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Risk-Based Capital Standards for Commercial Banks: Improved Capital-Adequacy Standards?

by John P. O'Keefe*

In August 1988, the Board of Governors of the Federal Reserve System agreed to adopt risk-based capital standards for U.S. commercial and savings banks and bank holding companies. The new standards, which substantially changed U.S. regulatory standards for assessing bank capital adequacy, replaced simple flat-rate standards with standards that explicitly incorporated risk. While well-run banks had their own "risk-based" systems for allocating capital, business plans had to be revised to incorporate the new regulatory standards. Interim minimum risk-based capital standards, which allowed for a transitional period, became effective at year-end 1990.¹ The new standards became fully effective at year-end 1992.

The primary purpose of this paper is to assess the risk-based capital standards as measures of capital adequacy.² The paper concludes that the risk-based capital standards are an improvement over the former primary and secondary capital constraints they replaced. This paper first reviews the reasons for bank capital requirements and discusses the flaws inherent in the previous primary and secondary capital standards which were estab-

lished in 1985. The next section examines the motivation behind risk-based capital standards and briefly describes the new standards. Subsequently, factual information is added to the theoretical discussions. Brief histories of banks' risk-based capitalization, as well as other capital-adequacy measures, are used to assess the standards as measures of bank capital adequacy. Conclusions and recommendations are presented in the final section.

Bank Capital Adequacy

The subject of bank capital adequacy has received extensive treatment in the academic literature.^{3,4} One reason for this is that the topic is intrinsically multifaceted: adequate capital for what purposes and from whose perspective? Once the relevant functions of capital are established, one can select those types of financial instruments that best serve these functions and define an appropriate capital measure.⁵

The primary function of bank capital is to provide a cushion against losses, enabling banks to survive in difficult economic times. This function is served by equity capital, which

represents owners' investment in the bank. In addition, general loan- and lease-loss reserves, which banks have

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¹The interim risk-based capital standards established a minimum total risk-based capital ratio of 7.25 percent. The final standards increased this minimum to 8 percent.

²The same risk-based standards apply to both commercial and savings banks. Historical differences between commercial and savings banks' financial reports make direct comparisons difficult. For this reason, savings banks were excluded from the analysis. In addition, risk-based capital standards for savings associations (thrifts) were adopted by the Office of Thrift Supervision in 1989. A thorough discussion of thrift capital requirements is provided in Elmer (1990).

³Regulators' use of the term "adequate" versus "optimal" capital levels reflects the fact that bank regulators seek to set minimally-acceptable capital requirements for banks. These minimums have historically been well below those levels that the vast majority of banks have found to be optimal.

⁴In this discussion, the term capital is used in its broadest sense to refer to all forms of long-term corporate finance, debt and equity. This broad definition is based upon the standard delineation used in corporate finance literature between "capital markets" and "money markets." Financial instruments with long original maturities (usually over one year) are traded in capital markets, while instruments with shorter original maturities are traded in money markets.

⁵Vojta (1973) contains a useful discussion of the functions of bank capital.

provided for anticipated but as of yet unidentified future losses, can be used to absorb losses. After accounting equity capital (net worth) plus loss reserves have been exhausted the bank cannot absorb further losses.

Capital also can play a role in minimizing the costs of resolving bank failures. The most obvious way is to minimize the number of bank failures. After a bank fails, however, there are additional means of lowering these costs. The most direct means is to share bank failure resolution costs with bank creditors. Although the FDIC must compensate insured depositors in full, any losses present in the bank (due to the fact that bank liabilities exceed assets) may be shared with uninsured depositors and other noninsured creditors. Some forms of noninsured liabilities are high-cost or volatile sources of funding. Therefore, in selecting capital instruments to fulfill this second role, regulators prefer that capital requirements include long-term, stable sources of finance, such as limited-life preferred stock, convertible debt, and subordinated debt.

One should also note that capital instruments that serve one function of capital may not serve other functions. Subordinated debtholders share bank failure losses with the FDIC. However, periodic interest and principal repayments on outstanding debt must be made regardless of the bank's earnings. Therefore, debt instruments do not fulfill the first proposed function of capital, *i.e.*, aiding firms' survival during periods of losses.

Bank regulators are concerned with both functions of capital. In order to incorporate both functions, bank regulators historically used two regulatory capital measures, primary capital and secondary capital. Primary capital is composed of common and perpetual preferred stock (equity capital), a limited amount of mandatory convertible debt, minority interests in consolidated subsidiaries, and loan-

and lease-loss reserves, minus all intangible assets other than purchased mortgage servicing rights. Secondary capital includes any mandatory convertible debt that was excluded from primary capital, plus limited-life preferred stock and subordinated debentures.⁶

While the primary and secondary capital measures incorporate the two functions of capital described above, the capital requirements based upon these measures had several serious shortcomings. The most serious flaw was that the statutory minimum capitalization rates did not vary with the portfolio composition of the bank. The same flat-rate minimum standards of 5.5 percent primary capital and 6 percent primary plus secondary capital applied to all well-managed, sound banks. Bank supervisors were given the ability to set higher minimums for banks that were not considered well-run or in sound condition. No formal guidelines, however, were established on how these minimums would be adjusted with increased risks. The fact that the same capital requirements applied to both safe, low-yield assets, and risky assets with high expected yields was a serious shortcoming. The flat-rate standards allowed bankers to partially circumvent the leverage constraints by increasing concentrations of risky assets. