).

Average ACH payment size is substantially larger than other forms of retail payments because ACH transactions include direct deposit of payrolls by businesses, as well as relatively large consumer-to-business payments such as automatic mortgage payments.

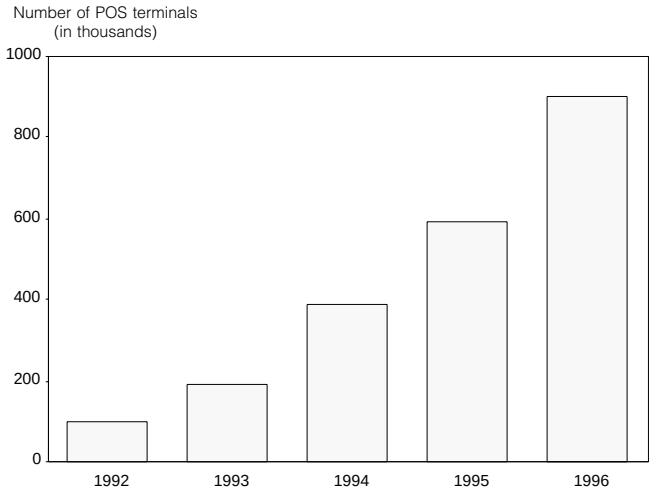
[3] Unlike the BIS data on noncash payments, which are widely considered to be accurate, estimates of cash usage are notoriously difficult to make and therefore are considered, at best, ballpark-type figures. On the problems associated with the estimation of cash usage, see Hancock and Humphrey (1997).

[4] See Committee on Payment and Settlement Systems (1997). The G–10 countries include Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States, and, since 1984, Switzerland as the eleventh member of the group.

Though there is wide variation in the relative proportion of paper-based versus electronic payments in the Group of Ten (G–10) countries, each of those countries has experienced a significant shift to greater reliance on electronic payments over the past five years.

shows. Though currently accounting for less than 12 percent of retail electronic payments, debit card use soared four-fold in volume terms and five-fold in value terms from 1992 to 1996. Many debit card transactions occur at point of sale (POS) terminals, and Figure 3 shows the correspondingly steep growth in number of POS terminals over the 1992-to-1996 period.

Figure 3—Steep growth in point-of-sale terminals

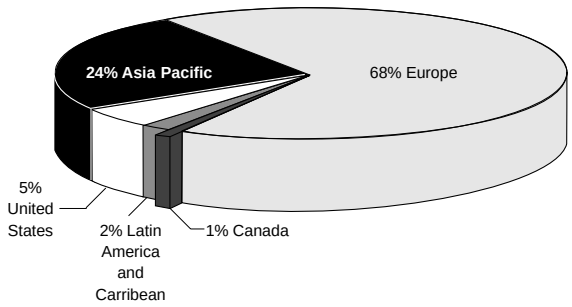


Source: Office of the Comptroller of the Currency, using data from Faulkner & Gray, *EFT Network Data Book* (various issues).

Because debit card transactions substitute for paper checks, and, to a far lesser extent, for cash, the potential for growth of debit card use is vast. American consumers currently write an estimated 12 billion checks annually at the point of sale. If only half of those payments were made by debit cards instead of checks, merchants could save an estimated $1.73 billion.[5] More generally, greater use of electronic payments not only enhances convenience, but can cut costs for consumers, businesses, and banks. One study estimates that the cost of using electronic payments is about one-third the cost of paper-based transactions.[6] Given the same study's estimate that the cost of a country's payment system may be equivalent to 3 percent of its GDP, a complete shift away from paper could therefore reduce payments transactions cost for the U.S. economy by $160 billion annually.

While the use of credit cards, debit cards, and ACH has grown significantly, use of electronic stored value ("e-money") has progressed slowly in the United States.[7] This stands in contrast to the growing use of e-money in other areas of the world, as indicated in Figure 4. Though there are no widespread open e-money systems operating in the United States, there has been steady growth in e-money use within limited systems on college campuses, military bases, and athletic stadiums.

Figure 4—Example of worldwide use of e-money



Source: Office of the Comptroller of the Currency using data on Visa's general-purpose, stored value chip cards, from Visa (1997), *Chip Card Programs Around the World.*

Some analysts question whether there is a significant business case for open-system e-money as a substitute for cash in small-value transactions. Other analysts believe that e-money use will become more widespread when consumers gain confidence in the security and reliability of e-money, and when e-money is combined with other electronic payment media such as debit and credit cards.[8]

Developments in Electronic Payment Processes

The development of electronic payment media can be seen as the spearhead for broader developments in

[5] In a recent study, the Food Marketing Institute (1998) includes a detailed comparison of transactions costs for supermarkets to handle customers' payments using various payment instruments. Our estimate of the savings was calculated by taking the difference between the cost to handle a transaction by check ($0.5827) and a transaction by on-line debit ($0.2892), multiplied by 5.9 billion (i.e., one half the 11.8 billion checks written by consumers at the point of sale per year in the United States).

[6] See Hancock and Humphrey (1997).

[7] Electronic money (e-money) refers to prepaid payment mechanisms ("stored value") for making payments at point-of-sale terminals or over open computer networks. Some e-money devices also enable users to make direct transfers between devices. Stored-value products include card-based mechanisms (also called "electronic purses") and network-based mechanisms (also called "digital cash"). Although stored-value cards can be "single-purpose"—e.g., telephone cards—general use of the term "e-money" has come to be more commonly associated with stored-value cards that can be used for multiple purposes. Because of security and increased functionality, most analysts believe that card-based e-money requires the use of cards that have a computer chip embedded in them (so-called "smart cards") rather than cards using magnetic stripe technology. As pointed out in a G–10 study on e-money, a single precise definition of e-money is difficult to provide, in part because of technological changes. See Group of Ten (1997) and Basle Committee on Banking Supervision (1998) for discussions of this issue.

[8] For recent discussions of security issues surrounding electronic money, see Committee on Payment and Settlement Systems and the Group of Computer Experts (1996), Group of Ten (1997), and Richards (1997).

electronic payment processes and electronic banking. In their most narrow sense, payment transactions are information transfers that credit and debit accounts. However, most payment transactions involve additional information exchanges accompanying the credit and debit instructions. For example, paper payment transactions typically involve the delivery of receipts or invoices. Many analysts and industry participants believe that the next great source of value and innovation in electronic retail payments will come from expanding the scope of the information exchanged in end-to-end electronic business-to-business and consumer-to-business transactions.

Currently, electronic payment instructions are typically accompanied by additional transfers of information, which are completed in the traditional paper-based way. For example, most companies must mail paper bills to customers even if the customer pays the bill electronically. "Electronic" bill payment instructions are often sent to a third party that provides a biller with a paper list of the "electronic check" information that must then be entered manually into the biller's system. In many cases, a part-electronic and part-paper system may be only a marginal improvement in efficiency relative to an all-paper environment. However, incorporating all of the transaction information into a smooth and efficient end-to-end electronic transaction has the potential to generate great efficiencies for both consumers and businesses through the elimination of the relatively costly paper components of transactions.[9]

This perceived potential for efficiency gains is driving investments in these processes, and it also explains the motivation behind the intense competition by banks and other businesses to become leaders in the implementation of new payments processes. While banks currently play the central role in the payment system, the extent of their future role in these expanded electronic retail payment processes is far from certain.[10] Banks may be able to leverage their current dominance in the payment system to become the dominant force in the new retail payment system. Alternatively, banks could play a relatively narrow role of maintaining transactions accounts, while nonbanks engage in higher value activities associated with new electronic retail payments processes.

[9] See, e.g., Microbanker (1997), Phillips Business Information Inc. (1998), and Clark (1998) for discussions of this issue.

[10] Increasingly, nonbank firms—including nonfinancial firms—are providing payment system services. In some respects such entities may compete directly with banks, but a bank-versus-nonbank dynamic is not the only possible outcome, inasmuch as banks and nonbanks can, do, and will form alliances and joint-ventures to exploit new technology opportunities. An important area for future research is to describe and analyze this activity and the policy issues emerging from it.

Business-to-Business Payment Systems

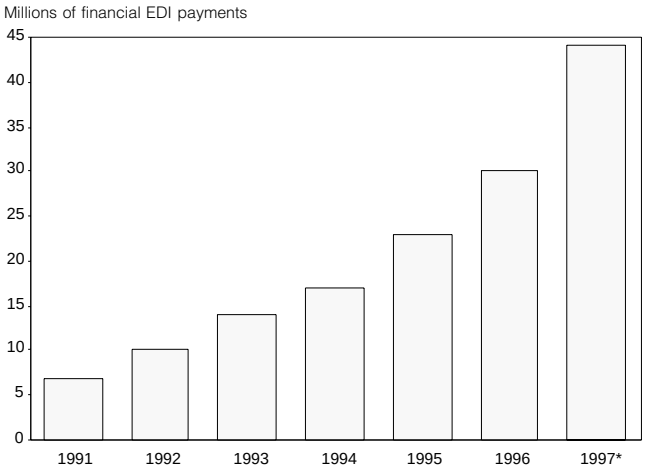
In the last several years there has been considerable growth and investment in electronic data interchange (EDI). Currently EDI is the principal system used by companies to transmit purchase orders and corresponding shipping and invoicing information to one another electronically. This enables information to automatically feed into inventory management and accounting systems within each company. Such information exchange allows businesses to substantially reduce operating costs. Financial EDI (FEDI) is the process of integrating payments with this commercial transmission of sales, inventory, and production information.

For example, when a consumer purchases a tool at a retail chain store, inventory management information is generated within the store from the point-of-sale terminal, and (once a set inventory drawdown has been reached) the electronic equivalent of a purchase order is transmitted to the toolmaker. The toolmaker ships the tools and electronically sends an invoice to the store. When the store receives the invoice, that information is routed to its accounts payable. At this point, the EDI transaction becomes a FEDI transaction if payment instructions (the amount to be paid and whom to pay) is electronically transmitted to the store's bank. The bank in turn makes an ACH payment (complete with associated information on the nature of the payment) to the toolmaker. In a variation on this procedure, payment instructions could go to an EDI-capable nonbank entity, which would arrange for payment to be made instead of the bank playing this role. Ultimately, the store's account will be debited by its bank.

Though financial EDI has been available for two decades, it is only in the last few years that its use has taken off, doubling between 1995 and 1997, as Figure 5 shows. Until recently, only the largest businesses and banks were capable of handling EDI transactions because of the high cost of EDI software. This situation has been changing as the costs of EDI-related software has declined significantly in the last several years. This decline in cost will receive an added boost at banking institutions later this year when the Federal Reserve distributes free software that allows banks to translate EDI payment information.

The growth in EDI use is itself increasing the incentives for a firm to become EDI-capable. Many of the costs of becoming EDI-capable are related to one-time set-up costs. These fixed costs are offset by the increased efficiency of information flows. The greater the number of transactions that can be completed using EDI, the greater are the efficiency gains and the more likely these gains will offset the set-up costs. This is an example of what economists refer to as "network externalities," where

Figure 5—Business-to-business electronic payments increasing rapidly



*Projected 1997 figures.

EDI—electronic data interchange.

Source: Office of the Comptroller of the Currency, using data from National Automated Clearing House Association (NACHA).

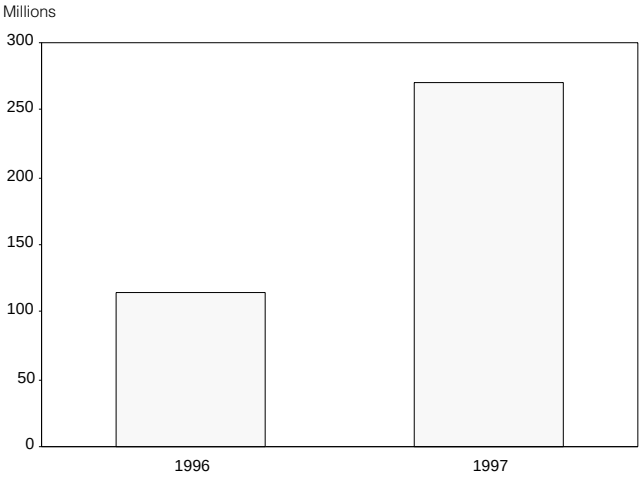
the value of a firm adopting EDI is positively related to the number of other firms that have adopted this technology.

Growth in the number of EDI-capable banks is likely to continue because EDI capability is now becoming a requirement for effectively servicing many large business customers. In addition, banks may decide to compete with nonbanks as suppliers of a wide range of services related to the receipt or disbursement of commercial payments.[11]

Consumer-to-business payment systems

Consumer-to-business payments technology is another area of rapid change in which banks and nonbanks are making major investments. As with EDI, there is a significant possibility that this market could continue to grow at a rapid pace. Two main aspects of the "electronification" of consumer-to-business transactions are electronic bill payment and electronic bill presentment. With electronic bill payment, a consumer issues payment instructions by telephone or by personal computer to his bank or a nonbank firm offering bill payment services. Currently, the bank or bill payment firm completes the bill-paying process by initiating an ACH transaction or by writing a check.[12] Though relatively new for consumers and not yet widely used, the use of electronic bill payment, shown in Figure 6, more than doubled in 1997 compared to 1996.

Figure 6—Very rapid growth in number of electronic bill payment transactions



Source: Office of the Comptroller of the Currency, using data from Coopers & Lybrand as reported in Marjanovic (1998).

Combining electronic billing with electronic payment can substantially increase the convenience and efficiency of consumer-to-business transactions. Electronic bill presentment is emerging as a practical reality, with several competing alternatives vying for acceptance. "Presenters"—i.e., firms engaged in providing electronic bill presentment services—are creating an electronic version of client businesses' bills. Consumers could then receive these bills in several ways. Consumers could visit their billers' Web sites and retrieve electronic bills from each business. Another model calls for consumers to visit presenters' Web sites for billing information. Alternatively, a bank might collect electronic bills for its customers, who then visit the bank's Web site for billing information. Consumers could also arrange for billers, presenters, or banks to deliver bills electronically to them as e-mail. Electronic bill presentment has the potential to enable a business to incorporate the receipt of an electronic payment into its accounting system more efficiently and accurately.

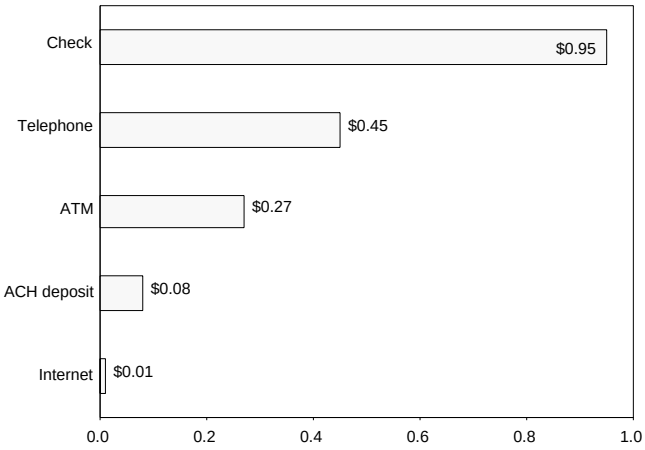
[11] As a part of their cash management services, banks may offer a comprehensive payables service where a company could send an electronic file to the bank with instructions for all payments (both paper and electronic), and the bank would make the payment in the format specified. Companies may also outsource accounts receivable, such as lockbox services where the remittance data is converted from paper documents (e.g., checks and coupons) to an electronic format during lockbox processing. This electronic data is then transmitted to the company. One of the advantages to a company using these services is that payment information is reported back to the company in a standard format regardless of how the payment or payment information is received by the bank or service provider.

[12] Pre-authorized debits such as automatic mortgage payments, which give a consumer's mortgage holder the ability to originate an ACH transaction for payment by the consumer's bank, are not included as electronic bill payment because the initiation of each monthly transaction is not controlled by the consumer.

Banks' Response: Substantial Increases in Technology Spending

Technological innovation can increase profitability either through enhancing revenues or lowering costs. Figure 7 illustrates the substantially higher costs for banks of conducting customer transactions via paper checks compared to electronic means. For example, a transaction handled via the Internet may cost a bank about one cent, versus almost a dollar to handle a deposit by check over the counter at a branch office. Benefits may also come from preventing erosions in profitability and market position as banks and nonbanks compete in these emerging markets.

Figure 7—Banks have cost incentives to encourage electronic payments

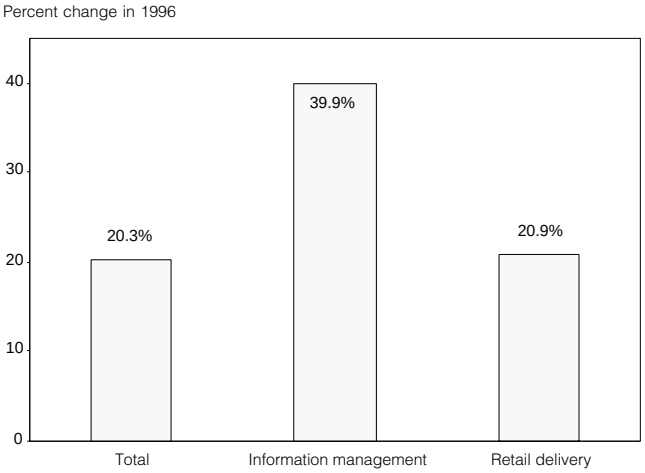


Note: Estimated cost per transaction. For checks, figures are for deposit by check using a bank teller.

Source: Office of the Comptroller of the Currency, using data from Faulkner & Gray (1997) and from the National Automated Clearing House Association (NACHA).

Banks boosted technology investment spending strongly to address revenue, cost, and competitiveness concerns. One recent study estimated a 20 percent increase in total technology spending by banks in 1996, to $27.8 billion, approximately one-quarter of which ($5.2 billion) went for capital investment in technology.[13] As Figure 8 illustrates, the biggest leap in banks' recent technology investment spending was for information management, which increased almost 40 percent over the previous year. Information management investment spending includes the development of data warehousing (the collection and storage of vast amounts of data on customer relationships from various systems), and data mining (integration and analysis of data). A key aim of this investment is to enhance the efficiency and revenue-generating potential of both traditional delivery channels such as branches, automated teller machines (ATMs), and call centers, and new delivery channels such as Internet banking.

Figure 8—Bank technology investment: substantial increases



Source: Office of the Comptroller of the Currency, using data from Faulkner & Gray (1997).

Many banks are counting on a payoff in the near-term from technological improvements in their traditional delivery channels. In particular, many banks hope to increase marketing and "cross-selling," i.e., the sale of additional products and services to a customer based on an analysis of data about the customer's current purchases of products and services.[14] They look for such an outcome as a direct result of technological improvements in branches and call centers, underpinned by investment in data warehousing and data mining. Consistent with this expectation, banks increased technology investment in retail delivery channels by 21 percent (see Figure 8). Approximately half of this increased investment was allocated to improving the delivery and management of customer information at branches in order to enhance the ability of bank personnel to access information on all of a customer's business with the bank. A majority of the remainder of the technology investment in retail delivery channels was allocated to improvements in ATMs and telephone banking and call centers.

The analysis is somewhat different when it comes to investments in other new technology products and services. Banks are making investments in new electronic

[13] These figures are from Faulkner & Gray (1997). "Total technology spending" includes purchases of new equipment, software, and information systems, as well as personnel expenditures. Definitions of what constitutes "technology spending" and "investment in technology" vary widely, and it is therefore difficult to make precise comparisons between sources.

[14] We are not aware of any definitive study demonstrating the profitability of cross-selling, though its virtues are increasingly touted in the business press. See for example Moyer (1998). To establish the efficacy of cross-selling in an analytically sound manner will require grappling with issues such as how a bank can precisely measure both the costs for establishing and operating cross-selling activities, and the returns earned by each "cross-sale."

Table 1—Most important motivation for three types of banking technology

	Installing and upgrading ATMs		Offering PC banking		Data warehousing	
	Banks with large networks	Banks with small networks	All banks (according to GAO survey)	All banks (according to Mentis survey)	Large banks	Small banks
Motivation:						
Response to competitive pressures	X	X	X	X		X
Revenue enhancement					X	
Cost reduction						

Source: Office of the Comptroller of the Currency, using data from Faulkner & Gray (1997); General Accounting Office (1998); and Mentis Corporation (1998).

products and services, such as PC banking, even though the actual volume of transactions using these products is still relatively small, and these products have little direct impact on a bank's bottom line. Why then are so many banks expressing a desire to introduce PC banking and other electronic payment systems? Table 1 shows that the perceived need to respond to competitive pressures is the primary driver for banks' investments in many of the new electronic technologies, as compared with revenue enhancement and cost reduction. Many banks are concerned that they will lose profits and market share over the long run if their competitors are better able to take advantage of these low-cost delivery channels. In addition, banks are concerned that higher-income customers who use multiple bank services will be attracted to institutions offering these new technology products. Banks are facing crucial strategic decisions concerning when to enter the market, and how to maintain sufficient flexibility given rapid changes in technology.

Are Banks Rushing into Technology Decisions?

There is considerable evidence that banks are planning to continue significant expenditures on introducing new technology products.[15] However, in some areas, banks' plans may be overly ambitious. For example, though less than 3 percent of banks currently offer customers the ability to access their accounts via the Internet for transactional purposes, a GAO survey of bankers estimates that almost half of all banks say they intend to offer PC banking by the end of this year. Other surveys report similar results.[16] Such expectations may be unrealistic; however, they highlight the sense of urgency about technology within the banking community.

Given existing market pressures and the urgency many bankers feel about the necessity of adopting new technology, a "leap-before-you-look" pattern of behavior could emerge if banks do not develop an appropriate approach to managing technology risks. Further, the possibility that some senior bank managers are poorly informed about technology risks faced by their bank is another potential cause for concern.[17] An appropriate risk management system will guard against the urge to invest in new technology without first developing a fundamental understanding of the risks involved.

Increased use of technology in banking and payments is likely to raise consumer protection issues as well. Because technological advancements greatly enhance the ability of banks and other financial institutions to collect and use vast amounts of information, concerns arise about appropriate privacy safeguards. In addition, consumers will wish to have a clear understanding of their rights and responsibilities in using new systems and products, and will want to know how financial institutions intend to resolve disputes in the event of errors or malfunctions. In the midst of their efforts to adopt new payments and banking technologies, banks that fail to effectively address such concerns are likely to erode or destroy customer trust.

The Response of Bank Regulators

Bank supervisory authorities have recognized the important challenges posed by the rapid advance of technology and have devoted increasing attention to technology-related issues. In the United States, the OCC and other federal regulatory authorities have recently published

[15] Several estimates of banks' technology spending in 1997 show spending levels below the Faulkner & Gray (1997) figures for 1996 technology spending. Though these studies are not strictly comparable to each other, a decline in new technology spending accords with recent reports in the business press suggesting that banks may be becoming somewhat cautious about spending on new technology in the face of challenges posed by addressing the year-2000 problem.

[16] See, e.g., General Accounting Office (1998), and Mentis Corporation (1998). A "transactional" Web site allows a customer to engage in activities such as account inquiry, funds transfers between accounts, bill payment services, and loan applications.

[17] The year-2000 problem complicates the issue further. As bankers' awareness of the difficulties facing them in this respect grow, they may be forced to cut back spending on new technology, heightening their fears about "falling behind." Alternatively, if some banks feel the need to go ahead with technology plans regardless of strains on resources caused by dealing with the year-2000 problem, risk exposures could rise.

guidance that helps banks identify and prioritize risks, and which suggests possible risk management measures.[18] Internationally, the Basle Committee on Banking Supervision, whose members include bank regulators from the G–10 countries, has also recently published a report on risk management for electronic banking activities.[19]

These various supervisory documents do not address in detail the new technology products being introduced into the market. Rather, they contain common themes that are useful for managing risk in the technology area. First, basic steps in the risk management process include assessing risks, implementing appropriate measures to limit risk exposures, and monitoring risk exposures. Second, while it is conceivable that technology activities may raise a wide variety of risks, banks and supervisors are likely to be particularly concerned with transactional risks, including security risks, as well as reputational and legal/compliance risks. Third, in an environment that will continue to change rapidly, it is crucial that bank management establish and promote two-way communication between the organization's technical experts and senior decision makers. Finally, transparency is central to addressing consumer protection concerns. Banks should strive to explain clearly their intentions regarding collection and use of personal information, as well as product features, costs, and dispute resolution procedures.

Summary and Conclusions

Our analysis yields several key observations:

- There has been a significant shift by consumers and businesses to electronic payments. In some areas of consumer and business electronic payments there are indications that the market may be poised for a rapid and substantial expansion of transactions volume in the near term.
- Significant innovation and investment is under way that could lead to very rapid expansion in fully electronic business-to-business and consumer-to-business payments in the near term. While the pace of change in these markets is difficult to determine, eventually these innovations will generate substantial efficiencies in retail payments systems.
- In response to developments in electronic payments and remote banking, banks have greatly increased their investment in technology, particularly in retail banking. For some activities, banks hope to see a near-term impact on profitability. Other investments are motivated more by a desire to establish a competitive position or avoid falling behind the competition.
- Survey evidence reveals a sense of urgency about the adoption of new technology and reflects substantial competitive pressures to act quickly. Such pressures may heighten the chance that some banks will rush into technology spending without being fully prepared to assess and manage risks.
- Bank regulators are paying significant attention to appropriate risk management of new technology. This will be a growing area of importance that will require greater resources from banks and banking regulators.

The gains from technological advancements in banking and payments are likely to be substantial, both from the point of view of individual financial institutions and economy-wide. In this environment, it is essential that banks review and, if necessary, adjust their risk management practices in tandem with upgrading their technology activities.

[18] See, e.g., Office of the Comptroller of the Currency (1998a) and (1998b); Federal Reserve Bank of New York (1997); Federal Deposit Insurance Corporation (1997); and Office of Thrift Supervision (1997).

[19] Basle Committee on Banking Supervision (1998).

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Recent Corporate Decisions

Interstate Transactions

On April 2, 1998, the OCC granted approval for NationsBank of Texas, National Association, Dallas, Texas, to merge with NationsBank, National Association, Charlotte, North Carolina, pursuant to 12 USC 215a and 1828(c). NationsBank, N.A., the resulting bank in the merger, was also permitted to retain and operate the offices of both banks, including the offices in Texas, as branches under 12 USC 36. In addition, the OCC determined that the Texas opt-out statute would not block the merger. [Corporate Decision No. 98–19]

On April 2, 1998, the OCC granted approval for Rhode Island Hospital Trust National Bank, Providence, Rhode Island, to merge with BankBoston, National Association, Boston, Massachusetts, pursuant to 12 USC 215a–1 and 1831u. BankBoston, the resulting bank in the merger, was permitted to retain and operate its branches in Massachusetts, New Hampshire, and Connecticut, as well as the 44 offices of the target bank in Rhode Island as branches under 12 USC 36. [Corporate Decision No. 98–20]

On April 15, 1998, the OCC granted approval for CoreStates Bank, National Association, Philadelphia, Pennsylvania, to merge with First Union National Bank, Charlotte, North Carolina, pursuant to 12 USC 215a–1 and 1831u. CoreStates operated branches in three states and First Union operated branches in 11 states and the District of Columbia. First Union, the resulting bank in the merger, was also permitted to retain and operate the offices of both banks as branches under 12 USC 36. [Corporate Decision No. 98–21]

Charters

On October 14, 1997, the OCC granted conditional final authorization for Rockdale National Bank, Conyers, Georgia, to open for business. Final approval was subject to supervisory conditions related to security controls and independent system testing that the bank would need to complete before commencing the proposed personal computer banking and electronic bill payment service. On June 18, 1998, the OCC agreed to allow the external security review to be conducted in two phases. [Conditional Approval No. 278 and 279]

On June 8, 1998, the OCC granted preliminary conditional approval to charter Heritage Trust Company, National Association, in Oklahoma City, Oklahoma. The bank is required to maintain a minimum of $2 million in Tier I capital at all times. [Corporate Decision No. 98–34]

Reinsurance Operating Subsidiaries

On May 1, 1998, the OCC granted approval for Fifth Third Bank of Northwestern Ohio, N.A., Toledo, Ohio, to establish an operating subsidiary to reinsure a portion of the mortgage insurance on loans originated or purchased by the bank or its lending affiliates. [Corporate Decision No. 98–23]

On May 11, 1998, the OCC granted approval for Fleet National Bank, Providence, Rhode Island, to establish Fleet Life Insurance Company and Fleet Insurance Company as operating subsidiaries of the bank. Fleet Life Insurance Company will underwrite and reinsure credit life and credit disability insurance. Fleet Insurance Company will underwrite and reinsure involuntary unemployment insurance. In this decision the OCC defines for the banking industry the scope of credit insurance coverage. [Corporate Decision No. 98–28]

Title Insurance Subsidiaries

On April 22, 1998, the OCC granted conditional approval for National Penn Bank, Boyerstown, Pennsylvania, to establish a wholly owned subsidiary that would acquire and hold a 70 percent noncontrolling limited partner interest in a Pennsylvania limited partnership, which will engage in the business of selling title insurance as agent. The approval was granted on conditions that the partnership engage only in activities permissible for national banks; that the bank's subsidiary will prevent the partnership from engaging in activities not permissible for national banks or withdraw from the partnership; that the bank will account for its investment under the cost method; and the partnership will be subject to OCC supervision, regulation, and examination. [Conditional Approval No. 275]

On May 8, 1998, the OCC granted conditional approval for Mellon Bank, N.A., Pittsburgh, Pennsylvania, to establish an operating subsidiary to hold, as a general partner, a 50 percent interest in a limited liability general partnership engaged in title insurance agency, real estate appraisal, loan closing, and other activities in connection with certain loans made by the bank or its lending affiliates. The approval was granted on conditions that the partnership engage only in activities permissible for

national banks; that the bank's subsidiary will prevent the partnership from engaging in activities not permissible for national banks or withdraw from the partnership; that the bank will account for its investment under the equity method; the partnership will be subject to OCC supervision, regulation, and examination; and that the partnership ensure compliance with applicable requirements of the Real Estate Settlement Procedures Act. [Conditional Approval No. 276]

Community Reinvestment Act Decisions

On May 27, 1998, the OCC granted conditional approval for the United National Bank, Monterey Park, California, to establish a branch in Irvine, California. The OCC concluded that the bank had CRA performance weaknesses and required the bank, prior to opening the new branch, to submit a plan for OCC approval containing, among other things, measurable CRA goals and objectives, plans to increase lending penetration within its assessment area responsive to community credit needs, and plans to increase its level of qualified investments and community development services. The bank is required to implement and adhere to the approved plan. These conditions are enforceable under 12 USC 1818. [CRA Decision No. 80; Conditional Approval No. 277]

On June 19, 1998, the OCC approved an application by BankBoston, N.A., Boston, Massachusetts, to establish a branch in Wallingford, Connecticut. The OCC received adverse public comments concerned primarily with the bank's closing of a branch in Hartford, Connecticut. The OCC's most recent evaluation of the bank's performance under the CRA rated the bank as having an Outstanding record. The OCC conducted a review of the bank's branch openings and closings in Connecticut and found no net change in the distribution of branches between LMI and other income areas and no evidence of a systematic movement of branches from urban to suburban areas as alleged by the commenters. [Corporate Decision No. 98–36]

On June 23, 1998, the OCC granted approval for National City Bank of Indiana, Indianapolis, Indiana, to acquire the Indiana branches of its affiliate, First of America, N.A., Kalamazoo, Michigan. Two organizations had filed letters with the Federal Reserve, in connection with the merger of the banks' parents, expressing concern with the CRA performance of the banks and their subsidiaries, and with the OCC's evaluation of those banks' records. The concerns were focused on the level of lending to minority borrowers and borrowers in LMI communities. Using examiners not involved in the prior examinations of the banks, the OCC reviewed the banks' lending to minorities and in LMI areas. The OCC concluded that the banks' records were consistent with approval of the transaction. [Corporate Decision No. 98–37]

On June 29, 1998, the OCC granted conditional approval for First Union National Bank, Charlotte, North Carolina, to acquire as operating subsidiaries The Money Store, Inc., Union, New Jersey, and its various direct and indirect subsidiaries. The Money Store, Inc., through its various subsidiaries, makes home equity loans, loans guaranteed by the Small Business Administration, commercial loans, and student loans. The approval was subject to special consumer protection conditions. [Conditional Approval No. 280]

Other

On April 15, 1998, the OCC posed no objection to a Notice of Change in Bank Control filed on behalf of the Eastern Shawnee Tribe of Oklahoma involving the People's National Bank, Seneca, Missouri. The OCC's decision relied on the tribe's representations and commitments regarding federal banking agency jurisdiction and federal banking law applicability and regarding activities and transactions between the tribe and bank. [Conditional Approval No. 274]

On June 10, 1998, the OCC granted conditional approval for Bank of America National Trust & Savings Association, San Francisco, California, and for BankBoston, National Association, Boston, Massachusetts, each to establish an operating subsidiary to hold a 50 percent interest in limited liability company (LLC) that will engage in leasing activities. Certain of the leases to be held by the limited liability company are for personal property that contain incidental real property interests. The approval was granted on conditions that the LLC engage only in activities permissible for national banks; that the banks' subsidiaries will prevent the LLC from engaging in activities not permissible for national banks or withdraw from the LLC; that the banks will account for their investments under the equity method; and that the LLC will be subject to OCC supervision, regulation, and examination. [Corporate Decision No. 98–35]

Special Supervision/Fraud and Enforcement Activities

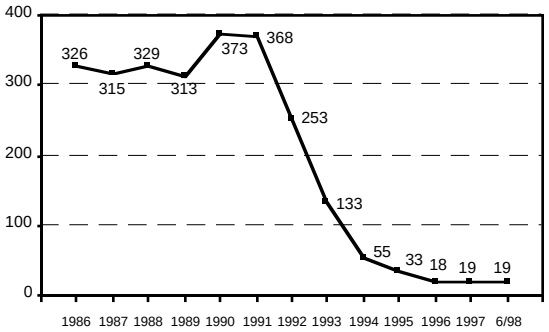
The Special Supervision/Fraud Division supervises the resolution of critical problem banks through rehabilitation or orderly failure management, monitors the supervision of delegated problem banks, coordinates fraud/white collar crime examinations, provides training opportunities, manages information dissemination activities, and supports OCC supervisory objectives as an advisor and liaison to OCC management and field staff on emerging problem bank and fraud/white collar crime related issues. Fraud experts are located in each district office as well as the OCC's Washington office.

This section includes information on problem national banks, national bank failures, and enforcement actions. Data on problem banks and bank failures is provided by OCC's Special Supervision/Fraud Division in Washington. Information on enforcement actions is provided by the Enforcement and Compliance Division of the OCC's law department. This department is principally responsible for presenting and litigating administrative actions on the OCC's behalf against banks requiring special supervision.

Problem National Banks and National Bank Failures

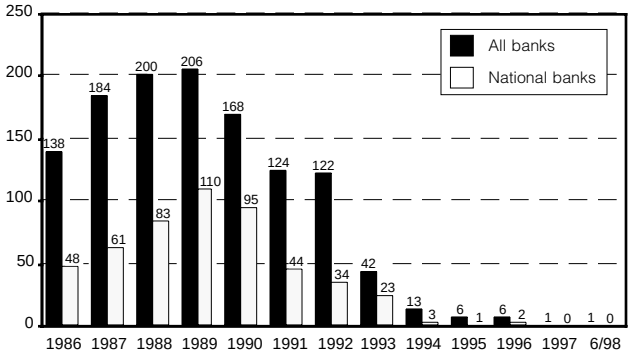
Stable trends continue with numbers of problem national banks. Problem banks (banks rated 4 or 5) represent less than 1 percent of the national bank population at June 30, 1998. After reaching a high of 373 at the end of 1990, the number of problem national banks significantly declined to 19 as of June 30, 1998. The small number of problem banks results from the overall favorable condition of the banking system brought about by an extended period of low interest rates and other positive economic conditions. There were no national bank failures through June 30, 1998 and only one commercial bank failure.

Figure 1—Problem National Bank Historical Trend Line



Source: Special Supervision

Figure 2—Bank Failures



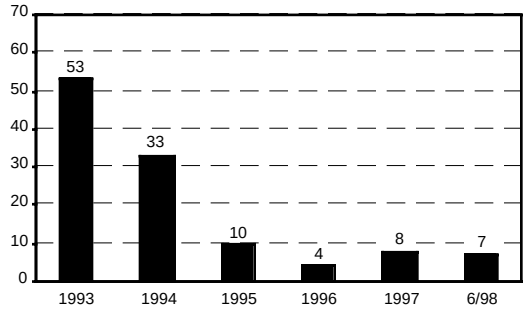
Source: OCC Supervisory Monitoring System (SMS) data*

Enforcement Actions

The OCC has a number of enforcement remedies with which to carry out its supervisory responsibilities. When it identifies safety and soundness or compliance problems, these remedies range from informal advice and moral suasion to informal and formal administrative enforcement actions. These mechanisms are designed to achieve expeditious corrective and remedial action to return the bank to a safe and sound condition.

The OCC takes enforcement actions against both banks and individuals associated with banks. The OCC's informal enforcement actions against banks include commitment letters and memorandums of understanding (MOUs). Informal enforcement actions are meant to handle less serious supervisory problems identified by the OCC in its supervision of national banks. Failure to honor informal enforcement actions will provide strong evidence of the need for the OCC to take formal enforcement action.

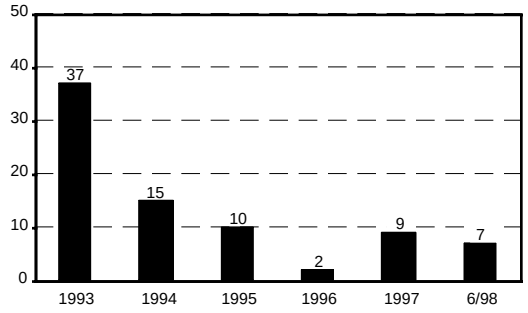
Figure 3—Commitment Letters



Source: OCC Supervisory Monitoring System (SMS) data*

* Note that SMS totals for previous years' enforcement actions may be adjusted to reflect revised aggregates.

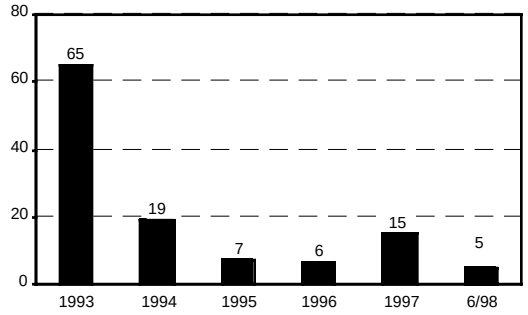
Figure 4—Memorandums of Understanding



Source: SMS*

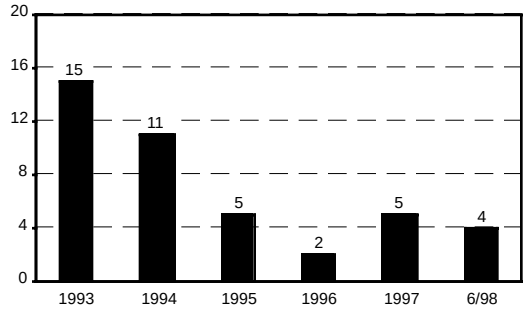
The most common types of formal enforcement actions issued by the OCC against banks over the past several years have been formal agreements and cease-and-desist orders. Formal agreements are public documents signed by a national bank's board of directors and the OCC in which specific corrective and remedial measures are enumerated as necessary to return the bank to a safe and sound condition. Cease-and-desist orders (C&Ds), often issued as consent orders, are also public documents and are similar in content to formal agreements. If violated, both formal agreements and C&Ds may form the basis for assessment of civil money penalties (CMPs). However, C&Ds, unlike formal agreements, may also be enforced through an action for injunctive relief in federal district court.

Figure 5—Formal Agreements



Source: SMS*

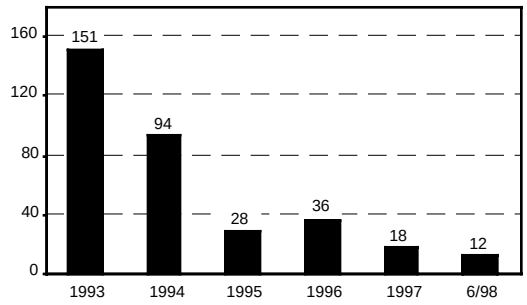
Figure 6—Cease-and-Desist Orders Against Banks



Source: SMS*

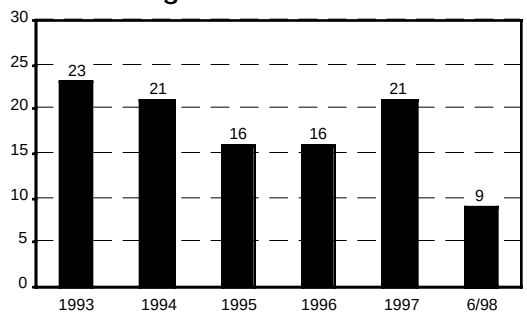
The most common formal enforcement actions against individuals are CMPs, personal C&Ds, and removal and prohibition orders. Civil money penalties are authorized for violations of laws, rules, regulations, formal written agreements, final orders, conditions imposed in writing, and, under certain circumstances, unsafe or unsound banking practices, and breaches of fiduciary duty. Personal C&Ds may be used to restrict individuals' activities and to order payment of restitution. Removal and prohibition actions, which are used in the most serious cases, result in lifetime bans from the banking industry.

Figure 7—Civil Money Penalties Against Individuals



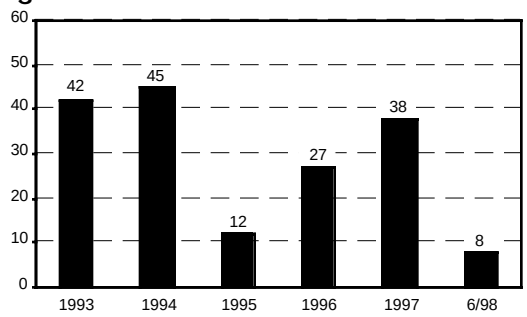
Source: SMS*

Figure 8—Cease-and-Desist Orders Against Individuals



Source: SMS*

Figure 9—Removal and Prohibition Orders



Source: SMS*

* Note that SMS totals for previous years' enforcement actions may be adjusted to reflect revised aggregates.

In addition, the OCC was given authority under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), to issue "prompt corrective action" (PCA) directives against undercapitalized banks, and to issue safety and soundness orders against banks that fail to meet the Interagency Guidelines Establishing Standards for Safety and Soundness, codified at Appendix A to 12 CFR 30. Both PCA directives and safety and soundness orders are public documents that are enforceable in the same manner as C&Ds. In 1997, the OCC became the first federal banking agency to issue a safety and soundness order under FDICIA. The agency also sent two Notice of Deficiency letters to national banks, thereby requiring the banks to submit compliance plans, but the OCC did not issue any safety and soundness orders in the first half of 1998.

Recent Enforcement Highlights

Appellate Decisions

On March 3, 1998, the Court of Appeals for the D.C. Circuit summarily affirmed the Comptroller's decision to assess a civil money penalty of $250,000 against Charles R. Vickery, former senior chairman of the First National Bank of Bellaire, Texas. The Court of Appeals also upheld the prohibition order issued by the Federal Reserve Board against Vickery, based on the same recommended decision from the administrative law judge. The Comptroller had found that Vickery had engaged in self-dealing when he made 23 loans totaling over $46 million to a Houston developer and then diverted a portion of the title insurance premiums paid by the developer to himself.

Comptroller and Federal Reserve Board Decisions

The Comptroller upheld the administrative law judge's recommended decision to require restitution of $813,000 and assess a civil money penalty in a case where OCC's Enforcement and Compliance Division charged a national bank vice president and loan administrator with running a loan kiting scheme involving a total of 24 loans. The Federal Reserve Board also upheld the administrative law judge's recommendation to prohibit the vice president from further participation in the banking industry.

Suspensions and Temporary Orders

In May 1998, the OCC suspended three directors of a national bank in Wisconsin, one of whom was also the bank's president. The OCC based the suspension actions upon evidence that the president/director made two nominee loans for the benefit of him and another director who is also his wife. The OCC also alleged that all three directors caused the bank to fund personal expenses through a bank expense account. In April, the OCC issued a temporary cease-and-desist order against the bank to prevent it from making payments to certain insiders without the entire bank board's approval and to prevent bank insiders from removing documents from the bank.

Consent Orders

In January 1998, the former chairman of the board of a national bank consented to a prohibition from banking and a civil money penalty, based primarily on his violation of the Change in Bank Control Act by concealing the source of funds of his purchase of stock, as well as the existence and identity of his partners in the transactions.

In January and February 1998, two Argentinean nationals consented to civil money penalties of $261,000 and $177,000 for violations of the Change in Bank Control Act. The two individuals acted in concert to acquire the power to vote 25 percent or more of the stock in a Maryland national bank without informing the OCC and receiving the required approval. The consent orders also require the two to reduce their ownership and control of the bank's common stock to below 10 percent of the shares outstanding and to obtain the approval of the OCC before acquiring more than 10 percent.

In April 1998, the president of a community bank in Indiana consented to a prohibition and a $6,000 CMP. The president misappropriated funds from a trust account he administered in order to bring current unrelated bank loans that were developing serious weaknesses. Prior to being discovered, he did attempt to make restitution with his own funds but in so doing he falsified numerous bank records.

In the spring of 1998, the OCC issued a C&D against a national bank based on evidence of money-laundering activities at the bank. The OCC determined that deposits of hundreds of thousands of dollars in cash were made, several times a week, to numerous accounts held or controlled by the same individual. In addition, numerous cash deposits of just under $10,000 were made into related accounts and appeared to constitute impermissible structuring. The C&D requires the bank to, among other things: retain a capable Bank Secrecy Act (BSA) officer; perform a complete, external BSA audit; implement appropriate BSA policies and procedures; ensure adequate BSA training; establish appropriate suspicious activity report review and reporting procedures; and develop appropriate know-your-customer requirements. We also referred the matter to the appropriate U.S. Attorney's Office, the Federal Bureau of Investigation, the Drug Enforcement Administration, and the Internal Revenue Service–Criminal Investigation Division. With the OCC's assistance, these agencies have frozen over $4 million in assets at the bank.

In May 1998, an executive vice president and regional manager of a national bank in Vermont agreed to a 10-year removal from banking. The OCC based the order

upon his involvement in making several nominee loans that he did not benefit from, and from his involvement in obtaining a personal loan from a borrower whose loans he apparently supervised.

In June 1998, prior to the issuance of a notice of charges, two officers and directors of a national bank consented to pay civil money penalties of $18,000. The penalties were assessed primarily for a large overline loan that resulted when the bank made loans to farmers who turned the money over to a grain elevator, with which they had entered into hedge contracts for the delivery of corn. The loans were all attributed to the grain elevator, which used the funds for margin calls on its contracts at the Chicago Board of Trade.

During the first half of 1998, the OCC reached settlement with six current or former officers of a national bank in Illinois. The case involved the submission of false expense vouchers by the officers to obtain reimbursement from the bank for political contributions made by the officers to local politicians. The officers submitted the false expense vouchers to conceal the true nature of the reimbursements, which are prohibited by the Federal Election Campaign Act of 1971 (2 USC 441b). Under the settlements, the six officers agreed to pay a total of $59,000 in civil money penalties, and $37,975 in restitution to the bank for the reimbursements. One of the six was the bank's former chairman and CEO who also agreed to a prohibition from banking under 12 USC 1818(e), and who also pled guilty to a criminal information charging him with bank fraud in connection with the contributions and reimbursements. Two of the six also agreed to personal cease-and-desist orders. Six other officers who were also involved in the scheme received reprimands or supervisory warnings.

Year-2000 Enforcement Actions

During the first half of 1998, the OCC began taking enforcement actions against national banks that have failed to adequately prepare their computer systems for the year 2000. Since most computer systems have traditionally registered the year in dates only by recording the last two digits of the year, banks that do not properly convert their systems could experience problems after January 1, 2000, if their computers interpret "00" as the year 1900. The OCC has worked with other agencies and the Federal Financial Institutions Examination Council to develop practices and procedures for proper remediation of banks' computer and information systems.

The OCC has taken several enforcement actions against national banks for failing to convert their systems in a timely and prudent manner. During the first half of 1998, the OCC issued 253 supervisory directives for year-2000 deficiencies. In addition, the OCC negotiated three memorandums of understanding and one formal agreement related to the year 2000. Finally, the OCC issued two notices of deficiency under 12 CFR 30 for year-2000 deficiencies. Both these banks responded by filing acceptable compliance plans and therefore the OCC did not issue safety and soundness orders under Part 30 against these banks. In one of these cases the bank was given the option of accepting a formal agreement or the commencement of the safety and soundness process; it chose the latter and submitted an acceptable plan and is now rated satisfactory.

Fast Track Enforcement Cases

The OCC continued its Fast Track Enforcement Program, initiated in 1996, which ensures that bank insiders who have engaged in criminal acts in banks, but who are not being criminally prosecuted, are prohibited from working in the banking industry. As part of the Fast Track Enforcement Program in the first half of 1998, the Enforcement and Compliance Division completed two consent prohibition orders against institution-affiliated parties; one of these orders incorporated restitution payments to the appropriate banks for losses incurred. In one of these cases, for example, a teller who embezzled over $10,000 from customer accounts by making electronic transfers to her own account consented to a prohibition in January 1998.

In a case that arose out of the Fast Track program, a former teller at a multinational bank in California defaulted on a prohibition and restitution action against her. Accordingly, the Comptroller issued a restitution order for $2,550 and the Federal Reserve Board issued a prohibition order.

Appeals Process

Case One: Appeal of "Satisfactory" CRA Rating

Background

A formal appeal was filed concerning the bank's Community Reinvestment Act (CRA) rating of "Satisfactory Record of Meeting Community Credit Needs." The bank believed that the rating should be "Outstanding Record of Meeting Community Credit Needs."

The appeal centered on the bank's assertions that:

- The OCC placed undue weight on the application of the "market share test" in circumstances inappropriate for it;
- The OCC compared the bank's performance with some of the largest banks in the United States, and that this comparison was unfair and contrary to the CRA regulation; and
- The bank also believed that the OCC was unaware of many of their unique credit-related programs that were not fully described in the Public Evaluation.

Discussion

The evaluation of a bank's CRA activities requires a full understanding of the performance context in which it operates. The performance context considers the economic condition and demographics of the assessment area, competition, and the types of products and services offered by the bank. In the evaluation of the lending test, a bank's market share of HMDA reported loan activity is only one of the multiple sources of data considered and analyzed. Market share is not considered in isolation, but rather as one of a family of measures used in the evaluation process.

In evaluating the bank's performance under the "lending test," the ombudsman's market share analyses consistently demonstrated that the bank served middle- and upper-income geographies significantly better than low- and moderate-income geographies within its markets. The appeal questioned the applicability of market share analysis because of competition in low- and moderate-income geographies from subprime lenders. However, the HMDA data (e.g., number of lenders doing business in low- and moderate-income geographies compared to the number of lenders doing business in more affluent geographies) indicated that the competition for loans is much more intense in middle- and upper-income geographies than in low- and moderate-income geographies within its markets. The ombudsman concluded that the OCC's market share analyses in the evaluation process was properly considered with other pertinent measures of performance in assigning the "lending test" rating.

While the CRA activities of other similarly situated financial institutions were considered, bank-by-bank comparisons are not a component of the overall rating process. The ombudsman concluded that the consideration of the activities of other financial institutions was not a component of the rating process.

The ombudsman acknowledged and appreciated the bank's overall commitment to the spirit and intent of the CRA. While the initiatives and unique credit-related programs undertaken as part of the CRA program are noteworthy, the assessment area is a challenge with unique needs and demands that a financial institution must convert into positive opportunities. The bank has been a positive influence in its market with successful initiatives; however, there are still obvious gaps to fill.

Conclusion

After a detailed and extensive assessment of all the facts and circumstances surrounding the appeal, and comparing all of the findings with the CRA rating guidelines, the ombudsman determined that the "Satisfactory Record of Meeting Community Credit Needs" rating as assigned in the CRA Public Evaluation was appropriate at the time of the examination.

Case Two: Appeal of "Needs to Improve" CRA Rating

Background

The ombudsman's office received a formal appeal from a large bank affiliate concerning the bank's composite CRA rating of "Needs to Improve Record of Meeting Community Credit Needs." In particular, the bank appealed the assigned "service test" rating of the individual test ratings. The individual ratings and overall point scores that supported the composite "Needs to Improve" rating were as follows:

Lending test	Low Satisfactory	6 points
Investment test	Low Satisfactory	3 points
Service test	Needs to Improve	1 point
Composite rating	Needs to Improve	10 points

The "Needs to Improve" rating on the "service test" prevented the bank from achieving the minimum 11 points needed for an overall "Satisfactory" CRA rating. As a result, the "service test" performance was the focus of the bank's appeal. The appeal stated that the OCC did not consider several important factors that had a direct bearing on the level of the bank's services. In particular, the bank felt that the examiners did not appropriately consider the accessibility of the bank's branch network to residents of low- and moderate-income (LMI) geographies, and they inappropriately discounted the bank's record of serving the banking needs of the local university community, which constituted a large portion of the population along with the residents in their surrounding LMI census tracts.

Discussion

The bank's recent CRA Public Evaluation lists the following factors in support of the bank's "Needs to Improve" performance under the "service test":

- Branch and automated teller machine (ATM) delivery systems are not accessible to all parts of the bank's assessment area.
- Bank management could not affirmatively demonstrate that alternative delivery systems reached the portions of the assessment area not serviced directly by a branch or ATM.
- The bank has not closed any branches since the last evaluation; however, it has opened one branch in an upper-income tract and one branch on the campus of a local state university.
- The bank provided an adequate level of community development services.

The appeal letter raised six points that the bank believed warranted the raising of the "service test" rating. These points were:

- The proximity of bank branches to LMI census tracts makes them very accessible to residents in those tracts.
- The fact that the bank has captured a large percentage of LMI tract residents as its customers provides further evidence of the accessibility of its branches.
- The accessibility and convenience of the branch system has substantially improved since the previous examination, in which the bank's performance was rated "Outstanding."
- The bank's new state university branch should be characterized as being located in a LMI tract.
- The OCC staff discounted or disregarded the bank's successes in serving the members of the local state university community residing in LMI areas.
- The products and services offered in the university branch are not exclusive to the university student body, and, since the branch continues to mature, it will have additional opportunities to serve the residents of the surrounding LMI areas who are not associated with the university.

The "service test" evaluates a bank's record of helping to meet the credit needs of its assessment area by analyzing both the availability and effectiveness of a bank's system for delivering retail banking services and the extent and innovativeness of its community development services. The definitions for the "service test" rating of "Low Satisfactory" and "Needs to Improve" are:

(iii) *Low satisfactory.* The OCC rates a bank's service performance "low satisfactory" if, in general, the bank demonstrates:

(A) Its service delivery systems are reasonably accessible to geographies and individuals of different income levels in its assessment area(s);

(B) To the extent changes have been made, its record of opening and closing branches has generally not adversely affected the accessibility of its delivery systems, particularly in low- and moderate-income geographies and to low- and moderate-income individuals;

(C) Its services (including, where appropriate, business hours) do not vary in a way that inconveniences its assessment area(s), particularly low- and moderate-income geographies and low- and moderate-income individuals; and

(D) It provides an adequate level of community development services.

(iv) *Needs to improve.* The OCC rates a bank's service performance "needs to improve" if, in general, the bank demonstrates:

(A) Its service delivery systems are unreasonably inaccessible to portions of its assessment area(s), particularly to low- or moderate-income geographies or to low- or moderate-income individuals;

(B) To the extent changes have been made, its record of opening and closing branches has

adversely affected the accessibility of its delivery systems, particularly in low- or moderate-income geographies or to low- or moderate-income individuals;

(C) Its services (including, where appropriate, business hours) vary in a way that inconveniences its assessment area(s), particularly low- or moderate-income geographies or low- or moderate-income individuals; and

(D) It provides a limited level of community development services. [12 CFR 25, App. A, (b)(3)(iii)–(iv)]

Conclusion

The review of the bank's product delivery systems included an analysis of the information provided in the appeal, an on-site visit to the bank by members of the ombudsman's staff, and various discussions with OCC personnel. In arriving at a decision, the bank's branch network was carefully evaluated, taking into consideration the size of the institution, the demographic characteristics of the assessment area, and competition from other financial institutions.

As stated in the bank's appeal letter, no branches had been closed since the last evaluation, and in fact, two branches had been opened, one in an upper-income tract and one on the campus of the local university. While no branches were located in LMI census tracts, two of the bank's branches were close to a significant portion of the assessment area's LMI tracts. In fact, the branch located on the university campus is easily accessible to LMI residents living adjacent to the university, and to the large number of LMI individuals employed by the university. Additionally, because of the open nature of the university campus coupled with the areas high population density, the ombudsman concluded that the bank had improved accessibility by opening a branch location in this area. The services offered at the branches, including the two branches close to the LMI census tracts, do not vary in a way that inconveniences its assessment area. In fact, lobby hours and operations have been tailored to better serve the community.

Based on the above, the ombudsman concluded that the bank's level of performance under the "service test" was more indicative of a "Low Satisfactory" rating than the assigned "Needs to Improve" rating. The change in the "service test" rating increased the bank's overall CRA rating to a "Satisfactory Record of Meeting Community Credit Needs." A revised CRA Public Evaluation was prepared to reflect these changes and forwarded to the bank by the OCC's supervisory office.

Case Three: Appeal of "Needs to Improve" CRA Rating

Background

A formal appeal was filed with the ombudsman's office regarding a bank's Community Reinvestment Act (CRA) rating of "Needs to Improve." The supervisory office concluded that the bank did not meet the guidelines for satisfactory performance under the CRA. The Public Evaluation states that the bank's loan-to-deposit ratio did not meet the standards for satisfactory performance given the bank's size, financial condition, and assessment area credit needs.

The appeal indicated that the board of directors and management agreed that the loan-to-deposit ratio was much lower than that of other banks in the assessment area; however, several underlying factors should be considered to accurately compare it to other banks. These factors are:

1. The bank is a community bank providing services to the predominately rural area immediately west of a major metropolitan city. Growth of the agricultural business around the bank's city is stifled by the existence of large, well-established family-owned farms. In contrast, the other surrounding cities are experiencing dramatic growth from their unencumbered geography.

2. The bank is approximately three miles from a major thoroughfare. A comparison between the bank and other banks in the assessment area is not practical since the other institutions have significantly higher visibility and accessibility from both the major interstate and the state highway.

3. Four of the six banks used for comparison purposes have total assets twice as large as the bank. This highlights the fact that the resources available to these financial institutions far exceed those available to the bank. In addition, the bank's having only one loan officer limits available time for business development.

4. As noted in the Uniform Bank Performance Report, the bank's loan growth for the years ended 1994, 1995, and 1996 was 24 percent, 24 percent, and 6 percent, respectively. This substantially exceeded peer growth of 8 percent, 6 percent, and 7 percent, respectively, over the same period. Additionally, for the first nine months of 1997, the bank's loan growth was 36 percent compared to the peer's 8 percent average. These numbers indicate that the bank's loan originations far exceed those of its peer group.

5. The city where the bank is located is predominately in the low- to moderate-per-capita-income level.

6. The bank exceeds the standards in "Lending within the Assessment Area," and it meets the standards in "Lending to Borrowers of Different Incomes" and "Geographic Distribution of Loans." Also, the bank did not receive any complaints regarding CRA since the prior examination. This indicates that the bank is cognizant of the complete picture of reinvesting within the community.

The appeal further detailed that comparing the bank to other banks within the assessment area should be greatly discounted, as the subject bank is unique. Management states the uniqueness of this bank is evident by the fact that the bank does not have the accessibility and resources afforded the other institutions within the assessment area but nonetheless has successfully increased its loan portfolio by over 75 percent in almost three years.

Discussion

The ombudsman's review of the appeal included an analysis of the information provided by management, an on-site visit to the community and the bank by members of his staff, and discussions with OCC personnel.

While the community where the bank is located is primarily agricultural and has experienced little growth, the bank's designated assessment area includes six other communities and some of the southwestern tracts of a major metropolitan area. These areas do reflect significant growth and lending opportunities particularly, because of urban flight from the large metropolitan city. Also, an analysis of the ATM activity at the bank's on-site location indicated that over half of all transactions were from nonbank customers. All of which supports the position that the bank's accessibility does not seem to be a problem for ATM users. This level of nonbank customer usage presents an opportunity to cultivate additional customers.

While four of the financial institutions in the bank's assessment area have twice the total assets, two of the banks are of comparable total asset size and have fewer resources (capital). These banks have loan-to-deposit (L/D) ratios of 40 percent and 50 percent, respectively, more than twice the L/D ratio of the bank. Furthermore, while the bank's loan growth, as a percentage, is increasing at a faster rate than its peer group, it had the same incremental dollar change.

The appeal mentioned performance based on a "per capita" income basis; however, census tracts are categorized and CRA performance is evaluated using median family income. The bank's assessment area includes 26 census tracts of which six are moderate, 14 are middle, and six are upper income. There are no low-income tracts, and the community where the bank is located is in an upper-income census tract.

Conclusion

The ombudsman acknowledges that the Public Evaluation states that the bank had met or exceeded the standards in "Lending within the Assessment Area," "Lending to Borrowers of Different Incomes," and "Geographic Distribution of Loans" for the level of lending done by the bank during the assessment period. Also, the bank's efforts in making small dollar loans effectively meet a credit need identified by local community contacts. Forty percent of the loans originated during the assessment period were for less than $1,000.

When evaluating CRA performance, a bank's L/D ratio is a strong indicator of its ability or willingness to fulfill the assessment area's credit needs. The bank's L/D ratio is significantly lower than similarly situated institutions. The bank's L/D ratio as of a particular month in 1997 was 18.14 percent. The bank's average L/D ratio during the assessment period was 15.23 percent compared to local competitors' average of 45.42 percent. Although there is strong competition in the assessment area, the board's and management's conservative lending practices and lack of commercial and residential lending expertise are the primary reasons for the low L/D ratio.

The ombudsman concurred with the "Needs to Improve" rating assigned during the examination. Consistent with the safe and sound operation of the bank, more and/or new lending opportunities should be explored. Lending opportunities clearly exist as demonstrated by the fact that the lowest L/D ratio of a competing bank is 40.61 percent.

The OCC recognizes that every bank is unique in its own right and evaluates each bank on a case-by-case basis. The bank is atypical in that its loan portfolio is less than its total capital, which indicates that the bank is able to take on more risk in the loan portfolio. The ombudsman is not advocating relaxation of the bank's high credit standards, but rather a program to increase lending slowly and gradually, and most importantly, safely.

Case Four: Appeal of Composite Rating of 4 and Several Component Ratings

Background

A bank formally appealed its composite CAMELS rating of 4. [The Uniform Financial Institutions Rating System is used to rate six components of a bank's performance: capital, asset quality, management, earnings, liquidity,

and sensitivity to market risk (CAMELS) in a combined composite rating.] Management cited several reasons for the appeal, including:

- Factual errors in the Report of Examination (ROE);
- A feeling on the part of the board of directors and management that the examiner was overzealous, and came into the bank with a predetermined conclusion to downgrade the bank's overall condition;
- General statements were made in the ROE that did not have backup, or could be considered improper statements; and,
- The CAMELS component ratings were not justified based on the ROE and condition of the bank, and the overall conclusions were therefore inappropriate.

Management acknowledges that many of the deficiencies identified in the ROE are legitimate and corrective action has been implemented. However, they state that they are at a loss as to why the rating dropped from a 2 to a 4 with no changes in management or operations.

Discussion and Conclusions

The bank's ROE stated the following reasons for the composite rating downgrade from a 2 to a 4:

- The overall condition of the bank deteriorated significantly as a result of deficient management supervision and board oversight. Risk management systems are inadequate, and the level of problems and risk exposure is excessive.
- Management and board supervision has not been effective.
- Capital is deficient relative to the bank's increased risk profile, earnings have deteriorated and are poor, asset quality and credit administration need improvement, sensitivity to market risk is moderate, and liquidity is satisfactory.
- Supervision of management bank information systems is unsatisfactory.

The supervisory office acknowledges that certain factual errors were made in the ROE; although the errors are regrettable, none of the errors affected the examination conclusions. In the appeal letter, the board of directors stated they believed the examiner-in-charge was overzealous and had predetermined that the bank's rating should be downgraded. As examiner objectivity and professionalism are fundamental elements in effective bank supervision, this contention was taken seriously. After review of related documentation and discussions with all parties involved, the ombudsman did not find evidence that the examiner-in-charge nor members of his staff were biased toward the bank. However, certain aspects of the communication of the examination findings could have been handled more effectively. Bank management noted a number of general statements in the ROE that they considered to be unsupported and improper. The statements referenced were primarily those that contained adjectives such as "material, significant, and substantive" in describing various identified weaknesses. Since management considers the examination conclusions and ratings to be inappropriate, their objection to the adjectives used to describe the identified deficiencies and exceptions is understandable. The following discussion and conclusions regarding the assigned ratings will help resolve management's objection to the referenced statements.

Capital

The bank's capital ratios declined significantly between examinations, primarily the result of purchasing a large amount of deposits from another bank that was closing a branch. Losses identified during the examination also contributed to the decline in the bank's capital ratios. The result of the aforementioned events caused the bank's capital ratios to fall to the "adequately capitalized" category, and the examination resulted in capital being rated a 4. While it is apparent the capital ratios declined significantly, implicit in a 4 rating is concern about the viability of an institution, which was not the situation in the case of this bank. Further, it is reasonable to assume management's projections for profitability are attainable, and that earnings should return to a level sufficient to supplement capital. Therefore, the ombudsman concluded that a capital rating of 3 was appropriate. A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, which is evident in this case.

Asset Quality

The level of classified assets remains high at over 60 percent of Tier 1 capital plus the allowance for loan and lease losses (ALLL). There is little improvement from the level of classified asset to capital ratio recorded at the previous examination. The level of classified assets has been high for the past three examinations. While some of the credit administration issues in the ROE may individually be mitigated, collectively they represent a concern. As defined, a rating of 3 is assigned when asset quality and/or credit administration practices are less than satisfactory. Trends may be stable; however, the level of classified assets is elevated, indicating a need to improve risk management practices. The ombudsman concurred with a 3 component rating for asset quality.

Management

The ROE is very critical of "deficient management supervision and board oversight." The ROE states that problems

and significant risks have not been adequately identified, measured, monitored, or controlled. A number of deficiencies were identified in the examination that support that conclusion; i.e., accounting errors that materially overstated earnings and capital, ineffective strategic/capital planning and budgeting, and weaknesses in internal controls, audit, and management information systems. The deteriorating condition of the bank is undeniable, and there is no question that deficiencies in board and management supervision have been a factor in that decline. However, the bank's capital and earnings problems are largely attributable to the deposit acquisition and the ALLL allocation made at the examination in question. The large ALLL allocation should not reoccur since it was attributable to a change in the ALLL analysis process, and it is reasonable to assume that the net interest margin should improve as the bank is able to gradually employ a greater percentage of the acquired deposits into higher yielding loans. The ombudsman recognized the steps management had taken to implement corrective measures. The bank's supervisory record with the OCC indicates that the board and management team have been cooperative and there is no reason to believe they cannot implement corrective action with respect to the weaknesses noted at this examination. However, the deteriorating condition of the bank is undeniable, evidencing a need for improved risk management. The ombudsman concluded that a component management rating of 3 was more appropriate than the assigned 4. The 3 management component rating clearly acknowledges that overall management and board supervision warrant improvement.

Earnings

Most of the earnings problems are attributable to one-time adjustments and the temporary impact of the deposit acquisition. The bank achieved a small profit for the year despite the adjustments made, and management is projecting a return on average assets of 0.75 percent for this year. While many of the bank's earnings problems are attributable to a one-time adjustment, improvements in the quality of earnings are also needed. Earnings have declined for four consecutive years, and even if the bank meets its current projections and achieves a return on average assets of 0.75 percent, earnings performance would remain below average. Per OCC Bulletin 97–1, a rating of 3 indicates earnings that need to be improved. Discounting the one-time adjustment and deposit purchase, earnings may not fully support operations and provide for the accretion of capital and ALLL levels. The ombudsman concluded that a component earnings rating of 3 was more appropriate than the assigned 4.

Liquidity

While there were several statements in the ROE that the bank disagreed with, there was no disagreement regarding the component rating. Based on the ROE and the bank's response thereto, improvements could be made in the accuracy of information provided in the funds management/liquidity area. Liquidity is satisfactory and the rating of 2 remains unchanged.

Sensitivity to Market Risk

The primary reason for the 3 component rating in the ROE was "the bank's poor earnings and deficient capital do not support the current level of IRR" [interest rate risk]. While the ombudsman acknowledges the bank's level of interest rate risk is moderate when compared to other banks, this is not the case relative to the bank's capital and unsatisfactory earnings. The ombudsman found the rating of 3 remained appropriate.

Composite CAMELS Rating

The ombudsman agreed that the bank has significant deficiencies in its risk management processes, which have contributed to deterioration in the bank's overall condition. However, the deterioration was not to the point that failure is a distinct possibility. Management has already addressed many of the issues identified during the examination and, with the OCC's guidance, the bank can be returned to sound financial footing.

The composite CAMELS rating of 4 was upgraded to a 3. As stated in the Uniform Financial Institutions Rating System, institutions rated 3 exhibit some degree of supervisory concern in one or more of the component areas. Such financial institutions exhibit a combination of weaknesses that may range from moderate to severe. Their management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in such a group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, financial institutions rated 3 may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. Such financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure would appear unlikely, however, given the overall strength and financial capacity of 3-rated institutions.

Case Five: Appeal of a Composite 3 CAMELS Rating

Background

A bank formally appealed the composite CAMELS rating of 3 that was confirmed a second time during a follow-up visit to the bank. Six months prior to this visit, a full-scope examination was performed that initially resulted in a composite rating of 3. The major reason for the first 3

composite rating was the board's and management's failure to correct several ongoing credit administration and risk management deficiencies. The credit administration and risk management deficiencies were particularly troubling because the bank sustained 50 percent growth during the past year. Classified assets were relatively high, at slightly over 50 percent of capital. Earnings performance was below average and recent trends were negative. The above-mentioned risks resulted in several "Matters Requiring Board Attention" (MRBA) comments relating to loan staffing and credit administration, loan review, compliance, and internal audit, in the Report of Examination. At the time of the examination, capital was not considered a major issue, in part because of plans to inject a large amount of capital during the following year. The bank did not disagree with the findings of the initial examination.

Six months later, the follow-up visit was performed to assess the bank's progress in correcting the MRBA comments included in the initial Report of Examination. The revised policies, procedures, and systems in the lending area, the recently completed audit, loan review, and compliance reports were also reviewed. The results of that visit were positive. The examiners concluded that the board and management had substantially addressed all the deficiencies noted as MRBAs at the previous examination. The examiners noted significantly improved risk management systems and stated the bank now had the personnel and systems in place to provide adequate coverage for audit, compliance, and loan review. However, the previously assigned composite rating of 3, was maintained because of concerns regarding the adequacy and management of the bank's capital and earnings posture. The bank had continued to grow rapidly between the examination and the visit. While substantial capital injections had taken place (although short of the amount originally projected), management still had not developed a realistic capital plan.

In the bank's appeal, bank management stated the OCC had committed to upgrade the composite rating to a 2, if the MRBAs were satisfactorily addressed. The bank further stated the amount of equity capital injected was sufficient to keep the bank's capital ratios within the definition of well capitalized.

Discussion

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5. The composite ratings of 2 and 3 are defined as follows:

Composite 2. Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3. Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions. [From Federal Financial Institutions Council. "Uniform Financial Institutions Rating System," *Federal Register,* December 19, 1996, Vol. 61, No. 245, p. 67026, attachment to OCC Bulletin 97–1.]

Conclusions

A fundamental issue during any examination is the accurate assessment of the bank's risk profile, and the processes and controls in place to manage that risk. The deterioration in the bank's financial condition noted during the initial examination, coupled with substantive growth, warranted a more comprehensive risk management process than existed at the time. The detailed MRBAs included in the initial examination helped guide management in improving the bank's risk assessment systems. Improvement of the bank's risk management processes were evident during the follow-up supervisory office's visit to the bank. The major problems noted at the

initial examination had or were being satisfactorily resolved. Loan quality had improved, additional staff was in place, internal audit was satisfactory, and administrative problems in the lending and compliance areas were significantly improved.

Based on the bank's risk profile, it became very important for management to maintain an adequate capital base. Equally important was the need for a capital plan, which provides various alternatives for the maintenance of satisfactory capital consistent with the bank's risk profile. Management must also develop an overall strategic plan that includes a comprehensive focus on maintenance of adequate capitalization. This is particularly important in light of the growth opportunities shared with the ombudsman's office during the visit to the bank. The plan should include growth targets, capital projections, and a determination of the level of capital needed for the bank in both the short and long term.

After the ombudsman reviewed the issues noted in the bank's appeal letter, the initial ROE, the follow-up review, and discussions conducted with bank management and the OCC supervisory personnel, the ombudsman concluded that a composite rating of 2 was appropriate, as a result of the follow-up visit. The improvements that occurred between the examination and the follow-up visit reflected positively on the ability of the board and management team to supervise the bank. This was a major factor in the ombudsman's decision to change the rating.

Case Six: Appeal of Potential Violation of the Equal Credit Opportunity Act (ECOA)—Disparate Treatment on the Basis of National Origin

Background

A Competitive Equality Banking Act (CEBA) institution filed a formal appeal with the ombudsman's office concerning potential violations of the Equal Credit Opportunity Act (ECOA). The potential violations involved possible disparate treatment on the basis of national origin. The institution received correspondence stating the Office of the Comptroller of the Currency (OCC) had determined that it has reason to believe the bank engaged in a pattern or practice of violating the ECOA and Regulation B by treating Spanish-language applicants less favorably than similarly situated English-language applicants involving a co-branded credit card. Specific practices included holding Spanish-language customers to a different standard of approval, excluding them from certain promotional credit services commonly offered to English-language customers, and assigning them lower credit limits.

In the early 1990s, the bank established a co-branding credit card relationship with a company whereby the bank offered a credit card through "take-one" applications in company stores. The bank's initial program offered applications in the English language only. However, the following year, the bank began offering Spanish-language application forms in order to reach out to predominately Spanish-speaking communities.

In order to keep track of the Spanish-language program's performance and to facilitate record-keeping requirements, the bank created a separate subfile of the co-branded portfolio in its processing systems. At the time the Spanish-language program was started, the underwriting standards were no less favorable than those used to underwrite the English-language accounts. The terms and conditions of both credit card groups, including fees, charges, and credit line assignments, were the same for both Spanish- and English-speaking account holders.

The only distinction between the handling of accounts originated through Spanish- and English-language applications was that the subfile of accounts generated from the Spanish-language applications was placed on a marketing "exclusion" list. Any accounts on this particular list did not receive marketing mailings for special balance consolidation offers or similar promotional programs. Bank management felt that these customers had made a clear election to be treated as Spanish-language applicants, and they therefore might take offense at periodically receiving promotional materials in the English language. Since the number of accounts generated from the Spanish-language application process was relatively low, the bank also felt that they could not justify the additional business expense of having promotional materials translated into the Spanish language for the relatively small group of account holders (less than 2,000).

Periodically, it was the bank's policy to conduct an analysis of each credit card program in order to evaluate its overall performance and profitability (i.e., a loss control analysis). The purpose of these periodic analyses was to identify if underwriting standards and application processing needed to be changed, based on the performance of the specific pool. The bank's credit card portfolio was separated into "subfiles" of various sizes for each type of co-branding card. The bank's policy was that it was cost effective to conduct the loss analysis of the largest subfile first.

Accordingly, in early 1996 the bank conducted an analysis of the English-language application subfile. Consistent with the bank's policy, management did not review the Spanish-language subfile because it was considered too small. As a result of the analysis, credit score cutoffs

and credit line assignment matrices for the English-language applications were lowered in an effort to address loss issues. Because the Spanish-language application subfile was very small, the bank did not apply the same underwriting standard changes to the Spanish-language generated account holders. This change in application processing resulted in unequal treatment of the Spanish-language application group of customers.

In addition to the application of different underwriting standards between the English- and Spanish-language portfolios, disparate treatment was also found in the differences of the availability of credit-related programs between the two groups. As a result of management's original decision to place Spanish-language accounts on their internal marketing "exclusion" list, many Spanish-language account holders were excluded from certain skip-a-payment and balance consolidation programs offered to English-applicant account holders. Because these programs had an impact on credit terms but were only offered to one group, the effect was that different services and potentially less favorable credit terms were provided to cardholders of Spanish-language origin.

During the examination, management stated that their practices of disparate treatment were unintentional and isolated. Upon notification of these findings, management took actions to cease the potentially discriminatory practices and address the problem. In particular, all credit card applications were processed using the same decision tree, all Spanish- and English-language applications were treated equally in terms of credit score cutoffs and line assignments, and all Spanish-language applicant account holders were included in marketing and special promotion programs. In addition, management identified those Spanish-language applicants who were improperly denied credit or given lower credit lines as a result of the possible disparate treatment. They subsequently completed the process of offering credit cards or increasing credit lines to those persons identified as part of the affected pool. Management also took steps to correct deficient internal controls and compliance management weaknesses, which will improve management oversight.

The OCC conducted an examination of the bank's compliance with fair lending statutes. The agency concluded that there was "reason to believe" that the bank imposed different credit requirements on applicants based on their national origin, in violation of ECOA. The agency stated there was "reason to believe" that the bank engaged in a pattern or practice of violating ECOA by treating its Spanish-language applicants and customers less favorably than similarly situated English-language customers. The supervisory office concluded that it was therefore obligated to refer this matter to the U.S. Department of Justice.

The bank appealed this decision to the ombudsman based on the following issues:

1. Because of fewer cardholders and costs involved, it is an industry practice not to offer subfile cardholders the same promotional opportunities that are made available to the main-file cardholders. Therefore, the different treatment of the Spanish-language subfile did not constitute disparate treatment or disparate impact and was not a violation of ECOA.
2. The potential number of accounts is too small to support a finding of a pattern or practice of discrimination.

Discussion

While it may be industry practice to treat an account subfile differently, this practice may result in disparate treatment or disparate impact.

The ECOA, 15 USC 1691(a) prohibits a creditor from discriminating against an applicant on a prohibited basis regarding any aspect of a credit transaction. The implementing regulation 12 CFR 202.4 (Regulation B) defines prohibited basis as follows:

> *Prohibited basis* means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Board. (12 CFR 202.2 (z))

While ECOA does not define the term "pattern or practice" the Interagency Policy Statement on Discrimination in Lending offers guidance on the meaning of a pattern or practice. The policy statement states that "repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice" of lending discrimination but "isolated, unrelated, or accidental occurrences will not." In assessing whether a pattern or practice exists, the OCC considers the totality of circumstances, including the following factors:

- Whether the conduct appears to be grounded in a written or unwritten policy or established practice that is discriminatory in purpose or effect.
- Whether there is evidence of similar conduct by a bank toward more than one applicant.
- Whether the conduct has some common source or cause within the bank's control.

- The relationship of the instances of conduct to one another.
- The relationship of the number of instances of conduct to the bank's total lending activity.

This list of factors is not exhaustive and whether the OCC finds evidence of a pattern or practice depends on the egregiousness of the facts and circumstances involved. Each inquiry is intensively fact-specific and there is no minimum number of violations that will trigger a finding of a pattern or practice of discrimination.

The term "pattern or practice" is not defined in the ECOA but has generally been interpreted to mean that the discrimination must not be isolated, sporadic, or accidental. Also, while there is no minimum number of incidents that must be proven as a prerequisite to finding a pattern or practice of discrimination, a party does not have to discriminate consistently to be engaging in a pattern or practice.

What the facts in the judicial decisions and the examples in the policy statement indicate, however, is that a "pattern or practice" involves some degree of *action* or *conduct* toward a protected person. In particular, the policy statement specifically refers to a lender's "conduct" in describing relevant factors to a "pattern or practice" determination.

Conclusion

The ombudsman concluded that there was sufficient reason to believe that a violation of the ECOA occurred and, as such, remanded to the OCC's supervisory office the matter for referral to the U.S. Department of Justice.

Case Seven: Appeal of Potential Violation of the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA)—Disparate Treatment on the Basis of Race and National Origin

Background

An institution filed a formal appeal with the ombudsman's office concerning potential violations of the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA). In addition to the core disagreement with the potential violations, the appeal also highlighted the bank's concern with the following:

- Lack of an acknowledgment of the bank's response to the agency's initial findings;
- Concerns about prejudgment by the examination staff; and,
- The impact of hearsay from former bank employees on the agency's conclusions.

The potential violations involved possible disparate treatment on the basis of race and national origin. The institution received correspondence stating the Office of the Comptroller of the Currency (OCC) had determined it had reason to believe the bank engaged in a patten or practice of treating white, Hispanic, and black applicants for home mortgage loans less favorably than Asian applicants. Beginning in the early 1990s, the bank regularly made home purchase loans through two channels, a wholesale mortgage division, and the retail loan department. The wholesale division generated a significant volume of home purchase and home refinance loans, primarily referred by brokers, while loans originated through the retail loan department generated a much lower volume.

During this time period, the bank also offered a special "low-documentation" loan program. The program characteristics were a low loan-to-value, no requirement of a social security number or credit history, acceptance of overseas funds for down payment, nonresident aliens could qualify, and minimal documentation. These loans were retained on the bank's books.

To evaluate the bank's fair lending performance, the OCC conducted a comparative file analysis both manually and by statistical modeling. The manual analysis compared the treatment of Asian applicants with the treatment of white, Hispanic, and black applicants. The statistical analysis, which consisted of a legitimate regression model, compared the treatment of Asian and white applicants. There was an insufficient number of applications from Hispanics and blacks to permit statistical analysis of their treatment.

The manual file analysis showed evidence of discriminatory practices that indicated that more stringent underwriting standards were applied to whites, Hispanics, and blacks than to Asians. Differing treatment was found in the following areas:

- Requiring asset and income verifications;
- Handling discrepancies in applications or credit bureau reports;
- Offering of counteroffers;
- Reviewing credit history;
- Handling applicant occupancy; and
- Handling related buyers and sellers.

Statistical analysis, in the form of a regression model, was used to refine and extend the judgmental analysis. The same conclusions occurred. The results identified instances where it appeared Asian applicants were qualified more frequently than similarly situated non-Asian applicants. Whites had largely increased odds of being denied home loans, even after controlling for other variables in the regression analysis that were critical to the underwriting process. Subsequent discussions with officers, employees, and two former employees of the bank failed to mitigate most of the instances of apparent difference in treatment identified from the file sample. After evaluating all the evidence, including the bank's response, the OCC concluded there remained reason to believe the bank had potentially engaged in a pattern or practice of discrimination against non-Asian applicants for home loans. Therefore, the OCC concluded it was obligated to refer this matter to the U.S. Department of Justice and to notify the U.S. Department of Housing and Urban Development.

Discussion

The ECOA, 15 USC 1691(a) prohibits a creditor from discriminating against an applicant on a prohibited basis regarding any aspect of a credit transaction. The implementing regulation 12 CFR 202.4 (Regulation B) defines prohibited basis as follows:

> *Prohibited basis* means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Board. (12 CFR 202.2 (z))

The Fair Housing Act (FHA), 42 USC 3605, prohibits a lender from discriminating on a prohibited basis in a residential real estate related transaction (including the making of loans) or in the terms or conditions of the transaction. The implementing regulation, 24 CFR 100.130, states it shall be unlawful for any person or entity engaged in the making of loans or in the provision of other financial assistance relating to the purchase, construction, improvement, repair, or maintenance of dwellings, or which are secured by residential real estate, to impose different terms or conditions for the availability of such loans or other financial assistance because of, among other factors, race and national origin.

While the ECOA and the FHA do not define the term "pattern and practice," the Interagency Policy Statement on Discrimination in Lending offers guidance on the meaning of a pattern or practice. The policy statement states that "repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice" of lending discrimination but "isolated, unrelated, or accidental occurrences will not." In assessing whether a pattern or practice exists, the OCC considers the totality of the circumstances, including the following factors:

- Whether the conduct appears to be grounded in a written or unwritten policy or established practice that is discriminatory in purpose or effect.
- Whether there is evidence of similar conduct by a bank toward more than one applicant.
- Whether the conduct has some common source or cause within the bank's control.
- The relationship of the instances of conduct to one another.
- The relationship of the number of instances of conduct to the bank's total lending activity.

This list of factors is not exhaustive and whether the OCC finds evidence of a pattern or practice depends on the egregiousness of the facts and circumstances involved. Each inquiry is intensively fact-specific and there is no minimum number of violations that will trigger a finding of a pattern or practice of discrimination.

The term "pattern or practice" is not defined in the ECOA or the FHA but has generally been interpreted to mean that the discrimination must not be isolated, sporadic, or accidental. Also, while there is no minimum number of incidents that must be proven as a prerequisite to finding a pattern or practice of discrimination, a party does not have to discriminate consistently to be engaging in a pattern or practice.

What the facts in the judicial decisions and the examples in the policy statement indicate, however, is that a "pattern or practice" involves some degree of *action* or *conduct* toward a protected person. In particular, the policy statement specifically refers to a lender's "conduct" in describing relevant factors to a "pattern or practice" determination.

Conclusion

The ombudsman reviewed the issues noted in the bank's appeal letter, the bank's response to the district's initial conclusions, and all relevant supporting internal and external documents. Discussions were held with appropriate bank managers and involved OCC staff. Based on this comprehensive analysis, we arrived at the following conclusions.

The ombudsman concluded that there was sufficient reason to believe that violations of the ECOA and the FHA occurred and, as such, remanded to the OCC's supervisory office the matter of notification to the U.S. Department of Housing and Urban Development and a referral to the U.S. Department of Justice.

While the OCC supervisory office did not send a written acknowledgment of the bank's response to the OCC's initial conclusions, that fact alone did not mean that the additional information supplied by the bank was not considered in the OCC's final decision to refer the violations of ECOA and FHA to the Department of Justice. In fact, the ombudsman found that the bank's response was carefully analyzed and considered in detail by OCC bank supervisory and enforcement offices prior to rendering the final decision. As a result, this issue was not remanded back to the OCC's bank supervision and enforcement staff for further analysis. However, based on the concerns identified in the appeal, the OCC will, in the future, acknowledge initial conclusion submissions. The ombudsman found no evidence of prejudgment by OCC staff, or any undue reliance on hearsay from former bank employees at any point in the decision-making process.

Speeches and Congressional Testimony

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the Women in Housing and Finance, on issues raised by recent proposed mergers of large financial institutions, Washington, D.C., April 28, 1998

I am delighted to be delivering my first formal address as Acting Comptroller of the Currency before the Women in Housing and Finance, an organization which has done so much to support the professional development of women in the financial and housing arena. I myself have been a direct beneficiary of these efforts—and of the many friendships formed along the way. There is no group with which I would rather be sharing my thoughts about the vital banking issues of the day—and my real pride to be following in the footsteps of the fine men—all of them men, until now—who have headed the Comptroller's office over its long and distinguished history.

Let me begin by expressing my thanks to one distinguished holder of that office. Many people have spoken about Gene Ludwig's achievements and, in the future, many more undoubtedly will. Suffice it to say that the OCC and the national banking system will bear his imprint for a long time to come. We should be grateful to Gene for giving so much of himself in pursuit of the goal we share: a safe, sound, and competitive national banking system that serves the people, businesses, and communities of our nation.

I became Acting Comptroller of the Currency on April 5. The following day, April 6, Citicorp and Travelers announced plans to merge into a financial conglomerate to be called Citigroup, with assets of over $700 billion. One week later, the nation's third and fifth largest banks, respectively—NationsBank and BankAmerica—followed suit. In this case, the new entity's total assets would amount to $570 billion. And, just hours later, Banc One and First Chicago NBD announced that they were proposing to join forces into a $279 billion superregional bank. Certainly, my first two weeks in office were not dull.

Since these transactions were announced, the banking world has spoken of little else. And not only bankers: consumer groups, community organizations, national, state, and local government officials, analysts, and pundits of every type—all have had their say about what these giant transactions might mean for the economy, for the legislative process, and for consumers. So I thought I would spend the better part of my time with you today offering *my* perspective on these questions.

Indeed, I believe that maintaining one's perspective—a sense of balance and context—is especially important in these times, so that we react, not just to the breathtaking scale of some of the transactions, but to the real issues they pose. In some respects, for example, these transactions raise issues very similar to what we have seen before in other mergers that have preceded them in recent years. But they also present some new challenges.

It is helpful when assessing the implications of these transactions to recognize that they are the product of long-term changes in the financial services industry. The fact is that banking has been undergoing fundamental change for more than a generation now. Today's analysts speak in terms of the "evolution of the bank balance sheet," and evolution—in the sense of long-term adaptive change—is a good way to think of it. Its manifestations are certainly familiar to us: the decline in core deposits and proportionate increase in nondeposit liabilities; the migration of top-rated corporate borrowers from banks to the commercial paper market; the proportionate increase in lending to lesser, potentially riskier firms and to consumers; the rise in off-balance-sheet activities; the search for fee-generating activities to offset rising credit risk; new competition in the U.S. credit markets—all of these market-driven developments and many more are part of a broad secular trend that dates back at least to the 1960s but that has gained noticeable momentum in recent years.

A few statistics illustrate the point. For all insured commercial banks, foreign and *non*deposit liabilities constituted about *two* percent of total liabilities in 1960; in 1997, it was more than 50 percent. In 1963, commercial banks earned 10 dollars in interest income for every dollar in noninterest income; in 1991, the ratio had dropped to 5 to 1; in 1997, it was 3 to 1. In 1963, commercial and industrial loans represented about 35 percent of the aggregate loan portfolio, with real estate, agriculture, and consumer loans making up most of the rest; in 1997 commercial loans were down to 27 percent of the portfolio.

It should be clear, then, that banks and their balance sheets have been in transition for a long time. And so have bank corporate structures, as bankers, in response to the market conditions I have just described, search for ways to control operational costs, broaden their base of customers, achieve greater functional and geographical diversification, and capture economies of scope and scale.

Since 1980, thousands of bank mergers have taken place, a trend which has sent the number of commercial banks down from roughly 14,000 to little more than 9,000 in the same period of time. Most of these mergers involved smaller banks—$1 billion or less. But, even with the pruning of redundant bank branches and the rationalization of systems and facilities, the institutions that result from these combinations are almost invariably larger—and stronger—than the sum of their original parts. That's one reason why the typical bank today is bigger than its counterpart of 20 years ago. And, certain benefits can come from large size. For example, larger banks are more likely to have the resources to provide increasingly sophisticated customers with a wide range of products and services and to make those products and services conveniently available through advanced technology.

Larger banks will also tend to be more geographically diverse and thus more resistant to the ups and downs affecting regional economies. They also have more scope to diversify their activities, which can also enhance their safety and soundness.

Yet consolidation in banking generally and bank merger activity specifically do present various public policy and supervisory concerns. One is simply whether we understand all the consequences of bigness. Many Americans have a traditional fear of concentrated financial power—and the more concentrated, the more it is feared. Yet, the United States has always had, and—even after the announced mergers—still will have, the most decentralized banking system among the advanced nations of the world.

From the consumer perspective, some consumer advocates worry that large banks are impersonal, indifferent to local financial needs, especially in smaller localities. Others perceive that large banks charge higher fees for certain services than smaller, locally based institutions. Others worry that in large financial companies cross-selling of products will not be conducted appropriately.

People also worry—understandably—about the impact on the life of a community when leading corporate citizens—and most banks are just that—no longer have a headquarters in their town. The existence of giant financial conglomerates of unprecedented size and resources also may present competitive issues of a dimension not heretofore seen.

Issues of personal privacy may become more significant because, as financial firms get larger and engage in more types of activities, they also gain more and more information about their customers. Thus, we may worry more now about privacy—and whether big financial companies will share our personal financial information among their various affiliates and subsidiaries in ways that we didn't anticipate. These are all issues that must be carefully considered as the banking industry enters its latest phase of evolution.

Concerns have also been voiced about the ability of the financial regulatory agencies to do our jobs when the institutions we supervise increasingly reach across geographic and functional lines. This is a subject that I want to spend some time discussing with you here today.

At the OCC, we too have also been asking ourselves a good many questions about the proposed combinations. From our previous experience with many large corporate transactions, we can identify key issues, that, as supervisors, we will be watching closely. It is helpful to divide these issues into those that are closely connected with the combination transaction itself, and other issues that relate to ongoing supervision of very large financial institutions.

For example, OCC experience with previous combination transactions demonstrates the importance of clear business plans, lines of authority, and accountability in the combination process. *Execution is crucial.* Anything short of a tightly controlled transition process can lead to significant disruptions of ongoing business and imprecise focus on future business strategies. Big mergers in the past also have sometimes occasioned a flight of managerial talent, resulting in insufficient expertise to manage the systems of merging companies or to assist in transitioning customers to the new combined organizations. Particularly when severance packages are widespread and generous, valuable managers may elect to leave. Our experience shows the importance of senior managers addressing in their merger plans the issues of retainment and continuity of critical staffing. Our experience also teaches that cost-cutting designed to achieve post-combination operational savings must not be allowed to debilitate essential internal controls and audit functions.

Similarly, merging management information systems and automated transaction systems to common platforms presents enormous challenges. Bank management must assure that core business activities remain viable throughout the transition and that integration processes are continually confirmed, verified, and audited.

In addition, few issues have absorbed our supervisory attention in recent months more than the banking industry's readiness for the year 2000 (Y2K). For organizations in the process of merging, our concerns are compounded. The combining businesses must inventory systems, identify vulnerabilities, and develop plans to ensure Y2K compliance. Management must decide promptly which systems can be integrated now and which systems must

be run parallel and integrated after the year 2000, to avoid disrupting Y2K remediation efforts.

Some of the other questions we have been asking ourselves relate to the issues that may arise in the ongoing supervision of the combined organizations after the combinations have been consummated. The new organizations will be larger and more complex, posing novel risk management and operational challenges. There will be a need for strong risk management functions to measure, monitor, and manage risk across a large and complex organization. In particular, risk management systems must identify risks to the *bank* in the resulting business, as well as take into account how the bank is impacted by the activities of nonbank affiliates.

Transactional issues also loom large. The combined entities will have to be ready to capture, process, and monitor a larger volume of transactions—millions more—than has ever been attempted before. Computer systems will need to capture huge volumes of data and convert this data into quality management information on a timely basis. The need for profitability analysis, stress testing for various economic and market scenarios, and financial risk modeling will increase. At the same time, beyond bank management's needs, the technology used must serve the needs of the combined customer base and delivery systems—for example, providing for cash management processes and accurate and timely account statements.

And, of course, in addition to these issues, we will be alert to the same safety and soundness issues with respect to the proposed merger partners as with every national bank, such as underwriting standards and credit exposures.

Our supervisory approach to these transactions and to the ongoing supervision of the large organizations that may result will be based on our experience overseeing many large bank mergers in recent years, and our fundamental supervisory philosophy—supervision by risk. Over the past five years, we have developed, tested, and refined this supervisory strategy—designed expressly to address the special challenges posed by bigger, more complex banks. Supervision by risk orients the supervisory process to anticipate and deal with problems before they become entrenched. These procedures require OCC examiners to assess a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas. Examiners must identify areas of highest risk, understand exactly what management is doing to address those risks, and communicate regularly with management to indicate where additional management actions are needed. Our examiners make this evaluation by considering not only the activities of the bank itself, but also how the bank's risk profile in the nine key risk areas is affected by the activities of the bank's subsidiaries and affiliates. The latest refinements in our examination procedures for large banks—the "Large Bank Supervision" booklet of the *Comptroller's Handbook*—is in the final stages of completion and will soon be released.

Clearly, it is timely.

Utilizing the supervision by risk approach, OCC's resident staff at each of the institutions involved in the recently proposed transactions have already begun to coordinate their supervisory strategies, identifying each institution's strengths and weaknesses. They will closely monitor their banks to ensure that appropriate risk management controls are maintained in the affected companies during the combination process, and adequately implemented in the combined company. Examiners will assess and measure risks within each company, and then integrate the risk profiles of the different entities and develop a combined risk assessment and supervisory strategy. In addition to our work with respect to the individual institutions involved, we are also planning to gather some of our examiners most experienced in large merger and combination transactions for a special meeting to review the issues they have seen in connection with those transactions and identify "best practices" in how those issues were addressed by the institutions involved and by OCC supervisory responses.

In short, I believe that we have the right approach and the right tools to supervise the large institutions that may emerge from the recently announced transactions—and others that may be formed in the future. But we are not complacent. The scale of these transactions does present challenges—real challenges—as I have described above. We will need to be vigorous in our approach to supervision and very sensitive to the emergence of any familiar and certainly any novel supervisory issues. Given the size of the organizations being formed, problems must not be allowed to fester.

Although I have focused on the supervisory implications of "mega-mergers," it is important that we not lose sight of the public policy issues that these transactions also raise. I touched on some of these issues at the beginning of my remarks today, and I will be discussing them in greater detail in the coming weeks. But there is one issue that I think demands a special note now, and that is the potential impact of pending legislative proposals on competition in the financial services arena.

The current H.R. 10 proposal for financial modernization would significantly affect whether banks of all sizes will be able to compete effectively with the conglomerate financial firms that the legislation would authorize. At the OCC, we have repeatedly said that if new legislation

allows banking organizations to engage in a new, wider range of financial activities, banking organizations must have the ability to choose the structure in which to conduct those activities that is most effective and efficient for them. Financial modernization legislation would unfairly tilt the competitive playing field in favor of large financial conglomerates if potential—and less mega-sized—competitors of those conglomerates are denied the ability to compete using the corporate organizational form that is most efficient for them. This is a very real and practical dimension of the question of whether legislation should allow new activities to be conducted in bank operating subsidiaries as well as bank holding-company affiliates.

This is not just a community bank issue. Banks of all sizes, when faced with the prospect of competing in new lines of business against a conglomerate financial titan, need to be able to do business in a corporate structure that allows them to compete in the manner that is most effective and efficient for each of them. Moreover, considering the formidable companies they could well face, it is also ill-advised for legislation to deprive banks of authorities they have today that could help them remain competitive. These are concerns with broad ramifications for competition in the financial services industry as well as for the long-term role banks play in our communities and in our national economy.

In closing, let me just note that numbers such as those presented by the proposed mega-mergers *can* be daunting. That is why it is so important that we try to maintain our sense of perspective in assessing the changes taking place in financial services today and the issues those changes may present. I have tried to provide some of that perspective in my remarks this afternoon and look forward to doing so again in the future. Promoting constructive public discussion of relevant policy issues is another important way that the OCC contributes to a safe, sound, and competitive national banking system.

Statement of Julie L. Williams, Acting Comptroller of the Currency, before the U.S. House Committee on Banking and Financial Services, on recent proposed mergers of large financial institutions, Washington, D.C., April 29, 1998

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the committee, I appreciate this opportunity to testify on the recent proposed mergers of a number of large financial institutions. As you note in your letter of invitation, there have been many significant developments in the financial services industry in recent years, and these developments raise a number of important public policy issues. I commend the committee for convening this hearing to focus attention on these matters.

Today, we are here to discuss two developments: mergers between large, superregional banks and thrifts, and a proposed combination between a banking company and a financial services firm designed to create a diversified financial conglomerate. The scale and scope of each of these mergers raises important questions about their impact on consumers and local communities; about their implications for domestic and international competition; and, about the preparedness of regulators to oversee the resulting organizations.

It is helpful when assessing the implications of these transactions to recognize that they are the product of long-term changes in the financial services industry. The fact is that banking has been undergoing fundamental change for more than a generation now. Today's analysts speak in terms of the "evolution of the bank balance sheet," and evolution—in the sense of long-term adaptive change—is an apt way to consider these changes. Its manifestations are certainly familiar: the decline in core deposits and the proportionate increase in nondeposit liabilities; the migration of top-rated corporate borrowers from banks to the commercial paper market and the increased lending to smaller, potentially riskier firms and to consumers; technological developments that result in enhanced electronic product delivery; the rise in off-balance-sheet activities; the search for fee-generating activities to expand and diversify income sources; the sustained efforts to reduce operating costs and compete more efficiently; and, increased intra-industry and nonbank competition in the U.S. credit markets that is now global.

In addition, legislative changes have removed most restrictions on the geographic scope of bank operations and reduced regulatory burdens that restricted more efficient bank operations. Banks, in response, have sought to adapt structurally, seeking out merger and acquisition partners to realign their franchises.[1] All of these and other market-driven developments are part of an evolutionary trend that dates back at least to the 1960s but that has gained noticeable momentum in recent years.

As the charterer, regulator, and supervisor of the national banking system, we at the Office of the Comptroller of the Currency (OCC) have been focussing on how such industry restructuring will affect the safety and soundness of the national banking system and the customers and communities served by national banks.

My testimony today, therefore, addresses the key issues you have raised from the perspective of a bank supervisor. I will first discuss the key safety and soundness issues we perceive and the steps the OCC has undertaken to address those issues. I will next discuss community, consumer, and competitiveness issues in relation to the recently announced merger activity. I will conclude by discussing the question you raised as to whether legislation is needed to provide smaller banks with the ability to compete on a level playing field with these emerging financial conglomerates. This last question, in fact, highlights an issue that has been of great concern to the OCC in connection with the current version of H.R. 10. To compete effectively in the financial services marketplace of the future, banks of all sizes need the ability to choose the organizational structure that will best enable them to operate efficiently and compete effectively. Particularly when faced with the prospect of competing against giant financial conglomerates, banks—of all sizes—should not be subject to artificial constraints on their ability to compete. Moreover, banks must not be deprived of authorities that they have today under current law as they face the challenges of competition in the emerging financial services industry.

Supervisory Issues and OCC Plans

Overview

Our supervisory approach to the transactions and organizations we are discussing today is based on our

[1] These activities, combined with the failures of large numbers of banks and savings associations in the 1980s and early 1990s, have resulted in a significant consolidation of the banking system, one that has whittled the number of commercial banks from roughly 14,000 in 1980 to little more than 9,000 today.

experience overseeing many large bank mergers in recent years, and our fundamental supervisory philosophy—supervision by risk. Over the past five years, we have developed, tested, and refined this supervisory strategy, which we believe is uniquely suited to address the special challenges posed by bigger, more complex banks. Whereas our historical supervisory practices were essentially reactive, supervision by risk better enables us to anticipate and deal with bank problems before they become entrenched. These procedures require OCC examiners to assess a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas.[2]

The supervision by risk framework provides a consistent and common structure for risk assessment for national banking companies. Through this process, examiners are required to draw conclusions on the quantity of risk and quality of risk management in all nine risk categories for each of our banks. The framework established by supervision by risk also allows for greater comparability of examination findings between and among banks. Peer analysis is a regular aspect of the large bank supervisory process.

In addition, the OCC is completing a revision of its examination guidance for large banks, building on our existing supervision by risk framework. This revised guidance, the "Large Bank Supervision" booklet of the *Comptroller's Handbook,* represents an enhancement to our evaluation of bank risk management processes, centered on the evaluation and management of existing and emergent areas of bank risk. The principal addition to the new handbook booklet is the specification of minimum conclusions that examiners of large banks must make during each 12-month supervisory cycle in assessing the nine categories of risk.

Supervision Issues

Applying the supervision by risk approach, OCC resident staff at each of the institutions involved in the recently proposed transactions have already begun to coordinate their supervisory strategies, identifying each organization's strengths and weaknesses. They will closely monitor their banks to ensure that appropriate risk management controls are maintained in the companies during the combination process and adequately implemented in the proposed combined companies. Examiners will assess and measure risks within each company and then integrate the risk profiles of the different entities and develop a combined risk assessment and supervisory strategy.

In addition to this work with respect to particular institutions, we plan to gather some of our examiners most experienced in large merger and combination transactions for a special meeting to review the issues they encountered in those transactions and identify "best practices" in how those issues were addressed by the institutions involved and by OCC supervisors.

We already know from experience, however, many of the near-term and long-term challenges banks involved in large mergers and combinations face. For example, beginning with the transition, management must establish clear business plans, lines of authority, and accountability within the new company. Anything short of a tightly controlled merger transition process can lead to significant disruptions of ongoing business. Execution is crucial. Other merger transition issues that management must address include the departure of key management and technical personnel at the time of the merger announcement or shortly thereafter, the challenge of combining operational and information systems without interfering with ongoing operations, and the retention and enforcement of necessary risk management controls and systems. Our experience also demonstrates that cost-cutting designed to achieve post-merger savings must not debilitate essential internal controls and audit functions.

We also know that different issues will emerge after the transition phase in connection with ongoing supervision of the combined entity. Some of these post-merger supervisory issues include ensuring that the combined entity can process and monitor larger volumes of transactions, verifying that risk management systems identify risks to the bank in the large, complex organization, and evaluating whether management information systems are adequate to support critical management decision making in the new organization.

Let me now turn to a fuller discussion of these issues, and our supervisory approaches to them.

Concentrations. To invest large quantities of funds efficiently, larger entities generally tend to engage in transactions of larger size. Larger loan and product transactions will, by their nature, be more visible, particularly if there are problems, leading to potentially increased reputation risk.

To address these types of concerns, OCC examiners focus on areas of highest financial risk at the affected companies and ensure they have a clear understanding of how those risks will be addressed by bank management. As an example, examiners will closely supervise efforts by bank management to identify and control their loan and investment concentrations and ensure that reserves and capital levels are appropriate for retained

[2] The OCC has identified risk categories in the areas of credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation risks. Most bank activities contain one or more of these risks.

risks. The OCC issued "Loan Portfolio Management" booklet of the *Comptroller's Handbook* last month to promote more sophisticated loan portfolio management efforts by banks. Examiners will also evaluate how bank management controls firmwide liquidity and avoid reliance on a small number of funds providers or markets. They will also ensure that appropriate contingency plans are in place in the event large funds sources are unable to continue providing funds. As the merger transition occurs, examiners will monitor the merged entity's development of new or revised policies, operating processes, and controls governing financial risk. We also use Ph.D. economists from our Risk Analysis Division to evaluate more effectively bank efforts to identify, measure, monitor, and control asset and liability concentrations.

Talent depth and drain. A significantly larger firm providing more services to more customers can stretch the capacity of managers at all levels. There will be an increased need to retain and recruit capable executives, line managers, risk management personnel, and back office staff to manage the larger and more diverse operations. During and after the merger process, however, key managers and executives in operations or business lines may depart, resulting in insufficient expertise to manage systems of merging companies or to ensure that appropriate levels of customer service are maintained at the new combined organization. Particularly when "golden parachutes" are widespread and generous, valuable senior managers may elect to leave. Management must address the retention and continuity of critical staffing in their merger plans.

OCC examiners monitor changes in bank personnel and review the actions of bank management to mitigate undesired attrition. When they identify personnel gaps that present supervisory concerns, the examiners-in-charge (EICs) bring these issues to the attention of executive bank management and require that appropriate actions be taken.

Technology/management information systems. Merging management information systems and automated transaction systems to common platforms often presents considerable challenges in bank mergers. Bank management will need to ensure that core business activities remain viable throughout the transition and that integration processes are continually confirmed, verified, and audited. Computer systems will need to capture huge volumes of data and convert data into quality management information on a timely basis (including profitability analysis, stress testing for various economic and market scenarios, financial risk modeling, etc.). At the same time, the technology used must serve the needs of the bank and its customers, for example, providing for efficient cash management processes and accurate and timely account statements. The merging institutions must also inventory systems, identify vulnerabilities, and develop plans to ensure Y2K compliance. Management must decide promptly which systems can be integrated now and which systems must run parallel, with an appropriate systems linkage to ensure that effective risk management mechanisms remain in place and be integrated after the year 2000, to avoid disrupting Y2K remediation efforts.

OCC examiners evaluate and monitor the respective bank's merger-related project plans, including those related to operational systems, to ensure that the integration process can be implemented effectively by bank management. Examination staff will continue to evaluate and monitor the risk management processes of ongoing core businesses, including appropriate transaction testing, to ensure that key information systems enable quality oversight and control by bank management. Examiners evaluate how management has allocated personnel, technology, and capital. When assessing information technology and management, examiners must ensure that adequate management information systems support critical management decision making. Critical information must be readily accessible, and examiners must verify the accuracy of new or renovated reports, risk measurement models, or analytical tools based on information obtained from the new organization. Examiners also will be particularly watchful that cost-cutting designed to achieve post-combination savings does not debilitate essential internal controls and audit functions.

In addition, the OCC is monitoring the Y2K readiness of the merging banks on an ongoing basis to evaluate whether they address all significant Y2K issues in advance of January 1, 2000. For mergers envisioning systems integration prior to completion of Y2K conversions, we will review the merger plan to make sure it addresses Y2K issues. If merger plans call for keeping mission-critical operations separate until after January 1, 2000, we will verify that the Y2K project plan of the merged entity is revised appropriately and sufficient resources are committed to get the job done efficiently and effectively.

Scale of risk management. Management of the merged financial institution will need a strong risk management function to measure, monitor, and control risk across the large and complex organization. In particular, risk management systems must identify risks to the *bank* in the resulting business. They also must take into account how nonbank activities within a banking organization affect the bank.

The assessment of risk management is a fundamental tenet of the OCC's supervision by risk program. OCC examiners include specialists in the areas of credit, capital markets, compliance, asset management, and

technology risks, positioning the OCC to identify and respond more quickly to evolving risks within the banks. As noted above, our examiners and specialists are already developing supervisory strategies and objectives in each of these areas for the merged entity. When assessing risk management systems, examiners consider the bank's policies, processes, personnel, and control systems. We are also using quantitative methods to better supervise the underlying portfolios of large companies. These techniques supplement an examiner's ability to review individual transactions, and permit a more systemic approach to risk identification and measurement.

Transactional volume. In these large, financially complex companies, the volume of transactions required to be processed will be huge. The combined organization's systems must be able to capture, process, and monitor millions of customers and their transactions daily.

Transaction risk transcends all bank divisions and products. Examiners review transaction risk in all of a bank's business lines and focus their review of transaction processing by determining the quality of internal controls, audit coverage, information systems and development, the complexity of products and services, and management operating processes. Examiners also ensure merger and operational integration planning has appropriately taken into consideration all of the necessary factors to address transactions risk and ensure that transaction processing is conducted without harm or disfavor to bank customers, causing related reputation risk to the institution.

Supervision of Global Banks

The latest wave of merger announcements, without question, takes our challenges to a new level. There is no individual risk, or difficulty, associated with these combinations that we have not encountered before. However, the size and scope of some of these mergers are unprecedented in the United States, and are creating a new tier of world-class banks. Indeed, this phenomenon is not limited to the United States. In the last two years, there have been announcements of bank combinations similar in size and scope to those occurring here in Japan, Switzerland, and France.

Given this worldwide trend, the international regulatory community has been working together for some time to ensure that adequate mechanisms are in place to supervise these global banks. The OCC has been participating in this through our work on the Basle Committee on Banking Supervision, which meets under the auspices of the Bank for International Settlements in Basle, Switzerland. The Basle Committee has established principles governing the supervision of internationally active banks headquartered in the G–10, with the focus on preventing banking companies from taking advantage of different legal and supervisory regimes in a way that impairs safety and soundness. The Basle Committee has undertaken agreements to harmonize basic approaches to prudential requirements (capital being the most notable); ensure that all banking activities within a financial company are supervised on a consolidated basis, regardless of where those activities are conducted; and ensure that adequate, timely information exchange takes place between supervisors.

In 1996, the Basle Committee took note of the increasing trend toward the formation of cross-border financial conglomerates and formed the Joint Forum on Financial Conglomerates, of which the OCC is also a member. The Joint Forum is comprised of banking, securities, and insurance regulators from 13 countries, and is developing principles governing the supervision of global financial companies that operate in at least two of the three financial sectors. While the Joint Forum is not attempting to unify methods of regulating the different financial sectors, it, like the Basle Committee, is focussing on ensuring nothing slips through "supervisory cracks," and on the critical issue of ensuring adequate information exchange between supervisors.

The OCC has actively contributed to, and learned from, these international groups and we will continue to do so. However, we have long had to deal with issues of supervising across borders, and have significant on-the-ground experience in doing so. Indeed, over 25 years ago the OCC established an office in London in order to supervise national banks' European operations. So, while not looking at new issues, the OCC and our domestic and foreign counterparts are looking at these issues with renewed vigor to ensure that worldwide supervisory arrangements are adequate for the new and emerging global banks.

Community, Consumer, and Competitiveness Issues

As you noted in your letter of invitation, policy makers must also consider the impact of such mergers on communities and consumers. Several of the key issues we see in these areas are discussed below.

Community Reinvestment Act (CRA) implementation and investment in community development. The implementation of CRA becomes more logistically challenging for the bank and its regulators as a bank increases its size and branches across states. The goal of CRA is to ensure that banks help meet the financial needs of the communities in which they are chartered to do business. But that achievement can be harder to evaluate when a bank's main office is located thousands of miles away in another state.

Congress anticipated this situation, however, in crafting interstate branching legislation, and bank regulators have revised their examinations and procedures accordingly. As a result of the Riegle–Neal legislation, banks operating in more than one state are rated not only for their performance overall, but also separately for performance in each *state* in which they are located, and each multi-state metropolitan statistical area in which they operate. Accordingly, the OCC evaluates a bank's CRA performance in all of its relevant CRA geographies. The Community Reinvestment Act, however, does not now apply directly to a bank's nonbank affiliates, even if they sell products originated by the bank.

The OCC currently is working to make its CRA examination procedures more consistent throughout an entire institution and across the population of large banks. Specifically, with respect to the application of CRA to large banks, the OCC is using special teams comprising its most experienced CRA examiners to conduct CRA examinations in 1998 at large national banks with multistate operations. The results of these initiatives will help us improve consistency and efficiency in scoping CRA examinations, enhance consistency in the application of standards under the new CRA rule, and provide more meaningful and usable public evaluations of the CRA performance of large institutions.

Institutions planning to engage in a series of acquisitions have substantial incentives to have a strong CRA record. Large national banks and their community development partners are the primary investors in community development corporations, community development projects, and other public welfare investments. The vast majority of CRA lending commitments in recent years have been made by large banks active in mergers and acquisitions. Many mergers, therefore, have resulted in an acquiring bank making additional CRA commitments. In fact, increased size may benefit community reinvestment and development activity, moreover, in that larger banks have enhanced capacity and improved technology to support their lending activities and to provide innovative products, investments, and services.

Furthermore, to preserve CRA advances as the industry consolidates, it is OCC policy to require the surviving bank in a merger to indicate in its application—on the public record—whether it will honor the commitments made by the target bank to community organizations (or similar entities) and if not, to explain the reasons and the impact on the affected communities. If an acquiror indicates it does not plan to honor the commitments made by the target bank, we will consider that to be a significant issue that will result in a removal of the application from our expedited review procedures, and we will investigate the situation as part of the application process. The OCC is the first federal bank regulator to have such a requirement of bank merger applicants. Since we initiated this procedure, no acquiring bank has indicated that it would not honor CRA commitments previously made by a target bank.

Cross-marketing products. If cross-marketing of nonbank products is an important strategy of the combined enterprise, it is essential that firms provide customers adequate information regarding the nature of the products they offer—most particularly when an uninsured product is offered to a bank customer. An efficient market depends on individuals making informed choices.

Bank supervisors have experience in this area. The OCC and the other banking agencies that are members of the Federal Financial Institutions Examination Council (FFIEC) published interagency guidance on this issue in 1994, recognizing the growing importance of the sale of nondeposit products by banks. Earlier this year the FFIEC, which I now chair, began a project to explore whether a uniform interagency regulation should be adopted to update and formalize this earlier guidance addressing sales of securities and insurance products by banks and thrifts.

The ability of companies to cross-market products to customers of their affiliates is facilitated by the ability of these various institutions to share customer information within the corporate family. The amendments to the Fair Credit Reporting Act (FCRA) that Congress adopted in 1996 allow affiliated companies to share their customer information provided it has been disclosed to the consumer that this information may be shared, and the consumer is given the opportunity to direct that the information not be disclosed.

The reality of diversified financial institutions underscores the importance of responsible corporate information-sharing practices. These companies may possess information bearing on crucial and very personal aspects of a consumer's life—including medical, credit, and investment information. Financial conglomerates that are sharing customer information pursuant to the provisions of the FCRA need to make sure that their customers have an informed and realistic opportunity to "opt out" of having their personal information shared among affiliates in the conglomerate. Failure to deal responsibly with this issue risks a customer backlash that could disable the company from utilizing one of its most precious resources: its customer information.

As banking organizations grow and diversify, this is an area to which the OCC will be paying increased attention.

Fees and costs for consumers. Although economic literature is not definitive on the specific impact of large mergers on consumer account fees, Federal Reserve

Board surveys have shown that fees for deposit account services are higher at multi-state banks than single-state banks, and surveys by some public interest groups indicate that big banks charge higher fees than small banks for many products.[3]

The pricing of bank products and services is complex, and it is difficult to ascertain precise reasons for the differences in prices. This is an area in which the OCC will remain vigilant, with a particular concern about access to credit and other financial services by low- and moderate-income individuals.

It is important, however, not to lose sight of the potential benefits of these mergers. For example, large banks may offer the convenience of a wider array of services, for which some consumers are willing to pay through a combination of higher fees and lower interest rates. Technological advances at large banks may also result in enhanced services and lower barriers to entry. Also, despite the reduction in the absolute number of banks, the number of banking offices has continued to increase over time, going from 58,100 in 1986 to more than 67,000 in 1997. Large banks tend to have more extensive ATM networks and are more experienced in offering in-home banking. The number of ATMs keeps expanding, growing significantly over this period from 64,000 to more than 165,000. The bottom line is that the market for deposit accounts remains highly competitive, and there are choices available for consumers. For the foreseeable future, there should continue to be healthy competition in the market from community and mid-size banks, ensuring that consumers will have a wide variety of services to choose from.

Credit availability. Larger institutions are "commoditizing" more products and using decision technology, such as credit scoring systems, to make credit decisions. Although credit availability in general has increased as the banking industry has consolidated, the long-term effect of increased reliance on decision technology for credit availability is unclear. The OCC will continue to monitor this area aggressively to ensure fair access to credit.

Economic studies find conflicting results concerning the impact of mergers and bank size on small-business lending.[4] Pre-merger business strategy is apparently an important factor: mergers tend to increase lending to small business when the acquiring bank has a strong small-business lending strategy.[5] This suggests that acquisitions made by large banks that use new credit scoring technologies to make small-business loans could enhance credit to small businesses.

International competitiveness. Assuming the challenges of managing and supervising these global banks can be met, which I believe they can, then there will be significant benefits to the U.S. economy from these mergers, due to the increased business opportunities for U.S. banks. Moreover, the banks themselves will have opportunities to reduce their risk through greater sources of diversification. Finally, consumers here and in other countries stand to benefit from the increased price and product competition that will result.

Ensuring the Competitiveness of Smaller Banks

The third question raised in your letter of invitation was whether legislation is necessary to provide smaller banks and financial services firms with the ability to compete on a level playing field with these newly created entities. Your question, in fact, highlights an issue that has been of great concern to the OCC in connection with the current version of H.R. 10. In order to compete effectively in the financial services marketplace of the future, banks of all sizes need to have the ability to choose the organizational structure that will best enable them to operate efficiently and compete effectively. Particularly when faced with the prospect of competing against conglomerate financial titans, banks—of all sizes—should not be subject to artificial constraints on their ability to compete.

Yet, H.R. 10 would unfairly tilt the playing field in favor of large financial conglomerates by denying potential competitors the ability to compete using the corporate organizational form that is most efficient for them. This is a concrete illustration of why it is crucial that financial modernization legislation allow new financial activities to be conducted in bank operating subsidiaries as well as bank holding company affiliates. Moreover, H.R. 10 would also deprive banks of authorities they *have today*

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[3] See Board of Governors of the Federal Reserve System, *Annual Report to the Congress on Retail Fees and Services of Depository Institutions*, June 1997. See Public Interest Research Groups (PIRG), "Big Banks, Bigger ATM Fees: A Third PIRG National Survey of ATM Surcharging Rates," at http://www.igc.org/pirg/consumer/banks/atm98/index.htm. Also, see Steven A. Holmes, "Huge Bank Mergers Worry Consumer Groups," *New York Times*, April 19, 1998, p. 19.

[4] See, for example, Whalen, G., "Out-of-State Holding Company Affiliation and Small Business Lending," Economic and Policy Analysis Working Paper 95-4, Office of the Comptroller of the Currency (September 1995); Strahan, P.E., and J.P. Weston, "Small Business Lending and the Changing Structure of the Banking Industry," *Journal of Banking and Finance* 22 (forthcoming); and Berger, A.N., A. Saunders, J.M. Scalise, and G.F. Udell, "The Effects of Bank Mergers and Acquisitions on Small Business Lending," *Journal of Financial Economics* (forthcoming).

[5] Peek, J., and E.S. Rosengren, "Bank Consolidation and Small Business Lending: It's Not Just Bank Size That Matters," *Journal of Banking and Finance* 22 (forthcoming).

that could help them remain competitive. These aspects of H.R. 10 need to be changed in order to enable banks of all sizes to compete effectively with the conglomerate financial firms that the legislation would authorize.

Conclusion

The recently proposed mergers reflect continued evolution in the banking industry in response to legislative, regulatory, and competitive changes. These mergers raise a number of important issues, including issues related to the regulator's ability to supervise effectively financial conglomerates and larger banks. Although confident we can handle these challenges, we are not complacent. One of the compelling lessons of the past is that we must never relax our supervisory vigilance.

Thank you for the opportunity to present the OCC's views. I will be pleased to respond to any questions you may have.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the Bankers Roundtable Lawyers Council, on the treatment of confidential customer information and privacy issues, Washington, D.C., May 8, 1998

It is a great pleasure to be here this morning with you to discuss a topic that is significant for the banking industry today, and will be even more so in the future—customer information and personal privacy. This subject has come into the spotlight with the recently proposed megabanks and financial services conglomerates, as well as with the continuing advances in electronic banking and commerce. The banking organizations that comprise the Bankers Roundtable—the largest banking organizations in the country—are particularly likely to possess large amounts of information about very large numbers of customers. And you, in your role as counsel to these organizations, have the potential to influence how your company deals with this precious information resource.

I thought, therefore, that I would offer my perspectives on this issue—an issue that is already commanding significant attention in our increasingly information-driven economy.

My premise is a very simple one. The banking industry needs to demonstrate *leadership* in the treatment of confidential customer information and personal privacy issues. Otherwise, it risks a customer backlash that could fuel reactions at the federal and state levels that lead to restrictions on your ability to use precious information resources.

You have much at stake here. The latest developments in the financial world underscore the importance of information-sharing for consumers and providers of financial services alike. One key rationale for the recently announced megamergers in financial services is that the resulting companies will be able to gather and distill data on an expanded customer pool, and use that data to design better, more efficient product and service offerings to meet individual customer needs—for example, offering advice and products to help consumers realize bigger returns on their savings, build assets for retirement, and obtain ancillary products, like property insurance, at the same time and place that they secure financing for that property. Another rationale for these mergers is to provide more convenient access to existing and potential bank customers. This geographic expansion probably means more sophisticated data warehousing that can result in low-cost access to new, perhaps custom-tailored product and service offerings for bank customers. In both situations—expansion by scope or scale—we're seeing a natural marriage of technology and relationship banking, and it's one reason why these mergers look so attractive from the vantage point of the constituent companies. In the best case, we have a win-win situation: new business and new synergies for financial institutions, more choice and more convenience for consumers.

But it's not simply in connection with the cross-selling of products and services and data collection and storage that information management can provide real benefits for consumers of financial services. The Internet and personal computing have brought many banking transactions into the home—a special boon for our aging population and for all of us leading too-busy lives. Recent advances in the availability of credit—especially to segments of the population formerly viewed as less creditworthy—may be traceable in large part to the growing sophistication of the credit analysis and reporting business, which is now able to gather more complete and more accurate information on potential borrowers and help lenders better control and price risk. Surveys show that consumers recognize that financial institutions have a legitimate need for personal information to make rational credit decisions, and that consumers generally are willing to provide that information for such purposes.

But the same surveys also reveal growing anxiety about how personal information is being used and, in some cases, misused. The media regularly bring us tales of individuals whose lives have been disrupted by fraudulent use of social security numbers, bank and credit card account information, real estate recordation, and even medical records and other nonfinancial data, much of which can be gathered without special authorization and without violating any current law. Consumers are discovering the limits of confidentiality and the absence of effective protections against the determined thief, hacker, or snoop. There is little doubt that privacy concerns today are slowing widespread acceptance of electronic commerce generally and electronic banking particularly.

The seriousness of these concerns was a key finding of the Consumer Electronic Payments Task Force, a group which Treasury Secretary Rubin asked the OCC to chair back in 1996 and whose final report was released last week. The report's focus is on "e-money," but the questions we heard from consumer representatives during the Task Force's investigations speak to the broader issue of financial privacy. First, consumers want adequate disclosure about a company's information collection and use

policies. Secondly, they don't want to have to reveal more information than is needed for a transaction. And, finally, they are also concerned about the use of that information for purposes other than the original transaction, either by the information collector or by a third party to whom the information is sold or transferred.

Interestingly, while we heard a few calls for sweeping new laws that would involve the government more directly in the electronic marketplace, that was a decidedly minority opinion. Most of what we heard was consistent with a market-oriented policy toward electronic commerce. This is also the approach of the Administration's "Framework for Global Electronic Commerce," which articulated five basic principles to govern this fast-developing part of our economy. Those principles include private sector leadership; the avoidance of undue government restrictions; predictable government involvement where necessary; respect for the decentralized nature of the electronic marketplace; and the minimization of international barriers to electronic exchange.

The recommendations of the Consumer Electronic Payments Task Force are consistent with this general approach. In the area of privacy, we call for meaningful and effective industry self-regulation—self-regulation that responds to consumers' privacy concerns, provides disclosure to consumers about privacy policies, and offers some means to assure compliance with these policies. The report also suggests that the industry explore ways, through the use of technology, to provide consumers with greater control over the collection and use of information pertaining to them and their financial transactions.

Industry self-regulation has the potential to address many consumer privacy concerns. But, although I am hopeful, as a bank regulator, I am a paid skeptic. And if self-regulatory initiatives are viewed as weak and toothless, the stage will be set for a more active government role.

Indeed, we are already seeing growing government interest in this issue—movement the financial services industry should view as a signal that pressure is beginning to build. In a very short time, the Federal Trade Commission will be delivering a report on privacy to the Congress, and, separately, the Commerce Department is due to deliver to a report on online privacy to the President. The Clinton Administration has also focused on privacy issues raised in connection with electronic commerce. And just last week, the House Commerce Committee opened a series of hearings on electronic commerce in which privacy was a recurring theme. Assurances from industry representatives that self-regulation was sufficient to eradicate abuses met with some skepticism.

Your course should be clear. It is emphatically in the interests of the financial services industry—whose basic raw material, after all, is information—to take the lead in demonstrating that self-regulation can and will work, and that public concerns about privacy can be addressed without requiring externally imposed government solutions to the problem.

What I would like to do in my remaining minutes here today is to comment on the industry's self-regulatory efforts to date *and* suggest how, from a regulator's perspective, we might make better use of the laws already on the books to deal with some of the privacy concerns we are hearing from consumers.

For the last several years, the financial services industry has been hastening to address the public's heightened interest in privacy. In 1995, MasterCard issued a statement assuring customers of privacy protection, and Visa soon followed suit. The following year, the American Bankers Association (ABA) issued a report underscoring the privacy obligations of the banking industry. In May 1997, the SmartCard Forum issued its "Guide to Responsible Consumer Information Practices." And in September of last year, the Banking Industry Technology Secretariat—the B-I-T-S—of the Bankers Roundtable adopted a far-reaching set of privacy principles, later endorsed by the Roundtable itself, the American Bankers Association, the Consumer Bankers Association, and the Independent Bankers Association of America.

The BITS principles are intended to apply to all phases of a consumer's banking relationship, and not just to electronic transactions. They include a recognition of the customer's expectation of privacy, limitations on the use, collection, and retention of customer information, control over employee access to that information, restrictions on sharing of account information, disclosure of an institution's privacy policies, the consumer's right to "opt-out" of any information-sharing arrangement, and more. The Bankers Roundtable is to be commended for sponsoring this important work.

But while principles like the BITS principles certainly move us in the right direction, I believe that additional steps need to be taken if those or any other principles that the industry chooses to adopt are to lead to truly effective self-regulation in the banking industry. My major concern centers on the lack of means to assure adherence to the principles. Principles may call on banks to establish internal procedures to ensure compliance with the bank's own privacy policies, but who will judge whether a bank's policies are consistent with a particular set of industry self-regulatory principles or whether they are being complied with? What remedies will be available to deal with those institutions that fall short of the standards?

These questions are relevant not just to privacy policies applicable to electronic banking and electronic commerce, but to the treatment of confidential customer information generally. It seems essential that self-regulation in the privacy area must have teeth in order to be credible. For example, other self-regulated industries in the United States retain independent auditors to check on the level of compliance with the industry's own standards and principles; in European countries, there are consumer ombudsmen whose job it is to resolve complaints, including those related to privacy. It may be that the banking industry needs to consider similar arrangements. But if, for whatever reason, banking organizations decline to adopt industry-wide policing, it is especially important that the market be allowed to operate through full disclosure of privacy policies. In the coming years, as former FTC Commissioner Christine Varney has noted, "privacy may well become a market commodity," and third parties could find a commercial niche comparing the privacy policies of competing banks and advising consumers on where their privacy is most likely to be respected and safeguarded.

To understand why enforcement matters so much, let's look at a related area—compliance with the 1996 amendments to the Fair Credit Reporting Act (FCRA), which affects the use of consumer information. Congress passed these amendments in response to industry concerns about pre-existing limitations on their use of select credit bureau information and about restrictions on their ability to share and use information among companies within the same corporate family, such as affiliates and subsidiaries. The amendments greatly enhanced market opportunities for business. Congress revised the rules, granting banks more flexibility in their use of credit bureau information, and expanded the scope of permissible information-sharing among affiliates.

But consumer privacy was a key political consideration in the final agreement to liberalize the rules, and Congress required that consumers be given the right to request that their information not be used. For credit bureau information, a credit bureau and any business that typically accesses credit bureau information in advance of communicating with consumers must inform those consumers contacted that they have the right to exclude their name from any future information requests for two years. In the affiliate information-sharing area, an institution that wants to share information with a related company may do so free of restrictions placed on credit bureaus, provided that the consumer receives advance notice and opportunity to direct that the information *not* be shared. In other words, consumers have the right to "opt out" of any information-sharing arrangements.

But, unfortunately, it has been known to happen that the affiliate-sharing "opt out" disclosure is buried in the middle or near the end of a multi-page account agreement. For existing accounts, some institutions have gotten into the habit of reducing the required "opt out" disclosures to the fine print along with a long list of other required disclosures. Few consumers are likely to have the fortitude to wade through this mass of legal verbiage, and fewer still will take the time to write the required "opt out" letter. I have even heard of people getting two separate notifications covering different types of information, requiring two separate letters to opt out. Such techniques may fall within the letter of the law, but they certainly fall short of its spirit.

On the other hand, I have seen evidence of responsible consumer notification and opportunity to opt out. In one case, the bank sent its customers a separate letter informing them of the benefits, by way of greater product and service availability, that resulted from the sharing of customer information among affiliates, but also providing a detachable form for their customers to use to opt out. This type of simple, straightforward, and convenient approach should be embraced by the banking industry.

If, however, the industry is perceived as failing to administer the opt out process in an unambiguous, straightforward way, public pressure could build to impose new regulatory standards or to broaden the banking agencies' ability to examine banking organizations regarding their implementation of the opt out process. With respect to the latter, as a result of the 1996 amendments to the FCRA [Fair Credit Reporting Act], the federal banking agencies are currently authorized to conduct examinations under two circumstances: when a specific consumer complaint is received or when the supervisory agency "otherwise has knowledge" of a FCRA violation. We believe that the second circumstance applies to knowledge of FCRA violations obtained in the normal course of a review for compliance with other laws and regulations, and we intend shortly to release specific guidance to clarify this point for bankers and examiners.

In closing, let me emphasize that government, private sector, consumer, and other voluntary organizations *all* have important parts to play in implementing the benefits of cross-selling and targeted marketing and the convenience of new technologies, while preserving social and personal values. Privacy remains one of those basic values. The banking industry today has a rare opportunity to step up to the plate and become a leader on the critical issue of personal privacy and responsible customer information practices—an issue upon which so much of the industry's long-term future depends.

Thank you.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the National Housing Conference, on affordable housing, Washington, D.C., June 3, 1998

It is an honor and a real pleasure to join you at your annual policy convention. Since 1931, the National Housing Conference has brought people together from many different walks of life. You all share a commitment to the cause of a better-housed America. The NHC has truly been, as your motto says, "the unified voice for housing" in this country.

Thanks to you and others, many of our cities and towns do have a brighter future. After decades of decline, urban populations are growing again. Home ownership is on the rise. Serious crime is down. According to this year's American Housing Survey, two-thirds of local officials report more conditions improving than worsening and more optimism about our cities than about our country as a whole. They believe, as I do, that our best days lie before us.

Despite the gains we have made, the jobs you do have certainly not gotten any easier. Nor—despite the increasing number of American homeowners—have our basic housing needs grown any less acute. A study by the Department of Housing and Urban Development released just weeks ago shows that affordable housing remains one of our nation's most pressing social and economic problems. According to this study, the number of American households with critical housing needs rose by nearly one-third in the early 1990s and has held steady ever since, despite a generally buoyant economy. Indeed, in some places, rising national income has actually exacerbated the affordable housing shortage by pushing up real estate prices beyond what the poor can hope to pay.

Meanwhile, federal housing resources have grown scarcer. Inflation-adjusted federal funding for low-income housing dropped by more than three-quarters in the past 20 years. For the first time in many years, HUD has a budget proposal pending before the Congress that would increase the level of government support for housing assistance to low- and moderate-income Americans. But even this bill would represent only a small step toward erasing the deficit in past federal assistance to affordable housing.

At the same time, making use of the limited government resources that *are* available seems to require more patience, resourcefulness, and fortitude than ever before. No one doubts, for example, that reform of the Section 8 rental assistance program was in order.[1] But those reforms have had the unintended effect of undermining the viability of some affordable housing projects, which could once count on long-term commitments from Section 8 recipients.

The shifting relationship between the federal government and the states has also changed the ground rules governing the availability of public subsidies for affordable housing. Where local officials previously could obtain federal funding earmarked for specific projects, they now must develop comprehensive housing affordability strategies in order to obtain federal funds. These strategies must consider community needs, priorities, and local matching resources to benefit whole neighborhoods, not just individual projects.

Given the challenges of government assistance programs, a greater burden has fallen upon private sector/community partnerships that can leverage the resources and expertise we need to get the job done for our unhoused and underhoused fellow citizens.

In this connection, let me mention the work of the Neighborhood Reinvestment Corporation (NRC), on whose board I sit. Through the NRC's NeighborWorks Campaign for Home Ownership 2002, banks, insurance companies, secondary markets, government, the real estate industry, and others will work with 107 community-based NeighborWorks organizations to create 25,000 new home buyers and generate $1.8 billion of investment in underserved communities over the next four years.

I should also say that I am particularly proud of the creativity and commitment shown by national banks in the affordable housing field over the last decade. They have become major backers of community development banks and major participants in the loan consortia that are mobilizing funding to enlarge—and enhance—our nation's housing stock. Since 1993, under our community development and public welfare investment authority, the OCC has approved national bank community development investments totaling $5.6 billion, 45 percent of which involved limited partnerships with developers in

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[1] [This is a federal rental assistance program that permits eligible households to pay a portion of their rent, with the government contributing the difference, as originally authorized by Section 8 of the United States Housing Act of 1937. *See* 42 USC 1437, General Program of Assisted Housing *et seq.*]

multifamily housing projects that meet requirements for federal low income housing tax credits. This investment authority has also provided national banks with an opportunity to help fund private secondary market entities. One of these entities is currently planning to convert to the first known community development real estate investment trust—a CD REIT.

Banks have themselves become active lenders in the affordable mortgage market. This is particularly noteworthy because banks' participation in this area was negligible just 10 years ago. But today, some of our larger national banks have more than 10 percent of their residential real estate loans in the affordable market, and the numbers are growing. Just two weeks ago, NationsBank and BankAmerica pledged $115 billion in affordable housing loans alone over the next 10 years, and other institutions contemplating mergers have also earmarked significant sums for housing to low- and moderate-income Americans.

Not only are banks major players in the affordable mortgage market, they are increasingly market innovators. Some banks are working with their local government and community development partners to provide funds, structured either as grants or as soft second mortgages, that reduce or offset the home purchaser's down payment, closing costs, or mortgage insurance. Low down-payment and second-look mortgage programs, housing counseling and home repair programs, and other new products and services introduced by financial institutions in recent years reflect their determination to make these loans and to make them work—not simply as a compliance activity, but as part of broad marketing strategy with real potential for mutually profitable relationships. I like to refer to this as a *domestic* emerging market.

Over the years, we have seen yet another promising development—the increasing integration of our nation's capital markets with community development and affordable housing lending. In recent months, two national banks, in separate deals, packaged a total of almost $750 million-worth of affordable mortgage loans and marketed them as such to the investment community. We understand that similar deals are soon to follow.

Conventional wisdom has always been skeptical of the notion that the capital markets would purchase loans to nontraditional home buyers. The assumption was that if these securitizations were saleable at all, it would be at a prohibitive discount to the originating institutions. In some quarters, simply acknowledging that a portfolio was comprised of affordable housing loans made the deal problematical.

But the skeptics have lately been proved wrong. Reports suggest that, with regard to the two most recent offerings, the market could have absorbed five times as many of these securities as were available at the offered price.

What made these securities so saleable? When you look beyond the label, the substance of these securities proves attractive for several reasons. As a rule, affordable housing loans generally have prepayment rates that are well below average in the mortgage market. Low- and moderate-income borrowers are far less likely to refinance their housing debt than conventional borrowers. With their relatively small outstanding balances and high loan-to-value ratios, these borrowers have less to gain from refinancing. In short, the purchasers of affordable mortgage-backed securities have reason to expect a steady, reliable income stream for the original life of the loan.

Moreover, as a group, low- and moderate-income mortgagees have demonstrated at least as much responsibility in their handling of credit as their conventional counterparts. It turns out that fewer than one in 10 holders of these loans has ever been delinquent on *any* loan—mortgage or otherwise. As two Wall Street analysts recently wrote, to many lower-income borrowers, "being able to own a home is a near-sacred obligation. A family will do almost anything to meet that monthly mortgage payment."

This recent experience with affordable mortgage-backed securities remind us again of the importance of thinking "outside the box"—not allowing negative stereotypes and preconceptions to inhibit us from pursuing innovative approaches to our public policy objectives.

This lesson has been especially relevant throughout the history of the Community Reinvestment Act. For years, CRA was a bureaucrat's dream, replete with burdensome paperwork and extensive process requirements. That was partly the result of a deep-seated skepticism—to which the regulators were frankly not immune—about whether it was possible to make community reinvestment loans that were also good, profitable loans. On the community side, there was equal skepticism that bankers would enter into wholehearted partnerships with the communities they were supposed to be serving. And so, for nearly 20 years, implementation of CRA was marked by too much finger-pointing and too little original thinking.

The reforms to the CRA regulation that became final last year have gone far toward changing that. When OCC examiners now visit a national bank to conduct a CRA compliance exam, they look for results. Where they once looked for documentation of community outreach efforts, they now look for loans and investments actually made. And, as I said at the outset, we increasingly have the results to show for it—results measured in record new CRA commitments for affordable housing, small business lending, and community development; results measured in neighborhoods that are being rejuvenated.

We are proud of this progress, but by no means satisfied. Although virtually everyone agrees that the new CRA regulations represented a significant step toward carrying out the original intent of the law, implementation remains the key. At this early stage, the new regulations are—inevitably—a work in progress. A number of community groups have raised concerns about grade inflation and lack of consistency within and among the regulatory agencies in evaluating the CRA performance of financial institutions. While they welcome our new emphasis on performance, they rightfully expect CRA ratings to reflect not merely the number of loans a bank is making, but the degree to which a bank's lending and investment activities are truly responsive to community needs.

These are very legitimate concerns, and we are taking action to address them. Let me take just a minute or two to tell you what the OCC is doing, both on our own and on an interagency basis, to improve the effectiveness of our new CRA regulations.

Earlier this year, the OCC, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision launched a joint review of each agency's CRA performance evaluations for those large institutions that had been examined and rated under the CRA regulation, including the new tests to assess a bank's lending, service, and investments in its community. This review, which was completed just six weeks ago, showed that while the regulatory agencies are fairly consistent in their application of the regulations, there are differences in the how we analyze a bank's lending performance. For example, OCC evaluations tended to focus on the big picture and an institution's overall performance, but said less about each of the metropolitan areas in which performance was analyzed. The other regulators tended to reverse those emphases.

To cite another example, the Fed was found to make extensive use of quarterly loan-to-deposit ratios to measure lending performance, whereas the other agencies relied more on qualitative judgments about lending volume and loan growth. And our review showed inconsistency over such things as the kinds of investments and grants that qualify as community development, the relative importance of binding commitments for future lending and investment, and the evaluation of a bank's small-business lending data.

Identifying inconsistency is the first step toward reducing it. And that is exactly what we will be working to do in the coming months.

We are also taking steps to improve our own internal consistency through our ongoing Large Bank CRA Exam Project. It has several facets. First, we are scrutinizing our CRA performance evaluations from the standpoints of clarity and conciseness and will be making changes to improve their value as public documents. Second, we are revisiting the measures for assessing a bank's performance to help examiners make more informed qualitative judgments about the degree to which particular bank activities satisfy CRA requirements.

Third, we are considering a new strategy for supervising the CRA activities of our large banks with multi-state operations. This strategy is based on the concept of "continuous supervision"—in essence, applying the same techniques to our CRA examinations as we have used for years in our safety and soundness exams of large banks. Under this plan, we would assign a cadre of examiners to examine large, multi-state banks. Those examiners would move from one state or region to another over a period of 24 months, evaluating CRA compliance and assigning a CRA rating in each state, or multi-state area in which a bank has branches. These ratings would be provided as they are completed, and at the end of the process, the bank would receive an overall CRA rating that reflected the evaluations occurring over the preceding 24 months. Then the process would begin anew. We are currently field-testing these changes, using a team of the OCC's most experienced CRA field examiners, plus our regional experts in community development lending and investment, along with staff who helped write the revised CRA regulation and examination procedures.

But, finally, with respect to CRA, I must note that I see one very big potential stumbling block in the road ahead—a development that threatens to undermine prospects for further advances under CRA in the future. That threat is the currently proposed, so-called "financial modernization" legislation. Just a few weeks ago, the House of Representatives, by a single vote, passed H.R. 10, the Financial Services Act of 1998. The Senate Banking Committee will open hearings on this bill on June 17.

If this law is enacted, a growing base of financial assets would not be available to enhance the ability of banks and thrifts to perform under CRA or to be considered in evaluating an institution's CRA performance compared to its financial capacity. And a growing base of financial institution assets would not be subject to comprehensive enforcement—including routine, on-site CRA examinations—currently applied to banks and thrifts.

The net effect, long term, will be a serious reduction in the share of financial services industry assets available for CRA.

In my view, it would be a shame if the enormous progress we have made so far under CRA—and the possibilities that await us to do more for all bank customers—were sacrificed in a rush to pass legislation designed to

benefit basically a handful of large financial firms. I would like to think that, in the end, good judgment *will* prevail, and that we will see financial modernization legislation that truly serves the interests of this nation's communities and consumers—as well as the needs of the financial community.

In the meantime, you have my assurance that we at the OCC will do what we can to press ahead to improve and enhance our implementation of the Community Reinvestment Act and that we will look for opportunities to support innovative approaches to affordable housing finance.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the Tennessee Bankers Association, on financial modernization and concerns about H.R. 10, the Financial Services Act of 1998, Nashville, Tennessee, June 8, 1998

Thank you and good morning. I was delighted when the Vice President's office called to ask if I would be available to join you today, because it gives me the opportunity to resume some of the acquaintances that I made during the recent visit of the Tennessee bankers to our offices in Washington and to make new acquaintances of those of you who were not then able to join us. It also permits me to share my thoughts with you on some key legislative issues in greater detail than was possible given your busy schedules while you were in the capital.

I have a confession to make: I have spent nearly my entire adult life in Washington, and most of my childhood, too, since my father was an attorney with the Department of Justice. Over that span, I have witnessed many public policy controversies. And, in recent years, I have been a frequent participant in the debate surrounding our policies toward financial institutions. But I frankly do not recall a legislative season—and I've seen my share—so full of significance for bankers as the one we are in the midst of today. Right now, we have pending before one or both houses of Congress legislation dealing with credit unions, IMF refunding, regulatory relief, bankruptcy reform, year-2000 readiness, privacy in electronic commerce, and more. But the legislation I am most concerned with now—as I believe you should be—is more comprehensive in scope and far-reaching in effect. I'm referring to H.R. 10—the Financial Services Act of 1998. That is what I'd like to talk to you about today.

Just weeks ago, the House of Representatives leadership finally brought H.R. 10 to the floor. It was the culmination of months of hearings, negotiations, procedural wrangling, backroom bargaining, and political arm-twisting. It involved dozens of lobbyists representing the insurance, securities, and banking industries, as well as consumer and other affected groups. When the votes were counted, H.R. 10 had passed by a margin of one.

Although most analysts now question whether the Senate will invest much of its remaining time this session in a bill that has barely survived its first real test, its supporters have hardly abandoned the fight. They point out—rightly—that H.R. 10 has several times returned to life after others had written it off. The way the bill's backers see it, they have won a historic victory—the narrowest of victories, to be sure, but a highly significant one nonetheless.

Just as those who have supported H.R. 10 are looking ahead, those who oppose the bill in its current form must not view its passage as either a foregone conclusion or a lost cause. Regardless of what becomes of it during the current session, H.R. 10 is still very much in play—and thus, so is your future. The worst thing that could happen now—for people on all sides of the debate—would be to call a halt to our discussion of the issues and what H.R. 10 would actually mean for financial institutions and the American people. Indeed, precisely what *is* crucial is that all involved parties truly understand what the bill does and its implications for the future. My remarks here today are designed to aid in that understanding.

Certainly a number of misunderstandings have arisen in the course of the debate over H.R. 10. Take the operating subsidiary issue, for example. The basic question is this: who shall decide the manner in which banking organizations conduct the new types of financial activities—for example, securities activities and providing insurance and annuities—that may be authorized under the legislation? Shall those new activities be conducted only in a holding company affiliate? Or—the alternative supported by the OCC, the Treasury Department, and our colleagues at the Federal Deposit Insurance Corporation—shall bankers like yourselves have the choice of conducting those activities either in a holding company affiliate or in a subsidiary of the bank? Although both forms have their advantages and drawbacks, for many banks the subsidiary will be the simpler and less costly organizational alternative. Some bankers have told me that, for them, it is the only feasible option.

Recent comments by the Federal Reserve have suggested that allowing bank subsidiaries to conduct the same range of financial and financially related activities as would be permitted for bank holding companies would present risks to the federal deposit insurance funds. I respectfully disagree—and so does the FDIC, which has the primary responsibility for the safety of those funds. Indeed, FDIC Chairman Ricki Helfer testified that allowing banks to generate earnings from activities in bank subsidiaries actually lowers the probability of bank failures.

Until it started raising these safety and soundness concerns, the Fed's case against the operating subsidiary was largely based on the argument that a so-called "public subsidy" provided to banks could be passed along to a bank's subsidiaries, giving them a potential unfair advantage in competition with providers not owned by banks. The subsidy, as the Fed defines it, consists of

access to the Federal Reserve discount window, final settlement of payments transferred on Fedwire, and federal deposit insurance—benefits that supposedly exceed the costs of the federal regulation to which bankers are subject.

I must tell you that we have searched high and low for evidence of a net public subsidy to banks, and have come up with little analytical support for the Fed's proposition. In fact, the best estimates—not only the OCC's, but also those of leading independent scholars—show that the costs of regulation—in the form of assessments for examinations, forgone interest on sterile reserves, interest on Financing Corporation (FICO) bonds, deposit insurance premiums, the cost of compliance activities, and so forth—exceed the cost of any so-called safety net subsidy.

The real test, however, takes place in the real world, and there too we see no sign of bankers behaving as though a net subsidy existed. Do you feel like you have a government subsidy compared to your competitors?

The OCC's position on operating subsidiaries has been consistent throughout the H.R. 10 debate. We believe that banks of all sizes should be permitted to engage in an expanded range of financial activities and should have the freedom to choose the corporate structure that is best for their business, consistent with safety and soundness.

Why is this issue so important? It is crucial because if you hope to be able to compete against the giant financial conglomerates that H.R. 10 would permit—not to mention other competitors, such as credit unions, that you already face—you should at least be allowed to choose the corporate structure that allows you to compete and to compete most effectively and efficiently.

This is, quite simply, a matter of your future. While you may not be contemplating new financial activities today or tomorrow, it is essential that your options for the future not be cut off. Or think of it this way. Even though you may not want to go down the road to conduct certain new financial activities today, you don't want your business to be turned into a dead-end street. The banking industry is the only industry that is targeted this way in H.R. 10.

Let's take another example—the impact of H.R. 10 on bank insurance powers. Yet again we find needless regulatory burden and punitive provisions that would limit banks' ability to underwrite and to sell insurance products and annuities. H.R. 10 would permanently restrict banks' ability to offer "insurance" in a principal capacity to those products already approved by the OCC as of January 1, 1997. That means no bank could ever become an innovator in insurance products; indeed, under this provision, banks could not even emulate innovations introduced by others. This provision was plainly intended to ensure that banks could never compete on an equal footing in the insurance business.

Then there is the provision of H.R. 10 that would require banks wishing to sell insurance in a particular state for the first time after the enactment of the legislation to buy an existing insurance agency—a provision some have dubbed the "Independent Insurance Agents Retirement Income Security Act."

Backers of H.R. 10 are quick to point to the liberalization of the "place of 5,000" restriction as a symbol of the bill's evenhandedness toward banks. This refers to the provision of the National Bank Act that allows banks located in a place with less than 5,000 inhabitants to sell insurance. H.R. 10 would eliminate the "place of 5,000" requirement for insurance agency activities conducted in a bank subsidiary. But this liberalization comes with strings attached. When a bank subsidiary's insurance agency is located in a place with a population over 5,000, H.R. 10 would treat the subsidiary as an "affiliate" under the law and subject it to affiliate transaction restrictions. The paperwork and reporting requirements to document compliance with that standard would prove particularly burdensome for community banks, which might otherwise be the biggest beneficiary of the change. The bank subsidiary's insurance agency could avoid this new regulatory burden as long as the local population held below 5,000; but if, at the next census, the population passed that threshold, any new bank entrant would be effectively barred by competitive disadvantage from the local market. That result—bad for competition, bad for communities, bad for consumers—is unfortunately closer to the genuine spirit of H.R. 10.

There are other insurance-related provisions of H.R. 10 that are discriminatory and anti-competitive. But I would like to close this part of my discussion by mentioning just one. That is the provision that would eliminate the deference that the OCC receives from the courts in connection with our interpretations of permissible bank insurance activities under the National Bank Act. Naturally I am distressed at the prospect that the OCC might be stripped of its historic responsibility for interpreting the national banking laws in the interests of a safe, sound, and competitive national banking system—a mandate, dating back to the days of Lincoln, that has been endorsed in recent years by repeated unanimous decisions of the United States Supreme Court. What I find even more objectionable is H.R. 10's provision to do away with the deference principle—a principle carefully grounded not only in constitutional law but in the common sense proposition that, unless shown to be unreasonable, regulators' expert judgment deserves respect from the courts.

H.R. 10 would attack this precedent and, in an important area for the banking industry, distort the careful balance, established over decades, between the judicial, legislative, and executive branches of our government.

From a practical perspective, why should you care about this issue? Because it means you will have less certainty—and more litigation—about whether activities are permissible for banks. Because you will have less protection against discriminatory state regulation that targets banks' insurance activities. Because, down the road, there will be safe and sound new activities—new products and services—that you would like to provide to your customers—that you won't be able to provide, even though, today, under current law, the OCC might find them to be permissible.

Now, some have contended that despite all these faults, H.R. 10's redeeming feature is that it will prevent the mixture of commerce and banking. Whether these two lines of business should be kept apart is a separate and complex question. But if you believe in separation, be aware of the fact that, despite what its proponents say, H.R. 10 actually provides many new opportunities for firms to commingle banking and commerce. Financial holding companies with extended grandfathering of their commercial activities, wholesale financial institution holding companies (called "woofies"), unitary thrift holding companies, nonbank banks, merchant banking, insurance companies' permissible commercial investments, and investment bank holding companies—each of these entities could mix banking and commerce to at least some degree under H.R. 10, and in some cases to a greater extent than is permissible today. Some of these financial entities would have their commercial activities grandfathered for a 10 to 15 year period; for woofies, the grandfather would be permanent.

In the case of unitary thrift holding companies, grandfathered powers would be transferable. In other words, a commercial company could buy a unitary thrift holding company, and the acquiring commercial company could continue and expand its commercial activities because it succeeds to the unitary thrift holding company's powers, regardless of what the thrift holding company was actually doing.

For so-called "nonbank banks," H.R. 10 would eliminate the asset and activity restrictions that now prevent them from engaging simultaneously in banking and commerce. The list goes on and on, but the point should be clear: under H.R. 10, the mixture of banking and commerce would not only continue, but could expand.

I am heartened by the way the banking industry has been pulling together of late in expressing its concerns about H.R. 10 and trying to focus on the type of legislation the industry as a whole needs for the future. If you have not done so already, thinking perhaps that the complex legal gobbledygook of H.R. 10 cannot be of much relevance to you in terms of your ability to do your job, day in and day out, please think again. If you have not done so already, you owe it to yourself to understand the provisions of the bill and reflect upon how it would affect your business and the people you serve.

I do think that America needs financial modernization soon. We need legislation that recognizes the changes that have occurred in the marketplace. But we must have legislation that truly advances the needs of consumers and communities and that gives banks of all sizes an even chance to compete and succeed in the challenging financial world of the twenty-first century. In my judgment, H.R. 10 is not that legislation.

It's imperative that we take the time to fully understand the implications of financial modernization and get it right. You as bankers, your customers, and your communities deserve no less. Whatever we do will be yours to live with well into the next century.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the National Auditing and Regulatory Compliance Conference, Bank Administration Institute, on the strengthening of banks' internal controls, Chicago, Illinois, June 17, 1998

I'd like to begin this morning by sharing an interesting case that just came to my attention. The facts are these: on his own account, the CEO of a Washington, D.C., national bank made a big unsecured loan—amounting to nearly half the bank's total capital—to a Baltimore firm in which he was the majority shareholder. Through after-hours doctoring of the books, he was able to hide the transaction from OCC examiners and the bank's own auditors. Although the bank's bylaws called for weekly board meetings to consider major loan applications, few meetings were actually held. When the board did assemble, the CEO announced that there was no business requiring its attention, and sent the members on their way. Meanwhile, the CEO was furtively extending new loans to the Baltimore firm as its old loans came due. In the end, both the firm and the bank came crashing down. The CEO, one Leonard Huyck, wound up doing time in federal prison.

The bank in question was the Merchants National Bank. If the name doesn't ring a bell, perhaps it's because Merchants National failed during a sleepy Washington, D.C., summer—the summer of 1866. Merchants was, in fact, the second national bank ever to fail.

The lesson of this story is as relevant for bankers and bank supervisors today as it was 132 years ago. A basic foundation of bank safety and soundness is a vigorously administered and thorough system of internal controls. And my message to you this morning is simple: I am concerned that the vigor and thoroughness of banks' internal controls are slipping. This is a trend that must be reversed. You have a crucial role to play in accomplishing that result.

Today, increasing numbers of the cases that come to the OCC's special supervision division—the division that deals with problem banks—wind up there as a result of fraud. Much of it is garden-variety theft and embezzlement and loan and check fraud that would be instantly recognizable to any nineteenth-century banker.

Now as then, most of these schemes to defraud are simple in concept. How simple they are to execute depends upon the bank's internal control mechanisms and procedures. Where controls are effective, fraud can be prevented or uprooted before it affects the bank's solvency. When internal controls go awry, fraud can fester undetected—with possibly disastrous—and certainly expensive—consequences for the bank.

For example, a bank that violated the fixed principle of internal controls that "no single person shall both authorize loans and control their disbursement" recently suffered a big loss when its president made "nominal" loans to nonexistent borrowers—and used the cash in a bid to corner the bank's stock.

Or consider the bank that violated the fixed principle that "the board of directors shall exercise special vigilance in cases involving loans to insiders and affiliates." This bank recently suffered big losses when an unscrupulous officer originated an unsecured loan to an out-of-town jewelry store and used the proceeds to buy his wife lavish gifts.

A bank that violated the basic principle that "independent verification of all loan documentation shall be performed before a loan is issued" recently failed when an ambitious loan officer falsified borrowers' financial statements and collateral inspections. In this case, the fraud came to light as the result of the bank's adherence to another basic precept of internal controls: officers and employees in sensitive positions shall be away from their desks for at least two consecutive weeks each year.

In each of these cases, the failure to follow fundamental techniques for sound internal controls led to expensive mistakes that diminished bank capital and tarnished banking reputations even when the bank itself survived. In each of these cases, personal suffering and financial loss could have been avoided if only these simple, commonsense procedures had been in place.

Evidence of weakening internal controls is not merely anecdotal. Late last year, in a study similar to BAI's own Audit Benchmarking Survey, the OCC's Central District here in Chicago found that the growth in audit capabilities in the banks they looked at was not keeping pace with the growth of the banks themselves. We found that turnover in the banks' auditing departments was increasing; so was the employee-to-auditor ratio. While these findings represented preliminary results based on a small sample and are open to various interpretations, they do give us additional reason to be concerned. Particularly as banks seek to grow even larger, their internal control capacities should be strengthened, not diminished, relative to the size and complexity of the resulting organizations.

To some degree, the slippage in internal controls might be attributed to the current health of the economy and

the profitability of most banks. Some bankers in tight labor markets are reportedly finding it hard to recruit enough competent internal auditors to fill vacancies. Given the difficulty in hiring staff to guard against fraud, some bankers may have come to accept an understaffed, less robust internal control function and the fraud that attends it as just another incidental cost of doing what is these days a most profitable business. In good times, losses can be more readily absorbed, and in-house auditors often have a harder time getting the ear of senior management.

The decline in internal controls is also undoubtedly related to the competitive lending environment in which banks currently operate. As loan margins grow thinner, banks feel an increasing urgency to cut costs, and are most likely to economize in areas they perceive as having minimum impact on income. When this approach is directed to a bank's internal controls, it misguidedly sacrifices long-term strength and stability to short-term profits.

The apparent degradation of internal control systems come at a particularly critical time for the banking business—a time of rising risk in many phases of the industry. Many banks face intensified competition from domestic and foreign-based providers for what was once their core lending business, competition that has taken a toll in underwriting standards and loan terms. Technological challenges—such as those associated with the millennium change and electronic commerce—pose risks all their own. The information that banks have accumulated about their customers has great value—not only for the banks but for others as well. There is an increasing risk that unauthorized persons will look for ways—legal and illegal—to access bank customers' private account information. And, of course, the wave of announced massive bank consolidations in recent weeks alone has created a new element of uncertainty—and new challenges—for the affected banks.

In the face of such industry change, it stands to reason that banks would be strengthening their internal controls instead of cutting them back. It stands to reason that banks would be adding experts in this area—in-house or contract—to their staffs. It stands to reason that banks would be upgrading their monitoring systems to make them more effective and more resistant to tampering and intrusion. A few banks are doing all of those things. But not enough. This failure reflects structural and management weaknesses that could have serious safety and soundness implications for some banks.

This is obviously an important concern for us. To further our supervisory efforts and attention to internal controls, we will release the new *Comptroller's Handbook* "Internal Control" booklet next month. This publication caps the OCC's emphasis on internal controls—an emphasis that now permeates our whole approach to bank supervision for large banks and community banks alike. Indeed, our newly revised large and community bank examination procedures integrate the review and testing of internal controls into all OCC examinations.

The OCC's regimen calls for examiners to review each bank's internal controls during every 12- or 18-month supervisory cycle. What will they be looking for? We recognize that no one form of control system is right for all banks. Community banks can implement controls in a less formal, less structured manner than larger banks and still have an effective control mechanism. Many of these smaller banks necessarily rely on outside consultants to perform "internal" audit functions and still are able to get the job done properly.

But we do believe that there are common critical components in internal control systems for all banks, and we embrace the five identified by COSO, the Committee of Sponsoring Organizations of the Treadway Commission. The list includes: Control Environment; Risk Assessment; Control Activities; Accounting, Information, and Communication Systems; and Self-Assessment.

Each of these elements is important, but the first—control environment—really represents the foundation for all the others. It provides the basic discipline and structure vital to an effective control system. It reflects the level of management's commitment and awareness of the importance of internal controls, and sets the tone for the control activities that are undertaken to carry out management directives. Included among these control activities are the bank's procedures for approving and authorizing transactions and reviewing operating performance, the checks and balances that limit employees' access to assets and records, and the design and use of documents.

Risk assessment is the identification and analysis of relevant risk, both internal and external, that can prevent the bank from reaching its objectives or can jeopardize its operations. The assessment helps determine which risks exist, how they should be managed, and what types of controls are needed.

The fourth element in an effective internal control program deals with accounting, information, and communication systems. These systems must not only capture information and generate necessary reports, but also enable all bank personnel to understand their roles in the overall control system, how their activities relate to others, and their accountability for the activities they conduct. And, finally, the self-assessment function consists of periodically measuring—and testing—the effectiveness of controls.

In assessing the bank's overall arrangements for internal controls, OCC examiners will look first at its written procedures. Written procedures are required for controls relating to insider transactions, Bank Secrecy Act, real estate lending, asset management, financial derivatives, interbank liabilities, and retail nondeposit investments.

But good processes are not enough. Impressive though they might appear on paper, internal controls are of little value unless they are thoroughly understood and strictly adhered to. That responsibility falls squarely on bankers. Our examiners will determine how well that responsibility has been met. To make that determination, we will be drilling down and doing more testing and verifying of actual transactions. Where the bank's risk profile is higher, we will be doing proportionately more of that kind of in-depth testing. When warranted, we will be reviewing reconciliations and transaction originations, internal audit working papers, and external audit reports. And we will bring any deficiencies to the attention of senior management.

But as much as we can do as regulators to help build a banking system that is truly safe and sound, responsibility for the development, implementation, and testing of internal controls rests first and foremost with managers and bank board members. This responsibility, as we say in the internal controls handbook, is not diminished through delegation, outsourcing, or similar arrangements. This is crucial. Senior bank managers and board members—not their subordinates or their contractors—are responsible for ensuring that the internal control system is operating as intended and that it is modified, as appropriate, to adapt to changing conditions.

Bank managers and directors should be insisting that their own auditors constantly probe and test the effectiveness of the bank's internal controls. And they should welcome a vigorous internal control function that will prevent problems before they hatch—or catch them before they undermine the bank's assets and earnings and its good name.

As long as all parties—bank managers, board members, bank supervisors, and internal and external auditors—play their respective roles in a vigorous and thorough fashion, the banking industry will have the foundation it needs to successfully transit a time of change and challenge—and to prepare it for the new challenges that lie ahead.

Thank you.

Statement of Julie L. Williams, Acting Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on financial modernization and the H.R. 10, Financial Services Act of 1998, legislation, Washington, D.C., June 25, 1998

Statement required by 12 USC 250. The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today to discuss H.R. 10—the Financial Services Act of 1998. This legislation is comprehensive in scope and far-reaching in its effect on financial services providers, consumers, communities, and the American economy. I commend you for holding these hearings and ensuring that all involved parties have an opportunity to evaluate carefully all aspects of H.R. 10 and come to understand its many implications for the future of our financial services markets.

In light of the changes in the financial services industry over the past 20 years, the need for some form of financial modernization, soon, is evident. Our nation will benefit from an updated legislative framework that affirmatively supports the sound evolution of the financial services marketplace. But it is imperative that we proceed with care. The issues we are addressing are extraordinarily complex, and the consequences of the choices made by the Congress in this area will be far-reaching and long-lasting. As Secretary Rubin stated last week, financial modernization legislation will be "the constitution for the financial services system of the next century."[1] The industry and the communities and customers it serves could suffer if we rush into change without taking the time to get it *right*. The U.S. financial services industry is currently as competitive as ever in recent memory and the steps we take must enhance, rather than jeopardize, that success.

H.R. 10 contains some important and promising steps toward financial modernization, but unfortunately, it also contains such flaws that, on balance, it would be more damaging than progressive. In my statement today, I will detail where H.R. 10 needs major reconfiguration in order to be worthy to serve as the type of financial services framework that our financial firms, consumers, and communities deserve for the next century.

[1] Testimony of Robert E. Rubin, Secretary, Department of the Treasury, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, June 17, 1998, at 2.

Discussion of H.R. 10

Financial modernization legislation should be guided by principles that clearly embody our public policy goals. The five principles set forth by Secretary Rubin in his testimony to this committee last week provide reference points for a sound approach to those goals. These are:

I. Protecting the safety and soundness of our financial system;

II. Providing adequate consumer protection;

III. Reducing costs and improving access for consumers, businesses, and communities;

IV. Promoting innovation and enhancing the competitiveness of the financial services industry; and

V. Permitting financial services firms to choose the corporate structure that makes the most business sense.

I. Protecting the Safety and Soundness of Our Financial System

A cornerstone of bank regulation and supervision is protection of the safety and soundness of the financial system, both short and long term. Providing banks the opportunity to maintain strong earnings through prudently conducted financial activities is the essence of safety and soundness. Unfortunately, the complexities, convoluted structural requirements, and inefficient business restrictions contained in H.R. 10 undermine the favorable effects of product diversification and enhanced profitability that the bill seeks to promote.

Allowing new financial activities in subsidiaries of banks, subject to appropriate safeguards, enhances safety and soundness and does not put deposit insurance funds at risk.

H.R. 10 would require that financial organizations wishing to diversify into new financial and financially related activities as principal—such as new securities activities and the provision of insurance and annuities—do so only through bank holding company affiliates rather than having the choice of doing so through a bank subsidiary structure.

Supporters of H.R. 10 have put forth two considerations that they claim require this result. The first is that allowing subsidiaries of banks to conduct the same range of

financial and financially related activities as would be permitted for bank holding companies would raise safety and soundness concerns and present risks to the deposit insurance funds. The second contention is that banks receive a "safety net subsidy" and that this benefit could be more easily transferred to bank subsidiaries than to holding company affiliates, providing those subsidiaries with an unfair advantage in competition with providers not owned by banks.[2] I address the first concern here and the latter in Section V below.

With respect to safety and soundness, the restrictive approach of H.R. 10 *undermines* rather than enhances long-term safety and soundness. Bank subsidiaries provide a means for prudent diversification of bank activities and income. Fees and other income from the subsidiaries enable banks to offset the effects of cyclical downturns in other economic sectors, diminishing the volatility of bank earnings and making the banking system as a whole less risky.

This is in fact the foreign experience. Foreign experience with financial activities conducted by U.S. bank subsidiaries shows that expanded financial activities can be conducted in bank subsidiaries on a safe and sound basis. For example, evidence indicates that permitting U.S. banking organizations to engage in securities activities overseas through banking subsidiaries has benefited the safety and soundness of the bank. This analysis, as well as a more detailed examination of the performance of individual holding companies, indicates that banking companies *lowered* their overall risk by engaging in overseas securities activities through bank subsidiaries.[3]

Conducting authorized financial activities is no less risky for a subsidiary of a bank than for a holding company affiliate when subject to the same prudential safeguards. For example, the House Banking Committee version of H.R. 10 provides that the parent bank must deduct from its own capital any equity investment made in its financial subsidiary, and must continuously qualify as well-capitalized after making that deduction. This means that even if the subsidiary fails and the bank experiences a total loss, the bank will still be well-capitalized for purposes of regulatory capital adequacy determinations. Further, because the bank's investment in the subsidiary is deducted from its regulatory capital, the bank's regulatory capital is not affected by fluctuations in the earnings of the subsidiary. Moreover, the bank could not make an equity investment in the subsidiary that exceeds the amount the bank could otherwise pay in dividends to its shareholders, including a bank holding company, without regulatory approval.

Additional safeguards would include the application of the equivalent prudential restrictions of sections 23A and 23B of the Federal Reserve Act to any loans or other extensions of credit between the parent bank and its financial subsidiary. This means that, just like loans or other extensions of credit to a bank holding company affiliate, transactions between the parent bank and its financial subsidiary will be subject to quantitative limits (10 percent of capital for each subsidiary and 20 percent of capital in the aggregate for all affiliates), must be at least 100 percent collateralized with high-quality collateral, and must be conducted on an arm's length basis under the same terms that would apply to an unaffiliated third party. Moreover, a bank would be subject to the same very strict limitations on purchases of low quality assets from its financial subsidiary under section 23A that would apply to purchases by the bank from a bank holding company affiliate.

In sum, with these types of safeguards in place, new financial activities can be conducted as safely and soundly in a subsidiary as in an affiliate.

Indeed, the prudent diversification of activities through the subsidiary structure enhances bank safety and soundness by increasing banks' earnings and diminishing their volatility and thereby also strengthens the deposit insurance funds. In fact, current and former Federal Deposit Insurance Corporation (FDIC) chairmen have agreed that allowing banks to conduct new activities in subsidiaries is at least as safe and sound—probably more so—than conducting these activities in a holding company affiliate. FDIC Chairman Ricki Helfer noted that, "With appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having earnings from new activities in holding company affiliates."[4] Also, in the event of a bank failure, the value of the bank's investment in the subsidiary is fully available to the FDIC to cover the costs of failure resolution.

By contrast, the prompt corrective action provisions of the Federal Deposit Insurance Act of 1991 (FDICIA) specifically *limit* the ability of a federal agency to require a parent bank holding company to contribute funds to an

[2] Testimony of Alan Greenspan, Chairman, Federal Reserve Board, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, June 17, 1998, at pp. 25–26.

[3] Whalen, Gary, "The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns," Office of the Comptroller of the Currency, Economics Working Paper 98-2, February 1998.

[4] Testimony of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation, before the Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises of the U.S. House Committee on Banking and Financial Services, March 5, 1997, at p. 22.

undercapitalized bank through a capital restoration plan to the *lesser* of 5 percent of the bank's assets or the amount necessary to bring the institution up to the adequately capitalized standard.[5] While the assets and earnings of a bank subsidiary are always available to support a troubled parent bank, the ability of a federal agency to require a holding company to support a troubled subsidiary bank is uncertain. The Federal Reserve Board's so-called "source of strength" doctrine has never been fully litigated, and bank holding companies have occasionally successfully balked at meeting regulators' demands to downstream funds into a troubled bank. In fact, the FDIC has been sued twice to recover funds that were injected by a holding company into a bank subsidiary.

Finally, congressional and regulatory actions over the past decade have significantly strengthened the safety and soundness tools available for bank regulators.[6] These new supervisory tools enable regulators to address promptly supervisory concerns that may arise in connection with activities engaged in by banks or their subsidiaries.

II. Providing Adequate Consumer Protection

The second key principle underlying fair and effective financial modernization legislation is ensuring that consumers are adequately protected in the complex, sometimes confusing new environment for the provision of financial services. New activities and newly permissible affiliations may offer consumers greater convenience and greater choices, but may also give rise to enhanced responsibilities of financial firms to their customers.

H.R. 10 has important implications for consumers' privacy.

H.R. 10 would authorize the creation of diversified, potentially very large, financial conglomerates that will be able to amass vast amounts of information about the insurance, credit, and other transactions of their customers. In light of this, an issue that stands out is how the new conglomerates will use customer information to market and deliver their services to consumers and communities.

In this regard, I would note that in 1996, Congress amended the Fair Credit Reporting Act (FCRA) to allow persons related by "common ownership or affiliated by corporate control" to share and use any customer information they possess (in addition to experience information, which can be freely shared). These amendments balanced this valuable grant of authority with provisions designed to protect consumer privacy. Thus, the FCRA allows a company to share information within the corporate family only if it clearly and conspicuously discloses to the consumer that such sharing of customer information may occur. In addition, the consumer also must be provided the opportunity to direct that the information not be shared—that is, consumers have the right to protect their privacy by "opting-out."

However, the same amendments to FCRA also restricted the ability of the federal financial regulatory agencies to conduct examinations to ensure compliance with FCRA, including the information sharing disclosures and opt-out provisions. A banking agency can only conduct an examination for FCRA compliance if the agency has information, following an investigation of a complaint or otherwise, indicating that an institution has violated FCRA. In other words, we do not have the ability, absent those circumstances, to examine for compliance with the FCRA affiliate information sharing disclosure and opt-out requirements.

III. Reducing Costs and Improving Access for Consumers, Businesses, and Communities

Financial modernization also should facilitate broader access to financial services for consumers, businesses, and communities. It should neither erect new barriers to, or erode current protections for, fair access to financial services for all sectors of our society, nor undermine the ability of financial services providers to contribute to consumer welfare by artificially limiting the competitive incentives and opportunities for those providers to improve the content and delivery of their products and services. Unfortunately, again, certain provisions of H.R. 10 are inconsistent with this goal.

In particular, H.R. 10 will likely diminish the benefits of the Community Reinvestment Act (CRA), impair the future competitiveness of community banks, and deprive consumers of the benefits of additional competition and potentially greater convenience in the availability of insurance products.

H.R. 10 would undermine the current scope and success of CRA.

H.R. 10 would sap the effectiveness of CRA, because it would effectively force new growth businesses out of banks and their subsidiaries and into holding company affiliates. If financial modernization limits the new businesses that may be conducted in operating subsidiaries,

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[5] 12 USC 1831o(e)(2)(E).

[6] These measures include the Basle Accord of 1988, in which the regulatory agencies tied regulatory capital requirements to risk and adopted minimum risk-based capital standards, and several provisions of FDICIA. The provisions of FDICIA include the prompt corrective action provisions that require regulators to close a troubled institution before the book value of its equity reaches zero, reducing the loss to the deposit insurance fund. They also include the least-cost test that requires the FDIC to resolve failed banks at the least cost to the deposit insurance funds, increasing the likelihood that creditors would suffer losses in the resolution of a failed bank.

and encourages new types of financial activities only in affiliates, we must recognize that a bank's capacity to engage in community reinvestment activities will be diminished.

Significant assets and income at a bank subsidiary increase a bank's financial capacity and ability to lend or invest in its community. The joint agency CRA regulations provide that the "performance context" that governs the evaluation of a bank's CRA performance includes the "institutional capacity and constraints" of the institution "including the size and financial condition of the bank . . . and any other factors that significantly affect the bank's ability to provide lending, investments, or services in its assessment areas." The Office of the Comptroller of the Currency's (OCC) examination policy recognizes this link between the financial strength of national banks with operating subsidiaries and opportunities for enhancing CRA performance by the bank.

Stronger banks, which have greater potential for growth through operating subsidiaries, are in the best position to help meet the credit needs of local communities. If the bank's resources are limited by legal restrictions that permit new financial activities to be conducted only through holding company affiliates, resources will not be available to allow the bank to expand the products and services it offers in its communities.

The subsidiary option is important for community banks.

The subsidiary option is important for the future of the community bank franchise. If legislation allows banking organizations to engage in a wider range of activities, banks of all sizes should have the ability to choose a subsidiary or bank holding company structure. When faced with the prospect of competing against the type of financial conglomerates that H.R. 10 would authorize plus other types of financial institutions, banks should be allowed to choose the form that is most effective and efficient to allow them to compete. Inefficiencies that lead to increased costs would have a disparate impact on the ability of community banks to compete. Thus, H.R. 10 tilts the competitive playing field in favor of large financial conglomerates.

This is not merely a theoretical problem. For community banks in particular, the subsidiary structure may be the most efficient and perhaps only feasible option for conducting new activities. And the activities at issue can be very beneficial to community banks and their customers. For example, in Massachusetts, nearly 60 community savings banks joined together to provide savings bank life insurance through a jointly owned subsidiary. This joint venture has proven to be enormously successful in providing low-cost insurance to consumers in a safe and sound manner. H.R. 10 unnecessarily constrains options such as these and thereby undermines the competitive vitality of community banks.

Customers would be deprived of the benefits of more competition and increased convenience in connection with the provision of insurance.

H.R. 10 also would deprive customers of the benefits of increased competition by reducing the current insurance authority of both national and state banks. In some cases, the ability of banks to provide insurance or annuity products to their customers is eliminated; in other cases, H.R. 10 significantly restricts how banks may go about selling the insurance products they are currently authorized to provide. These limits on competitive incentives to provide and improve insurance product content and delivery simply penalize insurance customers. This concern is discussed in greater detail below.

IV. Promoting Innovation and Enhancing the Competitiveness of the Financial Services Industry

Financial modernization legislation also should promote innovation and enhance the competitiveness of the financial services industry. Developments within the financial services landscape—in particular, the increase in competition—have led to product innovation, increased geographic diversification, and other changes in banks' balance sheets. These developments have generally been beneficial to consumers—through greater choice in financial products and delivery mechanisms, and lower costs.[7] But H.R. 10 would restrict entry into certain markets, thereby denying consumers the possible benefits of increased competition.

H.R. 10 would cut back banks' current insurance authorities.

It is clear that financial services firms have, over time, developed products that have characteristics of both bank products and insurance products. The dynamic evolution of the marketplace has resulted in clear benefits for the consumers of bank and insurance products. It is therefore troubling that H.R. 10 would substantially limit such innovation by the banking industry in the future.

H.R. 10 prohibits banks and subsidiaries from providing new insurance products as principal. The bill grandfathers insurance products that the OCC had authorized national banks to offer as of *January 1, 1997,* and products that national banks were actually offering as of that date. However, the prohibition will bar banks from lines of business that are *today*, under current law, permissible for banks to offer. It will also prevent banks

[7] Product innovations such as the variable rate mortgage, securitization, and credit cards have expanded consumers' credit choices.

from offering products in the future that the OCC might find to be permissible. Because provisions in the Federal Deposit Insurance Act limit the ability of state-chartered banks to underwrite insurance with reference to what national banks can do, this section of H.R. 10 will also cut off insurance opportunities for state-chartered banks.

H.R. 10 also reduces the current authority of national banks to sell insurance as agent. First, the bill contains an anticompetitive requirement for banks to buy an existing insurance agency that is at least two years old if the national bank wants to sell insurance in a state in which it was not selling insurance as of the date of enactment.

With respect to title insurance, H.R. 10 provides that national banks may only sell title insurance if they are doing so as of the date of enactment of H.R. 10, and *no subsidiary* or affiliate provides *any kind* of insurance as principal. If state-chartered banks were authorized to sell title insurance as of January 1, 1997, national banks may also sell title insurance; but if a state-chartered bank is authorized to sell this insurance after January 1, 1997, national banks are not given parity.

H.R. 10 does allow national bank subsidiaries to sell other types of insurance—in an agency capacity—from any location. However, when a national bank's subsidiary's insurance agency is located in a place with a population of over 5,000, the subsidiary will be treated as an "affiliate" under section 23B of the Federal Reserve Act. This means that virtually all types of transactions between the bank and its own subsidiary (including the payment of any money or furnishing of services to the subsidiary) can only be made if they are on terms that are comparable to the terms that the bank would use for the same type of transaction with an unrelated third party. A bank would need to maintain sufficient records to reflect its compliance with this standard. Thus, an agency located in a place with a population of 5,001 would bear these new burdens, while an agency located in a place with a population of 4,999 would not. This treatment of banks' insurance *agency* activities is simply discriminatory and anticompetitive and has no basis in safety and soundness or other public policy goals.

Proponents of H.R. 10 have asserted that section 104 of the bill, which provides that state laws may not "prevent or significantly interfere" with a bank engaging in insurance (and other) activities authorized under *federal* law, simply reflects the decision of the Supreme Court in the *Barnett* case [*Barnett Bank* v. *Nelson,* 1996]. That assertion, however, is incorrect. H.R. 10 does not codify *Barnett*. The *Barnett* decision itself used several different phrases, and also specifically referenced other cases that use terms such as "hamper," and "impede." (In other words, the standard could be that state law should be preempted if it *hampers* the ability of a national bank to exercise a power authorized under federal law.) What section 104 does, in fact, is put into place a new standard that offers banks less protection from discriminatory and restrictive state regulation than is the case today under the standards spelled out by the Supreme Court in its *Barnett* decision—and virtually guarantees new rounds of litigation under the new standard.

Section 104 also refers to the recently adopted Illinois law regarding bank sales of insurance and provides that state laws that are no more restrictive than that law would not be deemed to "prevent or significantly interfere" with the ability of a bank to sell insurance. Using the Illinois law as a benchmark like this is particularly risky because the result will depend on how that law is *interpreted*. If the law is interpreted in certain ways, it should not be preempted under current standards for preemption, but if it is interpreted differently, it could significantly interfere with national bank insurance activities.

Removing OCC deference could discourage future innovation.

Given the ambiguities that the bill creates about when a product is "insurance," when an "insurance" product can be provided by a bank, and when state law that restricts a bank's ability to sell insurance would be preempted, the process by which these questions are resolved becomes crucial. H.R. 10 contains an unprecedented provision that *directs a court not to give any deference to the OCC*, even when the OCC is interpreting the National Bank Act, or even when the OCC is opining on whether a state law or rule interferes with the ability of a national bank to sell insurance. This result singles out national bank insurance activities and uniquely excludes OCC decisions in this area from the long-standing doctrine of judicial deference to federal administrative agency decisions that the Supreme Court pronounced in the *Chevron* case [*Chevron USA Inc.* v. *Natural Resources Defense Council, Inc.,* 1984]. This provision will effectively limit competition in insurance markets by preventing or discouraging banks from engaging in new activities that could be deemed to be "insurance" by a state insurance regulator, since the banking institution will not be able to rely on agency decisions that have not been tested in the courts. It will have the practical effect of elevating the unelected judiciary to the policy-making role of determining permissible banking activities.

In addition, section 104 limits the ability of an insurance affiliate of a bank to engage in insurance activities. While section 104 provides that a state law may not prevent or significantly interfere with the authority of a bank to affiliate with another entity under federal law, a state may freely regulate the insurance activities conducted by the affiliate or in other ways restrict its operations (other than cross-marketing) as long as the same regulation is applied to affiliates and nonaffiliates alike. There is no

protection against state regulation that appears neutral on its face but would have a disparate impact on the ability of a bank's insurance affiliate to do business.

V. Permitting Financial Services Firms to Choose the Corporate Structure that Makes the Most Business Sense[8]

The fifth and last modernization principle is that banks should have the freedom to choose the corporate structure that is best for their business, consistent with safety and soundness. Our position on this issue is that banks of all sizes should be permitted to engage in an expanded range of financial activities, thus receiving the proven and tangible benefits of financial diversification, and should have the freedom to use either a holding company affiliate or a bank subsidiary structure to do so. Without such appropriate organizational flexibility, banks will be less safe and sound, offer fewer choices to customers, may be under pressure to charge higher fees on the products and services they are allowed to offer, and be less able to serve the financial needs of their communities and their customers.

Operating subsidiaries and bank holding company affiliates offer the same opportunities for safety net subsidy insulation.

The form under which a bank chooses to operate should be a matter of choice absent compelling public policy considerations. As alluded to earlier, one of the most commonly asserted public policy reasons for denying this form of organizational choice is that banks receive a "safety net subsidy" and that that benefit could be more easily transferred to subsidiaries than holding company affiliates, providing those subsidiaries with an unfair advantage in competition with providers not owned by banks.

Some participants in this debate suggest that the bank holding company model is better than bank subsidiaries in containing the net subsidy, *i.e.*, funding advantage, accruing to banks from the benefits of the federal safety net. The OCC and many other independent analysts believe this assertion is fundamentally flawed for two significant reasons. First, government and private sector studies strongly suggest that—to the extent any subsidy actually exists—there is no meaningful *net* subsidy after factoring in the costs of bank regulation and the payments made by banks for the services contained within the federal safety net.[9] Second, even if the existence of a net subsidy could be proven, there is no evidence that a bank holding company structure is uniquely effective in limiting the transmission of that subsidy to organizations owned or affiliated with the bank.

There is no credible evidence that banks are subsidized in a manner that provides them with a special competitive advantage. The existence of a subsidy would imply that banks receive benefits without paying for them. Banks bear significant costs in return for access to the safety net. They are subject to a number of regulations, which impose operational limitations to protect their safety and soundness and to protect consumers. Laws and regulations also govern exit and entry to the banking system, geographic and product expansion, fiduciary activities, the quality of internal and external information systems, and equal access to credit and other financial services.

Recent studies also tend to confirm that only a small minority of the banks—those in the weakest financial condition—enjoy even a gross subsidy; that is, the majority of banks pay more for components of the safety net than they are worth, even before factoring in the costs of bank regulation. Additionally, one can credibly argue that recent legislative and regulatory measures have reduced any gross benefits from the federal safety net even further. Such measures have decreased the amount of benefit accruing to troubled institutions and increased the cost of safety net features. These measures include, among others, risk-based capital requirements, prompt corrective action provisions, and risk-related deposit insurance premiums.

Finally, the real test of this theory takes place in the real world. There is no indication that bankers behave as if a net subsidy exists. If it existed, banks would conduct their business to fully exploit that subsidy and dominate the markets they seek to serve. This type of behavior is nonexistent, neither in the way banks fund themselves or structure themselves, nor do banks dominate the businesses in which they are engaged.

For example, if banks enjoyed a lower cost of funds because of benefits accruing from the safety net, we would expect to see banking organizations issue debt exclusively at the bank level. Instead, we see debt issuances by banks, bank holding company parents, and nonbank affiliates. Furthermore, if there were a

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[8] The attached white paper ["Financial Modernization and Bank Subsidiaries: Sound Public Policy," prepared by Office of the Comptroller of the Currency staff, June 1998] contains a detailed analysis of issues raised by proposals to preclude choice in corporate structure.

[9] With respect to efforts to measure the value of the safety net, research by OCC staff, published as OCC Economics Working Paper 97-9, Whalen, Gary, "The Competitive Implications of Safety Net-Related Subsidies" (May 1997), focuses on measuring the value of federal deposit insurance. The safety net comprises two additional components: access to the Federal Reserve's discount window and coverage of daylight overdrafts through Fedwire. To the extent that those two components of the safety net convey any subsidies, their magnitude reflects decisions by the Federal Reserve to charge below market interest rates on those extensions of credit.

subsidy, banks could take best advantage of it by selling their debt directly to the public. Instead, most bank debt is issued to the parent holding company, which in turn funds this purchase by issuing commercial paper. If the deposit insurance subsidy were important, banks would rely almost exclusively on insured deposits as their source of funds. In fact, less than 60 percent of commercial bank assets are supported by domestic deposits, and some banks hardly use them. As of March 1998, domestic deposits at the 10 largest commercial banks ranged from 4 percent of liabilities to 91 percent of liabilities. Among the top 10 banks, foreign deposits, which are not insured, currently compose as much as 59 percent of liabilities.[10]

In their consumer finance and mortgage banking activities, among others, banks compete side by side with nonbank providers. If banks had a competitive advantage, they would dominate over other providers. However, in many fields, nonbank providers have a bigger market share than banks. As of June 1997, two out of the top five largest servicers of residential mortgages were nonbanks, and two of the top five originators of mortgages were nonbanks.[11] The Federal Reserve, in fact, has stated persuasively that banks engaging in permissible securities activities do not dominate their respective markets.[12]

Some have noted the movement of assets from holding companies to banks as an indication that the subsidy exists. In particular, they point to a reported drop over the last decade in the share of bank holding company assets held by nonbank subsidiaries, after removing the section 20 affiliates (firms engaged in Federal Reserve-approved securities activities). The argument seems to be that such a shift is motivated by a desire to exploit a subsidy available to banks and their subsidiaries but unavailable to affiliates of bank holding companies. However, evidence does not support that this shift—if one has in fact occurred—is due to a subsidy.

First, it is simply unclear that such an asset shift has actually occurred. There are no current systematic data available to document that a shift occurred. The existing data are problematic for several reasons: between 1994 and 1995, the Federal Reserve changed the instructions governing the filing of the asset data used in the calculation of the reported shift to reduce, if not eliminate, apparently widespread, year-by-year, reporting errors. The presence of these reporting errors and the changes in reporting instructions mean that we cannot make accurate year-to-year comparisons. Indeed, the absence of comparability could fully account for the reported drop in the bank holding company affiliate share of bank holding company assets.

Second, various explanations account for banking organizations moving activities from holding company affiliates to banks and bank subsidiaries. Importantly, over the past decade, the relaxation of geographical and other barriers to interstate banking has permitted banking companies to engage in the interstate conduct of lines of business in banks that they could previously conduct only through bank holding company subsidiaries. That flexibility could lead banking organizations to shift assets from long-established bank holding company subsidiaries in those states to newly permissible banks or bank subsidiaries.[13] Moreover, firms consolidate their operations for many reasons, including the desire for increased efficiency. Recent experience with intrastate and interstate branching demonstrates the efficiency gains of organizational flexibility. Research on intracompany mergers finds that choice of organizational form is an important determinant of the efficiency of a company's operations. These mergers enable banking organizations to streamline their operations and better serve their customers.[14] After many states eased restrictions on intrastate branching, most banking companies responded by consolidating all of their existing subsidiaries into branch banks, although this was not the universal response.[15]

Despite the weight of this evidence, let us assume, for the sake of argument, that a net subsidy exists. Is the holding company organizational form inherently more efficient in containing that subsidy than the bank subsidiary model? Again, the evidence is persuasive that the

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[10] Call report data as of March 1998.

[11] "Ranking the Banks: Statistical Review 1997," *American Banker*.

[12] In its 1987 ruling, "Order Approving Activities of Citicorp, J.P. Morgan, and Bankers Trust to Engage in Limited Underwriting and Dealing in Certain Securities, Legal Developments," the Federal Reserve Board stated, "the Board notes that banks do not dominate the markets for bank-eligible securities, *suggesting that the alleged funding advantages for banks are not a significant competitive factor"* (emphasis added).

[13] In fact, a 1994 Federal Reserve Bank of Dallas report indicates that "[t]he reduction in nonbank activity outside the securities areas is consistent with the view that the recent movement toward nationwide banking has reduced the attractiveness of nonbank subsidiaries, although additional factors may be at work. Before the mid-1980s, when many states began to relax interstate banking restrictions, nonbank subsidiaries were a useful vehicle for interstate expansion. However, the continued erosion of interstate banking restrictions may have reduced nonbank subsidiaries' usefulness in this regard, since bank holding companies can now establish, subject to some remaining restrictions, an interstate network of banks." From *"Financial Liberalization Changes Focus of Nonbank Subsidiaries, Financial Industry Issues,"* Federal Reserve Bank of Dallas, Third Quarter, 1994.

[14] Robert DeYoung and Gary Whalen, "Is a Consolidated Banking Industry a More Efficient Banking Industry?" *Quarterly Journal,* Office of the Comptroller of the Currency, September 1994.

[15] Robert DeYoung and Gary Whalen, "Banking Industry Consolidation: Efficiency Issues," Working Paper No. 100, The Jerome Levy Economics Institute, April 1994.

answer is no. The key point in this debate is how the alleged subsidy might flow to bank affiliates or subsidiaries and how to contain that flow. The legal restrictions that today apply—and apparently sufficiently prevent the transmission of any potential subsidy from a bank to its holding company affiliates (sections 23A and 23B of the Federal Reserve Act)—can be applied to transactions between a bank and its subsidiaries.

In fact, one can argue that, under current law, it is actually easier for the subsidy to reach holding company affiliates than it would be for the subsidy to reach a bank subsidiary, provided sections 23A and 23B are applied to transactions between the bank and the subsidiary. Under the bank holding company model, transmission of the potential subsidy involves a two-step process. First, the subsidy would need to be transmitted from the bank to the bank holding company in the form of a dividend payment; second, there must be a transfer of value from the holding company to the nonbank affiliate—either in the form of an equity investment or other transaction, such as below-market extension of credit by the bank holding company to the nonbank affiliate. There are no legal restrictions to contain transmission of the subsidy in this scenario, except for the requirement that the dividend be permissible for the bank.

Moreover, as discussed earlier, the OCC supports safeguards, such as those included in the House Banking Committee version of H.R. 10 and supported by the Department of the Treasury, that ensure that there is no economic difference between conducting an activity in a subsidiary or conducting the activity in an affiliate. These restrictions include applying the quantitative and qualitative limits in sections 23A and 23B to a loan made by a bank to its subsidiary engaged in the new financial activities in the same manner that these statutes apply to loans made by a bank to its bank holding company or other nonbank affiliates. Equity investments in the subsidiary would have to be deducted from a bank's regulatory capital, and assets and liabilities of the subsidiary could not be consolidated with the assets and liabilities of the parent bank. A bank would be prohibited from making a downstream investment in its subsidiary in excess of what it can legally pay out as a dividend to its bank holding company without specific regulatory approval. These safeguards will stop the spread of subsidized dollars, if there are any, to the subsidiary to the same extent that the restrictions impede the flow of subsidized dollars to the bank holding company and its nonbank affiliates.

Furthermore, it is simply incorrect to assert that the holding company structure better insulates the bank from the risks of an affiliate because courts are more likely to impose liability on a bank for activities of a bank subsidiary than for activities of a bank affiliate. In fact, statistics indicate that it is somewhat less likely that the corporate veil between a parent and its subsidiary will be pierced than between that parent company and a sister company (e.g., a bank holding company affiliate).[16] Whether a bank's corporate veil is pierced by a court depends on how the entity's operations were conducted, not on the entity's location in a corporate organizational chart.

Similarly, others have asserted that accounting conventions make a holding company affiliate a better choice than a subsidiary because generally accepted accounting principles (GAAP) require consolidation of a bank and its subsidiary's financial statements, and that therefore national banks would have strong incentives to rescue troubled subsidiaries. It is also argued that subsidiary losses, reflected in the consolidated financial statements, would cause depositors and investors to lose confidence in the bank. These arguments, too, upon close review, are not sustainable.

First, accounting standards do not determine corporate liability; rather they provide an external yardstick of an institution's financial condition. When financial reports are consolidated, companies are simply *reporting* their assets and liabilities on a combined basis, but *they do not become legally responsible for each other's liabilities*. Those statements simply reflect a reporting convention. Second, holding company financial statements also reflect the consolidation of the financial statements of its subsidiary entities. Thus, the same incentives exist for a holding company and its subsidiary bank to bail out their affiliates. Bank holding company statements reflecting financial difficulties could cause equal or greater concern to investors and depositors. In fact, for virtually all large banks, the only equity securities available to investors are those of the holding company, so any market reaction will be driven by those investors' views of the holding company. Third, accounting rules require the deconsolidation of subsidiary financial statements when a bank no longer controls a subsidiary, when it is ordered to sell or liquidate the company, or when a subsidiary goes bankrupt. At that point, a bank's financial statements would reflect the true economic loss to a bank, which would never be greater than its actual investment in the subsidiary (already deducted from capital) and any limited credit exposure under section 23A limits.

Once all of the foregoing factors have been considered, the public policy direction becomes clear. As long as appropriate prudential safeguards are in place to maintain safety and soundness and prevent transmission of any so-called safety net subsidy outside the bank, banks should have the choice of being able to engage in an

[16] Thompson, Robert, "Piercing the Corporate Veil: An Empirical Study," *Cornell Law Review* 76 (July 1991), 1036–1074.

array of financial and financially related activities through either affiliates or through their subsidiaries.

Conclusion

Financial modernization involves complex, far-reaching issues. Legislative changes will have long-term implications for the structure and vitality of our nation's financial institutions and their ability to serve their customers and support their communities. The bill before you contains some promising elements but requires a major reconfiguration before it will be worthy to serve as the framework for our nation's financial system in the next century.

[Attachment follows]

Attachment

Financial Modernization and Bank Subsidiaries: Sound Public Policy

June 1998 [prepared by OCC staff]

Contents

Introduction

Banks play a critical role in our nation's economy and Congress has chosen to implement important public policy goals through banks. Recently a number of initiatives that may profoundly affect the future role and functions of banks have been proposed in the pursuit of financial modernization. The purpose of these initiatives generally is to create a new framework defining relationships between the banking industry, the securities industry and the insurance industry; and with respect to banks, to redefine the activities they are permitted to conduct, directly and indirectly.

Banks are a critical transmission belt of our nation's economy, and Congress uses them to deliver important public policy goals. However, the role of banks has shifted over the years—and in some ways shrunk—in

response to both competitive forces and to well-intended restrictions that had the effect of hindering bank evolution. One key way to preserve the role played by banks is to enable them to diversify their income to enhance their long-term strength by conducting an expanded range of financial activities. Use of bank subsidiaries is an organizational option that allows banks to pursue such diversification prudently.

While some commentators advocate that banks should conduct certain new financial activities only through a bank holding company (BHC) affiliate, there is no sustainable reason to eliminate the organizational choice of a bank subsidiary. Conducting activities through bank subsidiaries—subject to the same regulatory safeguards followed by bank affiliates—enhances bank safety and soundness, helps further public policy goals, and aids in the ability of all banks to compete on a level playing field with each other and with nonbank firms. Domestic and foreign experience with financially related activities conducted in bank subsidiaries shows that such activities enhance rather than detract from the safety and soundness of banks. Furthermore, evidence does not support the contention that activities conducted in bank subsidiaries benefit from subsidies that are not available to BHC affiliates. As a result, claims that the bank subsidiary structure approach is flawed and, therefore, should be prohibited, are misconceived. This paper will address each of these points in turn.

The Special Role of Banks

The Role of Banks in Our Economy

Throughout our nation's history, banks have played a critical role in our economy. As Edward Furash noted, "The purpose of banking is to provide a stable world in which commerce can flourish."[1] Banking is an information-intensive business that provides funding to businesses, and, as such, allows commerce to flourish. Banks are the dominant lenders in markets that require extensive information about borrowers and a continuing monitoring relationship. Indeed, banks are an important source of credit to our nation's small businesses and rural communities. Banks extend more than 60 percent of the dollar value of credit to small businesses.[2] Furthermore, because banks develop long-term relationships with borrowers, they provide an important source of liquidity to firms that may be facing temporary liquidity problems.

Banks are not the only financial services providers to extend loans or take in customer funds, so why is their role in the economy unique? Gerald Corrigan, president of the Federal Reserve Bank of Minneapolis and later the Federal Reserve Bank of New York, characterized banks as having three features that distinguish them from all other financial institutions: "(1) banks provide transaction accounts; (2) banks are the backup source of liquidity to all other institutions; and (3) banks are the transmission belt for monetary policy."[3]

The late Federal Reserve Chairman Arthur Burns explained further:

> Commercial banks serve, in effect, as trustees of other people's money, and the public interest therefore requires that they be managed prudently. Although they are privately owned organizations, they are the main providers of an essential public service—that of administering our system for making monetary payments. Commercial banks have also been serving as the conduit for monetary policy—that is, as the channel through which central banks seek to stabilize national economies. Turmoil in banking has major implications for the public welfare in each of these connections, and that is why all modern governments regulate banking more closely than most economic activities.[4]

A safe and sound banking system is critical to economic stability in times of stress. Similarly, a stable and predictable payments system is a prerequisite for the orderly, efficient conduct of the national economy.

As a result, banks are subject to requirements designed to promote a safe, stable financial and economic system. For example, depository institutions are subject to extensive safety and soundness rules, including stringent capital requirements, restrictions on loans to one borrower, limits on exposure to correspondent banks, and prohibitions on engaging in certain risky activities. Federal banking regulators are also authorized to require banks to engage in corporate-wide contingency planning in order to minimize financial loss, ensure a timely

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[1] Furash, Edward. "Banks are Obsolete—and Who Cares?" *Proceedings of The Declining Role of Banking*, Federal Reserve Bank of Chicago, May 1994, p. 24.

[2] Cole, Rebel A., John D. Wolken, and R. Louise Woodburn. "Bank and Nonbank Competition for Small Business Credit: Evidence from the 1987 and 1993 National Surveys of Small Business Finances," *Federal Reserve Bulletin*, November 1996, p. 984.

[3] Corrigan, E. Gerald. "Are Banks Special?" *1982 Annual Report*, Federal Reserve Bank of Minneapolis, pp. 5–24. All references to Corrigan cite material found at the Internet home page of the Federal Reserve Bank of Minneapolis—http://woodrow.mpls.frb.fed.us/pubs/ar/ar1982.html. Also see, Boyd, John H., and Gertler, Mark. "U.S. Commercial Banking: Trends, Cycles, and Policy." *Macroeconomics Annual*, National Bureau of Economic Research, 1993, pp. 319–68, and Berger, Allen N., Anil K. Kashyap, and Joseph M. Scalise. "The Transformation of the U.S. Banking Industry: What a Long Strange Trip It's Been," *Brookings Papers on Economic Activity*, 2:1995, p. 56.

[4] Burns, Arthur F. *The Ongoing Revolution in American Banking*. American Enterprise Institute, Washington D.C., 1988, p. 1.

resumption of operations in the event of a disaster, and minimize disruptions of service to business operations or customers (by, for example, obtaining written backup agreements with alternative suppliers). Furthermore, the Bank Protection Act requires federal banking agencies to adopt standards applicable to banks regarding the physical security of premises, the safekeeping of cash and other valuables from robberies, burglaries, and larceny, as well as the identification and capture of persons who commit such acts.

The Role of Banks in Implementing Public Policy Objectives

Throughout our history, banks have also been critical to achieving other important public policy objectives, as determined by Congress, including those related to community development, integrity in the provision of financial services, and consumer protections. This results in the imposition of requirements that are not applied fully or, in some instances, not applied at all to other providers—including the type of regular examination by regulators that banks experience. The additional requirements banks meet benefit our society in significant ways.

Banks Provide Community Support

Banks supply a substantial amount of economic development, resources, and support for America's communities. For example, the Community Reinvestment Act (CRA) provides incentives for banks to help meet the credit needs of all communities in which they operate, including low- and moderate-income neighborhoods. Since the CRA became law, banks have made more than $410 billion worth of commitments to small businesses and low- and moderate-income consumers (not including, for example, the $115 billion pledged by Citicorp and Travelers and the $350 billion pledged by NationsBank and Bank of America, as part of their proposed mergers). CRA applies to FDIC-insured banks and thrifts, but other types of financial services providers are not subject to CRA obligations.

The Home Mortgage Disclosure Act (HMDA) provides the public with home mortgage loan data in order to help regulators identify possible discriminatory lending patterns and enforce anti-discrimination laws. HMDA automatically applies to federally insured banks and thrifts that make mortgage loans, but other financial services providers are not covered automatically.

Unlike other financial institutions, banks have unique obligations to address community needs in connection with closing their branches. Federal law requires that banks adopt policies for branch closings and provide notices before closing any branch (e.g., 90 days advance notice mailed to customers of the branch to be closed and 30 days notice to branch customers via the posting of a sign in the branch to be closed). Only federally insured banks and thrifts are subject to this obligation; it does not apply to other financial services providers.

Last, banks that engage in interstate branching under the authority of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 are subject to limitations on how they deploy funds that they raise. Specifically, that law prohibits banks from using their out-of-state branches to accept deposits from one community to be used primarily for loans in another community. Other types of financial services providers do not face such limitations on how they allocate borrowed funds.

Banks Enhance Financial System Integrity

Depository institutions, unlike other financial services providers, are subject to a number of specific laws that ensure that the distribution of credit will be made fairly, without preferential treatment and based on merit. Furthermore, depository institutions face regular examinations to determine their compliance with such laws. For example, the Bank Bribery Act generally prohibits a bank representative from seeking or accepting (and anyone from offering or giving) anything of value in connection with any bank transaction.

Banks are subject to certain limitations and prohibitions on loans to insiders (e.g., any executive officer, director, or principal shareholder of the bank or an affiliate) unless it is made on market terms. In addition, other arms'-length requirements are imposed on a bank's relationship with its affiliated companies in order to ensure that transactions are conducted on terms comparable to those that would exist if they were not affiliates.

Federal banking laws also generally restrict an institution's ability to condition the provision of banking products or services on a requirement that a customer also obtain one or more additional products or services from them or from their affiliates (this is referred to as tying). Generally speaking, tougher laws and more vigorous enforcement requirements to combat tying are applied to banking institutions than are applied to other financial institutions, to ensure fairness to consumers and bank competitors.

Finally, the Bank Secrecy Act requires record-keeping and reporting of certain transactions in order to prevent tax evasion and money laundering. While the act applies broadly to financial institutions and money transmitters, banks and thrifts are subject to more detailed requirements and a rigorous regime of examinations by bank regulatory agencies. This level of detail reflects banks' special role as payment intermediaries.

Banks Provide Consumer Protections and Disclosures in Deposit and Lending Activities

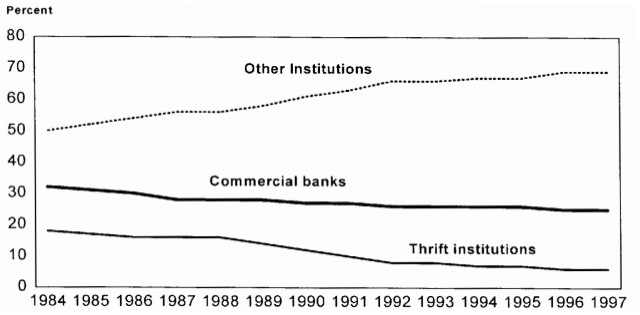
Depository institutions are required to purchase (i.e., through assessed premiums) deposit insurance, which protects consumers against a loss of their deposits (up to a statutory maximum amount) in the event of a bank failure. In addition, a number of laws benefitting consumers apply to depository institutions but not to other financial institutions. For example, the Expedited Funds Availability Act imposes a time limit within which a bank must make deposited funds available for withdrawal. The Truth in Savings Act imposes detailed rules governing everything from advertising disclosures and the contents of periodic statements to how depository institutions must calculate the account balance on which interest due is determined. Finally, the Real Estate Settlement Procedures Act requires that mortgage borrowers receive various disclosures (including good faith estimates and final statements of closing costs), places substantive limitations on the size of required escrow accounts, and generally prohibits payment for the referral of settlement business (e.g., a bank may not pay a real estate agent to refer customers to the bank for a mortgage loan). This act automatically applies to a bank when making certain mortgage loans but covers certain other financial institutions only if they make more than $1 million in residential real estate loans within a year.

Long-Term Loss of Competitive Strength

Well-intended legislative and regulatory restrictions over time have weakened the ability of banks to perform their special functions by hindering their ability to respond to market changes. For example, while other financial services providers have expanded their products or geographic reach, resulting in greater choices for traditional bank depositors and borrowers, banks were long restricted in their ability to offer such choices.[5] Bank customers also have different wants and needs today than in the past, and restrictions hinder banks' ability to respond. Furthermore, technological advances have enhanced the production and distribution of financial services, increasing competition with other financial services providers as well as helping new competitors emerge. As a result, the competitive strength of banks has declined over the long term.

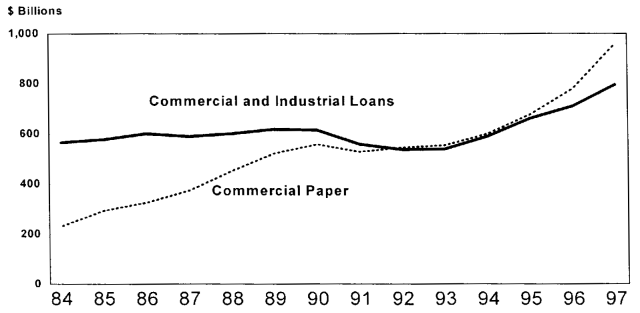
We see this in several ways. First, as Figure 1 indicates, the market share of assets of all financial institutions held by banks has declined for the last several decades. More and more of what used to be the core business of commercial banking—lending money to large corporate borrowers—has declined, as businesses are accessing the capital markets directly (Figure 2). Securities firms also compete with banks more directly by offering loans to businesses.[6] In addition, recent anecdotal evidence suggests that banks have become less competitive relative to finance companies in the origination of automobile loans.[7]

Figure 1—Percent of financial sectors' credit market assets held by commercial banks has declined



Source: Flow of Funds Report, Board of Governors of the Federal Reserve System.

Figure 2—Commercial paper exceeds bank C & I loans



Source: Flow of Funds Report, Board of Governors of the Federal Reserve System and Call Report data.

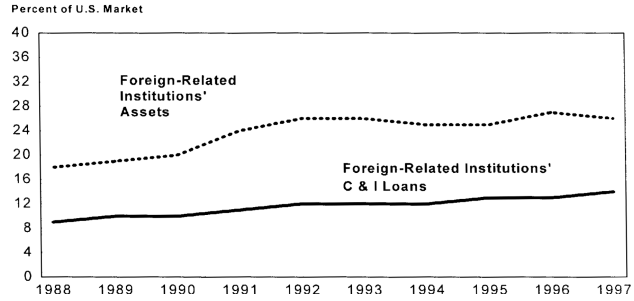
Next, even without significant legal or regulatory change, economic globalization has made financial services markets increasingly competitive (Figure 3). Within the United States, commercial bank assets held by foreign banks increased from 9 percent in December 1988 to 14 percent in December 1997. Foreign banks' share of total U.S. commercial banks' commercial and industrial loans

[5] The Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 eliminated the long-term restriction on interstate branching in recognition of the changes in the competitive environment.

[6] Knecht, G. Bruce. "Merrill Intends to Originate Major Loans," The Wall Street Journal, June 20, 1994, pp. A–2. More recently, in early May 1997, Merrill Lynch ran radio advertisements in the Washington, D.C. area (May 13, 1997, 5:55 am, WTOP [1500 AM]) offering working capital loans and other "banking products" to small businesses. For other examples of securities firms offering basic commercial lending services see Ben-Amos, Omri. "DLJ Banks on Junk Power for Lending Business," *American Banker*, June 25, 1997, p. 11. Also, American Express solicits small business loans over the Internet at http://www.americanexpress.com/smallbusiness/services/lending.

[7] McQuillen, Daniel. "On-line Auto Lending Seen Offering Banks an Advantage," *American Banker*, May 9, 1997, p. 10.

Figure 3—Foreign-related institutions increase their U.S. market share

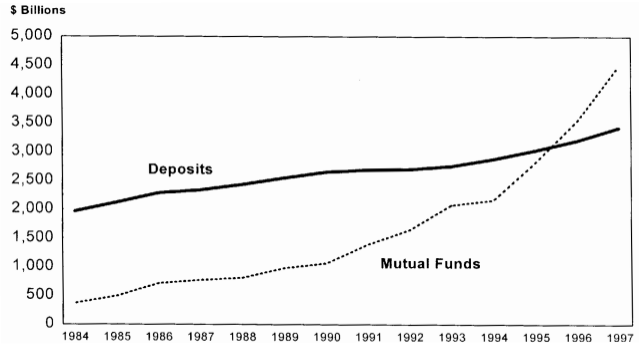


Source: H.8, Board of Governors of the Federal Reserve System, "Assets and Liabilities of Commercial Banks in the United States."

increased from 18 percent to 26 percent over that same time.[8]

Third, there has been a shift in consumer demand as investors moved their savings from insured deposits to mutual funds that offer an array of investment and risk/reward profiles. In 1996, for the first time in the history of the United States, assets held in mutual funds exceeded assets held in insured deposits, as shown in Figure 4. The percentage of U.S. households owning mutual funds grew from less than 5 percent in 1980 to over 37 percent in 1997.[9]

Figure 4—Mutual funds exceed bank deposits

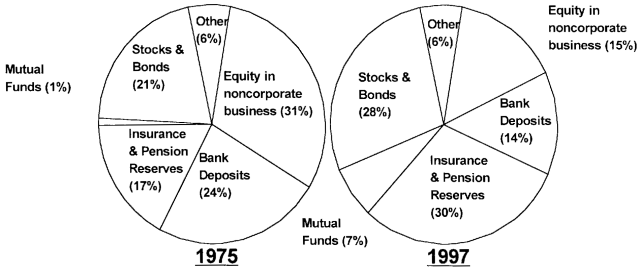


Source: Investment Company Institute and Call Report data.

Furthermore, the percentage of household and nonprofit organization financial assets invested in bank deposits decreased from 24 percent in 1975 to 14 percent in 1997, as shown in Figure 5. This decline indicates a major shift in the primary source of bank funding. Such a shift also represents movement away from liquid transaction accounts.

More recently, because of changing technology, banks face increasingly competitive challenges both within the industry and from nonbanks, including telecommunications companies and software development firms. Edwards and Mishkin have observed that "[a]dvances in information and data processing technology have enabled nonbank competitors to originate loans, transform these into marketable securities, and sell them to obtain more funding with which to make more loans."[10]

Figure 5—Bank deposits decline as a percentage of the financial assets of households and nonprofit organizations



Source: Flow of Funds Report, Board of Governors of the Federal Reserve System.

Why We Should Be Concerned

It is clear that banks have suffered a long-term loss in competitive position as their ability to respond directly to market challenges and adapt has been restricted. Why should Congress and federal policy makers be concerned if banks continue to diminish in relative importance as financial service providers? They should be very concerned because the diminution of the role of banks has implications for economic stability, for economic growth and development and for the implementation of other policy initiatives, especially with respect to communities and small businesses.

Empirical studies have shown that changes in the banking industry affect the economy. Bernanke and James (1991), for example, showed that economic downturns are worse if the banking system is unstable.[11] Furthermore, the long-term loss in bank competitive position weakens the ability of Congress to achieve its public policy goals by using banks as a conduit for policy initiatives. As Faresh explained in this discussion of the declining role of banking:

> As banks become increasingly less relevant, something must replace them in providing the coordinating and stabilizing functions required in a free

[8] Source: "Assets and Liabilities of Commercial Banks in the United States," H.8, Federal Reserve Board.

[9] Source: Investment Company Institute.

[10] Edwards, Franklin R., and Mishkin, Frederic S. "The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy," *Economic Policy Review*, Federal Reserve Bank of New York, July 1995, p. 32.

[11] Bernanke, Ben, and Harold James. "The Gold Standard, Deflation and Financial Crisis in the Great Depression: An International Comparison," in R. Glenn Hubbard, ed., *Financial Markets and Financial Crises*, Chicago, 1991, pp. 33–68.

market economy. At this point, no such institutional structure has emerged, nor is there one in sight."[12]

Nor has any other industrialized country developed a substitute for banks. In fact, Furash goes on to argue that although other financial services providers may flourish, "[t]hese emerging entities are neither strong enough nor comprehensive enough to pick up banking's economic role."[13] From these arguments, he concludes that "this is why we should care about strengthening banking."[14]

Even a decade before Furash made those remarks at the Chicago Fed's conference on the decline of banking, Diamond and Dybvig argued that public policy questions surrounding banks were highly relevant: "The important observation is that, even if banks were no longer needed for liability services and if they were constrained from performing their role in controlling the money supply, then important policy questions concerning banks would still arise since banks provide other important services. In other words, the banking system is an important part of the infrastructure in our economy."[15]

In summary, artificial constraints have prevented banks from adapting to changing market conditions. The role played by banks continues to be important to our economy and public policy concerns. It is costly to our economy to constrain banks unnecessarily and wait for other entities to emerge to fulfill the role played by banks. Instead, the wisest course is to remove unnecessary constraints on the ability of banks to adapt so that banks can continue to compete in the market and serve our economy and our communities.

How to Preserve this Critical Role

A Remedy for Banking: Prudent Diversification

It has long been acknowledged that the best way to enhance the ability of banks to provide benefits to the economy and their communities is to allow them to engage in an expanded, prudently defined range of activities, as long as the safety and soundness of the bank is not compromised. In 1987, the FDIC observed that "[t]here is almost universal agreement that something has to be done to allow banks and banking companies to become more competitive in a wider range of markets."[16] Several years ago, Franklin Edwards and Frederic Mishkin wrote, "To enhance competitiveness and efficiency of financial markets, banks could be permitted to engage in a diversified array of both bank and nonbank services."[17] Over the past year, several bills have been presented to Congress aimed in one way or another at enhancing the competitive opportunities of banks.[18]

Extensive empirical research demonstrates how diversification is critically important to maintaining a strong banking system. Modern portfolio theory teaches that firms with a diversified portfolio of activities can be financially stronger than non-diversified firms. Conversely, concentrations can hurt banks, depending on the timing of the business cycle. Diversified firms can experience, on average, less variable annual income compared to non-diversified firms. Also, diversified firms can achieve higher annual returns—but the same variability of returns—as non-diversified firms.[19] There is an extensive literature on how the theory works in practice for banks, and it supports the belief that diversification is good not only for banks but also for consumers of financial services.[20]

Allowing banks to diversify their financial and financially related activities will make them stronger and produce other benefits of increased competition. This is demonstrated by numerous empirical studies. For example, in a carefully reasoned review of the relevant studies, Silber (1979) calculated that competition from banks in the market for underwriting revenue bonds in 1977 could have saved state and local governments as much as $370 million.[21] In its 1987 decision to approve the so-called section 20 subsidiaries for bank holding companies, the Federal Reserve Board expressed its belief that banking company entry into new product markets would yield consumer benefits.[22] After evaluating studies of municipal revenue bond underwriting, Pugel and White (1994) concluded that similar savings would accrue to businesses if banks could underwrite corporate securities.[23] Studies of the benefits of bank sales of insurance

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[12] Furash, *op. cit.*, p. 25.

[13] Furash, *op. cit.*, p. 29.

[14] Furash, *op. cit.*, p. 25.

[15] Diamond and Dybvig, "Banking Theory, Deposit Insurance, and Bank Regulation." *Journal of Business*, 59, 1986, p. 62.

[16] Federal Deposit Insurance Corporation. *Mandate for Change: Restructuring the Banking Industry*. 1987, p. vii.

[17] Edwards and Mishkin, *op. cit.*, p. 42.

[18] H.R. 10 (Representative Leach); H.R. 268 (Representative Roukema); H.R. 669 (Representative Baker); S. 298 (Senator D'Amato).

[19] For a discussion of these points and how they are rooted in the theoretical work of Harry Markowitz, the founder of modern portfolio theory, see, Mote, Larry, R. "The Separation of Banking and Commerce," *Emerging Challenges for the International Services Industry*, JAI Press, 1992, pp. 197–230.

[20] For a review of this literature, see, Mote *op. cit.*, pp. 211–217, and Whalen, Gary. *Bank Organizational Form and the Risks of Expanded Activities*, Office of the Comptroller of the Currency, Economics Working Paper 97–1, January 1997, pp. 5–12.

[21] Silber, William. *Municipal Revenue Bond Costs and Bank Underwriting: A Survey of the Evidence*, New York University Graduate School of Business Administration, Monograph No. 1979–3, 1979.

[22] Federal Reserve Bulletin, Volume 73, April, 1987, p. 490.

[23] See Pugel, Thomas, and Lawrence White. "An Analysis of the Competitive Effects of Allowing Commercial Bank Affiliates to Underwrite Corporate Securities," in Ingo, Walter, ed., *Deregulating Wall Street*. New York: John Wiley & Sons, 1994, pp. 93–139.

are limited, but similarly encouraging. Ten years ago, the Consumer Federation of America sponsored such a study and reported that consumers would benefit from increased competition if banks entered the insurance business.[24] Furthermore, research indicates that bank entry into new geographic markets through branching leads to lower prices for banking services.[25]

The Question of Corporate Form

While there is high level of agreement that financial diversification is beneficial, extensive debate has ensued regarding the question of corporate form to be used by banks in offering a diversified array of financial products and services. Currently, the debate is whether to allow banks to use bank holding company (BHC) affiliates alone or to enable banks to have the choice to use BHC affiliates and bank subsidiaries.[26] Conceptually, the form under which a private business chooses to operate should be a matter of choice, absent compelling public policy considerations. Thus, the appropriate starting point ought to be that a bank should be free to choose between the two corporate forms unless public policy considerations disqualify one or the other choice. In the course of the recent debate on financial modernization, some have proposed that the use of bank subsidiaries be substantially disqualified. The public policy reasons given are that limiting the choice of organizational form is needed in order to preserve the safety and soundness of the bank or prevent transmission of any safety net subsidy from the bank to a subsidiary. In fact, careful examination of the evidence provided for such claims reveals no public policy reason to limit choice on either basis.

Why Corporate Form Matters

Enhancing Bank Safety and Soundness

Bank subsidiaries provide a means for the prudent diversification of bank activities, which enhances the long-term strength of banks. In this regard, the diversification of activities through bank subsidiaries *enhances* bank safety and soundness. Fees and other income from the subsidiaries will enable banks to offset the effects of cyclical downturns in other sectors of the economy. Hence, bank earnings would be less volatile, reducing risks to the banking system as a whole.[27]

By contrast, forcing banks to conduct an array of activities in BHC affiliates only would limit *bank* diversification. Franklin Edwards observed:

> With respect to maintaining the financial strength of banks, the use of wholly owned subsidiaries seems superior to that of a bank holding company affiliate structure. The earnings of a bank subsidiary are free to flow directly to the bank, so that subsidiaries would provide banks with a more diversified earnings structure than would the holding company model (where subsidiary earnings flow to the parent rather than to the bank affiliate of the holding company).[28]

The absence of expanded opportunities for banks and their operating subsidiaries will limit their ability to respond to changes in the marketplace and impose unnecessary costs that will render the bank less competitive. Either the assets and income stream of the bank itself will shrink, or the bank will feel pressure to reach ever farther out on the risk curve in "traditional" bank activities to be profitable and generate adequate returns to attract capital.[29] Banks will be less safe and sound, offer fewer choices to customers, be pressured to charge higher fees on the products and services they are allowed to offer, and be less able to serve the financial needs of their communities and their customers.

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[24] See Consumer Federation of America. *The Potential Costs and Benefits of Allowing Banks to Sell Insurance*, 1987.

[25] See, for example, Laderman, Elizabeth S., and Randall J. Pozdena. "Interstate Banking and Competition: Evidence from the Behavior of Stock Returns," *Economic Review*, Federal Reserve Bank of San Francisco, no. 2, 1991, pp. 32–47; Marlow, Michael L. "Bank Structure and Mortgage Returns: Implications for Interstate Banking," *Journal of Economics and Business*, 1982, pp. 135–142; and Calem, Paul S., and Leonard I. Nakamura. "Branch Banking and the Geography of Bank Pricing," Federal Reserve Board, Working Paper 95–25, 1995.

[26] The universal bank model used by other countries is not under consideration. Congress has long recognized the authority of national banks and other member banks of the Federal Reserve system to own operating subsidiaries. For example section 23A of the Federal Reserve Act specifically refers to member bank subsidiaries. For OCC authorization of operating subsidiaries see 12 CFR 7.10, 39 *Federal Register,* 11459 (August 31, 1966); *Comptroller's Manual for National Banks*, Rulings, paragraph 7376 (January 1969); Interpretive Ruling 7.7376, (1971); and 12 CFR 5.34 (1983 to date). For a detailed legal analysis of national bank operating subsidiaries, see memorandum from Williams, Julie L., Chief Counsel, OCC, "Legal Authority for Revised Operating Subsidiary Regulation," dated November 18, 1996, that was attached to Eugene Ludwig, Comptroller of the Currency, Testimony before the Subcommittee on Financial Institutions and Regulatory Relief of the Banking, Housing and Urban Affairs Committee of the U.S. Senate, available on the OCC's Internet Web site at http://www.occ.treas.gov as News Release 97–42. [Attachment omitted from Web site; for a copy, send a written request for Attachment 2 to New Release 97–42 to the Public Information Room, Communications Division, Washington, DC 20219 or by fax at 202–874–4448 or e-mail to Kevin.Satterfield@occ.treas.gov.]

[27] See, for example, Rose, Peter S. "Diversification of the Banking Firm," *The Financial Review*, 24, May 1989, pp. 251–280.

[28] Edwards, Franklin R. *The New Finance*, AEI Press, 1996, p. 158.

[29] See, for example, Edwards and Mishkin, *op. cit.*, p. 27.

By enhancing bank safety and soundness, bank subsidiaries also strengthen the deposit insurance funds. Federal Deposit Insurance Corporation (FDIC) Chairman Ricki Helfer noted that "[w]ith appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having earnings from new activities in holding company affiliates."[30] Also, in the event of failure, the assets of the subsidiary are fully available to the FDIC to cover the costs of failure resolution. By contrast, there are no cross-guarantee provisions for nonbank affiliates to assist a troubled bank, and under prompt corrective action, the amount that a bank holding company or companies can be required to contribute to an ailing bank subsidiary to bring it back into capital compliance is actually *limited to a maximum of 5 percent of the bank's total assets* at the time it became undercapitalized.

Enhanced Implementation of Public Policy Goals

By enhancing bank safety and soundness, bank subsidiaries also can improve the effective implementation of those laws that are meant to address other public policy goals. The bank subsidiary structure can increase the resources available to support the development and prosperity of all communities, particularly those including lower- and middle-income Americans. Banks have played a vital role in this area historically, and financial modernization must not reduce incentives for institutions to provide broad consumer access to financial services and credit to all sectors of our society.

The Community Reinvestment Act (CRA), mentioned earlier, is a significant program that helps provide consumers access to financial services and credit. The bank subsidiary structure can enhance a bank's capacity for CRA activities. While it is true, as some have pointed out, that bank subsidiaries' and affiliates' lending (and other) activities count toward the CRA performance at the option of the depository institution (thus, CRA does not apply *directly* to bank subsidiaries or bank affiliates), the OCC explicitly recognizes that, in assessing a bank's ability to perform its obligations under CRA, the assets of the bank and its subsidiaries must both be considered. OCC Bulletin 97–26 provides that, in developing and documenting a national bank's "performance context" in connection with a CRA evaluation, OCC examiners "will review the institution's corporate structure and affiliations, its business strategy and major business products, its targeted markets or communities, its distribution methods to serve those communities, and its financial condition, capacity, and ability to lend or invest in its community."[31]

The consolidated assets of the bank and its subsidiaries are relevant to determining the "bank's capacity to lend or invest in the community." If a national bank subsidiary has significant assets and income, the bank's financial capacity and ability to lend and invest in its community is greater. Since *banks* are, today, the only type of entity directly subject to CRA, stronger banks, which have greater potential for growth through subsidiaries and, because of greater capacity, face greater regulatory expectations about CRA performance, are better situated to help meet the credit and financial services needs of their communities.

Promoting Competition and Increasing Efficiency

Moreover, in order to compete effectively in the financial services marketplace of the future, banks *of all sizes* need to have the ability to choose the organizational structure that will best enable them to operate efficiently and compete effectively. When faced with the large financial conglomerates that would be authorized under proposed financial modernization legislation, banks of all sizes should not be subject to artificial constraints on their ability to compete. For example, very large financial conglomerates may be able to realize cost savings through the expanded use of technology and economies of scale and scope. This allows them to absorb costs and trade off inefficiencies resulting from being forced to operate within a particular corporate structure. Smaller banks will not have a similar opportunity to reduce the costs of providing new products and services through a structure that may be inefficient for them.

There are also currently 2,141 independent banks—i.e., banks without a bank holding company—representing 23 percent of all banks.[32] Many of these independent banks are community banks facing significant challenges in today's environment. Their sources of income are less diversified than larger banks because they tend to serve smaller communities and market niches. Providing small banks with safe and sound opportunities to strengthen their capacity to compete is clearly in the public interest. For independent community banks, the bank subsidiary option can be simpler and less costly than the BHC structure when providing new products and services. Compared to the BHC affiliate approach, there are fewer corporations, and lower administrative overhead. John Carusone, President of the Bank Analysis Center, has pointed out that the cost of establishing a BHC for a $103 million bank was about $35,000, and could be higher for

[30] Helfer, Ricki. Testimony on Financial Modernization before the Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997. Available on the Internet at http://www.fdic.gov/publish/speeches/97spchs/sp05mar.html.

[31] OCC Bulletin 97–26, July 1997, p. 1.

[32] As of December 31, 1997. Source: call report data.

other banks. He also noted that there are ongoing costs such as multiple sets of books and boards of directors.[33] For small banks in particular, these costs are a needless burden, and waste resources that could be better used to make loans and promote economic growth.

Finally, even as bank size increases, the need to keep costs under control remains strong, and the cost efficiencies of the bank subsidiary option remain obvious. In particular, for large banks, the bank subsidiary option can improve their comparative competitive efficiency by providing them with the same organizational flexibility in U.S. and foreign markets as their international rivals, improving the banks' ability to compete more effectively on a global scale.

Why the Arguments Against Bank Subsidiaries Are Misconceived

Given all of the benefits of the bank subsidiary, it is perplexing to suggest that its use be restricted. Yet, some have portrayed the bank subsidiary as the inferior, riskier organizational choice for the banking system. Such arguments are simply misconceived.

Safety and Soundness

There is vast literature comparing bank subsidiaries with nonbank affiliates. There is no evidence that financial activities, subject to basic safeguards, pose greater risk to the bank when they are conducted in a bank subsidiary than when they are conducted in the BHC affiliate. There are a number of experts who have adopted this position. In 1987, the General Accounting Office opined, "One cannot say that one structure insulates the bank while the other does not."[34] FDIC Chairman L. William Seidman testified before Congress, "If banks are adequately insulated . . . then, from a safety and soundness viewpoint, it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks."[35] In discussing the bank subsidiary option, William M. Isaac, in his role as chairman of the FDIC, stated that "[c]ertainly there's no more risk than would be present if the activities were conducted in a holding company affiliate."[36] Similarly, in a very recent analysis, Longstreth and Mattei found:

> . . . neither structure is so defective, in terms of regulatory objectives, that banking groups ought to be denied the right to use it; that the bank subsidiary model has substantial regulatory advantages over the BHC subsidiary model; [and] that the value of the safety net subsidy is marginal, if not negative, for all but the smallest institutions. . . .[37]
>
> [Assertions that nonbanking activities would cause harm to the bank] are logically flawed—insofar as they presuppose that a bank would act otherwise than in its own best interest when dealing with a subsidiary—and fail to give adequate weight to the corporate separateness of bank subsidiaries and the limited liability enjoyed by their shareholders.[38]

More recently, Bernard Shull and Lawrence White concluded that the operating subsidiary structure may be preferable to the BHC affiliate approach in their comparison of organizational structures:

> The choice of appropriate banking structure for a world of expanded banks and banking is not an easy one. . . . [H]owever, both the holding company affiliate arrangement and the operating subsidiary structure appear to be safer than the universal bank for non-traditional activities that are not examinable and supervisable by bank regulators. The operating-subsidiary structure, on the basis of efficiency, diversification, insolvency risk, and transfer of any marginal safety-net subsidies appears to offer modest advantages relative to the holding company structure. Accordingly, the op-sub structure as an alternative seems a prudent policy course for U.S. banking regulation.[39]

Although most major industrialized countries have explicit deposit insurance systems similar to the United States, no other country except Japan imposes such significant restrictions on their banks' powers or corporate structure. During the banking problems of the late 1980s and early 1990s, U.S. banking firms did no better than banks in other G–10 countries.[40] This suggests that the tight corporate restrictions imposed by the govern-

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[33] Sullivan, Joanna. "More Small Banks and Thrifts Setting Up Holding Companies," *American Banker*, June 4, 1997, p. 6. The article did not provide documentation in support of the headline, citing only two institutions, one of which was over a billion dollars in total assets.

[34] General Accounting Office. Bank Powers: *Insulating Banks From the Potential Risks of Expanded Powers*, 1987, p. 36.

[35] Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, December 3, 1987.

[36] Isaac, William. "OCC Rule on Subsidiaries is Sound Public Policy," *American Banker*, December 19, 1996, p. 5.

[37] Longstreth, Bevis, and Ivan E. Mattei, "Organizational Freedom for Banks: The Case in Support." *Columbia Law Journal*. 97:6, October 1997, p. 1899.

[38] *Ibid*., p. 1895.

[39] Shull, Bernard, and Lawrence J. White. "The Right Corporate Structure for Expanded Bank Activities." *Banking Law Journal,* May 28, 1998, pp. 446–476.

[40] Barth, James R., Daniel E. Nolle, and Tara N. Rice. "Commercial Banking Structure, Regulation, and Performance: An International Comparison," OCC Economics Working Paper 97–6, March 1997, p. 34.

ment in this country are no more effective in limiting risk than the more flexible corporate structures bank supervisors allow in other developed countries.

Domestic experience with financial activities conducted by bank subsidiaries shows that there are no disqualifying safety and soundness concerns. FDIC Chairman Ricki Helfer summarized her agency's experience as follows:

> While the experience of the FDIC with bona fide securities subsidiaries of insured nonmember banks has been limited, these subsidiaries generally have not posed safety and soundness concerns. Only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities permitted by the FDIC, but over 400 insured nonmember banks have subsidiaries engaged in more limited securities-related activities. These activities include management of the bank's securities portfolio, investment advisory services, and acting as a broker-dealer. With one exception, none of these activities has given cause for a significant safety and soundness concern.[41]

Similarly, foreign experience with financial activities conducted by U.S. bank subsidiaries shows no substantial safety and soundness concerns. In a preliminary analysis, Gary Whalen, an Office of the Comptroller of the Currency economist, produced evidence demonstrating that permitting U.S. banking organizations to engage in securities activities overseas through direct and indirect bank subsidiaries has not had a significant, deleterious impact on their performance. This empirical evidence is drawn from an extensive analysis of the performance of the foreign securities subsidiaries of U.S. banking companies over the relatively lengthy 1987–1996 time period. The data analysis, as well as a more detailed examination of the performance of individual holding companies, indicate that banking companies can *lower their risk* by engaging in overseas securities activities through bank subsidiaries.[42]

Safeguards

During the 1997 debate over financial modernization, the Treasury Department proposed an extensive set of corporate and supervisory safeguards to ensure that any new financial activities, conducted in a bank subsidiary that could not be conducted by the bank itself, *enhance* rather than impair the parent bank's safety and soundness. Under Treasury's proposal, these safeguards would apply regardless of the particular activity undertaken by the special bank subsidiary and generally would provide equivalent protections for activities undertaken by either subsidiaries or affiliates. Also, in many cases, activities would be regulated on a functional basis by another regulator.

The specific safety and soundness safeguards proposed by the Treasury Department would apply to bank subsidiaries undertaking new financial activities that could not be undertaken by the bank itself. These safeguards include the following:

- The bank would have to be well-capitalized and well-managed, and would face sanctions for failing to meet these standards;
- The amount of any equity investment made by a parent bank in a subsidiary would have to be deducted from the bank's capital in determining whether it satisfied the "well-capitalized" standard; and the assets and liabilities of the subsidiary may not be consolidated with those of the bank. Thus, if the subsidiary were to fail, the bank's regulatory capital would not be affected and the bank's economic loss could not exceed the amount of its investment;
- Sections 23A and 23B of the Federal Reserve Act would be applied to transactions between the parent bank and its subsidiary(ies). These provisions prohibit a bank from lending more than 10 percent of its capital to any one affiliate, prohibit a bank's combined loans to all affiliates from exceeding 20 percent of the bank's capital, and require that all loans and other transactions between a bank and its affiliates be fully collateralized and at arm's-length, market terms. The section 23A capital limitations would not apply to a bank's equity investment in a subsidiary;
- Although a bank under current law or proposed legislation can pay *dividends* to its holding company for an investment in new activity without being subject to sections 23A and 23B, an appropriate safeguard—in addition to the requirement that it deduct from its capital its equity investment in the subsidiary—would prohibit the bank from making a downstream equity investment in the subsidiary in excess of the amount that it could legally pay out as a dividend;
- The parent bank with a financial subsidiary is required to assure that it has procedures for identifying and managing financial and operational risks within the bank and its financial subsidiary to adequately protect the bank from such risks and assure that it has reasonable policies and procedures to preserve

[41] Helfer, *op. cit.*

[42] Whalen, Gary. "The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns," Office of the Comptroller of the Currency, Economics Working Paper 98–2, February 1998.

the separate corporate identities and limited liability of the bank and its financial subsidiaries.

Furthermore, it is simply incorrect to assert that the holding company structure better insulates the bank from the risks of new financial activities conducted in an affiliate because courts are more likely to hold the bank liable for activities of a bank subsidiary than for activities of a bank affiliate. In fact, statistics indicate that it is *more difficult to pierce the corporate veil* between a parent and its subsidiary than between that parent company and a sister company (e.g., a bank holding company affiliate).[43] Whether a bank's corporate veil is pierced by a court depends on how the entity's operations were conducted, not on the entity's location in a corporate organizational chart.

Similarly, proponents of the bank holding company approach have asserted that accounting conventions make a holding company affiliate a better choice than a bank subsidiary for conducting new financial activities. One argument is that because generally accepted accounting principles (GAAP) require consolidation of a bank and its subsidiary's financial statements, national banks would have strong incentives to rescue troubled subsidiaries. It is also argued that subsidiary losses, reflected in the consolidated financial statements, would cause depositors and investors to lose confidence in the bank. These arguments, too, upon close review, are not sustainable.

First, accounting standards do not determine corporate liability; rather they provide a measure of an institution's financial condition. When financial reports are consolidated, companies are reporting their assets and liabilities on a combined basis, but they do not become legally responsible for each other's liabilities. Those statements simply reflect a reporting convention. Second, holding company financial statements also reflect the consolidation of the financial statements of its subsidiary entities. Thus, the same incentives exist for a holding company and its subsidiary bank to bail out their affiliates. Bank holding company statements reflecting financial difficulties could cause equal or greater concern to investors and depositors. Third, accounting rules require the deconsolidation of subsidiary financial statements when a bank no longer controls a subsidiary, when it is ordered to sell or liquidate the company, or when a subsidiary goes bankrupt. At that point, a bank's financial statements would reflect the true economic loss to a bank, which would never be greater than its actual investment in the subsidiary (already deducted from capital) and any limited credit exposure under section 23A limits.

Finally, it can be credibly argued that, to the extent the corporate structure of a bank affects its safety and soundness, safety and soundness is *enhanced* when the financial and economic interests of the bank and its subsidiaries are more closely aligned. In their analysis of the arguments in favor of organizational freedom for banks, Longstreth and Mattei make the following critical point:

> Requiring that activities be conducted in a bank affiliate rather than in the bank introduces its own set of risks that can generically be labeled the risks of self-dealing. . . . A BHC is in control of its various subsidiaries and may have an incentive to cause them to engage in transactions with each other or with itself that accrues to the BHC's benefit and perhaps one or more of its subsidiaries while at the same time disadvantaging other subsidiaries within the group. When the bank, as one of those subsidiaries, is disadvantaged, its soundness suffers. By contrast, with the bank at the top, the potential for harm to bank soundness from self-dealing transactions is largely eliminated by operations of the structure alone. . . . With the bank at the top, it is not possible for the bank, through self-dealing, to hurt itself deliberately.[44]

The Question of the Safety Net Subsidy

Some contend that the use of bank subsidiaries should be limited because banks allegedly transfer the advantage of a safety net "subsidy" to their subsidiaries.[45] There is no evidence that banks are subsidized in a manner that gives them a special competitive advantage; nor that the BHC structure is uniquely effective in limiting any advantage a bank may gain from access to the federal safety net. The evidence cited below suggests strongly that banks do not benefit from any *net* subsidy. For example, Chairman Helfer of the FDIC stated the following:

> . . . [T]he evidence shows that, if banks receive a net subsidy from the federal safety net, it is small, and that both the bank holding company structure and the bank subsidiary structure would inhibit the passing of any net subsidy that does exist out of the insured bank. Thus, the potential expansion of the federal safety net is not a reason to prefer one organizational structure over the other.[46]

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[43] Longstreth and Mattei, *op. cit.*, p. 1906.

[44] Longstreth and Mattei, *op. cit.,* pp. 1903–1904.

[45] The "safety net subsidy" or "federal safety net" refers to the benefits that banks receive through their access to federal deposit insurance, and the Federal Reserve's discount window and payments system. It has been asserted that these benefits give banks a funding advantage over nonbanks and create incentives for banks to take on greater risks.

[46] Helfer, *op. cit.*

Moreover, the same rules that today contain the transfer of any alleged subsidy by a bank to its affiliates—sections 23A and 23B of the Federal Reserve Act—may be imposed on bank subsidiaries to effectively prevent transfer of any possible subsidy to a subsidiary as well.

Recent legislative and regulatory measures have reduced any gross benefit to banks arising from the so-called federal safety net. Such measures have decreased the amount of benefit accruing to troubled institutions and have increased the cost of safety net features. These measures include the Basle Accord of 1988, in which the regulatory agencies tied regulatory capital requirements to risk and adopted minimum risk-based capital standards; and several provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The provisions of FDICIA include the prompt corrective action provisions that require regulators to close a troubled institution before the book value of its equity reaches zero, reducing the loss to the deposit insurance fund. They also include the least-cost test that requires the FDIC to resolve failed banks at the least cost to the deposit insurance funds, increasing the likelihood that uninsured depositors and other general creditors would suffer losses in the resolution of a failed bank. Similarly, FDICIA greatly limited the ability of the regulators to prevent the failure of large banks, the "too-big-to-fail" policy of the past. Other provisions in FDICIA restricted the terms under which an undercapitalized bank can access the discount window. Legislative and regulatory changes also have reduced any subsidy that could have arisen from inaccurately priced access to the federal safety net by requiring the FDIC to enact a system of risk-related deposit insurance premiums that is based on the financial institution's perceived level of risk to the insurance fund.

Empirical analysis demonstrates that regulatory costs outweigh any gross safety net benefit. The existence of a "subsidy" would imply that banks receive benefits without paying for them. Banks bear significant costs in return for access to the safety net. They are subject to a number of regulations, which impose operational limitations to protect their safety and soundness and to protect consumers. Laws and regulations also govern entry and exit, geographic and product expansion, fiduciary activities, and the quality of internal and external information systems. They also provide measures ensuring equal access to credit.

The costs associated with regulation are direct and indirect; consequently, it is difficult to estimate the total costs accurately. In a study of banking industry data,[47] the Federal Financial Institutions Examination Council estimated that in 1991 banks paid anywhere from 6 percent to 14 percent of non-interest operating expenses to comply with requirements imposed by law and regulation. These cost estimates did not include costs associated with maintaining required reserves or interest payments on FICO bonds.[48] For 1995, the lower bound of the FFIEC estimate would suggest that the aggregate regulatory costs borne by banks was roughly $9 billion, or 35 basis points, when expressed as a percent of total deposits in insured banks.

Not surprisingly, banks do not behave as if there is a safety net subsidy. If a subsidy existed, banks would conduct their business to exploit that subsidy fully and would dominate the markets they seek to serve. Such skewed behavior is not evident in the way banks fund themselves or structure themselves. Nor do banks dominate the businesses in which they are engaged.

For example, if banks enjoy a lower cost of funds because of benefits accruing from the safety net, we would expect to see banking organizations issue debt exclusively at the bank level. Instead, we see debt issuances by banks, bank holding company parents, and nonbank affiliates. Furthermore, if there were a subsidy, banks could take best advantage of it by selling their debt directly to the public. Instead, most bank debt is issued to the parent holding company, which in turn funds this purchase by issuing commercial paper. If the deposit insurance subsidy were important, banks would rely almost exclusively on insured deposits as their source of funds. In fact, less than 60 percent of commercial bank assets are supported by domestic deposits, and some banks hardly use them. As of December 1997, domestic deposits at the 10 largest commercial banks ranged from 6 percent to 88 percent of liabilities. Among the top 10 banks, foreign deposits, which are not insured, currently compose as much as 61 percent of liabilities.[49]

The use of bank subsidiaries and bank holding company affiliates is another area of bank behavior bearing on the subsidy issue. If banks benefitted from a subsidy not available to the holding company, banks would locate all activities in bank subsidiaries and not in bank holding company affiliates, when they are permitted to choose between those two options. Again, bank behavior is not consistent with the presence of a subsidy. For example, banks can locate their mortgage banking operations in a bank, a bank subsidiary, or in an affiliate of a holding

[47] Federal Financial Institutions Examination Council, "Study on Regulatory Burden," December 17, 1992.

[48] These costs were estimated at 4.6 basis points by the FDIC. See Testimony of Ricki Helfer, Chairman, FDIC, on Financial Modernization before the Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997 [http://www.fdic.gov/publish/speeches/97spchs/sp05mar.html].

[49] Call report data as of December 1997.

company. Table 1 lists activities—such as consumer finance, mortgage banking, leasing and data processing—that banking companies offer through both holding company affiliates and bank subsidiaries.

Table 1—Most Common Nonbank Affiliates of Bank Holding Companies and Subsidiaries of Banks: 1996[50]

Type of Nonbank Subsidiary	Number of Subsidiaries, Bank Holding Companies	Number of Subsidiaries, Banks
Consumer finance	318	124
Leasing personal or real property	191	365
Mortgage banking	129	201
Data processing	123	96
Insurance agency or brokerage services[51]	72	74
Commercial finance	46	39

In offering many of the activities shown in the table above, banks compete side by side with nonbank providers. If banks had a competitive advantage, they would dominate over other providers. However, in many fields, nonbank providers have a bigger market share than banks. As of December 1996, three out of the top five largest servicers of residential mortgages were nonbanks, and three of the top five originators of mortgages were nonbanks.[52] The Federal Reserve, in fact, has stated persuasively that banks engaging in permissible securities activities do not dominate their respective markets, either.[53]

Additionally, evidence offered to support the subsidy claim simply does not withstand scrutiny. Several points cited in support of the existence of a subsidy are: 1) bank debt is rated higher than that of its parent bank holding company; 2) banks hold less capital than other financial institutions; 3) corporations are not leaving the banking business; and 4) bank holding companies are shifting activities from affiliates to banks or bank subsidiaries. In fact, none of these points demonstrates the presence of a safety net subsidy.

First, the small differential between the ratings of debt issued by banks and debt issued by bank holding companies is not due to a safety net subsidy. In 1996, this rating differential resulted in a cost of funds for bank holding companies that was only 4 to 7 basis points higher than the cost of funds for individual banks. According to the rating agencies, the difference is due to the federal banking agencies' ability to use prompt corrective action powers to limit bank payments to the holding company if the bank is undercapitalized.[54] A bank holding company is a shell corporation, with most of its assets held by, and income generated by, the subsidiary bank(s). Reductions in the flow of funds from the banks to the corporate shell decreases the debt-paying capacity of the holding company parent.

The second argument—that banks hold less capital than virtually all other financial institutions—is flawed, because it makes no sense to compare capital ratios of different industries in isolation from their relative risk. Also, differences in regulatory capital requirements reflect differences in the regulator's views of the purposes of capital and the different historical risks faced by firms in different sectors. For example, two institutions engaged in very different lines of business could have distinctively different risk profiles. The market would demand a higher equity-to-assets ratio of the firm that holds much riskier assets in its portfolio. Thus, merely comparing the capital ratios of industries in the financial sector to those in other economic sectors is insufficient; and a finding that banks' ratios are lower does not prove that there is a subsidy.

Third, some observers have argued that the fact that corporations are not leaving the banking business is evidence that a subsidy exists. However, various facts about the industry undermine this argument. If there were substantive barriers to entry, no one was leaving the business, and no other factors were at work, banks should experience excessive profits and a growing market share. The facts are not consistent with those implications. Bank profits, while strong in recent years, are not disproportionately higher than other competitors in the financial services industry.[55] Bank stock price-to-

[50] Data as of September 30, 1996. Includes all direct subsidiaries of the bank or holding company. All banks in this analysis were members of holding companies. Source: Federal Reserve Board National Information Center.

[51] Insurance agency or brokerage services related to credit insurance.

[52] "Ranking the Banks: Statistical Review 1996," *American Banker*.

[53] In its 1987 ruling, "Order Approving Activities of Citicorp, J.P. Morgan, and Bankers Trust to Engage in Limited Underwriting and Dealing in Certain Securities, Legal Developments," the Federal Reserve Board stated, "The Board notes that banks do not dominate the markets for bank-eligible securities, suggesting that the alleged funding advantages for banks are not a significant competitive factor."

[54] See, for example, Standard & Poor's BankRatings Service. New York, S&P, 1996. Updated quarterly.

[55] According to data presented in the *Property/Casualty Fact Book 1997* published by the Insurance Information Institute, banks had a lower annual rate of return than diversified financial services firms for all but two years in the period 1986 through 1995, the last year for which comparable data are available. However, as is true when comparing capital ratios, it is difficult to make a direct comparison of profits without making a risk adjustment. In other words, it is

earnings (P/E) ratios have averaged only about 60 percent of P/E ratios of other businesses.[56] Also, banks' market share, measured by income-based data, has remained flat at least since the late 1950s.[57] Moreover, industry consolidation, which is a form of exiting from banking, is at odds with the existence of a subsidy.

Finally, those who are seeking to prove the existence of a subsidy cite more recent developments as evidence. In particular, they point to a reported drop over the last decade in the share of bank holding company assets held by nonbank subsidiaries, after removing the section 20 affiliates (firms engaged in Federal Reserve-approved securities activities). The argument seems to be that such a shift is motivated by a desire to exploit a subsidy available to banks and their subsidiaries but unavailable to affiliates of bank holding companies. However, evidence does not support the notion that the shift—if one has in fact occurred—is due to a subsidy.

This is true for two reasons. First, it is simply unclear that such an asset shift has actually occurred. There are no current systematic data available to document that a shift occurred. The existing data are problematic for several reasons: Between 1994 and 1995, the Federal Reserve changed the instructions governing the filing of the asset data used in the calculation of the reported shift in order to reduce, if not eliminate, apparently widespread, year-by-year reporting errors. The presence of these reporting errors and the changes in reporting instructions mean that we cannot make accurate year-to-year comparisons. Indeed, the absence of comparability could fully account for the reported drop in the holding company affiliate share of bank holding company assets.

Second, various explanations account for banking organizations moving activities from holding company affiliates to banks and bank subsidiaries. Importantly, over the past decade, the relaxation of geographical and other barriers to interstate banking has permitted banking companies to engage in the interstate conduct of lines of business in banks that they could previously conduct only through holding company subsidiaries. That flexibility could lead banking organizations to shift assets from long-established holding company subsidiaries in those states to banks or bank subsidiaries. Moreover, firms consolidate their operations for many reasons, including the desire for increased efficiency. Recent experience with intrastate and interstate branching demonstrates the efficiency gains of organizational flexibility. Research on intracompany mergers finds that choice of organizational form is an important determinant of the efficiency of a company's operations. These mergers enable banking organizations to streamline their operations and better serve their customers.[58] After many states eased restrictions on intrastate branching, most banking companies responded by consolidating all of their existing subsidiaries into branch banks, although this was not the universal response.[59]

Conclusion

Historically, banks have played a special and critical role in our economy as catalysts of economic opportunity in our communities. This role has shifted over the years, both in response to competitive forces and to well-intended and now outdated restrictions that are hindering bank evolution. Technological and competitive forces are continuing to challenge the banking industry, and we must be concerned about the effect of change on the role played by banks in our economy. To preserve banks' critical role, banks must be allowed to prudently diversify their financial and financially related activities. In doing so, each bank should be allowed to choose the organizational form that best suits its needs. Corporate form matters, and to force new activities into the holding company structure will limit the ability of the banking industry to respond to changes in the marketplace and impose unnecessary costs that will render banks less competitive. The bottom line is that, as long as appropriate prudential safeguards are in place, banks should have the choice to engage in a diverse array of financially related activities through their subsidiaries.

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difficult to determine whether profits are commensurate with risks undertaken.

[56] According to data by Keefe, Bruyette & Woods, Inc., commercial bank P/E ratios as a percentage of the S&P 500 P/E ratio averaged 62 percent for the six years ending April 15, 1997.

[57] Kaufman, George, and Larry Mote, "Is Banking a Declining Industry? A Historical Perspective," *Economic Perspectives*, Federal Reserve Bank of Chicago (May/June 1994), pp. 2–21.

[58] DeYoung, Robert, and Gary Whalen, "Is a Consolidated Banking Industry a More Efficient Banking Industry?" *OCC Quarterly Journal* (Vol. 13, No. 3), September 1994.

[59] DeYoung, Robert, and Gary Whalen, "Banking Industry Consolidation: Efficiency Issues," Working Paper No. 100, The Jerome Levy Economics Institute, April 1994.

Statement of Robert B. Serino, Deputy Chief Counsel, Office of the Comptroller of the Currency, before the U.S. House Committee on Banking and Financial Services, on the anti-money-laundering initiatives of the Office of the Comptroller of the Currency and proposed legislation, Washington, D.C., June 11, 1998

Statement required by 12 USC 250. The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the committee, we appreciate the opportunity to testify today about the Office of the Comptroller of the Currency's (OCC's) anti-money-laundering efforts. Money laundering is a serious international law enforcement problem that may never be completely eradicated. However, we remain aggressive and vigilant in our efforts to combat this problem in the banks that we supervise. We welcome the committee's continuing interest in these matters, and commend the committee for focusing attention on money laundering and the problems that it poses.

In your invitation letter, you requested that we address two areas in our testimony today. First, you requested that we address the OCC's anti-money-laundering regulatory and enforcement efforts. Second, you requested that we provide our views regarding the two pieces of legislation that you, Mr. Chairman, and Congresswoman Velazquez have proposed to strengthen the federal government's authority to detect and prosecute money-laundering offenses.

The OCC has a long-standing commitment to combating money laundering. We have always shared the committee's belief in the importance of preventing the financial institutions we regulate from being used wittingly or unwittingly to aid in money laundering. We remain totally committed to working with the law enforcement community to assist in the investigation and prosecution of organizations and individuals who violate the law and engage in money laundering.

Acting Comptroller Julie Williams is committed to continuing our anti-money-laundering efforts. In June 1997, the OCC formed a task force within the OCC, called the National Anti-Money-Laundering Group (NAMLG), to serve as the agency's focal point for Bank Secrecy Act (BSA) and anti-money-laundering supervision, and we have adopted a number of new anti-money-laundering initiatives that I will describe to you shortly.

I. OCC's Anti-Money-Laundering Activities

Background

Money laundering is the movement of criminally derived funds for the purpose of concealing the true source, ownership, or use of the funds. Until 1970, when the BSA was signed into law, there were few laws and regulations aimed at combating money laundering. The BSA establishes requirements for record keeping and reporting by private individuals, banks, and other financial institutions. The BSA was created to help identify the source, volume, and movement of currency and other monetary instruments into or out of the United States or being deposited in financial institutions. It enables law enforcement and regulatory agencies to use that information in investigations of criminal, tax, and regulatory violations.

In 1986, Congress strengthened the anti-money-laundering laws by passing the Money Laundering Control Act. Under this statute, it is a criminal offense for a person or institution to knowingly assist in the laundering of money, or to structure transactions to avoid reporting.

Supervisory Efforts

The primary responsibility for compliance with the BSA and the money-laundering statutes rests with the nation's financial institutions themselves—they represent the front lines in the fight against money laundering. The OCC has a statutory mandate to ensure that national banks operate safely and soundly and comply with applicable laws. Where deficiencies are noted, we take supervisory and enforcement actions to ensure that the bank promptly corrects them.

The OCC conducts regular examinations of national banks and branches and agencies of foreign banks in the United States, covering all aspects of the institution's operations, including compliance with the BSA and review of anti-money-laundering efforts. The OCC monitors compliance with the BSA and money-laundering laws through its BSA compliance and money-laundering-prevention examination procedures. In September 1996, the OCC issued a new booklet from the *Comptroller's Handbook* (handbook) on BSA compliance. The handbook booklet contains procedures designed to assess BSA compliance as well as identify money laundering in accordance with the mandate in section 404 of the Money Laundering Suppression Act of 1994, which requires the federal banking agencies to develop enhanced examination procedures to better identify money laundering. The procedures were developed by the OCC, in cooperation with the other federal banking agencies. The handbook booklet also contains guidance in key areas such as the development of an effective "know your customer" program.

Strong internal policies, systems, and controls are the best assurance of compliance with the reporting and record-keeping requirements of the BSA and the money-laundering laws. Consequently, the handbook's mandatory procedures focus our examination efforts on a national bank's system of internal controls, audits, policies, and procedures in the BSA and money-laundering areas. When examiners note control weaknesses or when we receive a lead from a law enforcement or other external source, the examiners are directed to test the bank's policies, systems, and controls by utilizing supplemental procedures and reviewing certain individual transactions.

Combating money laundering depends on the cooperation of law enforcement and regulatory agencies. Therefore, the OCC participates in a number of interagency working groups aimed at money-laundering enforcement, and meets on a regular basis with law enforcement agencies to discuss money-laundering issues and share information that is relevant to money-laundering schemes. Through these interagency contacts, we often receive leads as to possible money laundering in banks that we supervise. Using these leads, we can target compliance efforts in areas where we are most likely to uncover problems. For example, if the OCC receives information that a particular account is being used to launder money, our examiners would then review transactions in that account for suspicious funds movements.

In cases where the OCC suspects that serious violations of the BSA or money laundering have occurred, the OCC conducts investigations. Once the OCC opens an investigation, the OCC can use its administrative subpoena power to compel the production of documents and testimony from individuals and entities both inside and outside of the bank. This information is not only used for our supervisory purposes, but, when it is relevant to a potential criminal violation, it is shared with the appropriate criminal law enforcement agencies. We also provide the proper state and federal governmental authorities with active assistance as well as documents, information, and expertise that are relevant to their money-laundering investigations. The OCC has conducted several investigations into suspected money-laundering activities, and we continue to closely cooperate with federal criminal law enforcement agencies. These investigations may result in both criminal convictions and significant asset forfeitures.

All banks are required by regulation to report suspected crimes and suspicious transactions that involve potential money laundering or violate the BSA. In April 1996, the OCC, together with the other federal financial institution regulatory agencies, and the Financial Crimes Enforcement Network (FinCEN), unveiled a new suspicious activity reporting system, suspicious activity report (SAR) form, and database. The new system provides law enforcement and regulatory agencies online access to the entire SAR database. Based upon the information in the SARs, law enforcement agencies will initiate an investigation and, if appropriate, take action against violators. By using a universal SAR form, consolidating filings in a single location, and permitting electronic filing, the new system greatly improves the reporting process and makes it more useful to law enforcement and to the regulatory agencies. As of September 1997, banks and regulatory agencies had filed nearly 110,000 SARs. Approximately 40 percent of these SARs were for suspected BSA/money-laundering violations.

The OCC uses the SAR database as a means of identifying potential cases against bank insiders and employees for administrative enforcement actions. For example, since 1996, through our review of SARs and its predecessor, the criminal referral form, the OCC has prohibited approximately 40 individuals from participating in the banking industry. Two of those prohibitions were for structuring currency transactions to avoid BSA reporting requirements.

National Anti-Money-Laundering Group

As noted above, the OCC has formed a new internal task force on money laundering called the NAMLG. During the past year, through the NAMLG, the OCC has embarked on several important projects.

A major project of the NAMLG involves the targeting of banks that may be vulnerable to money laundering for examinations using expanded-scope procedures. We select banks for these examinations based on law enforcement leads or criteria developed by the OCC. We already have conducted a number of expanded-scope anti-money-laundering examinations based on law enforcement leads.

The NAMLG has developed guidance to assist our examination staff in targeting institutions that might be vulnerable to attempts by individuals or institutions to engage in money-laundering activities. The guidance requires our supervisory offices in the four most active "High Intensity Drug Traffic Areas," designated by the Office of National Drug Control Policy, to consider a series of factors in developing a prioritized list of institutions that are considered most susceptible to money laundering. Some of the factors are the extent of funds transfers to or from entities in foreign countries that are believed to be money-laundering havens; the extent of account relationships with individuals and entities located or otherwise associated with the above-referenced countries; the strength of the bank's "know your customer" policy and monitoring mechanisms; and other factors which may make the bank susceptible to money laundering.

The NAMLG is also overseeing anti-money-laundering examinations of the overseas offices of several national banks. The purpose of these examinations is to review and analyze measures taken by national banks operating in foreign countries to minimize money-laundering risks; identify money-laundering risks and devise responsive supervisory strategies and examination procedures; and generate effective "best practices" information that we will share with the industry. The OCC recently completed some of those examinations. During the examinations, we reviewed the banks' corporate and local anti-money-laundering policies and procedures; assessed the banks' quality assurance and corporate audit functions; and met with host-country bankers' associations and central banks. We will use the results of these examinations as a basis for designing a supervisory approach for subsequent examinations of overseas offices, which we will conduct later this year or early next year.

The NAMLG is working with the other law enforcement agencies and the other regulatory agencies to develop an interagency examiner training curriculum that will include training on common money-laundering schemes. And we are continuing to review our examination procedures to ensure that they are effective in identifying potential money-laundering activities.

Other responsibilities of the NAMLG include sharing information about money-laundering issues with the OCC's district offices; analyzing money-laundering trends and emerging issues; and promoting cooperation and information sharing with national and local anti-money-laundering groups, the law enforcement community, bank regulatory agencies, and the banking industry.

Several of our district offices have also formed similar local groups that interact with the NAMLG. For example, our Southwestern District Task Team was formed in February 1997. Its purpose is to implement a more proactive approach to supervising bank compliance with the BSA and the money-laundering statutes by identifying and examining high-risk banks, working with local law enforcement and regulatory agencies, providing examiner training, developing and sharing "best practices" examination procedures and methodologies with the NAMLG and the other districts, and developing and implementing other anti-money-laundering initiatives.

OCC Resources Committed to the BSA and Money Laundering

In our ongoing efforts to deploy our resources most effectively and efficiently, the OCC has developed a special compliance cadre of approximately 100 examiners. The members of this cadre specialize in compliance issues and receive specific training and career development in compliance, including the BSA and money-laundering prevention.

In order to augment the agency's BSA and anti-money-laundering expertise, the OCC recently hired BSA compliance specialists to provide support to examiners and to assist with the development of BSA and money-laundering policy. These new BSA specialists have extensive experience and background in the BSA and anti-money-laundering areas.

We have also designated examiners with extensive backgrounds in fraud and money laundering to serve as a full-time fraud specialist in each of the OCC's six district offices. The "fraud squad" specialists' responsibilities include providing assistance and support to examiners on money-laundering issues, and serving as the agency's liaison, along with our district counsel and the Enforcement and Compliance Division, to the other regulatory and law enforcement agencies on matters involving fraud and money laundering. In addition to the district fraud specialists, the OCC has two full-time examiners in the Offshore Banking and Fraud Unit in Washington, D.C., who are responsible for tracking the activities of offshore shell banks and other types of suspicious activities that may be designed to defraud legitimate banks and the public. Over the past several years, this unit has issued hundreds of industrywide alerts, including 15 specific alerts on unauthorized banks operating over the Internet, some of which are suspected of being money-laundering vehicles.

The OCC provides formal BSA and anti-money-laundering training to our examining staff on an ongoing basis. This training includes the FFIEC's White Collar Crime and Testifying schools, as well as in-house training programs. In addition to these schools, last year, we provided BSA and anti-money-laundering training at each of the six OCC's district staff conferences, and as a major component of our Compliance Cadre Conference.

Interagency Working Groups and Initiatives

The OCC believes that interagency coordination and cooperation are critical to successfully addressing BSA and money-laundering issues. We actively participate in several interagency groups seeking to curtail money laundering through financial institutions by surfacing issues, sharing information, and making recommendations to improve money-laundering enforcement and awareness. These include the BSA Advisory Committee, chaired by the U.S. Treasury Department, which is composed of policy, legal, and operations representatives from the major federal and state law enforcement and regulatory agencies involved in the fight against money laundering, as well as industry representatives; the Interagency Money Laundering Working Group, co-chaired by the Department of Justice and FinCEN; and the National Interagency Bank Fraud Working Group, of which we have been an active member since its founding in 1984. We also work on an international basis with the

Financial Action Task Force, an inter-governmental body whose purpose is the development and promotion of policies to combat money laundering. In addition, we have participated in various State and Treasury Department missions to assist foreign governments in their anti-money-laundering efforts. We expect that these international efforts will continue.

For the past several months, the OCC has been working with the other federal financial institution regulatory agencies, on a uniform, interagency "know your customer" regulation. The regulation will ensure that banks establish and maintain procedures to identify their customers, and their customers' normal and expected transactions and sources and uses of funds. These procedures are intended to facilitate bank compliance with applicable statutes and regulations and with safe and sound banking practices, and prevent banks from becoming vehicles for, or victims of, illegal activities perpetrated by their customers. For the past several months, an interagency work group has been meeting on a regular basis to develop the proposed regulation. We anticipate that a regulation will be proposed for public comment this year.

Promoting Industry Awareness

As mentioned above, the primary responsibility for ensuring that banks are in compliance with the law remains with the bank's management and its directors. To aid them in meeting this responsibility, the OCC devotes time to educating the banking industry about its responsibilities under the BSA. In past years this has included active participation in conferences and training sessions across the country. We will continue to be active in this area.

The OCC provides guidance to national banks through:

(1) periodic bulletins that inform and remind banks of their responsibilities under the law, applicable regulations, and administrative rulings dealing with BSA reporting requirements and money laundering;

(2) publication and distribution of a guide in this area entitled "Money Laundering: A Banker's Guide to Avoiding Problems";

(3) publication and distribution of the new handbook booklet; and

(4) periodic alerts and advisories of potential frauds or questionable activities, such as the alerts on unauthorized Internet banks.

II. Proposed Legislation

You have asked us to comment on two bills that have been proposed to combat money laundering—the "Money Laundering Deterrence Act of 1998," and the "Money Laundering and Financial Crimes Strategy Act of 1998." Although the Administration has not yet put forward a position on the bills' particular provisions, the OCC believes that both bills could help detect and deter money laundering, and are deserving of serious consideration.

The Money Laundering Deterrence Act of 1998

The Money Laundering Deterrence Act of 1998 extends to accountants the statutory "safe harbor" from civil liability for banks and individuals who report potential crimes, facilitates the flow of information among law enforcement and regulatory agencies within the government, and creates a new "safe harbor" from civil liability for banks and individuals who share information in an employment reference about a prospective employee's possible involvement in a violation of law or a suspicious transaction. It also increases the penalties for certain violations of law, and requires the filing of reports relating to coins and currency received in nonfinancial trade or business.

The OCC is supportive of the goals of this proposal, especially the expansion of the statutory "safe harbor" for banks and individuals that report potential crimes and suspicious transactions, and the creation of a new "safe harbor" for banks and individuals who share information in an employment reference about a prospective employee's possible involvement in a violation of law or a suspicious transaction. Banks and their employees must feel free to report suspicious transactions, and to share information in the employment context about individuals involved in misconduct, without fear of liability.

The Money Laundering and Financial Crimes Strategy Act of 1998

The Money Laundering and Financial Crimes Strategy Act of 1998 would require the development of a national strategy for combating money laundering and related financial crimes, require that the Secretary of the Treasury designate certain areas as high-risk areas for money laundering and related financial crimes, and establish a Financial Crime-Free Communities Support Program (program). This program would enable the Secretary of the Treasury to make grants to support state and local law enforcement efforts in the development and implementation of programs for the detection, prevention, and suppression of money laundering and related financial crimes.

The OCC supports the undertaking of cooperative efforts involving federal, state, and local government officials to combat financial crimes. We also believe that designating an area as a "high-risk money-laundering and related financial crimes area" will help the OCC and others target resources to those areas experiencing the most problems. Finally, by awarding grants to law enforcement

officials located in areas designated as high-risk money-laundering and related financial crimes areas, the program will help ensure that the grants are used in areas that are most in need of assistance.

Conclusion

Money laundering is a serious problem. While it may be unrealistic to expect that it will ever be completely eradicated from the banking system, the OCC is committed to preventing national banks from being used to launder the proceeds of the drug trade and other illegal activities. We stand ready to work with Congress, the other financial institution regulatory agencies, the law enforcement agencies, and the banking industry to continue to develop and implement a coordinated and comprehensive response to the threat posed to the nation's financial system by money laundering.

With our anti-money-laundering initiatives, active interagency working groups, increased international cooperation, and a committed industry, the OCC intends to make substantial additional progress in preventing the nation's financial institutions from wittingly or unwittingly being used to launder money.

Remarks by James Kamihachi, Senior Deputy Comptroller for Economic and Policy Analysis, before the Measuring and Managing Capital Allocation conference, on new capital allocation practices, London, England, June 25, 1998

Good morning. The AIC conferences on financial issues are important fora for thoughtful discussion of public policy issues among bankers, financial market participants, and supervisors, so it is a distinct pleasure for me to be here today.*

Over the last 10 years, we have seen remarkable innovations in the financial marketplace. The increased use of asset securitization, the growth of credit and other types of derivatives, and technological advances in computers and telecommunications have transformed the traditional banking business. As well, advances in risk measurement modeling have given banks the ability to more finely estimate risk than ever before.

All of these innovations mean that the business of supervising banking must change too. Right now there is considerable debate surrounding the risk-based capital standards. Critics argue that these standards are seriously out-of-date. Some suggest that supervisors use the complex risk models bank develop internally to set capital charges. In my remarks this morning, I want to make two points. First, when it comes to capital requirements, the needs of bankers and supervisors differ in some important ways. Second, using internal bank models to set capital requirements presents difficult tradeoffs for supervisors, but internal models will undoubtedly be part of the capital allocation process at well-run banks.

I will begin by talking about the purposes of capital, and what bankers and supervisors must consider in deciding how much is enough. Then I'd like to discuss some of the strengths and weaknesses of the current risk-based capital standards, and the trend toward quantitative modeling. Lastly, I'll tell you about some of the things we at the OCC have learned about how we think capital allocation processes ought to be run.

1. The purpose of capital

First, let me make some observations about the purpose of capital and its limitations as a regulatory tool. Why do banks hold capital, and why do supervisors set minimum capital requirements? From the bankers' perspective, capital serves to provide the funds necessary to do such things as finance asset growth, engage in new activities, or make acquisitions. In deciding how much capital to hold, bankers must weigh their opportunities to make investments that meet shareholder expectations and their creditors' needs to have a cushion against insolvency.

From a supervisor's perspective, capital requirements are important because they provide incentives for prudent management and ownership oversight of banks. They are necessary to ensure that banks operate in a safe and sound manner, and that the banking system as a whole is financially sound. Thus, when supervisors set capital standards they are not only guarding against losses at an individual institution, but they must also consider the impact of capital in lowering the social costs associated with systemic events or contagion events.

As important, supervisors use bank capital ratios as a trigger for supervisory intervention. In November 1991, the U.S. Congress passed the Federal Deposit Insurance Corporation Improvement Act that includes a provision requiring early intervention and corrective action by bank supervisors in dealing with troubled institutions. Specifically, section 131 of FDICIA outlined for U.S. banks a series of capital thresholds used to determine what regulatory actions would be taken by supervisors.

So, what is the purpose of capital? While our discussion here has been somewhat on the surface, it does demonstrate that capital can serve a number of different purposes, and that banks and bank supervisors have different motivations when assessing capital adequacy.

2. How much capital is enough?

It naturally follows that depending on what banks and bank supervisors believe is the purpose of capital, the amount of capital they consider sufficient may differ. As a supervisor I would argue that regulatory capital standards should be set high enough that they keep the total costs to society of bank failures within acceptable bounds. Clearly, we don't want capital levels so low that bankers and investors do not take sufficient steps to avoid failure. Alternatively, capital requirements should not be set so high as to eliminate bank failures entirely. That would certainly interfere with banks' ability to be competitive and profitable.

* [AIC—the abbreviation for Australian Investment Conferences, currently known as AIC Worldwide, an international business-focused conference organizer]

As you well appreciate, the question of how much capital is enough is not an easy question to answer, and setting a regulatory capital ratio at some fixed level may yield a sub-optimal result. I say this because the relevant issue is not really how much capital a bank holds in an absolute sense, but rather, how much capital it holds relative to the amount of risk it takes. For this reason, well-developed bank risk models and capital allocation processes have a lot to offer banks and a lot to teach supervisors. With an ever-increasing array of financial assets and activities, the often-times unpredictable nature of world financial markets, and changing foreign and domestic economic conditions, a bank's risk profile changes frequently. Now compare this to a numerically fixed regulatory capital requirement which is a point-in-time estimate of capital, and not a fluid measure of the risk of loss or insolvency.

3. Risk-based capital

However, before we completely overhaul the risk-based capital standards in order to accommodate recent innovations in banking, it is important we all understand what the current capital standards have achieved.

It is commonly acknowledged that one of the major contributions of the Basle Accord is that it helped to reverse a downward trend in the capital ratios of banks in many countries. In the United States, the capital ratios of banks had fallen quite steadily during this century—that is, until 1990. Between 1990 and 1993, equity capital rose by 35.7 percent to $297 billion, and the equity-to-asset ratio increased from 6.46 percent to 8.01 percent. While other factors besides the risk-based standards certainly played significant roles in the increase in capital ratios, two recent studies involving OCC economists suggest that the risk-based capital standards, and prompt corrective action rules, caused U.S. banks to increase their capital ratios, without an offsetting increase in risk.[1]

So, given that risk-based capital standards have improved the safety and soundness of the international banking system, why should we want to rethink them? Let's look at some of the issues.

Critics have noted that the risk-based capital standards contain only four risk-weight categories. They argue that the risk weights are arbitrary. What I believe they mean by this is that the risk weights fail to satisfactorily differentiate between degrees of credit risk. For example, the standards ignore the term structure of credit risk; thus, the 8 percent risk-based capital requirement on an A-rated credit exposure may make it uneconomic for a bank to hold, relative to a lower-rated credit exposure. One answer to this problem is a risk-based system with more risk-weight categories. But this is an endless battle as there will always be products for which the risk weights are not well-suited, in either absolute or relative terms. Furthermore, part of the reason that there are only four risk-weight categories in risk-based capital is that, in initially designing the standards, supervisors desired to keep the system simple.

A second criticism frequently heard is that the risk-based capital standards account primarily for credit risk. While in recent years the Basle Committee has added a rule for market risk, the current risk-based capital system does not explicitly incorporate a number of other risks such as operational, transactions, or legal risk. However, while the current standards may be highly focused on credit risk, there are limits to our ability to devise quantitative measures for all of the risks a bank faces. It may be more appropriate to address some of these risks using other supervisory tools. The OCC has taken some steps in this direction with its supervision by risk approach, which requires examiner to rate banks according to nine broad categories of risk.

A third criticism is that the risk-based capital standards fail to account for the benefits of diversification or hedging. Thus, a $100 million loan to a single corporate borrower carries the same capital requirement as 100 different loans of $1 million each to corporate borrowers of the same credit rating. But modern portfolio theory suggests that the credit risk of these two exposures is probably different. However, if you think about it, accurately accounting for diversification in a regulatory model is a daunting task.

All of which brings me to the criticism that the risk-based capital standards have not kept pace with financial innovation. To be fair—and I do not think enough people appreciate this point—the risk-based capital standards are not a static set of standards. The Basle Committee has a process to interpret and, in some cases, amend the framework to address new products. And, as I noted earlier, recent amendments have been added to include market risk. But, the critics are fundamentally correct. The risk-based capital standards do not really accurately accommodate the rapid growth in off-balance-sheet risk.

So, what to do? What has intrigued bankers and supervisors alike is the continuing improvement and refinement of risk measurement models and techniques. These

[1] See Jacques, Kevin, and Peter Nigro, "Risk-Based Capital, Portfolio Risk, and Bank Capital: A Simultaneous Equations Approach," *Journal of Economics and Business,* December 1997, and Aggarwal, Raj, and Kevin T. Jacques, "A Simultaneous Equations Estimation of the Impact of Prompt Corrective Action on Bank Capital and Risk," 1998 Federal Reserve Bank of New York conference on Financial Services at the Crossroads: Capital Regulation in the 21st Century [http://www.ny.frb.org/rmaghome/conference/jacques.pdf].

innovations are essential to bankers for managing their portfolios. For instance, the recent advances we have seen in credit risk modeling, whether through the use of credit scoring models or portfolio models of credit risk, make it clear that, properly applied, today's models have much to offer in better managing credit risk. This is much of what we see in the capital allocation processes at banks, the continued use of new technologies and fresh ideas toward the development of better, more accurate models for measuring, not only the credit risk of an institution, but other types of risk as well.

Whether supervisors should use these models to set capital standards is a much more difficult question. We might all agree that a well-developed bank internal model should do a better job of accurately measuring a bank's risk than a universal model developed by supervisors. But using internal bank models to set capital standards is likely to result in a very costly system for supervisors to administer, with uncertain benefits. This is true for several reasons. First, it is a difficult and time-consuming task to evaluate internal models. Second, while a particular model may more accurately portray the risk in a particular bank, these models will be idiosyncratic to each bank. Ultimately, the internal model for a particular bank will yield estimates of risk that are not necessarily comparable with risk estimates developed by other banks. And precommitment, while a very interesting idea, does not get around this problem entirely. No supervisor could take the risk of accepting a bank's commitment without doing a lot of looking at the models on which those commitments were based.

In sum, supervisors have a lot to think about before they use internal bank models to set capital standards. But, for bankers, using these models as part of a well-developed capital allocation process is critical.

5. Implications for capital allocation processes

Having made the general point about the benefits of internal models for bankers, I want to add that, as with a lot of other things, the devil is in the details.

In the Economics Department at the OCC, we have a Risk Analysis Division staffed with Ph.D. economists who have considerable expertise in measuring risk, and who are members of our examination teams. These economists have examined some of the most sophisticated, well-developed internal risk models and capital allocation processes in U.S. banks. So, let me offer a few thoughts about the best practices we have seen regarding internal models and capital allocation processes at U.S. banks.

First, a capital allocation process is a key part of a disciplined management process. One benefit of having such a process is that it provides a framework for communicating knowledge about the trade-offs between risk and return. And this can be a valuable tool not only in developing business strategies, but also in making day-to-day decisions. Capital allocation processes can play an important role in a financial institution's sales and pricing decisions, strategic planning, risk management, and performance measurement and reporting—just to name a few areas.

A second lesson we have learned is that a good risk governance framework includes corporate definitions of risk and an explicit articulation of management's appetite for risk. It provides for a consistently applied standard for risk measurement across all the bank's business lines. Bank managers and directors make a decision about the level of risk with which they are comfortable, and concurrently, about the level of loss for which capital will serve as a cushion. The assessment of risk appetite, and its application throughout the institution, is often accomplished by identifying a common denominator for risk, such as a confidence interval. This can then be applied to activities throughout the institution, aggregated across activities, and serve as a basis for comparison.

A third point is that these processes need to be comprehensive in looking at all significant risks and activities to which the institution is exposed. There is often a tendency for institutions to develop methodologies to account for only the most easily measured risks or activities that they face. And, while developing capital allocation methodologies for some types of risk may be difficult, many of these "missing" risks are important.

Fourth, an effective capital allocation process incorporates statistically valid quantitative analysis as an important element in the process. And risk models contained in these processes must be periodically tested to assess their accuracy.

My fifth observation is that building a better mousetrap is not sufficient. Qualitative factors such as judgment and reason are also important elements. For example, what confidence level is appropriate for the model, given the risk appetite of the institution? Over what time frame should the probability of loss be calculated? For trading portfolios, the answer may be very short, while it may be quite long for loan portfolios; and strong systems have a means for equating these diverse portfolios or risks to a common time frame. Decisions also must be made about how to adjust capital allocation to recognize the benefits of diversification, as well as the correlation among risk factors. While these are just a few questions that need to be answered, my point is that capital allocation processes still require sound judgment and reason to be effective.

Finally, no matter how sophisticated the underlying models may be, capital allocation processes need to be effectively controlled and integrated throughout the organization, and the decisions well communicated. Strong processes are not simply tools used within particular business units. Of course, to produce valid results the capital allocation process must be informed by input from key business units and differing management disciplines throughout the institution. However, I believe central control is necessary to achieve consistency and to ensure that the process is comprehensive.

6. Conclusion

In conclusion, let me say that many of the questions I have discussed regarding capital requirements may become easier to answer over time, as we continue to see significant innovations in financial markets. With the changes we have seen to date, have come a recognition that capital and capital-based risk management have limitations. And while regulatory capital requirements may need to be changed, we need to proceed carefully given empirical evidence that the existing capital regulations have increased safety and soundness. In the end, internal models may help us to more closely align the incentives of bankers and their supervisors. But using models to set capital standards would be an expensive proposition.

On the other hand, for bankers, developing and refining their quantitative risk-measurement systems is an essential part of a good overall risk governance framework and a disciplined management process. Perhaps it is best summed up in a recent OCC study that, in discussing capital allocation processes, concludes, "The *thinking* about risk, and about the collection and presentation of information that goes into such a process, may be as important as the results."

Interpretations—April 1 to June 30, 1998

Interpretive Letters

825—March 16, 1998

12 USC 59

12 USC 83

Re: [ ] (the "bank")

Dear [ ]:

This replies to your letters requesting clarification of the concept of "legitimate corporate purpose" as the phrase is used in Interpretive Ruling 7.2020, 12 CFR 7.2020, in connection with the acquisition and holding of treasury stock by a national bank. As the bank's counsel and a director, you seek confirmation from the OCC that the bank's proposed stock repurchase plan would satisfy this requirement of a "legitimate corporate purpose" under the ruling.

The Proposal

Under the plan, the bank would offer from time to time to purchase, at fair market value, a certain amount of outstanding stock from its stockholders, subject to the approval of the stockholders and the OCC. You suggest an important reason would be to purchase the stock of major stockholders in the event such persons die, retire, or otherwise have need of selling the shares, *e.g.*, when elderly stockholders in the community no longer wish to remain stockholders or when heirs of past stockholders desire to sell inherited shares because they no longer reside in the bank's community. Fair market value would be determined by recent trades in the stock. Although the stock trades sporadically, there is a market and a recognized price at any given time. The bank's stock trades through the NASDAQ system and is listed on the NASDAQ "billboard." The stock has been traded through several New York Stock Exchange investment firms, including [ ], [ ], [ ], and [ ]. The bank would buy stock at the fair market price as stated on the billboard for that day with the approval of its board of directors. The bank would hold the stock so purchased as treasury stock to be made available to employees under an employee stock purchase plan to be established with the objective of enabling employees to have a stake in the bank's profitability.

In connection with this employee stock purchase plan, all full-time employees from time to time would be offered an opportunity to become stockholders through the purchase of the bank's stock at a discounted price, *i.e.*, at a yet-to-be-determined percentage of the billboard price of acquired treasury stock. A payroll deduction plan for employee stock purchase or a stock option plan are other alternatives under consideration. In addition to making stock available as an employee benefit, this proposal is part of a corporate strategy, to be explicitly stated in the bank's strategic plan, for keeping the bank community-focused and less likely to be an acquisition target. Treasury stock so acquired and held would not be available for general resale (*e.g.*, for creating a market for the bank's stock). Should the bank authorize a large public offering, available treasury stock might be included as part of such a public offering.

Discussion

As you know, the OCC issued Interpretive Letter No. 660, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,608 (December 19, 1994), which concluded that a national bank could lawfully acquire and hold treasury stock provided that: (1) the holding is for a legitimate corporate purpose; (2) certain procedures are satisfied; and (3) OCC approval is obtained pursuant to 12 USC 59. In that letter, examples of acceptable stock repurchase programs included holding shares in connection with an officer or employee stock option or bonus plan, holding stock for sale to a potential director in circumstances when a director is obligated to own qualifying shares, or purchasing a director's qualifying shares upon death or resignation of the director if there is no ready market for the shares. The letter further stated "[i]t would not be permissible for a national bank to acquire and hold treasury stock for speculation or as a means of bypassing some requirement or obligation under the federal banking laws."

That letter was based on a combined reading of 12 USC 24(Seventh), 59, and 83. Briefly, the OCC concluded that the authorities in sections 24(Seventh) and 59, when read together with the judicial precedent under section 83, permit the acquisition and holding of treasury stock when there would be no capital impairment and the prescribed procedures and conditions under section 59 are satisfied. Because 12 USC 59 limits capital reductions to situations where the bank receives the approval of the OCC and of two-thirds of its shareholders, we concluded there would be little risk of an improper use of treasury stock. Moreover, section 59 does not require that the stock repurchased be retired or even refer to retirement as a purpose for the reduction of capital. The OCC's examples of what would be legitimate corporate purposes were based upon the proposal of the bank that requested the interpretation and did not imply that those were the only legitimate reasons that could support an acquisition and holding of treasury stock.

Based upon the principles in OCC Interpretive Letter No. 660, *supra*, the establishment of an employee stock purchase plan is permissible. I am assuming that an

employee stock purchase plan would operate similarly to an employee stock option or bonus plan. Applying the same analysis as is contained in OCC Interpretive Letter No. 660, which read sections 59 and 83 as being harmonious with each other to the fullest extent possible, we conclude that, in the manner and for the reasons you describe and provided certain conditions are satisfied, the proposed repurchase and holding would be a legitimate corporate purpose.

The purpose of section 83's restriction on purchasing or holding a bank's own shares is to prevent impairment of a bank's capital resources and the consequent injury to its creditors in the event of an insolvency.[1] A reduction in capital, nevertheless, is expressly provided by section 59, if the procedures and conditions contained therein are met. Capital reductions are permissible when the bank receives the approval of the OCC and of two-thirds of its shareholders. 12 USC 59. Under its corporate policy, the OCC will approve capital reductions for banks in satisfactory condition unless the proposed capital structure is not considered adequate. For banks in unsatisfactory condition, the change in capital may be denied or approved conditionally at the OCC's discretion for reasons of bank safety and soundness and any other supervisory concerns. Specifically, approval of a change in capital may be withheld for banks that: fail to comply with a capital plan; propose a capital structure that the OCC considers inadequate; violate laws or regulations; exhibit conditions that threaten safety and soundness; or fail to provide adequate information. *Comptroller's Manual for Corporate Activities,* Vol. 1, page 172.[2]

Assuming the bank's capital structure is adequate and the bank is in satisfactory condition, the OCC may approve a capital reduction for the purpose of acquiring and holding treasury stock to establish an employee stock purchase plan. While section 83 states that a national bank cannot be the "purchaser or holder" of its own shares, section 59 permits capital reductions involving the purchase of some outstanding securities. When the interaction of these two statutes does not prohibit the purchase, the subsequent holding should not be prohibited either. Like the holding in *First Nat. Bank of Lake City* v. *Young's Estate,* 338 So.2d 67 (Fla. App. 1976), a case involving a bequest of bank stock, the employee stock purchase plan enhances and does not impair the bank's capital resources. Nor does the bank's proposal to acquire the stock of major shareholders, with the approval of shareholders and the OCC in accordance with 12 USC 59, and to hold it as treasury stock available to employees in connection with an employee stock purchase plan as described, violate laws or regulations or threaten the bank's safety and soundness. It is not speculative and does not create a market for the stock because the treasury stock so acquired would be offered at a discount only to employees through the stock purchase plan and not to the general public or others in the bank's community at a "market rate."

Structuring and operating an employee stock purchase plan in this way will help the bank to remain an independent and community-based institution, which is part of the bank's specific strategic plan for its future operations. It is not a means of bypassing any requirement or obligation under the federal banking laws.

In sum, a national bank has authority under 12 USC 24(Seventh) to hold treasury stock to fulfill a legitimate corporate need, provided it complies with section 59 in its repurchase of outstanding shares with the consequent reduction in capital. The bank's proposed employee stock purchase plan, to be operated in the circumstances and as described above and also subject to the approvals required by section 59, fulfills a legitimate corporate need. It is therefore legally permissible.

I trust this reply is responsive to your inquiry.

Jonathan Rushdoony
District Counsel
Northeastern District
1114 Avenue of the Americas, Suite 3900
New York, New York 10036–7780

[1] *See Deitrick* v. *Greaney,* 309 U.S. 190 (1940); *see also Wallace* v. *Hood,* 89 F. 11, 13 (C.C. Kan. 1898), *aff'd.* 97 F. 983, *aff'd.* 182 U.S. 555. (The object and policy of this section is to prevent the reduction of the outstanding stock of a national bank and the withdrawal *pro tanto* of its capital.)

[2] The *Comptroller's Manual for Corporate Activities* is in the process of revision. The policy guidance for OCC approval of decreases in permanent capital contained in the new *Comptroller's Corporate Manual,* "Capital and Dividends" booklet, pages 7 and 8 [published April 1998], states that the OCC generally approves reductions in permanent capital for banks in satisfactory condition, unless the proposed capital structure is not considered adequate under OCC policies. The OCC may deny or conditionally approve a reduction in capital that would: use treasury stock as a means to speculate in the bank's own stock or to bypass a requirement or obligation under federal banking laws; violate laws or regulations; or exhibit conditions that threaten safety and soundness.

826—March 17, 1998

12 USC 24(7) *[file 12 USC 24(7)92]*

Re: [ ] Insurance Company Separate Account Product

Dear [ ]:

This responds to your letter dated August 20, 1997, requesting an opinion from the Office of the Comptroller

of the Currency (OCC) that a national bank may purchase an interest in an insurance company separate account that will in turn invest in bank-eligible securities, and a clarification of the appropriate risk-based capital treatment for the interest. You made this request on behalf of the creator of this separate account product, [ ], Inc. *[subsidiary],* a wholly-owned subsidiary of [ ] Insurance Company *[parent].* Based upon your representations in your request for interpretive advice, we have concluded that the proposed investment is permissible for national banks. Our conclusion might differ if the activity is in any way materially different from what you have described.

I. Background

The [ ] separate account [ ] is a pool of assets *[parent]* holds for the benefit of multiple account holders. A bank would enter into a contractual agreement ("funding agreement") with *[parent],* under which *[parent]* would receive funds from the bank to purchase securities permissible for direct investment by a national bank pursuant to 12 CFR Part 1 ("bank-eligible investments"). These securities consist of U.S. Treasury securities, Agency notes and debentures, and government-sponsored enterprise ("GSE") obligations.[1] *[Subsidiary]* would actively manage the account, and *[parent]* would make monthly payments to the bank consisting of a return of principal plus interest. *[Parent]* provides a guarantee that it will pay the participating bank the book value of the bank's investment, less any principal previously returned, either at the specified maturity date, or at the time of early termination of the funding agreement by *[parent],* pursuant to its terms. *[Parent]* would not guarantee the payment of interest. *[Parent]* would receive an expense charge and *[subsidiary]* would receive a performance-based incentive fee as compensation, both paid monthly.

Pursuant to the terms of the funding agreement between a bank and *[parent],* securities held by *[parent]* in the [ ] separate account for the benefit of a bank may not be charged with liabilities arising from other business of *[parent]*. *[Parent]* has procured an opinion of the Massachusetts Division of Insurance ("Division of Insurance"), in which the Division of Insurance represents that this outcome is dictated by applicable Massachusetts law (Mass. Gen. L. ch. 175 sections 132F and 132G), and that the Division of Insurance would handle any receivership proceeding in accordance with its ruling. The Division of Insurance has also stated that the "funds [in the separate account] . . . would be available exclusively, to the extent necessary, to satisfy claims of the holders of such separate account products. . . ."[2]

II. Discussion

A. Qualification as a Permissible Investment

In our view, a bank's investment in the [ ] account represents a permissible investment. A national bank may purchase "investment securities" for its own account, subject to limitations prescribed by the OCC. *See* 12 USC 24(Seventh). The OCC defines an investment security to be "a marketable debt obligation that is not predominantly speculative in nature. A security is not predominantly speculative in nature if it is rated investment grade. When a security is not rated, the security must be the credit equivalent of a security rated investment grade." 12 CFR 1.2(e). A security is considered to be "marketable" if it is "offered and sold pursuant to Securities and Exchange Commission (SEC) Rule 144A," and is "rated investment grade or the credit equivalent of investment grade." 12 CFR 1.2(f)(3).

Funding agreements qualify as Type III investment securities. *See* 12 CFR 1.2(k). There is no definition of a debt security in 12 CFR Part 1. Paragraph 137 of Financial Accounting Standard 115 defines a debt security as "any security representing a creditor relationship with an enterprise." *[Subsidiary]* has obtained an accounting opinion that funding agreements are debt securities for purposes of this definition.[3] Although funding agreements are not rated securities, you have represented that because *[parent]'s* debt has investment grade ratings (AA+ by Standard & Poor's, AAA by Duff & Phelps, and Aa2 by Moody's), funding agreements are the credit equivalent of investment grade securities. *[Parent]* also would privately place funding agreements to banks pursuant to SEC Rule 144A, 17 CFR 240.144A, thus making them marketable for purposes of Part 1. *See* 12 CFR 1.2(f)(3). A bank must limit its holdings of the Type III securities of any one issuer to 10 percent of the bank's capital and surplus. *See* 12 CFR 1.3(c).

As an investment security, a [ ] Funding Agreement is comparable to investments in mutual funds composed of bank-eligible securities. A national bank may purchase

[1] *[Parent]* has represented that the separate account will, for purposes of hedging price and interest rate exposure, enter into exchange-traded and over-the-counter futures and options transactions; interest rate swaps, caps, and floors; short sales of U.S. Treasury and Agency securities; and covered dollar rolls, with the proceeds reinvested in short-term investments maturing within five days of the maturity date of the corresponding dollar roll.

[2] *See* letter of Daniel R. Judson, Deputy General Counsel, Massachusetts Division of Insurance (July 13, 1994).

[3] *See* letter of Arthur Andersen, LLP to *[subsidiary]* (May 27, 1997), stating that it is appropriate to classify an interest in the [ ] account as a debt security due to its fixed maturity date, fixed guaranteed principal amount, and payment of interest on a monthly basis.

shares of mutual funds which invest solely in bank-eligible securities, subject to the investment limitations set forth in 12 CFR 1.4(e). *See* 12 CFR 1.3(h).

With both a mutual fund and [ ], an identifiable entity (either an investment company or a separate account) holds a pool of assets for the benefit of holders of shares of the identifiable entity. However, [ ] differs from a mutual fund in that *[parent]* provides a guarantee of principal for holders of [ ] Funding Agreements, a feature that shares of a mutual fund generally do not possess. The [ ] separate account is not a registered investment company under the Investment Company Act of 1940, because the separate account qualifies for an exemption from registration. An exemption from registration is available for issuers whose securities are owned exclusively by "qualified purchasers," and where there is no public offering of the securities. *See* 15 USC 80a-3(c)(7). A "qualified purchaser" includes, among other things, any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25 million in investments. *See* 15 USC 80a-2(a)(51)(A)(iv). *[Parent]* requires that investors in [ ] be "qualified purchasers" to maintain the separate account's exemption from registration.

The assets held by *[parent]* in the separate account are also securities that a national bank is authorized to purchase directly. *[Subsidiary]* uses the funds deposited in the [ ] account to purchase bank-eligible U.S. Treasury, Agency, and GSE debt securities, and the bank receives a return on its investment based on the interest earned on those bank-eligible securities. Although *[parent]* retains legal title to the securities in the separate account, it holds those securities for the benefit of the holders of funding agreements. In the event that *[parent]* becomes insolvent, its receiver may not apply those securities in satisfaction of any general creditor of *[parent]*. Instead, the funds in the separate account are available to satisfy claims of the account holders. Thus, the benefits of owning the bank-eligible securities in the separate account pass through to the bank, while the guarantee of principal by *[parent]* protects the bank against loss in the value of its investment. At its most elementary level, the [ ] separate account is simply another conduit through which a bank can purchase bank-eligible securities, with the additional safety that *[parent]'s* guarantee provides.

B. Capital Treatment

The [ ] separate account is comparable to an investment in a mutual fund composed of bank-eligible securities, and as such would qualify for a 20 percent risk weight. The appropriate risk weight for an indirect holding in a pool of assets is the risk category of the highest risk-weighted assets that the pool is permitted to hold pursuant to its stated investment objectives. *See* 12 CFR Part 3, Appendix A, section 3. *[Parent]* has stated in its draft prospectus that the [ ] account will hold only assets qualifying for risk weights no greater than 20 percent. It is the responsibility of individual bank participants to obtain sufficient information to demonstrate that the funding agreement qualifies for a 20 percent risk weight. If sufficient information is not available to make this determination, the bank must apply the default risk weight of 100 percent. *[Parent]* will provide information on a quarterly basis to each bank that enters into a funding agreement, concerning the market value of the securities in the [ ] separate account. It is the bank's responsibility to ensure that it adjusts its risk weight calculations to account for any drop in the market value of the securities below the book value of the investment.

III. Conclusion

Based upon the foregoing facts and analysis, and the representations in your request for interpretive advice, we conclude that an interest in the [ ] account proposed by *[parent]* would be a bank-eligible product, providing that for a particular institution, entry into the [ ] Funding Agreement is consistent with safe and sound banking practices. Our conclusion might differ should the [ ] program differ in any material way from what you have described.

Julie L. Williams
Chief Counsel

827—April 3, 1998

12 USC 24(7) *[file 12 USC 24(7)43B]*

Re: "Debt Suspension Agreements"

Dear [ ]:

This responds to your request that the Office of the Comptroller of the Currency (OCC) confirm that a national bank that issues credit cards (the "bank") may offer its cardholders "debt suspension agreements." For the reasons discussed below, we agree that the proposed activity is permissible for national banks because it is part of banks' expressly authorized lending function and also because it is incidental to the business of banking.

Background

Under the proposed debt suspension agreements, the bank will agree, in exchange for the payment of a monthly fee by each participating cardholder:

(a) To "freeze" the cardholder's account for up to a specified number of months in the event that the cardholder becomes involuntarily unemployed, is unable to work due to disability, goes on an approved family leave, is hospitalized for more than a specified number of days, or becomes temporarily unable to continue to make payments on the account for certain other specified reasons; and

(b) To cancel the balance outstanding under the cardholder's credit card account (up to the cardholder's approved credit limit) in the event of the cardholder's death.

While a credit card account is "frozen," no monthly payment will be due; no finance, late, or other charge will accrue; no monthly suspension fee will be due; and the bank will not send any negative report to any credit agency due to the freeze. During the "freeze," the cardholder will not be permitted to use the credit card for additional charges. Once a "freeze" expires, the credit card account will be reactivated and the cardholder will again be required to make monthly payments.

Participation in this program will be completely at the option of the cardholder. The bank expects that a cardholder will not be eligible for a "freeze" until enrolled in the program for a specified minimum period of time. This waiting period may vary from one type of contingency to another. It may, for example, be longer for disabilities based on pre-existing conditions.

Discussion

A. Business of Banking

The National Bank Act provides that national banks shall have the power:

> [t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes . . . .
>
> 12 USC 24(Seventh).

The Supreme Court has held that the powers clause in 12 USC 24(Seventh) is a broad grant of the power to engage in the business of banking, including, but not limited to, the five specifically recited powers and the business of banking as a whole. *See NationsBank of North Carolina, N.A.* v. *Variable Life Annuity Co.*, 513 U.S. 251 (1995) *("VALIC").* Many activities that are not included in the enumerated powers are also part of the business of banking. Judicial cases reflect three general principles used to determine whether an activity is within the scope of the "business of banking": (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks. *See, e.g., Merchants' Bank* v. *State Bank*, 77 U.S. 604 (1871); *M & M Leasing Corp.* v. *Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977); *American Insurance Association* v. *Clarke*, 865 F.2d 278, 282 (2d Cir. 1988).

1. Functionally Equivalent to or a Logical Outgrowth of Recognized Banking Functions

Lending is one of the expressly enumerated powers in 12 USC 24(Seventh). Part of any lending transaction is the negotiation of the terms of the obligation, including the interest rate, due dates of payment, etc. Loan agreements often state the consequences of default, whether those consequences are penalties, repossession of collateral, or acceleration of the debt obligation. In the case of a debt suspension agreement, the parties have negotiated an option for the debtor to cease payments for a time, under specified circumstances, without adverse consequences. This type of contractual provision is no less a part of lending than any of the various other terms (covenants, security interests, etc.) that are part of a loan agreement. The authority of a national bank to offer debt suspension agreements is, therefore, an inherent part of its express authority to make loans.

Additionally, debt suspension agreements adjust an outstanding obligation of a customer in a way resembling, but more limited than, a debt cancellation agreement.[1] Like a debt cancellation contract, a debt suspension contract helps to protect the borrower against the risk of financial hardship in times of adversity. A debt suspension agreement simply interrupts the obligation to pay for a specified time, rather than cancels it. From the bank's perspective, a debt suspension contract provides a mechanism for the bank to manage and obtain compensation for the credit risk that it undertakes in making a loan. Thus, it is a very logical outgrowth of the bank's express lending authority.

2. Respond to Customer Needs or Otherwise Benefit the Bank or its Customers

As you note in your letter, a debt suspension agreement is finely tuned to the potential duration of financial

[1] The authority of a national bank to offer debt *cancellation* agreements is well established. *First National Bank of Eastern Arkansas* v. *Taylor*, 907 F.2d 775 (8th Cir. 1990); 12 CFR 7.1013. A national bank may offer debt cancellation agreements contingent not only on the death of the borrower, but also on other events such as disability or involuntary unemployment. Letter from William P. Bowden, Chief Counsel (January 7, 1994).

problems posed by temporary situations such as involuntary unemployment and hospitalization. For these types of situations, suspension of the debt serves the customer's need for relief from financial pressure while also protecting the bank's interest in the eventual repayment of the obligation. A customer who otherwise would suffer long-term damage to his or her credit rating can instead survive a period of difficulty with his or her standing as a borrower intact.

For the bank, debt suspension contracts provide a source of income, from the fees charged for the debt suspension option, to offset credit losses on credit cards. The agreements also help both the bank and the customer manage temporary situations that might otherwise result in default on the customer's obligations, thereby enhancing the bank's ability to eventually obtain repayment from the customer. Additionally, by providing a useful option for customers, debt suspension contracts could increase the competitiveness of the bank's credit card offerings.

3. Risks Similar in Nature to Those Already Assumed by National Banks

In times of financial stress, some borrowers will fail to repay with or without a debt suspension agreement. The risk assumed when a bank provides a debt suspension agreement is similar to the type of risk that the bank assumes when it makes a loan or provides a debt cancellation contract as part of a loan. In any of these situations, the bank accepts the risk that the borrower may be unable to repay some or all of the loan. The bank's proposal would permit the bank to obtain compensation for its assumption of this risk and the additional cost of temporarily foregoing the collection of interest.

B. Incidental to the Business of Banking

As the Supreme Court established in the *VALIC* decision, national banks are also authorized to engage in an activity if that activity is incidental to the performance of the five specified powers in 12 USC 24(Seventh) *or* incidental to the performance of an activity that is part of the business of banking. An activity is incidental to the business of banking if it is "convenient and useful" in the conduct of the banking business. *Arnold Tours, Inc.* v. *Camp*, 472 F.2d 427 (1st Cir. 1972).

The OCC and the courts have long authorized national banks to engage in credit-related activities that protect the bank and the borrower against a variety of credit-related risks. The OCC's approvals and court holdings concluded that these activities are incidental to a bank's lending activities because they protect banks' interest in their loans by reducing the risk of loss if borrowers cannot make their loan repayments. *See* OCC Interpretive Letter No. 283 (March 16, 1984), *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,447 (credit life, disability, mortgage life, involuntary unemployment, and vendors single-interest insurance); 12 CFR Part 2 (credit life insurance); *IBAA* v. *Heimann*, 613 F.2d 1164 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 823 (1980) (confirming the OCC's authority to adopt its credit life insurance regulation at 12 CFR Part 2). *See also* OCC Interpretive Letter No. 671 (July 10, 1995), *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,619, and OCC Interpretive Letter No. 724 (April 22, 1996), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,039 (vehicle service contracts); 12 CFR 7.1013 (1996) (debt cancellation contracts); *First National Bank of Eastern Arkansas* v. *Taylor*, 907 F.2d 775 (confirming the ability of national banks to enter into debt cancellation contracts).

The rationale behind these OCC precedents and court cases is applicable to the bank's proposal. A debt suspension contract provides a convenient and useful way for the bank and its borrowers to manage the risk of nonpayment due to temporary financial hardship. As was discussed above, it protects the bank by providing a source of compensation for the credit risk that is part of the transaction, and it protects the borrower from long-term credit damage during an interval of financial difficulty.

Conclusion

Based on the foregoing facts and analysis, we conclude that providing debt suspension agreements in connection with a bank's credit card business is permissible for national banks. This conclusion relates only to the permissibility of debt suspension agreements under the National Bank Act. The bank should, of course, satisfy itself regarding the treatment of such agreements under any other applicable laws and provide appropriate disclosures to fully inform consumers about the relevant costs and terms, such as may be required under the Truth in Lending Act.

Prior to conducting the described activities, any bank must consult with its examiner-in-charge or with the appropriate supervisory office to ensure that its program will comply with reporting and reserving requirements associated with providing debt suspension agreements. *See* 61 *Federal Register* 4852 (1996).

Julie L. Williams
Chief Counsel

828—April 6, 1998

12 USC 24(7)

12 CFR 5.34

Re: Proposed Mortgage Reinsurance Activities Through Reciprocal Insurer

Dear [ ]:

We are responding to your letter asking whether national banks may participate in a proposed reciprocal mortgage reinsurance exchange (the "exchange"). The exchange will provide for the reinsurance of private mortgage insurance on loans originated or purchased by participating lenders. Based on representations contained in your letter and made in conversations with OCC staff, as described herein, we conclude that national banks' participation in the exchange is permissible under 12 USC 24(Seventh).

You have also inquired about what OCC approvals are required for national banks to participate in the exchange. A national bank may participate directly in the exchange without prior OCC approval but we urge national banks to notify their examiners-in-charge (the EICs) in conjunction with commencing the activity. A national bank that participates through an operating subsidiary must obtain the OCC's prior approval under 12 CFR 5.34.

I. Background

A. Mortgage Insurance Generally

Mortgage insurance protects an investor holding a mortgage loan against default by the mortgagor. Banks and mortgage lenders generally require that borrowers obtain mortgage insurance from third-party mortgage insurers on low down-payment loans.[1] Mortgage insurance has played a vital role in helping low- and moderate-income families become homeowners by allowing families to buy homes with less cash. Mortgage insurance also has expanded the secondary market for low down-payment mortgages and the funding available for these loans. Government-sponsored enterprises such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, and most other purchasers in the secondary market, typically will not consider purchasing low down-payment conventional loans unless the loans have mortgage insurance. Secondary market purchases of low down-payment loans with mortgage insurance helped fuel the expansion in home construction and sales during the 1970s and 1980s, aiding many first-time and other home buyers. *See* Mortgage Insurance Companies of America 1995–1996 Fact Book.

B. Parties

Under your proposal, the [ ] (the "exchange") will be formed under Vermont insurance law as an association captive reciprocal insurer.[2] The authorized activities of the exchange will consist solely of writing private mortgage reinsurance[3] coverage for loans originated or purchased by the participating lenders. The exchange will not be a separate legal entity, but rather will exist as a relationship among the participating lenders that is established through agreements.[4] All lenders who will participate in the exchange are members of the [ ]. [ ] is a pooled arrangement among over 70 bank and nonbank mortgage lenders in *[States]* and *[State]* for the purchase of mortgage credit life insurance at advantageous rates. While all lenders who will be participating in the exchange are members of [ ], not all members of [ ] will participate in the exchange. [ ] Insurance Company *[Co. 1],* which serves as the insurer for [ ], will provide initial financial assistance to the exchange, so that the exchange can meet certain surplus requirements.[5] The [ ] Insurance Company *[Co. 2],* a *[State]* monoline insurance company licensed to write mortgage insurance in the states of *[State, State,]* and *[State],* will write the mortgage insurance coverage that will be reinsured by the exchange. *[Co. 1]'s* business is restricted to providing mortgage insurance.

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[1] For purposes of this letter, a low down-payment loan is a loan with a down payment of less than 20 percent of the property's value, or a loan with a loan-to-value ratio in excess of 80 percent.

[2] Captive insurers insure or reinsure only risks related to the business of their owner(s) and are subject to special insurance regulations. Vermont law (8 V.S.A. Chapter 141) has authorized the formation of captive insurers and reinsurers since 1981. Association captives are a type of captive insurer, all of whose participants or owners are also members of a sponsoring industry association or similar group, and that insures or reinsures only risks relating to its members.

[3] Reinsurance is a process whereby an original insurer reduces its underwriting risk by passing all or part of this risk on to another insurance company. The first underwriter may retain only a portion of the risk and reinsure the balance with a second company that then owns the cash flow and assumes that portion of the risk. *See* 13A John Alan Appleman & Jean Appleman, Insurance Law and Practice section 7681 (1976).

[4] Each participating lender will sign a (1) subscriber agreement which includes a pro rata reinsurance risk assumption, and a (2) power of attorney. A participating lender may voluntarily withdraw from the exchange at any time, and shall be entitled to receive the amount in the lender's subscriber savings account less any amounts owed by the subscriber to the exchange, subject to any restrictions or limitations on distributions to members of the exchange.

[5] *[Co. 1]* is assisting in formation of the exchange as an accommodation to the [ ].

C. The Proposed Reinsurance Activities

The exchange is authorized under Vermont law to write only private mortgage reinsurance coverage for loans originated or purchased by participating lenders.[6] Under a reinsurance agreement (the "reinsurance agreement"), the exchange will assume (i.e., reinsure) a portion of *[Co. 2]'s* risk on *[Co. 2]'s* mortgage insurance coverage. Each lender participating in the exchange, would contractually agree with each of the other members of the exchange to assume its pro rata share of the exchange's total reinsurance risk. For purposes of the agreement, loans will be divided into various product categories ("product books") based on loan-to-value ratios and whether the loans are fixed rate or adjustable rate. The sum of these product books originated during a calendar year will be treated as separate books of business ("annual books") for purposes of applying the overall loss layer provisions. The participant's pro rata share of the reinsurance risk applicable to an annual book is determined by dividing the aggregate amount of the ceded premium attributable to reinsured loans originated or purchased by that lender during the calendar year that are included in each annual book, by the aggregate principal amount of ceded premiums attributable to reinsured loans originated or purchased by all participating lenders during such calendar year that are included in that annual book. The exchange's reinsurance liability for an annual book terminates on December 31, 10 years after the end of the calendar year of origination.

The reinsured portion will be limited to a second layer above a layer of risk assumed by *[Co. 2];* the "excess loss" or "excess layer" of the portfolio. Under the reinsurance agreement, *[Co. 2]* would be responsible as to each annual book for the first layer of risk on the insured mortgages, up to specified percentages (between [ ] percent and [ ] percent) of the various product books included in the annual book. The exchange, in turn, would contractually assume from *[Co. 2],* and be obligated to *[Co. 2]* for, a second loss layer, which would be limited to an aggregate dollar amount equal to one-half of the sum of *[Co. 2]'s* maximum first loss layer on all product books included in the annual book. Notwithstanding the exchange's reinsurance obligations to *[Co. 2], [Co. 2],* as the primary insurer, will be directly liable to the insured (the holder of the mortgage) to pay the full amount of insured losses.

In return for assuming that second layer of risk, the exchange would receive [ ] percent of the mortgage insurance premium, subject to subsequent increase or decrease based on the loss experience of the insured mortgages over time (the "ceded premium"). In accordance with the reinsurance agreement, a specified percentage of the premium ceded to the exchange would be paid to the exchange and the remainder would be placed in trust as a reserve for the payment of reinsurance claims. An additional $[ ][7] will be placed in the trust as an initial reserve fund at the time of the program's start-up. In addition, the reinsurance agreement requires that the exchange make quarterly deposits to the trust equal to a specified percentage of the risk insured on loans added to an annual book during that quarter. The default experience reflected in the annual books will determine subsequent adjustments to the allocation of ceded premiums to reflect the loss experience of the portfolio.

D. Reserve Requirements and Capitalization

Vermont law requires an association captive formed as a reciprocal, like the exchange, to have free surplus[8] of at least $1 million. This amount is also sufficient to allow the exchange to issue its insurance obligations on a non-assessable basis, that is without recourse to the participants in the exchange.[9] To satisfy the free surplus requirement, the exchange will obtain a $[ ] letter of credit, in favor of the Vermont commissioner, from a bank not participating in the exchange, fully collateralized by cash or cash equivalents or other liquid assets acceptable to the Vermont commissioner. The collateral for the letter of credit will be pledged by *[Co. 1]* as an accommodation to [ ] and its members. The collateral will consist of liquid assets held by *[Co. 1]* as reserves built up over the years in connection with the [ ] mortgage credit life program and which exceed the statutory reserves required to be maintained by *[Co. 1]* for operation of the program.[10] The Vermont commissioner will require the exchange to maintain a contingency reserve equal to 50 percent of earned premiums each year. Amounts held as contingency reserves are not available for distribution to subscribers in the exchange.

[Co. 1] and [ ] will also assist the exchange in financing its start-up expenses (estimated at approxi-

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[6] You have confirmed that the Vermont Commissioner of Banking, Insurance, Securities and Health Care Administration (the "Vermont commissioner") has granted the application to form the exchange and has issued to the exchange a Certificate of General Good and a Certificate of Authority. However, no business operations as yet have been conducted.

[7] The initial trust deposit may exceed $[ ] to the extent the size of the first annual book exceeds the pro forma projections. In such event, the amount of the exchange's initial borrowings will be increased accordingly.

[8] Free surplus is a statutory term for capital.

[9] Should free surplus fall below $1 million for any reason, the exchange will suspend its assumption of reinsurance obligations on any new loans until the free surplus is restored to at least the $1 million level.

[10] The sponsors expect this collateral arrangement for the letter of credit will be phased out over approximately seven years as sufficient free surplus is built up by the exchange through operation of the mortgage reinsurance program.

mately $[ ]) and an initial contribution of approximately $[ ] by the exchange to a reinsurance loss reserve fund to be held by a third-party trustee under the terms of the exchange's reinsurance agreement. *[Co. 1]* is expected to lend the required funds (estimated at approximately $[ ]) to [ ] out of its excess loss reserves on the credit life program in exchange for a three-year promissory note, and [ ] in turn, will lend these funds to the exchange, receiving a surplus note as the form of repayment.[11]

Any income accruals a participating bank makes for its pro rata share of exchange income, will be based on the current year's income. No bank will accrue as income long-term estimates of expected income from the exchange. Participating national banks' investment in the exchange, and any potential reinsurance liability from exchange activities, will be paid only from earned ceded premiums or offsets against future ceded premiums.

E. Limitations on the Liability of Each Participant

No exchange participant will be liable for any of the activities of the exchange. The exchange's reinsurance obligations to *[Co. 2]* will be made on a nonassessable basis; that is, without recourse to the participants in the exchange. This means the participating banks will be liable for reinsurance losses only to the extent of their pro rata share of losses, up to the available funds in the reinsurance trust, plus offsets against future ceded premiums.[12] Each participants' liability under the subscriber agreement and Vermont insurance laws for future offsets of ceded premiums will be pro rata, not joint and several.

Because not all of the lenders participating in [ ] will also participate in the exchange, the exchange's subscriber's agreement provides that if operation of the exchange results in any expense or liability to [ ], the subscriber will hold harmless those participants in [ ] who are not members of the exchange for the member's pro rata share of the liability. However, the source of payment to [ ] will be limited to offsets against future administrative fees or other revenues under the [ ] credit life program.

As described earlier, *[Co. 1]* will pledge collateral to allow [ ] to secure a $[ ] letter of credit on behalf of the exchange. *[Co. 1]* will also finance the exchange's start-up expenses including the initial trust deposit, estimated to be approximately $[ ], by lending money to [ ]. In the event the letter of credit is drawn upon and *[Co. 1]'s* collateral is utilized to satisfy the obligation to the issuing bank, or in the event of a default on the $[ ] [ ] note to *[Co. 1], [Co. 1]* has agreed to limit its source of repayment to offsets against future administrative fees or other revenues under the [ ] credit life program. These events will not give *[Co. 1]* any direct claim against the capital or assets of any of the members of the exchange.

F. Consumer Provisions

The participating banks currently have relationships with various mortgage insurance companies and purchase mortgage insurance directly from insurers. The borrowers are charged for the cost of this insurance. Charges for mortgage insurance are included in the monthly payments and annual percentage rates disclosed by the participating banks to customers who are shopping for low down-payment mortgages. Mortgage insurance fees thus are a component of the costs customers consider when comparing competitive loan products.

Your letter represents that, in the highly competitive market for mortgage loans, the participating banks have an overriding incentive to arrange for reasonably priced mortgage insurance fees in order to offer competitively priced loans. Mortgage insurers are regulated under state laws that include requirements for rate filings and approval.

Once the exchange becomes operational, the participating banks will disclose to each borrower, prior to closing of loans they originate, that the exchange may reinsure a portion of the mortgage insurance issued in connection with the loan and, in return for assuming this risk, the exchange may receive a portion of the insurance premium. If a borrower objects, *[Co. 2]* will nevertheless furnish mortgage insurance for the loan (assuming the loan meets *[Co. 2]'s* underwriting criteria), but no part of the risk attributable to that loan will be reinsured by the exchange. The reinsurance agreement does not prohibit the exchange from establishing a reinsurance arrangement with any other mortgage insurer, nor does it require any of the participating lenders to place their mortgage insurance with *[Co. 2]*. Banks on an individual basis may obtain mortgage insurance from insurance companies other than *[Co. 2],* but these loans will not be placed in the exchange.

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[11] A surplus note is a promissory note subject to two contingencies on repayment. It may be repaid only out of the insurer's earned surplus and only with the approval of the Vermont commissioner. As a result, it is not treated as a fixed liability by the issuer, since the contingencies applicable to its repayment make it more in the nature of capital.

[12] The exchange's reinsurance loss reserves are expected to be built up to adequate levels over a three-year period following commencement of operations. No distributions will be made from the trust other than for payment of reinsurance losses until the amount of the reserve held in trust equals a specified percentage of the total amount of the exchange's estimated remaining risk. Amounts in excess of this required reserve will be released to the exchange and available for distribution to participating lenders, subject to compliance with applicable requirements of Vermont insurance law.

G. Safety and Soundness Considerations

As noted above, the liability of participating lenders from exchange operations will be limited to future ceded premiums and administrative fees. The authorized activities of the exchange will consist solely of writing private mortgage reinsurance coverage for loans originated or purchased by the participating lenders. The exchange will not reinsure other mortgage loans. All reinsured mortgages will have to meet *[Co. 2]'s* insurance criteria, which will provide minimal, uniform requirements.[13] In addition, the reinsurance agreement provides a financial incentive for participating lenders to contribute high-quality mortgage loans. *[Co. 2]* will pay to the exchange, 36 months following the close of an annual book, an additional percentage of the gross premium based on the extent to which the cumulative loss ratio for that annual book is below a specified percentage. As a licensed reinsurer in the state of Vermont, the exchange will be subject to ongoing supervision and regulation by the Vermont commissioner, and its operations will be limited to those specified in its Certificate of Authority from the Vermont commissioner (mortgage reinsurance). Any material change in the exchange's plan of operation (including the writing of any direct insurance, or any other kind of reinsurance) would require the prior approval of the Vermont commissioner. In return for accepting the limited credit risk associated with the proposed reinsurance arrangement, the exchange will receive reinsurance premiums, as well as investment income from its cash flow, providing a potentially important source of revenue for participating banks.

The exchange will allocate on at least an annual basis, each participating lender's pro rata percentage of the exchange's net income or loss. The percentage allocations will be based on the lender's portion of the ceded premium earned during that year on all annual books then in force.[14]

II. Analysis

A. "Business of Banking" Analysis

The OCC previously has determined that reinsuring a portion of the mortgage insurance on loans originated or purchased by the parent bank of an operating subsidiary, or by the parent bank's lending affiliates, is generally permissible under the National Bank Act, because this activity is part of, or incidental to, the business of banking. OCC Corporate Decisions No. 97–97 (November 10, 1997) (First Tennessee); No. 97–93 (October 20, 1997) (SunTrust); No. 97–89 (September 26, 1997) (Norwest); No. 97–27 (May 2, 1997) (Bank One); No. 97–15 (March 17, 1997) (PNC); and No. 97–06 (January 22, 1997) (Chase) (collectively, the "Mortgage Reinsurance Approval Letters"); and in OCC Interpretive Letter No. 743, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶81–108 (October 17, 1996) ("IL 743"). The OCC concluded that, in general, this reinsurance activity is part of the business of banking because it is comparable to an extension of low down-payment mortgage loans without reinsurance, but with a higher interest rate to cover the risk of repayment. The reinsurance activities also were found to be functionally equivalent to a partial repurchase of a national bank's own loans, a traditional banking activity. The OCC concluded that the reinsurance activities benefitted national banks by providing flexibility in acquiring credit risks and obtaining new sources of credit-related income. Banks' involvement in reinsurance may also benefit customers by increasing competition and promoting the availability of mortgage insurance at competitive rates. Finally, the OCC concluded that reinsurance involves credit judgments and the assumption of credit risks comparable to other lending activities. The OCC thus concluded that the reinsurance activities are part of the business of banking. Alternatively, the OCC concluded that mortgage reinsurance would be permissible as an activity incidental to banking, particularly to a national bank's express power to make loans, because it optimized the use of the bank's credit underwriting capacities. *Id.* To determine the permissibility of a national bank's participating in the exchange, we will discuss each of the "business of banking" factors analyzed in the Mortgage Reinsurance Approval Letters and IL 743, and apply them to the specific facts of the exchange proposal.

1. Functionally Equivalent to or a Logical Outgrowth of Recognized Banking Functions

Each national bank will contribute, to the exchange, mortgage loans the bank has originated or purchased. As noted above, each bank will assume its pro rata share of the reinsurance risk and receive its pro rata share of the reinsurance premium based on its participation in the annual books of the exchange. Thus national bank participants in the exchange are using this arrangement as a means to reinsure their own mortgages, an activity the OCC has found permissible for national banks.

The proposed arrangement differs somewhat from reinsurance activities previously approved by the OCC because the bank assumes risks arising from an annual book of mortgages that includes loans originated or held by the bank and other lenders. However, each annual

[13] Some of the participating lenders may have delegated underwriting authority to approve loans for mortgage insurance coverage utilizing *[Co. 2]*-approved underwriting criteria.

[14] Actual distributions by the exchange of available funds will be made only upon a vote of an advisory committee and receipt of prior approval from the Vermont commissioner.

book will be comprised of loans of the same product category (based on loan-to-value ratios and fixed or adjustable rate), and all the loans reinsured by the exchange must meet *[Co. 2]'s* underwriting criteria to be accepted for mortgage coverage. Thus, in addition to the product category composition of each annual book, *[Co. 2]'s* underwriting criteria will assure a level of consistency and uniformity analogous to the standardized credit underwriting criteria utilized by members of a bank holding company system. Those underwriting criteria will assure that participating national banks assume a pro rata share of reinsurance liability on an essentially homogenous mortgage pool issued under the same general credit guidelines.

The process of reinsuring mortgage insurance in the manner proposed is essentially a new way of conducting an aspect of the very old business of banking. *See M&M Leasing Corp.* v. *Seattle First National Bank,* 563 F.2d 1377, 1382–1383 (9th Cir. 1977). In the *M&M Leasing Corp.* decision, the court affirmed the opinion of the Comptroller, holding that personal property leasing was a permissible activity for national banks. The court concluded that leasing, when the transaction constitutes a loan secured by leased property, is essentially the lending of money on personal security, an express power under the National Bank Act. *Id.* at 1382. In its analysis, the court discussed how financial leasing is similar to lending on personal security, serves the same purpose as lending, and is "functionally interchangeable" with lending. The court stressed that this "functional interchangeability" was the touchstone of its decision. *Id.* at 1383. Similarly, in *American Insurance Association* v. *Clarke,* 865 F.2d 278 (D.C. Cir. 1988), the court also considered whether a new activity was "functionally equivalent" to a recognized banking power. There, the court affirmed the Comptroller's opinion that the use of standby credits to insure municipal bonds was functionally equivalent to the issuance of a standby letter of credit, a device long recognized as within the business of banking. The proposal to allow national banks to reinsure loans through their participation in the exchange is clearly consistent with this line of analysis and represents an alternative way for national banks to extend mortgage loans.

The proposal is also consistent with our precedents that hold that national banks may pool their resources to engage in banking activities collectively. *See,* Letter from James M. Kane, District Counsel dated June 8, 1988 (unpublished) (national banks permitted to purchase preferred stock in captive insurance company when stock purchase was a prerequisite to obtaining directors' and officers' liability insurance); OCC Interpretive Letter No. 554 [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶83,301 (captive insurer similar to Kane situation); OCC Interpretive Letter No. 427 [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,651 (May 9, 1988) (bank purchases of stock in the Federal Agricultural Mortgage Corporation (Farmer Mac) where stock purchases were necessary for participation in the agricultural mortgage secondary market promoted by Farmer Mac; Letter of James J. Saxon, Comptroller of the Currency (October 12, 1966) (banks may purchase minority interests in a corporation that operated a credit card clearinghouse for the benefit of the owner banks); and Letter of Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (equity investment to join an ATM network).

As with other collective ventures permitted by the OCC, the exchange offers the opportunity to engage in banking services more efficiently and effectively. Participating banks can realize an overall cost savings through economies of scale offered by the exchange that will reduce transaction costs. Participating banks also can achieve greater diversification through reinsuring in a larger, more diverse, portfolio of loans. This will be particularly helpful to community and mid-size banks, which, individually, may lack the resources and loan volume to achieve the level of diversification or economies of scale, offered by the exchange.

2. Respond to Customer Needs or Otherwise Benefit the Bank or Its Customers

The exchange would offer benefits for participating banks and their customers. The participating banks and mortgage companies usually require down payments on residential loans of at least 20 percent of appraised values. However, the participating lenders will accept smaller down payments if repayment of a mortgage is backed by mortgage insurance. Moreover, purchasers in the secondary market, including the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) will ordinarily not purchase low down-payment loans unless they are covered by mortgage insurance. Thus, customers benefit from mortgage insurance because it enables them to make small down payments on the purchases of their homes. They have the option of paying the higher monthly costs associated with low down payments, or making a larger down payment. The participating banks' involvement in mortgage reinsurance should not diminish customers' abilities to obtain optional mortgage insurance.

The exchange also would benefit the participating banks by providing the banks flexibility in structuring their activities to obtain new sources of credit-related income. *[Co. 2]* will assume some of the credit risks on low down-payment loans that might otherwise be borne by the

participating banks. Through the proposed reinsurance activities, the participating banks may acquire additional mortgage credit business that can be managed as part of their overall mortgage credit risk management programs. This additional business will provide the participating banks with an alternative vehicle for achieving risk objectives.

As described above, the exchange also offers participants a potentially more cost-effective and attractive vehicle for reinsurance of their own mortgages. Through economies of scale the exchange may enhance the profitability of reinsurance activities, particularly for community and mid-size banks. The expanded diversification offered to participants in the exchange also may reduce credit risks they assume through reinsurance.

3. Risks Similar in Nature to Those Already Assumed by National Banks

As discussed, the risks a national bank assumes in reinsuring mortgage insurance through the exchange are essentially the same risks associated with the permissible activities of underwriting mortgage loans. Through the proposed reinsurance activities, the participating banks will assume credit risks transferred to *[Co. 2]* and then back to the exchange. Consistent with the assumption of credit risks, there is a potential loss of future premiums to the exchange. However, these risks are similar to risks that would be incurred by the participating banks on loans with high loan-to-value ratios not covered by mortgage insurance or through purchases of participations in the mortgage loans.

As noted above, all loans reinsured by the exchange must meet *[Co. 2]'s* insurance underwriting criteria in order to be accepted for mortgage coverage. Thus, *[Co. 2]'s* underwriting criteria will serve as a "screen" for all loans reinsured by the exchange, and will provide the consistency and uniformity analogous to the standardized credit underwriting criteria utilized by members of a bank holding company system.[15] *[Co. 2]'s* underwriting criteria will help to ensure that participating national banks assume a pro rata share of reinsurance liability on a quality loan pool with relatively homogenous risk.

To the extent that the exchange will include residential mortgage loans originated in a tri-state area *[States, and State]* or originated in other states and purchased by participating lenders, participation in the pool is analogous to the purchase of participations to achieve geographic diversification and manage mortgage credit risk.

[15] *See* OCC Corporate Decision No. 97–15 (March 1997), p. 5, fn. 9.

B. Incidental To the Business of Banking Analysis

The OCC also determined in the Mortgage Reinsurance Approval Letters and IL 743 that even if mortgage reinsurance activities were not viewed as a part of the business of banking, those activities would be generally permissible as incidental to a national bank's express power to make loans. Similarly, national bank participation in the proposed exchange is incidental to the business of banking.

In *VALIC [NationsBank of North Carolina, N.A.* v. *Variable Life Annuity Co.*, 513 U.S. 251 (1995)], the Supreme Court expressly held that the "business of banking" is not limited to the enumerated powers in 12 USC 24(Seventh), but encompasses more broadly activities that are part of the business of banking. *VALIC* at 814, n. 2. The *VALIC* decision further established that banks may engage in activities that are incidental to the enumerated powers as well as the broader business of banking.

Prior to *VALIC,* the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours, Inc.* v. *Camp,* 472 F.2d 427 (1st Cir. 1972) *("Arnold Tours").* The *Arnold Tours* standard defined an incidental power as one that is "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its *express* powers under the National Bank Act." *Arnold Tours* at 432 (emphasis added). Even prior to *VALIC,* the *Arnold Tours* formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act. OCC Interpretive Letter No. 494 (December 20, 1989). The *VALIC* decision, however, has established that the *Arnold Tours* formula provides that an incidental power includes one that is convenient and useful to the business of banking, as well as a power incidental to the express powers specifically enumerated in 12 USC 24(Seventh).

Participation in the exchange is incidental to the business of banking under the *Arnold Tours* standard. Reinsuring mortgage insurance in the manner proposed through membership in the exchange is incidental to a national bank's express power to make loans. The proposed activity is "convenient" and "useful" to the power of participating banks to make loans because membership in the exchange will enable participating banks to structure mortgage loans in a more flexible way. *Arnold Tours.*[16]

[16] *See also, Franklin National Bank of Franklin Square* v. *New York,* 347 U.S. 373 (1954) (power to advertise bank services); and *Auten* v. *United States Nat'l. Bank,* 174 U.S. 125 (1899) (power to borrow money). In these cases the courts' holdings relied on whether the activity was "useful."

Specifically, the proposed activity will provide the participating banks an alternative structure for making loans that could otherwise be made with a higher rate of interest to cover the increased risk of nonpayment associated with a low down payment. The proposed activities also provide the participating banks an alternative to participating in loans to expand their credit activities. This flexibility is convenient and useful to the participating banks in determining how to structure their mortgage-lending activities in the most efficient and profitable manner and in offering a competitive array of mortgage-lending products to their customers. The proposed activities also are incidental to lending activities because they enable the participating banks to optimize the use of their existing credit staff and credit expertise to generate additional revenues through activities that support and enhance their lending businesses and enable them to better manage their credit risk.

III. Conclusion

Based upon the foregoing facts and analysis, and the representations in your request for interpretive advice, we have concluded that national banks' participation in the exchange is permissible under 12 USC 24(Seventh). A national bank must obtain prior approval of the OCC under 12 CFR 5.34, before an operating subsidiary (whether through a new subsidiary or through expansion of the activities of an existing subsidiary) may participate in the exchange. A national bank that wants to participate in the exchange directly should notify its EIC in conjunction with commencing the activity.[17]

Julie L. Williams
Chief Counsel
Attachment [Attachment omitted. See footnote 17.]

[17] We express no opinion on whether the proposal complies with any other potentially applicable standards, including the anti-kickback provisions of section 8 of the Real Estate Settlement Procedures Act, Pub. L. No. 93–533, 88 Stat. 1724; 12 USC 2601–2617 ("RESPA"). Attached for your reference is an August 6, 1997 letter from Department of Housing and Urban Development (HUD) Assistant Secretary for Housing Nicolas Retsinas, which discusses captive mortgage reinsurance arrangements and the standards of section 8 of RESPA. You should consult with HUD to the extent further clarification is needed to assure that the exchange arrangement is consistent with RESPA.

[Attachment omitted. The text of the HUD letter is published separately in the "Appendix to Chapter 2," of the *Federal Regulation of Real Estate and Mortgage Lending,* 4th ed., by Paul Barron and Michael A. Berenson (St. Paul: West Group, 1998), pp. App.2-101–App.2-103.]

829—April 9, 1998

12 CFR 9.18

Dear [ ]:

This responds to your request on behalf of [ ], *[city, state]* (bank), that the Office of the Comptroller of the Currency (OCC) express its views, consistent with the requirements of 12 CFR Part 9, concerning the ability of a national bank to charge different fund management fees to participants in a collective investment fund (CIF) commensurate with the amount and types of services the bank provides to the CIF participants. Based on the representations you made on behalf of the bank, and subject to the conditions below, we believe that a national bank may, in the manner described, charge CIF participants different fund management fees commensurate with the amount and types of services the bank provides to each participant, consistent with the requirements of 12 CFR Part 9.

I. Background

The bank is contemplating the establishment of a fluctuating net asset collective investment fund [ ] for employee benefit plans that would invest primarily in guaranteed investment contracts (GICs).[1] The GICs are issued primarily by insurance companies. Generally, the bank intends to maintain a 10 percent cash position in [ ].

At present, the bank (together with its affiliate banks) offers to 401(k) employee benefit plans and certain other employee benefit plans, choices of different retirement programs designed to meet the investment and administrative needs of the plans. Plan sponsors initially choose a retirement program offered by the bank, then select from the investment alternatives available under the program (usually no more than eight) those alternatives it will make available to plan participants as investment options under its plan.[2] The investment alternatives offered in this type of 401(k) product include certain mutual funds and [ ]. Before a sponsor decides to offer [ ] as an investment alternative to its plan participants, the bank proposes to provide the plan

[1] One of the bank's investment objectives will be to keep the [ ] units at a constant unit value to avoid administering fractional shares and for ease of transfer.

[2] Although any defined benefit or defined contribution plan may invest in [ ], the bank anticipates that the primary source of growth for the [ ] will come from 401(k)-defined benefit plans in which the sponsor may select [ ] as one of several investment alternatives available to participants under the plan and in which the investments are participant-directed.

sponsor with a disclosure statement describing how [ ] works and a copy of the [ ] Declaration of Trust. The bank also would provide the plan sponsor with information concerning the management fees applicable to its plan prior to the sponsor's decision whether to offer [ ] as an investment option.

Under the bank's proposal, the management fee structure varies the fees charged to [ ] participants depending on the services they receive. For example, the bank intends to charge a lower fee to plan participants investing in [ ] that contract directly with a third party for participant accounting or if the size of the plan allows for more cost-efficient servicing. The bank would charge a higher fee to plan participants who take advantage of the full range of services the bank offers for managing and administering the [ ], including [ ]'s portion of participant accounting. The bank's CIF presently has a single in-fund management fee. As a result, plans that would require fewer services or allow for more cost-efficient services tend not to participate in the CIF. Indeed, if such plans invested in the CIF and were to pay for services they did not receive or to pay more than warranted for the plan's services they did receive, the bank and the plan trustee(s) could potentially breach the fiduciary duty they owe to the plans and plan participants. Conversely, the bank does not believe a waiver of the entire management fee is appropriate, because it provides all CIF participants some level of customary services, including investment management, and they should pay a reasonable fee for those services.

The bank has proposed a management fee structure for [ ] so that plan participants (or their employers) pay only for those services participants receive and only those plan participants whose assets are actually invested in [ ] (or their employers) pay the management fees associated with [ ]. The proposed fees generally fall within one of the three following areas:

1. *No fee.* The bank would not charge a fund management fee when the employer pays the bank's fees in one of the following three situations:

   (a) When a plan and its participants otherwise would pay either the base service or full service fees but the employer decides instead to pay the appropriate fee directly;[3]

   (b) When a plan, rather than employing the bank for administrative services, instead opens a so-called "Invest Only" custody or investment advisory account for the sole purpose of investing in [ ]. The employer would pay a graduated fee that varies inversely with the amount of assets invested in [ ]. The bank would have no responsibilities with respect to participant accounts; and

   (c) When certain existing customers (mainly bank customers) previously negotiated various plan level fees that the employer pays, these arrangements would remain unchanged.

2. *Base fee.* The bank charges a base service management fee for certain general management and administrative services. The bank anticipates that, based on the CIF fees it currently charges, the base service management fee will range from [#] to [#] basis points.[4]

3. *Full fee.* The bank charges a full service management fee for the full range of management and administrative services that a trustee usually and customarily renders to a CIF. The bank would charge that fee in exchange for providing all administrative services to the plan and its participants' accounts. The bank anticipates that, based on the CIF fees it currently charges, a full service management fee will be approximately [#] basis points.

The bank believes that this fee structure would provide national banks a tool to price fiduciary services competitively and allow it to offer [ ] as a viable and competitive product to other investment alternatives. The bank believes that if it cannot offer multiple pricing flexibility, it cannot present a viable alternative to other, more attractive investment options, *e.g.*, where the sponsor of a 401(k) plan that qualifies for a lower expense ratio may select from a "menu" of more favorably priced investment options for plan participants (such as the purchase of institutional shares of a mutual fund).

The bank would charge all CIF plans annual fees for trustee and custodian services. The annual fee would vary, depending upon other administrative services the bank provides that are not directly related to investment services that the plans contract for, such as testing required under ERISA [Employee Retirement Income Security Act], filing the Form 5500, making contributions, issuing participant statements, and administering participant loans.

[3] [ ] could rebate the payments. The bank, however, believes that a rebate procedure would unnecessarily add to the administrative structure and expenses of [ ], and be cumbersome, costly, and confusing to participants.

[4] The bank's fee proposal would allow both small and large plans to benefit. While some bond and equity mutual funds allow only the largest plans ($100 million or more) to purchase their institutional shares, the bank would allow plans to participate in [ ] regardless of size, similar to certain other GIC commingled funds and institutional money market mutual funds.

You represented on behalf of the bank that each unit has a proportionate interest in [ ]'s assets. No unit would have any right, title, or interest in [ ] superior to, or different from, the right, title, or interest of any other [ ] unit. Due to the charging of fund management fees corresponding to the services the bank would provide plan participants, unit values may vary. As the bank deducts management fees at the [ ] fund level, the unit value of units held by plan participants who pay the full service fee will of necessity be lower than the unit value of units of plan participants subject only to the base service fee. Where a plan sponsor pays all fees directly, that plan's participants' units would have the largest per unit value since the bank would not charge fees at the [ ] fund level.

Participants will always purchase [ ] units at their then fair market value. If one participant buys units subject to the full service fee and another participant purchases units subject only to the base service fee and each participant invests $1,000, both participants will receive units worth $1,000. The participant buying the full service fee units will receive more units, however, since units subject to a full service fee will have a lower fair market value, due to the larger fund management fee that the bank periodically will deduct from those units. The value of the units will vary only to reflect the different fund management fees. You represent on behalf of the bank that appropriate bank systems and procedures will accurately account for, calculate, and report those value differences.

II. Discussion

As fiduciaries, national banks may invest funds held on behalf of retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from federal income taxation under the Internal Revenue Code in CIFs.[5] CIFs may invest in various assets, including GICs.[6] GICs are individually negotiated investment contracts between insurance companies and investors that resemble debt instruments and provide for fixed returns over a period of time, typically less than 10 years.[7] The OCC previously has approved the use of CIFs for employee benefit accounts that invest primarily in GICs.[8]

OCC regulations govern the administration of CIFs by national bank trustees.[9] National banks may charge fees for the management of CIFs consistent with the limitations in 12 CFR 9.18(b)(9) (1997). The management fees national bank may charge for administering CIFs are subject to an overall "reasonableness" standard. Accordingly, national banks may charge management fees for CIFs that are reasonable,[10] consistent with applicable state law requirements, and commensurate with the services the bank trustee is providing to the CIF.[11] A bank must also disclose the management fees to be charged to a CIF and to participating accounts in the bank's written plan[12] and at least annually in a manner consistent with applicable law in the state where the bank maintains the CIF.[13]

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[5] 12 CFR 9.18(a).

[6] *See* OCC Interpretive Letter No. 716 (December 21, 1996), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–031; OCC Trust Interpretive Letter No. 173 (August 31, 1988), *reprinted in* [1987–1988 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,940; OCC Trust Interpretive Letter No. 128 (November 17, 1987).

[7] *See* OCC Interpretive Letter No. 716, *supra*.

[8] *See* OCC Trust Interpretation No. 194 (January 13, 1989), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,961.

[9] *See* 12 CFR 9.18 (1997). Part 9, including 12 CFR 9.18, was amended effective January 29, 1997. 61 *Fed. Reg.* 68,543 (1996). The fiduciary precedents and trust interpretive letters preceding the January 29, 1997 effective date of 12 CFR Part 9 are interpretations of the former regulation. Even so, those precedents and interpretations can still be persuasive in interpreting the language in the new Part 9. Furthermore, in many instances the precedents and interpretations have become industry practice or simply articulate sound fiduciary principles. *See* OCC Bulletin 97–22 (May 15, 1997).

[10] Banks may charge "management" fees for any services that assist the bank in fulfilling its management role. *See* Investment Securities Letter No. 48 (May 3, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,261. The reasonableness of a fee depends in part on the services obtained for the fee. *See* OCC Interpretive Letter No. 722 (March 12, 1996), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–031.

[11] The OCC's regulation on CIF management fees provides:

> Management fees. A bank administering a collective investment fund may charge a reasonable fund management fee only if: (i) The fee is permitted under applicable law (and complies with fee disclosure requirements, if any) in the state in which the bank maintains the fund; and (ii) The amount of the fee does not exceed an amount commensurate with the value of legitimate services of tangible benefit to the participating fiduciary account that would not have been provided to the accounts were they not invested in the fund.
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> 12 CFR 9.18(b)(9)(i) and (ii) (1997).

[12] National banks are required to establish and maintain each CIF in accordance with a written plan approved by a resolution of the bank's board of directors or by a committee authorized by the bank's board of directors. 12 CFR 9.18(b)(1)(iii).

[13] 12 CFR 9.18(b)(6)(ii). Alternatively, if the bank concludes that the proposed management fees do not conform with the overall reasonableness standard in Part 9, the bank must request an exemption to Part 9 management fee requirements, by submitting to the OCC a written plan that identifies: (i) The reasons that the CIF requires a special exemption; (ii) The provisions of the proposed CIF that are inconsistent with 12 CFR 9.18; (iii) The provisions of 12 CFR 9.18 for which the bank seeks an exemption; and the manner in which the proposed CIF addresses the rights and interest of participating accounts; and (iv) The manner in which the proposed fund addresses the rights and interests of the participating accounts. The OCC will grant the bank an exemption if the written proposal is consistent with the bank's fiduciary duties and with safe and sound banking practices.

Part 9's reasonableness standard replaces a quantitative management fee limitation formerly applicable to CIF management fees.[14] The quantitative management fee limitation permitted a national bank trustee to charge a CIF a management fee only if the fractional part of such fee proportionate to the interest of each participant would not exceed the total fees that the participant would be charged if the participant had not invested assets in the CIF.[15] The OCC replaced the more restrictive quantitative management fee limitation with the reasonableness standard, in order to provide "updated operating standards for national bank fiduciary activities" and "sufficient protections for bank's fiduciary customers."[16] Under the new standard, national banks may charge CIF management fees provided that the fees are reasonable under the particular facts and circumstances.

OCC regulations do not address the ability of national banks to charge different fees to different classes of CIF participating accounts. The OCC determined under the former quantitative limitation that national banks may charge different management fees to different classes of participant accounts.[17] In OCC Interpretive Letter No. 300,[18] the OCC permitted a bank trustee to charge a reduced management fee to large dollar employee benefit CIF participants because the bank made available reduced fees for individually invested large dollar accounts.[19] The fee concession conformed with the quantitative management fee restrictions then applicable under section 9.18(b)(12) because, while the bank charged different management fees to different classes of CIF participants, the total fees charged did not exceed the total fees the bank charged accounts receiving individual investment management.

Similarly, Part 9 does not address the issue of whether national banks may accept management fees from other than CIF participants and plans as the bank proposes under its no fee option, or how the reasonableness standard applies when a bank chooses to do so. The OCC concluded that a national bank may receive fees in a similar circumstance under the quantitative standard. In OCC Interpretive Letter No. 722,[20] a national bank inquired about the permissibility of assessing management fees to CIF participants when the CIF simultaneously received fee payments from nonparticipants. The OCC concluded that a national bank CIF could receive both the participant and nonparticipant fee payments provided the bank concluded, based on a reasoned opinion of trust counsel, that applicable state law, the governing trust instrument, and the management fee restrictions contained in 12 CFR 9.18 permitted the fees.

Provided the bank's management fee structure, including the trustee/custodian fee, meets the reasonableness standard and the bank complies with appropriate disclosure requirements, the bank can proceed with its proposal. Although OCC has reviewed the ability of national banks to charge different classes of management fees and accept fees from other than the CIF participants and plans under the old quantitative test, those former precedents support the position that a national bank may also do so under the current reasonableness standard. Indeed, the bank's ability to charge different management fees based on employer fee payments, previously negotiated fees, and services the bank provides to participants furthers the OCC's goal of updating the operating standards for national banks fiduciary activities, as envisioned by the OCC when drafting the new Part 9. In addition, allowing the bank to offer CIF units incorporating the proposed fee structure will enable the bank to offer an investment product that can effectively compete with other investment alternatives, including similarly structured mutual funds.[21] Equally important, the bank's proposed fee structure enables the bank to establish one CIF that offers a variety of fee options as opposed to multiple CIFs that accomplish that same result, saving the bank the expense associated with establishing and administering numerous CIFs. Therefore, consistent with the OCC's desire to provide sufficient protections for bank's fiduciary customers, the bank may charge the proposed CIF management fees to CIF participants if, based on the relevant facts and supported by a well-reasoned opinion of trust counsel, the bank concludes that:

(1) the fees are reasonable;

(2) applicable law permits the fees (and the bank complies with fee disclosure requirements, if any) in the state where the bank maintains the fund;

(3) the amount of the fees do not exceed an amount commensurate with the value of legitimate services of tangible benefit to the participating fiduciary accounts that would not have been provided to accounts were they not invested in the fund;

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[14] 12 CFR 9.18(b)(12) (1996).

[15] 12 CFR 9.18(b)(12) (1996).

[16] *See* 61 *Fed. Reg.* 68,543, 68,550 (1996).

[17] *See* OCC Trust and Securities Letter No. 300 (April 26, 1984), *reprinted in* [1985–1987 Transfer Binder] (CCH) ¶ 85,470.

[18] OCC Trust and Securities Letter No. 300, *supra*.

[19] The bank reduced its management fees when it rebated a portion of its management fee to purchase additional fund units for its large dollar CIF participants. OCC Trust and Securities Letter No. 300, *supra*.

[20] *See* OCC Interpretive Letter No. 722, *supra*.

[21] A mutual fund may issue multiple class shares under Rule18f–3 of the Investment Company Act of 1940. 12 CFR 270.18f–3.

(4) the management fees to be charged to the fund and to participating accounts are disclosed in the bank's written plan; and

(5) the bank discloses the management fees, along with other fees and expenses charged to the plan, at least annually in a manner consistent with applicable law in the state where the bank maintains the CIF.

Finally, 12 CFR 9.18(b)(3) requires that all participating accounts in a CIF have a proportionate interest in all of the CIF's assets. Under the bank's proposal, the value of the [ ] units will vary depending, in part, on the services the bank provides in connection with the units. Under the bank's proposal, the bank will subtract all fees from the value of a participant's [ ] units so that the unit value of units held by plan participants that incur the full service fees will be lower than the unit value of units subject to base service fees and no service fees, and the unit value of units subject to base service fees will be lower than the unit value of units subject to no service fees. The bank will provide participants buying full service units with more units for the same dollar investment as participants buying base service units or no service fee units and participants buying base service units will receive more units than participants purchasing no service fee units. Under these circumstances, the bank's increase in the number of units provided to purchasers of full service units over base service units and to purchasers of base service units over no-fee units permits all unit purchasers to retain a proportionate interest in [ ]'s assets. Despite the fact that the value of the units will vary due to the different fund management fees, each [ ] participant will have a proportionate interest in [ ]'s underlying assets as required under 12 CFR 9.18(b)(3).

III. Conclusion

Based on the representations made by the bank, the bank may charge different management fees to [ ] participants, commensurate with the amount and types of services it provides to the participants, when the fees meet the requirements of the reasonableness standard of 12 CFR 9.18(b)(9) and each participant retains a proportionate interest in [ ]'s underlying assets as required by 12 CFR 9.18(b)(3).

I trust this letter responds to your inquiry. If you have any further questions, please contact Tena M. Alexander, a senior attorney with the Securities and Corporate Practices Division, at (202) 874–5210.

Dean E. Miller
Senior Advisor for Fiduciary Activities

830—May 19, 1998

12 USC 29

12 CFR 34.83(a) *[file 12 USC 29E2]*

Dear [ ]:

This is in response to your letter of May 1, concerning a real property lease of the premises known as the [ ] at [ ] Boulevard, *[city, state].* Your bank leased the property for a 25-year term from [ ], commencing on January 1, 1965. The lease included two successive options to extend for 10 years each. [ ] subsequently sold the property to *[Co.],* who is now the owner-lessor.

The bank occupied the premises as a branch office during the 25-year term, and renewed for another 10 years in 1990. In January 1994 the bank decided to close the branch, in part due to severe earthquake damage. It proposed to assign the lease to *[Inc.],* but *[Co.]* refused to give its permission. So instead the bank subleased the premises to *[Inc.]* for the remainder of the lease.

The current lease term expires on December 31, 1999, and can be extended for one more 10-year term by exercise of the second extension option. The sublease between the bank and *[Inc.]* provides that if "it is then legal for Sublessor [i.e., the bank] to do so," upon stated conditions the bank will "assign to the Sublessee, or exercise on behalf of Sublessee, Sublessor's right under the Master Lease for an additional period of ten (10) years, in which event the Term of this Sublease will be extended. . . ."

You have inquired whether the bank would lawfully be able to exercise sometime prior to December 31, 1999, the second extension option, i.e., the option to renew the lease term for an additional 10 years. The bank, in other words, would be the sublessor, and *[Inc.]* the sublessee, for another 10 years after December 31, 1999.

It is my opinion that such an extension of the lease for a new 10-year period commencing on January 1, 2000, by the bank, would not be legal under 12 USC 29 and the OCC's implementing regulation, 12 CFR Part 34, Subpart E ("Other Real Estate Owned"). The statute provides that a national bank shall "hold . . . real estate" only if the real estate is necessary for its accommodation in the transaction of its business, or is acquired for debts previously contracted. The property in question was leased as bank premises until January 1994, and so qualified as a permissible holding. When the bank vacated the property with no intention of ever again using it as a branch office, the property became "other real estate owned"

(OREO), *see* 12 CFR 34.81(c) and (e) (defining OREO to include former banking premises).

Twelve USC 29 provides that a national bank must dispose of OREO property within five years, or with OCC approval within up to an additional five years. The former branch became OREO in January 1994, and at that time the bank subleased the property to *[Inc.]* for the remainder of the lease term, which ends on December 31, 1999.

By this action, the bank "disposed" of the property for purposes of 12 USC 29 and 12 CFR 34.83. The OCC's OREO regulation provides that a national bank may comply with its obligation to dispose of real estate in a number of ways. In the case of a lease, one way to dispose of the property is to enter into a "coterminous sublease," i.e., a sublease that runs to the end of the lease term. 12 CFR 34.83(a)(3). That is what your bank did in 1994. Having disposed of the OREO property in this way, there is no legal basis under 12 USC 29 or the OREO regulation for the bank to enter into a new 10-year lease term beginning on January 1, 2000, for the purpose of entering into a new sublease to *[Inc.]* for the same duration.

I trust that this reply is responsive to your inquiry.

William B. Glidden
Assistant Director
Bank Activities and Structure Division

Mergers—April 1 to June 30, 1998

Mergers—April 1 to June 30, 1998

Most transactions in this section do not have accompanying decisions. In those cases, the OCC reviewed the competitive effects of the proposals by using its standard procedures for determining whether the transaction has minimal or no adverse competitive effects. The OCC found the proposals satisfied its criteria for transactions that clearly had no or minimal adverse competitive effects. In addition, the Attorney General either filed no report on the proposed transaction or found that the proposal would not have a significantly adverse effect on competition.

Nonaffiliated mergers (mergers consummated involving two or more nonaffiliated operating banks), from April 1 to June 30, 1998

Title and location (charter number)	Total assets
Alabama	
SouthTrust Bank, National Association, Birmingham (014569)	30,714,713,000
and American National Bank of Florida, Jacksonville (014464)	540,660,000
merged on June 19, 1998 under the title of **SouthTrust Bank, National Association, Birmingham** (014569)	31,255,373,000
Colorado	
Vectra Bank Colorado, National Association, Denver (023684)	305,391,000
and First National Bank of Colorado, Steamboat Springs (018436)	92,841,000
merged on May 29, 1998 under the title of **Vectra Bank Colorado, National Association, Denver** (023684)	398,232,000
Georgia	
The Summit National Bank, Dekalb County (021484)	152,079,000
and California Security Bank, San Jose	100,000
merged on June 30, 1998 under the title of **The Summit National Bank, Atlanta** (021484)	152,079,000
Illinois	
First National Bank in Olney, Olney (014217)	138,515,000
and Mt. Erie State Bank, Mount Erie	15,281,000
merged on May 15, 1998 under the title of **First National Bank in Olney, Olney** (014217)	153,796,000
Louisiana	
Whitney National Bank, New Orleans (014977)	3,737,194,000
and Louisiana National Security Bank, Donaldsonville (014281)	104,507,000
merged on May 16, 1998 under the title of **Whitney National Bank, New Orleans** (014977)	3,841,701,000
Pennsylvania	
First Union National Bank, Avondale (022693)	27,577,093,000
and Covenant Bank, Haddonfield	453,971,000
merged on January 16, 1998 under the title of **First Union National Bank, Avondale** (022693)	28,009,148,000
Texas	
Surety Bank, National Association, Hurst (015187)	176,831,000
and Texstar National Bank, Universal City (018548)	73,635,000
merged on April 1, 1998 under the title of **Surety Bank, National Association, Hurst** (015187)	250,866,000

Nonaffiliated mergers—thrift (mergers consummated involving nonaffiliated national banks and savings and loan associations), from April 1 to June 30, 1998

Title and location (charter number)	Total assets
Louisiana	
Whitney National Bank, New Orleans (014977)	3,623,194,000
and Meritrust Federal Savings Bank, Thibodaux	233,311,000
merged on April 24, 1998 under the title of Whitney National Bank, New Orleans (014977)	3,856,505,000
Missouri	
South Side National Bank in St. Louis, St. Louis (014128)	353,316,000
and Public Service Bank, a Federal Savings Bank, St. Louis	70,470,000
merged on June 29, 1998 under the title of South Side National Bank in St. Louis, St. Louis (014128)	424,409,000

Affiliated mergers (mergers consummated involving affiliated operating banks), from April 1 to June 30, 1998

Title and location (charter number)	Total assets
Alabama	
SouthTrust Bank, National Association, Birmingham (014569)	29,081,728,000
and SouthTrust Asset Management Company of the Carolinas, Inc., Charlotte	3,023,000
merged on June 30, 1998 under the title of **SouthTrust Bank, National Association, Birmingham** (014569)	29,084,751,000
SouthTrust Bank, National Association, Birmingham (014569)	29,081,737,000
and SouthTrust Asset Management Company of Georgia, National Association, Atlanta (022542)	2,149,000
merged on June 30, 1998 under the title of **SouthTrust Bank, National Association, Birmingham** (014569)	30,714,704,000
SouthTrust Bank, National Association, Birmingham (014569)	30,714,704,000
and SouthTrust Asset Management Company of Florida, National Association, St. Petersburg (023027)	3,052,000,000
merged on June 30, 1998 under the title of **SouthTrust Bank, National Association, Birmingham** (014569)	33,766,704,000
California	
U.S. Trust Company of the Pacific Northwest Interim National Bank, Portland (023661)	240,000
and Trust Company of the Pacific Northwest, Portland	4,066,000
and U.S. Trust Company, National Association, Los Angeles (022413)	314,863,000
merged on June 22, 1998 under the title of **U.S. Trust Company, National Association, Los Angeles** (022413)	319,169,000
Colorado	
Community First National Bank, Fort Morgan (007004)	1,243,476,000
and Community First National Bank, Gunnison (002686)	95,817,000
merged on May 3, 1998 under the title of **Community First National Bank, Fort Morgan** (007004)	1,339,293,000
Vectra Bank Colorado, National Association, Denver (007904)	398,232,000
and Vectra Bank, Denver	726,932,000
merged on May 28, 1998 under the title of **Vectra Bank Colorado, National Association, Denver** (007904)	1,125,164,000
Vectra Bank Colorado, National Association, Denver (007904)	217,445,000
and State Bank and Trust of Colorado Springs, Colorado Springs	87,946,000
merged on May 29, 1998 under the title of **Vectra Bank Colorado, National Association, Denver** (023684)	305,391,000
Florida	
Big Lake National Bank, Okeechobee (020494)	64,046,000
and Clewiston National Bank, Clewiston (016321)	47,420,000
merged on May 1, 1998 under the title of **Big Lake National Bank, Okeechobee** (020494)	111,004,000
Illinois	
First National Bank of Joliet, Joliet (013705)	554,803,000
and Southwest Suburban Bank, Bolingbrook	45,798,000
and Bank of Lockport, Lockport	99,532,000
and Community Bank of Plano, Plano	69,889,000
merged on March 14, 1998 under the title of **First National Bank of Joliet, Joliet** (013705)	770,022,000
Indiana	
Old National Bank in Evansville, Evansville (012444)	1,783,291,000
and The National Bank of Carmi, Carmi (005357)	64,099,000
merged on April 17, 1998 under the title of **Old National Bank in Evansville, Evansville** (012444)	1,847,390,000
Iowa	
Bank Iowa, National Association, Red Oak (005738)	46,092,000
and The Security Trust and Savings Bank, Shenandoah	36,767,000
merged on June 1, 1998 under the title of **Bank Iowa, National Association, Red Oak** (005738)	81,100,000
Massachusetts	
BankBoston, National Association, Boston (000200)	64,953,769,000
and Rhode Island Hospital Trust National Bank, Providence (015723)	3,437,717,000
merged on May 21, 1998 under the title of **BankBoston, National Association, Boston** (000200)	69,528,760,000
Minnesota	
U.S. Bank National Association, Minneapolis (013405)	67,375,521,000
and First Trust Company of North Dakota National Association, Fargo (022055)	7,737,000
merged on April 16, 1998 under the title of **U.S. Bank National Association, Minneapolis** (013405)	67,382,084,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
U.S. Bank National Association, Minneapolis (013405)	67,598,384,000
and Piper Trust Company, Minneapolis	3,243,000
merged on June 15, 1998 under the title of **U.S. Bank National Association, Minneapolis** (013405)	67,601,627,000
New Mexico	
Norwest Bank New Mexico, National Association, Albuquerque (006187)	2,365,179,000
and Norwest Bank New Mexico Northeast, National Association, Tucumcari (006081)	93,446,000
merged on May 16, 1998 under the title of **Norwest Bank New Mexico, National Association, Albuquerque** (006187)	2,458,625,000
North Carolina	
NationsBank, National Association, Charlotte (014448)	168,646,671,000
and NationsBank of Texas, National Association, Dallas (021834)	44,208,672,000
merged on May 6, 1998 under the title of **NationsBank, National Association, Charlotte** (014448)	198,829,921,000
First Union National Bank, Avondale (022693)	146,796,000,000
and CoreStates Bank, National Association, Charlotte (000001)	44,430,000,000
merged on May 15, 1998 under the title of **First Union National Bank, Charlotte** (000001)	191,226,000,000
Ohio	
National City Bank, Cleveland (000786)	10,551,671,000
and National City Bank of Columbus, Columbus (005065)	6,345,916,000
and National City Bank of Dayton, Dayton (001788)	2,489,280,000
merged on January 31, 1998 under the title of **National City Bank, Cleveland** (000786)	22,189,978,000
Tennessee	
First Commercial Bank, National Association of West Memphis, West Memphis (023608)	290,464,000
and First Commercial Bank, National Association of Memphis, Memphis (022278)	472,883,000
merged on March 27, 1998 under the title of **First Commercial Bank, National Association of Memphis, Memphis** (023608)	763,347,000
First American National Bank, Nashville (003032)	10,594,000
and Victory Bank and Trust Company, Cordova	131,588,000
merged on June 1, 1998 under the title of **First American National Bank, Nashville** (003032)	142,182,000
National Bank of Commerce, Memphis (013681)	3,274,339,000
and Citizens' Bank, Marion	66,440,000
and Bank of West Memphis, West Memphis	106,410,000
merged on June 19, 1998 under the title of **National Bank of Commerce, Memphis** (013681)	3,447,189,000
Texas	
National Bank of Commerce, Pampa (017829)	59,537,000
and First Bank & Trust, Shamrock	21,238,000
merged on March 31, 1998 under the title of **National Bank of Commerce, Pampa** (017829)	81,431,000
Norwest Bank Texas, National Association, San Antonio (014208)	8,345,098,000
and Fidelity Bank & Trust, National Association, Fort Worth (022989)	104,242,000
and Continental State Bank, Boyd	139,061,000
merged on June 20, 1998 under the title of **Norwest Bank Texas, National Association, San Antonio** (014208)	8,574,379,000
The Harlingen National Bank, Harlingen (014776)	173,036,000
and First National Bank of La Feria, La Feria (012747)	46,255,000
merged on May 18, 1998 under the title of **The Harlingen National Bank, Harlingen** (014776)	215,124,000
San Angelo National Bank, San Angelo (023445)	272,990,000
and San Angelo Trust Company, National Association, San Angelo (023448)	1,033,000
merged on May 4, 1998 under the title of **San Angelo National Bank, San Angelo** (023445)	274,023,000
The Frost National Bank, San Antonio (005179)	5,389,479,000
and Overton Bank and Trust, National Association, Fort Worth (016716)	861,723,000
merged on May 29, 1998 under the title of **The Frost National Bank, San Antonio** (005179)	6,251,202,000
Wisconsin	
The Stephenson National Bank and Trust, Marinette (004137)	111,000,000
and The Stephenson National Bank, Menominee (023535)	1,000
merged on April 20, 1998 under the title of **The Stephenson National Bank and Trust, Marinette** (004137)	111,000,000

Affiliated mergers—thrift (mergers consummated involving affiliated national banks and savings and loan associations), from April 1 to June 30, 1998

Title and location (charter number)	Total assets
Ohio	
Bank One, National Association, Columbus (007621)	25,773,935,000
and First USA Federal Savings Bank, Wilmington	269,967,000
merged on April 1, 1998 under the title of **Bank One, National Association, Columbus** (007621)	25,339,643,000
FirstMerit Bank, National Association, Akron (014579)	3,852,064,000
and Jefferson Savings Bank, West Jefferson	62,513,000
and PremierBank & Trust, Elyria	601,637,000
merged on May 22, 1998 under the title of **FirstMerit Bank, National Association, Akron** (014579)	4,605,900,000
The First National Bank of Zanesville, Zanesville (000164)	479,378,000
and County Savings Bank, Newark	564,442,000
and The Bellbrook Community Bank, Bellbrook	42,381,000
merged on May 16, 1998 under the title of **The First National Bank of Zanesville, Zanesville** (000164)	479,378,000
Virginia	
One Valley Bank-Central Virginia, National Association, Lynchburg (023467)	697,735,000
and First Federal Savings Bank of Lynchburg, Lynchburg	562,369,000
merged on June 8, 1998 under the title of **One Valley Bank-Central Virginia, National Association, Lynchburg** (023467)	1,260,104,000

Tables on the Corporate Structure of the National Banking System

Changes in the corporate structure of the national banking system, by state, January 1 to June 30, 1998

	In operation January 1, 1998	Organized and opened for business	Merged	Voluntary liquidations	Payouts	12 USC 214		In operation June 30, 1998
						Converted to non-national institutions	Merged with non-national institutions	
Alabama	34	0	0	0	0	0	0	34
Alaska	4	0	0	0	0	0	0	4
Arizona	15	1	0	0	0	0	0	16
Arkansas	66	0	1	0	0	0	0	64
California	105	5	0	0	0	2	3	105
Colorado	89	1	3	0	0	15	0	72
Connecticut	9	0	0	0	0	0	0	9
Delaware	21	1	1	0	0	0	1	21
District of Columbia	7	0	0	0	0	0	0	7
Florida	98	4	4	0	0	1	2	95
Georgia	62	2	1	0	0	0	0	63
Hawaii	1	0	0	0	0	0	0	1
Idaho	1	0	0	0	0	0	0	1
Illinois	236	0	2	0	0	0	1	233
Indiana	49	2	0	0	0	0	1	50
Iowa	53	6	6	0	0	0	1	52
Kansas	116	0	0	0	0	0	1	115
Kentucky	71	0	0	0	0	2	0	69
Louisiana	25	1	2	0	0	0	0	24
Maine	7	0	0	0	0	0	0	7
Maryland	21	0	0	0	0	0	0	21
Massachusetts	22	1	0	0	0	0	2	21
Michigan	39	1	1	0	0	0	1	38
Minnesota	142	2	0	0	0	0	0	145
Mississippi	24	0	2	0	0	0	0	22
Missouri	47	4	0	0	0	0	0	51
Montana	22	0	3	0	0	1	0	18
Nebraska	99	3	0	0	0	0	1	101
Nevada	7	0	0	0	0	0	0	7
New Hampshire	9	0	1	0	0	0	0	8
New Jersey	27	1	0	0	0	0	1	27
New Mexico	20	1	2	0	0	0	0	19
New York	68	0	0	1	0	0	0	67
North Carolina	10	0	2	0	0	0	0	10
North Dakota	20	0	1	0	0	0	0	19
Ohio	108	2	5	1	0	0	0	104
Oklahoma	117	3	1	0	0	0	0	119
Oregon	4	0	0	0	0	0	0	4
Pennsylvania	114	1	0	0	0	0	1	112
Rhode Island	3	0	1	0	0	0	0	2
South Carolina	23	1	1	0	0	0	2	21
South Dakota	24	1	2	0	0	0	0	23
Tennessee	42	1	7	0	0	0	0	36
Texas	428	10	11	1	0	1	9	416
Utah	8	0	0	0	0	0	0	8
Vermont	12	0	0	0	0	0	0	12
Virginia	31	2	2	0	0	0	0	31
Washington	21	0	0	0	0	0	1	20
West Virginia	33	1	0	0	0	0	0	34
Wisconsin	63	2	1	0	0	0	1	62
Wyoming	20	3	0	0	0	0	0	23
United States:	2,697	63	63	3	0	22	29	2,643

Notes: The column "organized and opened for business" includes all state banks converted to national banks as well as newly formed national banks. The column titled "merged" includes all mergers, consolidations, and purchases and assumptions of branches in which the resulting institution is a nationally chartered bank. Also included in this column are immediate FDIC-assisted "merger" transactions in which the resulting institution is a nationally chartered bank. The column titles "voluntary liquidations" includes only straight liquidations of national banks. No liquidation pursuant to a purchase and assumption transaction are included in this total. Liquidations resulting from purchase and assumptions are included in the "merged" column. The column titled "payouts" includes failed national banks in which the FDIC is named receiver and no other depository institution is named as successor. The column titled "merged with non-national institutions" includes all mergers, consolidations, and purchases and assumptions of branches in which the resulting institution is a non-national institution. Also included in the column are immediate FDIC-assisted "merger" transactions in which the resulting institution is a non-national institution.

Applications for new, full-service national bank charters, approved and denied by state, from January 1 to June 30, 1998

Title and location	Approved	Denied
California		
Canyon National Bank, Palm Springs	March 5	
Colorado		
Community First National Bank, Longmont	March 11	
Florida		
Seminole Bank, National Association, Seminole	April 24	
Georgia		
North Atlanta National Bank, Alpharetta	January 16	
Unity National Bank, Cartersville	February 11	
Atlantic National Bank, Brunswick	February 12	
North Georgia National Bank, Calhoun	March 11	
Chattahoochee National Bank, Alpharetta	April 3	
Kentucky		
PRP National Bank, Pleasure Ridge Park	May 18	
Minnesota		
Lakeland National Bank, Lino Lakes	January 22	
Missouri		
Hometown Bank, National Association, Carthage	February 26	
Nebraska		
Western Nebraska National Bank, Valentine	April 9	
Nebraskaland National Bank, North Platte	April 16	
New York		
Metropolitan National Bank, New York	February 18	
North Carolina		
Alamance National Bank, Graham	January 15	
Oklahoma		
Bank South, National Association, Tulsa	February 10	
South Carolina		
Firstbank of the Midlands, National Association, Columbia	February 19	
Bank of Anderson, National Association, Anderson	May 8	
Tennessee		
Mountain National Bank, Sevierville	June 16	
Texas		
Boet Interim Bank, National Association, Nacogdoches	January 8	
United Community Bank, National Association, Highland Village	January 14	
State National Bank of El Paso, El Paso	February 13	
Virginia		
Cardinal Bank, National Association, Fairfax	March 18	
Virginia National Bank, Charlottesville	May 19	
West Virginia		
Community Trust Bank of West Virginia, National Association, Williamson	April 24	

Applications for new, limited-purpose national bank charters, approved and denied, by state, January 1 to June 30, 1998

Title and location	Type of bank	Approved	Denied
California			
Mission Trust Company, National Association, Pasadena	Trust (non-deposit)	January 5	
Delaware			
Republic Bank Delaware National Association, Wilmington . . .	Trust (non-deposit)	January 9	
Minnesota			
United Trust Company National Association, Eagan	Trust (non-deposit)	May 4	
Ohio			
Granite National Bank, Bowling Green	Credit card	March 19	
Oklahoma			
Heritage Trust Company, National Association, Oklahoma City	Trust (non-deposit)	June 8	
South Dakota			
U.S. Bank Trust National Association SD, Sioux Falls	Trust (non-deposit)	January 22	
Wisconsin			
M&I National Trust Company, Milwaukee	Trust (non-deposit)	March 2	

New, full-service national bank charters issued, January 1 to June 30, 1998

Title and location	Charter number	Date opened
Arizona		
Union Bank of Arizona, National Association, Gilbert	023330	May 1
California		
California National Bank, Beverly Hills	023543	January 2
Auburn National Bank, Auburn	023420	February 2
Colorado		
Community First National Bank, Longmont	023619	April 30
Florida		
Seminole Bank, National Association, Seminole	023638	May 29
Tarpon Coast National Bank, Port Charlotte	023519	June 1
Georgia		
The Buckhead Community Bank, National Association, Atlanta	023242	February 6
Indiana		
First Bank Richmond, National Association, Richmond	023570	June 1
Michigan		
The Stephenson National Bank, Menominee	023535	April 20
Missouri		
Hometown Bank, National Association, Carthage	023603	June 8
Nebraska		
Nebraskaland National Bank, North Platte	023645	May 14
Western Nebraska National Bank, Valentine	023639	June 29
New Jersey		
Crown Bank, National Association, Ocean City	023071	April 13
Oklahoma		
Tri Star National Bank, Blanchard	023336	February 2
Bank of Elgin, National Association, Lawton	023516	March 2
South Carolina		
Florence County National Bank, Florence	023566	April 1
Texas		
First Mercantile Bank, National Association, Dallas	023466	January 28
Boet Interim Bank, National Association, Nacogdoches	023584	January 30
First National Bank of Bay City, Bay City	023223	February 26
Bank of the Hills, National Association, Kerrville	023475	April 9
American First National Bank, Houston	023521	May 18
City National Bank, Austin	023198	May 27
United Community Bank, National Association, Highland Village	023545	May 27
Virginia		
First National Exchange Bank, Roanoke	023534	May 1
Cardinal Bank, National Association, Fairfax	023606	June 8
West Virginia		
Community Trust Bank of West Virginia, National Association, Williamson	023644	June 26

New, limited-purpose national bank charters issued, January 1 to June 30, 1998

Title and location	Charter number	Date opened
California		
Mission Trust Company, National Association, Pasadena	023549	March 12
Delaware		
Republic Bank Delaware National Association, Wilmington	023579	May 21
Florida		
TCM Bank, National Association, Tampa	023363	May 18
Georgia		
Cedar Hill National Bank, Lawrenceville	023323	February 2
Indiana		
New Covenant Trust Company, National Association, Jeffersonville	023421	January 2
Louisiana		
United Credit Card Bank, National Association, Baton Rouge	023169	June 1
Massachusetts		
Congress Trust, National Association, Boston	023486	January 8
Nebraska		
Nebraska Trust Company, National Association, Fremont	023571	January 20
Oklahoma		
Heritage Trust Company, National Association, Oklahoma City	023620	June 19
Pennsylvania		
New Trust Company, National Association, Pittsburgh	023548	November 24, 1997
South Dakota		
U.S. Bank Trust National Association SD, Sioux Falls	023604	March 17
Wisconsin		
M&I National Trust Company, Milwaukee	023617	March 18

State-chartered banks converted to full-service national banks, January 1 to June 30, 1998

Title and location	Effective date	Total assets
California		
South Bay Bank, National Association, (023633),		
conversion of South Bay Bank, Torrance	May 8	116,867,000
Cuyamaca Bank, National Association, (023610),		
conversion of Cuyamaca Bank, Santee	June 5	38,333,000
Florida		
PineBank, National Association, (023181),		
conversion of PineBank, Miami	June 30	111,074,000
Minnesota		
First Integrity Bank, National Association, (023524),		
conversion of First Integrity Bank, Staples	January 1	59,073,000
Signal Bank National Association, (023582),		
conversion of Signal Bank, Inc., West St. Paul	March 16	242,107,000
Missouri		
First National Bank, (023529),		
conversion of Texas County Bank, Houston	January 2	33,979,000
First National Bank, (023530),		
conversion of The Bank of Mountain View, Mountain View	January 2	55,468,000
First National Bank, (023531),		
conversion of Summersville State Bank, Summersville	January 2	28,057,000
New Mexico		
First Bank of Grants, National Association, (023652),		
conversion of First Bank of Grants, Grants	May 28	45,123,000
Ohio		
First County Bank, National Association, (023599),		
conversion of First County Bank, Chardon	December 29, 1997	46,368,000
Metropolitan National Bank, (023595),		
conversion of The Metropolitan Savings Bank of Ohio, Youngstown	December 29, 1997	305,225,000
Texas		
Landmark Bank, National Association, (023528),		
conversion of Landmark Bank, Denison	January 2	5,843,000
Sunwest Bank of El Paso, National Association, (023647),		
conversion of Sunwest Bank of El Paso, El Paso	April 15	626,443,000
First Bank Katy, National Association, (023651),		
conversion of First Bank, Katy	May 22	318,491,000
Wisconsin		
First National Bank, (023581),		
conversion of State Bank of La Crosse, La Crosse	February 2	216,586,000
Wyoming		
Wyoming Bank and Trust Company, National Association, (023594),		
conversion of Wyoming Bank and Trust Company, Buffalo	February 2	28,525,000
The Bank of Laramie, National Association, (023592),		
conversion of Bank of Laramie, Laramie	February 2	29,109,000
Stockgrowers State Bank, National Association, (023593),		
conversion of Stockgrowers State Bank, Worland	February 2	47,376,000

National banks in voluntary liquidation, January 1 to June 30, 1998

Title and location	Charter number	Effective date
New York		
Barclays Bank of New York, National Association, Lake Success	015641	November 30, 1997
Ohio		
The First National Bank of Jewett, Jewett	013150	June 4, 1991
Texas		
Cypress National Bank, Houston	018401	September 21, 1996

National banks merged out of the national banking system, January 1 to June 30, 1998

Title and location	Charter number	Effective date
California		
Culver National Bank, Culver City	018264	December 31, 1997
Rancho Vista National Bank, Vista	017419	May 15
De Anza National Bank, Riverside	017367	May 29
Delaware		
PNC National Bank of Delaware, Wilmington	017395	November 30, 1997
Florida		
Citizens National Bank and Trust Company, Port Richey	021652	January 16
First National Bank of Florida at Bonita Springs, Bonita Springs	015201	February 12
Illinois		
Coal City National Bank, Coal City	010132	January 29
Indiana		
Citizens National Bank of Madison, Madison	017431	November 22, 1997
Iowa		
Liberty Bank & Trust, National Association, Pocahontas	006550	February 13
Kansas		
First United National Bank and Trust Company, Great Bend	011707	January 30
Massachusetts		
The Foxboro National Bank of Foxborough, Foxboro	009426	March 20
Safety Fund National Bank, Fitchburg	002153	April 10
Michigan		
The Madison National Bank, Madison Heights	015105	May 15
Nebraska		
Security National Bank of Superior, Superior	014083	January 8
New Jersey		
Security National Bank and Trust Company of New Jersey, Newark	015505	February 5
Pennsylvania		
Lebanon Valley National Bank, Lebanon	000680	March 27
South Carolina		
Regions Bank, National Association, Anderson	018282	May 11
Regions Bank, National Association, Spartanburg	021664	May 11
Texas		
First National Bank of Grapevine, Grapevine	012708	December 5, 1997
First National Bank of Dayton, Dayton	016977	December 30, 1997
West University Bank, National Association, Houston	016550	January 29
Fidelity Bank National Association, University Park	018073	February 6
Brownsville National Bank, Brownsville	016374	February 19
First National Bank of Silsbee, Silsbee	015384	February 20
Austin National Bank, Austin	020506	April 17
Shady Oaks National Bank, Fort Worth	018168	April 24
Sunbelt National Bank, Houston	017863	May 22
Washington		
Pacific One Bank, National Association, Kennewick	017508	December 31, 1997
Wisconsin		
F&M Bank-Darlington, National Association, Darlington	003308	May 8

National banks converted out of the national banking system, January 1 to June 30, 1998

Title and location	Effective date	Total assets
California		
Clear Lake National Bank, Clearlake (020254)	January 28	77,132,000
Channel Islands National Bank, Oxnard (020344)	February 20	85,365,000
Colorado		
FirstBank of Arvada, National Association, Arvada (016765)	March 30	138,011,000
FirstBank of Aurora, National Association, Aurora (017526)	March 30	147,861,000
FirstBank of Boulder, National Association, Boulder (016465)	March 30	234,951,000
FirstBank of Breckenridge, National Association, Breckenridge (020534)	March 30	61,113,000
FirstBank of Douglas County, National Association, Castle Rock (016471)	March 30	150,400,000
FirstBank of Cherry Creek, National Association, Denver (020967)	March 30	95,930,000
FirstBank of Denver, National Association, Denver (018751)	March 30	148,999,000
FirstBank of Tech Center, National Association, Englewood (017460)	March 30	187,317,000
FirstBank of Colorado, National Association, Lakewood (015063)	March 30	542,239,000
FirstBank of Lakewood, National Association, Lakewood (017037)	March 30	146,724,000
FirstBank of Arapahoe County, National Association, Littleton (021676)	March 30	161,770,000
FirstBank of Littleton, National Association, Littleton (018704)	March 30	116,143,000
FirstBank of Silverthorne, National Association, Silverthorne (017948)	March 30	78,203,000
FirstBank North, National Association, Westminster (020903)	March 30	134,544,000
FirstBank of Wheat Ridge, National Association, Wheat Ridge (015763)	March 30	188,745,000
Florida		
Enterprise National Bank of Sarasota, Sarasota (021859)	October 20, 1997	167,449,000
Kentucky		
Citizens National Bank, Grayson (021805)	January 1	13,883,000
First National Bank of Lewis County, Vanceburg (016611)	January 1	29,290,000
Montana		
Glacier National Bank, Whitefish (008589)	December 18, 1997	41,600,000
Texas		
Texas Bank and Trust National Association, Dallas (017608)	January 30	88,000,000

Federal branches and agencies of foreign banks in operation, January 1 to June 30, 1998

	In operation January 1, 1998	Opened January 1–June 30	Closed January 1–June 30	In operation June 30, 1998
Federal branches				
California	3	0	0	3
Connecticut	1	0	0	1
District of Columbia	1	0	0	1
New York	44	0	1	43
Washington	1	0	0	1
Limited federal branches				
California	7	1	0	8
District of Columbia	2	0	0	2
New York	4	0	0	4
Federal agency				
Illinois	1	0	0	1

Tables on the Financial Performance of National Banks

Tables are provided by the Financial and Statistical Analysis Division and include data for nationally chartered, FDIC-insured commercial banks that file a quarter-end call report. Data for the current period are preliminary and subject to revision. Figures in the tables may not sum to totals because of rounding.

Assets, liabilities, and capital accounts of national banks
June 30, 1997 and June 30, 1998
(Dollar figures in millions)

	June 30, 1997	June 30, 1998	Change June 30, 1997–June 30, 1998 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,657	2,546	(111)	(4.18)
Total assets	$2,688,361	$2,978,601	$290,240	10.80
Cash and balances due from depositories	198,550	204,510	5,960	3.00
Noninterest-bearing balances, currency and coin	140,026	146,930	6,904	4.93
Interest bearing balances	58,523	57,580	(943)	(1.61)
Securities	408,280	474,122	65,842	16.13
Held-to-maturity securities, amortized cost	71,857	65,246	(6,611)	(9.20)
Available-for-sale securities, fair value	336,423	408,876	72,453	21.54
Federal funds sold and securities purchased	96,055	95,748	(307)	(0.32)
Net loans and leases	1,712,915	1,887,129	174,213	10.17
Total loans and leases	1,746,937	1,923,469	176,533	10.11
Loans and leases, gross	1,749,571	1,925,610	176,040	10.06
Less: Unearned income	2,634	2,141	(493)	(18.71)
Less: Reserve for losses	34,021	36,340	2,319	6.82
Assets held in trading account	84,088	92,256	8,168	9.71
Other real estate owned	2,449	1,982	(466)	(19.05)
Intangible assets	45,343	62,036	16,693	36.82
All other assets	140,681	160,817	20,137	14.31
Total liabilities and equity capital	2,688,361	2,978,601	290,240	10.80
Deposits in domestic offices	1,580,898	1,708,326	127,428	8.06
Deposits in foreign offices	298,392	327,123	28,731	9.63
Total deposits	1,879,289	2,035,448	156,159	8.31
Noninterest-bearing deposits	405,587	422,097	16,510	4.07
Interest-bearing deposits	1,473,702	1,613,351	139,649	9.48
Federal funds purchased and securities sold	207,708	219,355	11,648	5.61
Demand notes issued to U.S. Treasury	16,547	28,006	11,459	69.25
Other borrowed money	189,893	232,205	42,311	22.28
With remaining maturity of one year or less	127,783	152,415	24,632	19.28
With remaining maturity of more than one year	62,110	79,790	17,680	28.47
Trading liabilities less revaluation losses	12,936	17,649	4,713	36.43
Subordinated notes and debentures	35,164	47,806	12,641	35.95
All other liabilities	114,167	134,445	20,278	17.76
Trading liabilities revaluation losses	38,331	47,665	9,334	24.35
Other	75,836	86,780	10,944	14.43
Total equity capital	232,656	263,687	31,030	13.34
Perpetual preferred stock	429	504	75	17.60
Common stock	17,910	17,404	(505)	(2.82)
Surplus	111,950	133,625	21,675	19.36
Net undivided profits and capital reserves	103,137	113,164	10,027	9.72
Cumulative foreign currency translation adjustment	(768)	(1,011)	(242)	NM

NM indicates calculated percent change is not meaningful.

Quarterly income and expenses of national banks
Second quarter 1997 and second quarter 1998

(Dollar figures in millions)

	Second quarter 1997	Second quarter 1998	Change Second quarter 1997–Second quarter 1998 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,657	2,546	(111)	(4.18)
Net income	$8,784	$9,581	$797	9.08
Net interest income	25,941	27,615	1,673	6.45
Total interest income	48,357	52,738	4,381	9.06
On loans	37,696	40,967	3,271	8.68
From lease financing receivables	1,107	1,474	367	33.12
On balances due from depositories	849	622	(227)	(26.77)
On securities	6,703	7,640	937	13.97
From assets held in trading account	746	830	84	11.33
On federal funds sold and securities repurchased	1,237	1,204	(32)	(2.61)
Less: Interest expense	22,416	25,123	2,708	12.08
On deposits	16,119	17,482	1,364	8.46
Of federal funds purchased and securities sold	2,570	2,864	295	11.47
On demand notes and other borrowed money*	3,117	3,988	871	27.94
On subordinated notes and debentures	598	789	192	32.04
Less: Provision for losses	3,179	3,725	547	17.20
Noninterest income	15,508	19,274	3,766	24.28
From fiduciary activities	1,895	2,322	427	22.52
Service charges on deposits	3,059	3,411	353	11.53
Trading revenue	792	1,205	412	52.01
From interest rate exposures	338	488	150	44.24
From foreign exchange exposures	570	629	59	10.26
From equity security and index exposures	(107)	48	155	NM
From commodity and other exposures	(10)	40	49	NM
Total other noninterest income	9,722	12,336	2,615	26.89
Gains/losses on securities	233	464	230	NM
Less: Noninterest expense	24,813	28,459	3,647	14.70
Salaries and employee benefits	9,978	11,279	1,301	13.04
Of premises and fixed assets	3,139	3,529	389	12.41
Other noninterest expense	11,695	13,651	1,956	16.73
Less: Taxes on income before extraordinary items	4,912	5,572	660	13.43
Income/loss from extraordinary items, net of income taxes	5	(14)	(19)	(374.40)
Memoranda:				
Net operating income	8,630	9,296	666	7.72
Income before taxes and extraordinary items	13,692	15,167	1,476	10.78
Income net of taxes before extraordinary items	8,779	9,595	816	9.29
Cash dividends declared	6,058	3,855	(2,203)	(36.37)
Net charge-offs to loan and lease reserve	2,979	3,485	506	17.00
Charge-offs to loan and lease reserve	3,973	4,480	507	12.75
Less: Recoveries credited to loan and lease reserve	995	995	0	0.02

* Includes mortgage indebtedness

NM indicates calculated percent change is not meaningful.

Year-to-date income and expenses of national banks
Through June 30, 1997 and through June 30, 1998

(Dollar figures in millions)

	June 30, 1997	June 30, 1998	Change June 30, 1997–June 30, 1998 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,657	2,546	(111)	(4.18)
Net income	$17,406	$19,558	$2,152	12.36
Net interest income	51,390	54,533	3,143	6.12
Total interest income	95,545	104,997	9,452	9.89
On loans	74,359	80,659	6,300	8.47
From lease financing receivables	2,170	2,930	760	35.04
On balances due from depositories	1,651	1,779	128	7.77
On securities	13,155	15,141	1,987	15.10
From assets held in trading account	1,417	1,661	245	17.27
On federal funds sold and securities repurchased	2,794	2,826	33	1.17
Less: Interest expense	44,155	50,464	6,309	14.29
On deposits	31,642	35,168	3,527	11.15
Of federal funds purchased and securities sold	5,326	6,073	747	14.02
On demand notes and other borrowed money*	6,030	7,661	1,632	27.06
On subordinated notes and debentures	1,158	1,561	404	34.86
Less: Provision for losses	5,922	7,044	1,122	18.95
Noninterest income	30,617	37,682	7,065	23.07
From fiduciary activities	3,701	4,498	797	21.53
Service charges on deposits	6,056	6,674	617	10.19
Trading revenue	1,816	2,355	539	29.71
From interest rate exposures	787	793	5	0.70
From foreign exchange exposures	986	1,364	378	38.33
From equity security and index exposures	25	140	115	466.83
From commodity and other exposures	17	58	41	234.21
Total other noninterest income	19,044	24,155	5,111	26.84
Gains/losses on securities	432	1,083	651	150.67
Less: Noninterest expense	49,338	56,408	7,070	14.33
Salaries and employee benefits	19,999	22,241	2,243	11.21
Of premises and fixed assets	6,344	6,953	608	9.59
Other noninterest expense	22,995	27,214	4,219	18.35
Less: Taxes on income before extraordinary items	9,802	10,811	1,009	10.29
Income/loss from extraordinary items, net of income taxes	29	523	495	NM
Memoranda:				
Net operating income	17,100	18,335	1,236	7.23
Income before taxes and extraordinary items	27,179	29,845	2,666	9.81
Income net of taxes before extraordinary items	17,377	19,035	1,657	9.54
Cash dividends declared	11,522	11,528	6	0.05
Net charge-offs to loan and lease reserve	5,735	6,813	1,078	18.79
Charge-offs to loan and lease reserve	7,760	8,796	1,035	13.34
Less: Recoveries credited to loan and lease reserve	2,025	1,983	(43)	(2.10)

* Includes mortgage indebtedness

NM indicates calculated percent change is not meaningful.

Assets of national banks by asset size
June 30, 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Total assets	$2,978,601	$65,899	$270,371	$482,286	$2,160,046	$5,182,759
Cash and balances due from	204,510	3,538	13,207	31,412	156,353	331,516
Securities	474,122	17,864	71,382	89,737	295,140	894,496
Federal funds sold and securities purchased	95,748	4,046	11,776	22,139	57,787	270,077
Net loans and leases	1,887,129	37,622	161,681	305,163	1,382,662	3,035,285
Total loans and leases	1,923,469	38,136	164,093	313,150	1,408,091	3,091,664
Loans and leases, gross	1,925,610	38,291	164,471	313,318	1,409,530	3,095,990
Less: Unearned income	2,141	155	378	168	1,440	4,326
Less: Reserve for losses	36,340	513	2,412	7,987	25,429	56,379
Assets held in trading account	92,256	6	77	1,328	90,845	301,000
Other real estate owned	1,982	85	236	205	1,456	3,530
Intangible assets	62,036	196	1,562	11,231	49,047	76,195
All other assets	266,084	4,804	10,587	19,994	230,700	413,158
Gross loans and leases by type:						
Loans secured by real estate	742,042	21,205	97,802	125,379	497,655	1,284,564
1–4 family residential mortgages	373,928	10,566	47,178	62,416	253,767	643,873
Home equity loans	66,922	486	4,524	10,271	51,641	97,178
Multifamily residential mortgages	23,543	488	3,244	4,606	15,204	42,179
Commercial RE loans	190,752	5,908	31,699	35,886	117,259	348,144
Construction RE loans	51,936	1,417	7,418	10,349	32,752	95,693
Farmland loans	10,570	2,340	3,717	1,711	2,802	28,407
RE loans from foreign offices	24,392	0	22	140	24,230	29,090
Commercial and industrial loans	552,144	6,515	29,164	62,200	454,265	850,388
Loans to individuals	365,339	5,767	26,918	105,745	226,910	547,880
Credit cards	159,452	321	4,951	66,215	87,965	216,954
Installment loans	205,888	5,446	21,966	39,531	138,945	330,925
All other loans and leases	266,084	4,804	10,587	19,994	230,700	413,158
Securities by type:						
U.S. Treasury securities	66,873	3,759	12,101	15,250	35,763	149,968
Mortgage-backed securities	234,964	3,917	22,677	45,304	163,066	392,983
Pass-through securities	155,761	2,601	15,087	29,246	108,827	251,888
Collateralized mortgage obligations	79,203	1,317	7,589	16,058	54,239	141,095
Other securities	172,286	10,188	36,604	29,183	96,311	351,545
Other U.S. government securities	60,815	6,621	21,447	15,231	17,516	159,201
State and local government securities	36,815	2,938	11,313	7,824	14,740	80,050
Other debt securities	57,765	260	2,113	2,719	52,673	83,848
Equity securities	16,891	368	1,732	3,409	11,383	28,446
Memoranda:						
Agricultural production loans	20,744	4,239	5,417	3,143	7,946	47,082
Pledged securities	222,815	6,215	30,868	43,990	141,741	413,214
Book value of securities	470,294	17,787	70,959	88,995	292,553	886,376
Available-for-sale securities	405,048	13,280	53,727	72,314	265,727	730,516
Held-to-maturity securities	65,246	4,507	17,232	16,681	26,826	155,861
Market value of securities	474,955	17,903	71,561	89,914	295,577	896,130
Available-for-sale securities	408,876	13,357	54,150	73,056	268,314	738,635
Held-to-maturity securities	66,078	4,546	17,412	16,858	27,262	157,495

Past-due and nonaccrual loans and leases of national banks by asset size
June 30, 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Loans and leases past due 30–89 days	$21,499	$544	$2,019	$5,054	$13,882	$35,711
Loans secured by real estate	8,428	257	974	1,373	5,824	14,305
1–4 family residential mortgages	5,077	157	550	677	3,693	8,389
Home equity loans	522	4	40	94	384	793
Multifamily residential mortgages	188	3	24	46	114	336
Commercial RE loans	1,534	55	242	366	870	2,919
Construction RE loans	688	18	85	170	415	1,256
Farmland loans	105	18	32	20	34	278
RE loans from foreign offices	314	0	0	0	314	334
Commercial and industrial loans	3,961	160	500	948	2,354	6,974
Loans to individuals	8,037	126	501	2,469	4,940	12,295
Credit cards	3,869	16	136	1,594	2,123	5,453
Installment loans	4,168	110	365	876	2,817	6,842
All other loans and leases	1,073	1	44	263	764	2,136
Loans and leases past due 90+ days	5,983	142	465	1,787	3,589	9,445
Loans secured by real estate	1,561	65	200	274	1,022	2,733
1–4 family residential mortgages	953	34	111	142	666	1,585
Home equity loans	123	1	8	36	78	174
Multifamily residential mortgages	17	0	2	7	8	42
Commercial RE loans	306	15	56	64	171	589
Construction RE loans	108	3	11	19	76	186
Farmland loans	35	11	13	7	4	126
RE loans from foreign offices	19	0	0	0	19	30
Commercial and industrial loans	548	49	122	113	264	1,172
Loans to individuals	3,685	27	128	1,354	2,176	5,171
Credit cards	2,592	9	70	1,146	1,368	3,387
Installment loans	1,093	19	59	207	808	1,784
All other loans and leases	188	0	14	46	128	370
Nonaccrual loans and leases	11,794	272	916	1,337	9,269	19,639
Loans secured by real estate	5,881	129	489	754	4,509	9,538
1–4 family residential mortgages	2,505	50	196	277	1,981	4,054
Home equity loans	155	2	8	19	126	237
Multifamily residential mortgages	188	1	15	28	144	312
Commercial RE loans	1,915	42	192	336	1,345	3,239
Construction RE loans	412	9	43	69	290	768
Farmland loans	157	25	35	23	74	298
RE loans from foreign offices	550	0	0	1	549	630
Commercial and industrial loans	4,085	120	313	394	3,258	6,860
Loans to individuals	1,275	20	79	132	1,045	2,470
Credit cards	231	0	31	64	137	987
Installment loans	1,043	19	48	68	908	1,483
All other loans and leases	553	3	34	58	458	771

Liabilities of national banks by asset size
June 30, 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Total liabilities and equity capital	$2,978,601	$65,899	$270,371	$482,286	$2,160,046	$5,182,759
Deposits in domestic offices	$1,708,326	$56,402	$219,676	$309,905	$1,122,343	$2,957,538
Deposits in foreign offices	327,123	0	521	5,712	320,890	549,037
Total deposits	2,035,448	56,402	220,196	315,617	1,443,233	3,506,574
Noninterest to earnings	422,097	8,902	35,432	70,172	307,592	687,030
Interest bearing	1,613,351	47,500	184,765	245,445	1,135,641	2,819,544
Other borrowed funds	497,215	1,661	20,368	103,041	372,146	873,052
Subordinated notes and debentures	47,806	6	191	4,547	43,061	67,283
All other liabilities	134,445	709	3,339	10,011	120,386	289,875
Equity capital	263,687	7,121	26,276	49,069	181,220	445,974
Total deposits by depositor:						
Individuals and corporations	1,822,882	51,193	201,523	289,701	1,280,464	3,115,314
U.S., state, and local governments	70,636	4,386	14,959	15,791	35,499	136,227
Depositories in the U.S.	58,539	421	2,060	7,184	48,875	79,819
Foreign banks and governments	70,240	6	184	1,151	68,898	147,797
Certified and official checks	9,709	397	1,470	1,770	6,072	17,999
All other foreign office deposits	3,443	0	0	19	3,424	9,417
Domestic deposits by depositor:						
Individuals and corporations	1,589,977	51,193	201,142	284,622	1,053,020	2,746,301
U.S., state, and local governments	70,636	4,386	14,959	15,791	35,499	136,227
Depositories in the U.S.	34,110	421	2,011	7,146	24,531	47,855
Foreign banks and governments	4,692	6	93	575	4,019	10,174
Certified and official checks	8,911	397	1,470	1,770	5,274	16,980
Foreign deposits by depositor:						
Individuals and corporations	232,905	0	382	5,079	227,444	369,013
Depositories in the U.S.	24,429	0	48	37	24,344	31,964
Foreign banks and governments	65,547	0	91	577	64,880	137,623
Certified and official checks	799	0	0	0	799	1,019
All other deposits	3,443	0	0	19	3,424	9,417
Deposits in domestic offices by type:						
Transaction deposits	437,448	17,121	57,447	75,907	286,972	743,883
Demand deposits	360,458	8,898	34,229	63,202	254,130	582,119
NOW accounts	75,696	8,036	22,812	12,475	32,374	159,032
Savings deposits	669,016	11,467	60,380	119,618	477,551	1,069,683
Money market deposit accounts	460,434	5,716	35,248	72,013	347,457	703,207
Other savings deposits	208,582	5,750	25,132	47,605	130,094	366,477
Time deposits	601,862	27,814	101,849	114,380	357,820	1,143,972
Small time deposits	406,742	20,383	72,340	77,229	236,791	745,202
Large time deposits	195,120	7,431	29,509	37,151	121,029	398,770

Off-balance-sheet items of national banks by asset size
June 30, 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Unused commitments	$2,441,512	$196,937	$120,609	$542,949	$1,581,016	$3,478,666
Home equity lines	82,626	373	4,702	10,891	66,660	114,387
Credit card lines	1,422,597	192,306	90,494	457,668	682,129	1,925,768
Commercial RE, construction, and land	73,781	1,006	6,488	10,964	55,323	119,976
All other unused commitments	862,509	3,253	18,926	63,426	776,904	1,318,534
Letters of credit:						
Standby letters of credit	135,432	171	1,680	10,008	123,573	215,087
Financial letters of credit	105,382	108	1,055	8,203	96,016	173,862
Performance letters of credit	30,050	63	625	1,805	27,557	41,225
Commercial letters of credit	21,882	37	712	1,043	20,090	32,728
Securities borrowed and lent:						
Securities borrowed	12,996	20	539	4,494	7,943	23,517
Securities lent	48,378	14	535	7,881	39,948	348,423
Financial assets transferred with recourse:						
Mortgages—outstanding principal balance	19,123	26	242	1,376	17,480	32,313
Mortgages—amount of recourse exposure	5,165	24	203	606	4,332	8,537
All other—outstanding principal balance	191,027	1	1,891	67,923	121,211	253,008
All other—amount of recourse exposure	13,378	0	1,406	3,402	8,570	16,214
Spot foreign exchange contracts	280,587	0	4	98	280,485	661,795
Credit derivatives (notional value)						
Reporting bank is the guarantor	15,632	0	40	1	15,591	58,962
Reporting bank is the beneficiary	15,885	0	0	1	15,884	70,240
Derivative contracts (notional value)	9,815,132	535	4,091	68,064	9,742,442	28,175,900
Futures and forward contracts	3,839,152	4	604	10,693	3,827,850	10,003,134
Interest rate contracts	1,531,632	4	577	10,074	1,520,976	4,817,716
Foreign exchange contracts	2,275,462	0	27	619	2,274,816	5,063,070
All other futures and forwards	32,059	0	0	0	32,059	122,348
Option contracts	3,045,875	531	872	15,449	3,029,022	7,197,165
Interest rate contracts	2,143,721	531	868	15,448	2,126,875	5,071,073
Foreign exchange contracts	776,588	0	0	2	776,586	1,719,493
All other options	125,566	0	5	0	125,561	406,599
Swaps	2,898,588	0	2,575	41,919	2,854,094	10,846,399
Interest rate contracts	2,754,223	0	2,575	41,224	2,710,424	10,163,978
Foreign exchange contracts	126,818	0	0	695	126,123	606,665
All other swaps	17,547	0	0	0	17,547	75,756
Memoranda: Derivatives by purpose						
Contracts held for trading	8,943,486	400	581	9,549	8,932,956	26,599,874
Contracts not held for trading	840,128	135	3,470	58,512	778,011	1,446,824
Memoranda: Derivatives by position						
Held for trading—positive fair value	107,107	0	0	23	107,083	370,688
Held for trading—negative fair value	106,120	0	0	45	106,075	369,393
Not for trading—positive fair value	7,162	0	6	547	6,609	11,328
Not for trading—negative fair value	3,487	0	32	208	3,247	6,582

Quarterly income and expenses of national banks by asset size
Second quarter 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Net income	$9,581	$211	$899	$1,726	$6,745	$16,128
Net interest income	27,615	699	2,815	5,254	18,847	45,504
Total interest income	52,738	1,244	5,118	9,341	37,035	89,980
On loans	40,967	902	3,824	7,460	28,781	66,124
From lease financing receivables	1,474	4	27	99	1,345	2,089
On balances due from depositories	622	12	28	62	520	1,372
On securities	7,640	268	1,075	1,412	4,885	14,065
From assets held in trading account	830	0	1	19	810	2,750
On federal funds sold and securities repurchased	1,204	59	163	288	695	3,579
Less: Interest expense	25,123	546	2,303	4,087	18,188	44,477
On deposits	17,482	524	2,019	2,585	12,354	31,033
Of federal funds purchased and securities sold	2,864	7	125	565	2,167	5,421
On demand notes and other borrowed money*	7,661	28	307	1,662	5,665	13,237
On subordinated notes and debentures	789	0	9	75	706	1,122
Less: Provision for losses	3,725	36	192	1,285	2,213	5,265
Noninterest income	19,274	398	1,203	3,953	13,721	30,651
From fiduciary activities	2,322	3	159	361	1,799	4,674
Service charges on deposits	3,411	78	282	529	2,523	4,926
Trading revenue	1,205	(0)	12	40	1,153	2,513
From interest rate exposures	488	(0)	12	30	446	947
From foreign exchange exposures	629	0	0	4	625	1,415
From equity security and index exposures	48	0	0	5	43	114
From commodity and other exposures	40	0	0	1	38	98
Total other noninterest income	12,336	316	750	3,024	8,247	18,534
Gains/losses on securities	464	2	12	52	397	575
Less: Noninterest expense	28,459	768	2,500	5,210	19,980	46,392
Salaries and employee benefits	11,279	301	1,102	1,615	8,261	19,408
Of premises and fixed assets	3,529	80	309	506	2,634	5,818
Other noninterest expense	13,651	387	1,090	3,089	9,085	21,166
Less: Taxes on income before extraordinary items	5,572	83	439	1,032	4,018	8,932
Income/loss from extraordinary items, net of taxes	523	0	1	530	(8)	524
Memoranda:						
Net operating income	9,296	209	890	1,700	6,496	15,763
Income before taxes and extraordinary items	15,167	294	1,338	2,764	10,772	25,073
Income net of taxes before extraordinary items	9,595	211	899	1,732	6,753	16,141
Cash dividends declared	3,855	143	452	1,128	2,133	7,764
Net loan and lease losses	3,485	26	174	1,299	1,986	4,900
Charge-offs to loan and lease reserve	4,480	39	243	1,544	2,655	6,404
Less: Recoveries credited to loan and lease reserve	995	12	69	245	669	1,504

* Includes mortgage indebtedness

Year-to-date income and expenses of national banks by asset size
Through June 30, 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Net income	$19,558	$445	$1,767	$4,056	$13,290	$32,036
Net interest income	54,533	1,380	5,570	10,322	37,262	89,839
Total interest income	104,997	2,457	10,117	18,374	74,048	178,610
On loans	80,659	1,776	7,566	14,633	56,684	130,328
From lease financing receivables	2,930	7	52	199	2,672	4,146
On balances due from depositories	1,779	23	54	116	1,586	3,265
On securities	15,141	536	2,133	2,847	9,626	28,028
From assets held in trading account	1,661	0	2	32	1,627	5,399
On federal funds sold and securities repurchased	2,826	116	311	546	1,853	7,444
Less: Interest expense	50,464	1,078	4,548	8,052	36,787	88,771
On deposits	35,168	1,035	3,982	5,147	25,005	62,045
Of federal funds purchased and securities sold	6,073	15	245	1,097	4,716	11,168
On demand notes and other borrowed money*	7,661	28	307	1,662	5,665	13,237
On subordinated notes and debentures	1,561	0	14	145	1,402	2,320
Less: Provision for losses	7,044	71	409	2,373	4,192	10,236
Noninterest income	37,682	812	2,376	7,496	26,998	59,810
From fiduciary activities	4,498	6	307	707	3,478	9,078
Service charges on deposits	6,674	152	545	1,028	4,948	9,634
Trading revenue	2,355	0	21	69	2,265	5,165
From interest rate exposures	793	0	20	50	723	2,022
From foreign exchange exposures	1,364	0	0	7	1,357	2,778
From equity security and index exposures	140	0	0	9	131	262
From commodity and other exposures	58	0	0	4	55	223
Total other noninterest income	24,155	654	1,503	5,692	16,306	35,934
Gains/losses on securities	1,083	4	25	90	963	1,372
Less: Noninterest expense	56,408	1,497	4,939	9,962	40,010	92,107
Salaries and employee benefits	22,241	594	2,181	3,179	16,288	38,571
Of premises and fixed assets	6,953	157	615	982	5,199	11,525
Other noninterest expense	27,214	746	2,143	5,802	18,524	42,012
Less: Taxes on income before extraordinary items	10,811	183	857	2,049	7,722	17,167
Income/loss from extraordinary items, net of taxes	523	0	1	530	(8)	524
Memoranda:						
Net operating income	18,335	442	1,748	3,468	12,678	30,615
Income before taxes and extraordinary items	29,845	628	2,622	5,574	21,021	48,678
Income net of taxes before extraordinary items	19,035	445	1,765	3,525	13,299	31,512
Cash dividends declared	11,528	398	869	1,981	8,280	18,600
Net loan and lease losses	6,813	46	337	2,555	3,875	9,696
Charge-offs to loan and lease reserve	8,796	72	474	3,048	5,202	12,663
Less: Recoveries credited to loan and lease reserve	1,983	26	136	494	1,327	2,967

* Includes mortgage indebtedness

Quarterly net loan and lease losses of national banks by asset size
Second quarter 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Net charge-offs to loan and lease reserve	$3,485	$26	$174	$1,299	$1,986	$4,900
Loans secured by real estate	60	2	11	22	26	103
1–4 family residential mortgages	59	1	6	12	40	97
Home equity loans	25	0	1	3	21	34
Multifamily residential mortgages	6	0	3	(1)	4	5
Commercial RE loans	(36)	0	1	6	(43)	(39)
Construction RE loans	(3)	0	1	1	(5)	(2)
Farmland loans	3	(0)	1	0	2	3
RE loans from foreign offices	6	0	0	0	6	5
Commercial and industrial loans	428	13	41	42	331	727
Loans to individuals	2,858	11	119	1,222	1,506	3,819
Credit cards	2,284	5	87	1,124	1,067	3,027
Installment loans	574	6	32	98	438	792
All other loans and leases	139	0	2	13	124	251
Charge-offs to loan and lease reserve	4,480	39	243	1,544	2,655	6,404
Loans secured by real estate	223	3	20	40	160	339
1–4 family residential mortgages	81	1	9	16	54	136
Home equity loans	37	0	1	5	31	47
Multifamily residential mortgages	11	0	3	2	6	13
Commercial RE loans	70	1	5	14	50	110
Construction RE loans	11	0	1	2	8	19
Farmland loans	4	0	1	1	3	6
RE loans from foreign offices	8	0	0	0	8	7
Commercial and industrial loans	592	18	55	75	443	1,052
Loans to individuals	3,480	17	164	1,408	1,890	4,689
Credit cards	2,605	6	113	1,251	1,235	3,499
Installment loans	875	11	51	158	655	1,190
All other loans and leases	185	0	3	20	161	324
Recoveries credited to loan and lease reserve	995	12	69	245	669	1,504
Loans secured by real estate	163	2	8	19	134	236
1–4 family residential mortgages	22	1	3	4	14	39
Home equity loans	11	0	0	2	9	14
Multifamily residential mortgages	6	(0)	0	3	3	8
Commercial RE loans	107	1	4	9	93	149
Construction RE loans	15	0	0	1	13	21
Farmland loans	1	0	0	0	0	4
RE loans from foreign offices	2	0	0	0	2	2
Commercial and industrial loans	163	5	14	33	112	325
Loans to individuals	622	6	45	187	384	870
Credit cards	321	1	26	127	167	472
Installment loans	301	5	19	60	217	398
All other loans and leases	46	0	2	7	38	72

Year-to-date net loan and lease losses of national banks by asset size
Through June 30, 1998

(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,546	1,329	1,030	147	40	8,984
Net charge-offs to loan and lease reserve	6,813	46	337	2,555	3,875	9,696
Loans secured by real estate	155	2	19	31	103	243
1–4 family residential mortgages	120	1	10	19	89	189
Home equity loans	60	0	2	9	49	75
Multifamily residential mortgages	4	(0)	3	(1)	2	3
Commercial RE loans	(48)	1	3	2	(53)	(42)
Construction RE loans	(3)	1	1	1	(6)	(0)
Farmland loans	3	(1)	0	(0)	4	2
RE loans from foreign offices	17	0	0	0	17	17
Commercial and industrial loans	726	18	57	54	597	1,301
Loans to individuals	5,693	26	258	2,444	2,965	7,684
Credit cards	4,470	12	191	2,230	2,037	6,017
Installment loans	1,223	14	67	213	928	1,667
All other loans and leases	239	0	4	26	209	468
Charge-offs to loan and lease reserve	8,796	72	474	3,048	5,202	12,663
Loans secured by real estate	429	6	34	70	318	649
1–4 family residential mortgages	166	3	18	28	117	268
Home equity loans	82	0	2	13	67	101
Multifamily residential mortgages	16	0	3	2	10	21
Commercial RE loans	120	2	9	22	87	193
Construction RE loans	19	1	2	3	13	36
Farmland loans	7	0	1	1	5	10
RE loans from foreign offices	21	0	0	0	21	21
Commercial and industrial loans	1,096	28	89	127	852	1,980
Loans to individuals	6,923	38	344	2,811	3,731	9,401
Credit cards	5,111	14	239	2,485	2,373	6,952
Installment loans	1,812	23	105	326	1,358	2,449
All other loans and leases	347	1	7	40	300	633
Recoveries credited to loan and lease reserve	1,983	26	136	494	1,327	2,967
Loans secured by real estate	274	4	16	39	216	406
1–4 family residential mortgages	46	2	8	9	28	79
Home equity loans	21	0	0	4	17	26
Multifamily residential mortgages	12	0	0	3	8	17
Commercial RE loans	167	1	6	20	140	235
Construction RE loans	21	0	1	2	19	36
Farmland loans	4	1	1	1	1	9
RE loans from foreign offices	3	0	0	0	3	4
Commercial and industrial loans	370	10	32	74	255	679
Loans to individuals	1,230	12	86	367	765	1,718
Credit cards	641	2	48	254	336	935
Installment loans	590	9	38	113	430	782
All other loans and leases	108	0	3	14	91	165

Number of national banks by state and asset size
June 30, 1998

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
All institutions	2,546	1,329	1,030	147	40	8,984
Alabama	34	19	14	0	1	170
Alaska	3	1	0	2	0	6
Arizona	15	5	5	4	1	42
Arkansas	61	22	37	2	0	221
California	97	42	50	2	3	336
Colorado	71	49	18	4	0	210
Connecticut	7	3	4	0	0	26
Delaware	16	3	6	5	2	34
District of Columbia	5	1	4	0	0	6
Florida	86	39	35	11	1	258
Georgia	63	28	33	2	0	346
Hawaii	1	0	1	0	0	13
Idaho	1	0	1	0	0	17
Illinois	227	110	102	12	3	772
Indiana	43	10	25	8	0	184
Iowa	51	30	19	2	0	443
Kansas	115	88	26	1	0	399
Kentucky	67	37	25	5	0	269
Louisiana	24	12	7	4	1	155
Maine	5	1	4	0	0	17
Maryland	21	4	15	1	1	82
Massachusetts	13	4	8	0	1	45
Michigan	38	16	19	1	2	163
Minnesota	142	85	51	4	2	520
Mississippi	22	10	10	2	0	101
Missouri	49	25	19	5	0	398
Montana	17	13	2	2	0	91
Nebraska	100	77	20	3	0	325
Nevada	7	2	1	4	0	25
New Hampshire	6	1	4	1	0	19
New Jersey	26	2	17	6	1	71
New Mexico	19	8	9	2	0	57
New York	64	24	33	5	2	152
North Carolina	10	2	5	0	3	62
North Dakota	19	9	8	2	0	117
Ohio	98	46	40	7	5	223
Oklahoma	118	80	36	2	0	317
Oregon	3	0	3	0	0	42
Pennsylvania	111	32	70	6	3	209
Rhode Island	2	0	0	1	1	7
South Carolina	21	8	12	1	0	77
South Dakota	22	13	7	1	1	105
Tennessee	36	9	19	5	3	214
Texas	411	274	127	8	2	820
Utah	8	3	2	2	1	50
Vermont	11	5	5	1	0	21
Virginia	29	7	20	2	0	150
Washington	18	14	4	0	0	80
West Virginia	34	15	15	4	0	95
Wisconsin	58	27	28	3	0	351
Wyoming	21	14	5	2	0	52
U.S. territories	0	0	0	0	0	19

Total assets of national banks by state and asset size
June 30, 1998
(Dollar figures in millions)

	All national banks	National banks				Memoranda:
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
All institutions	$2,978,601	$65,899	$270,371	$482,286	$2,160,046	$5,182,759
Alabama	39,133	1,238	3,274	0	34,621	115,772
Alaska	4,234	54	0	4,180	0	4,906
Arizona	34,109	62	2,266	15,798	15,984	37,925
Arkansas	13,927	1,269	8,713	3,945	0	29,029
California	376,984	1,982	13,034	6,625	355,343	481,488
Colorado	20,147	2,229	3,498	14,420	0	35,340
Connecticut	910	212	698	0	0	5,397
Delaware	78,445	181	1,958	23,943	52,362	121,943
District of Columbia	1,100	31	1,070	0	0	1,185
Florida	82,451	2,397	9,848	27,680	42,526	119,659
Georgia	21,073	1,550	9,378	10,145	0	71,547
Hawaii	297	0	297	0	0	22,961
Idaho	175	0	175	0	0	1,564
Illinois	171,956	5,434	26,394	41,516	98,611	280,144
Indiana	45,565	459	8,666	36,439	0	71,451
Iowa	14,876	1,521	4,653	8,702	0	43,730
Kansas	13,085	3,915	7,303	1,867	0	32,401
Kentucky	26,998	2,255	4,271	20,472	0	52,256
Louisiana	32,005	593	2,375	17,164	11,873	46,776
Maine	1,111	35	1,075	0	0	4,714
Maryland	16,902	261	5,363	1,166	10,111	36,972
Massachusetts	70,462	205	2,041	0	68,216	132,630
Michigan	32,242	847	3,834	2,191	25,370	119,565
Minnesota	114,303	3,739	11,810	9,428	89,326	133,755
Mississippi	15,931	637	2,162	13,132	0	32,558
Missouri	27,862	1,067	4,667	22,127	0	64,312
Montana	3,411	424	273	2,714	0	9,461
Nebraska	15,310	3,364	4,232	7,713	0	26,424
Nevada	15,549	76	103	15,370	0	23,450
New Hampshire	6,398	39	998	5,360	0	14,789
New Jersey	47,494	102	5,422	13,691	28,279	89,684
New Mexico	7,441	342	2,601	4,498	0	11,601
New York	362,783	1,699	11,443	9,548	340,092	1,174,271
North Carolina	510,025	138	2,701	0	507,186	565,627
North Dakota	5,772	338	2,489	2,944	0	10,574
Ohio	202,013	2,343	14,511	20,540	164,619	246,125
Oklahoma	20,575	4,021	7,891	8,664	0	34,923
Oregon	406	0	406	0	0	6,215
Pennsylvania	153,520	1,720	20,658	8,280	122,862	197,767
Rhode Island	78,073	0	0	6,474	71,599	85,559
South Carolina	3,939	333	2,235	1,371	0	17,904
South Dakota	20,537	488	2,233	4,247	13,569	27,756
Tennessee	66,613	639	5,285	17,947	42,742	86,811
Texas	124,096	13,154	28,992	32,262	49,688	180,256
Utah	23,044	169	305	7,505	15,066	39,291
Vermont	3,514	343	1,377	1,795	0	7,210
Virginia	11,037	351	4,228	6,458	0	70,191
Washington	1,720	604	1,116	0	0	12,297
West Virginia	13,296	864	4,412	8,019	0	22,660
Wisconsin	19,543	1,493	6,780	11,271	0	75,720
Wyoming	6,209	681	857	4,672	0	8,874
U.S. territories	0	0	0	0	0	37,335

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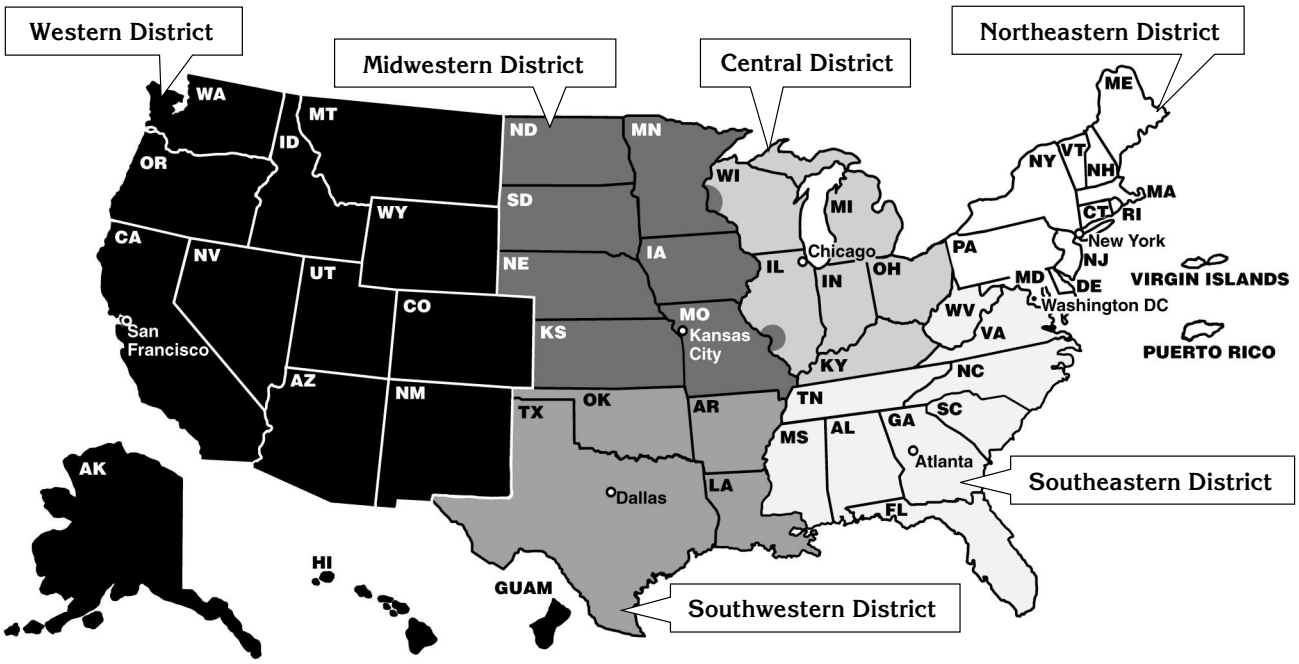

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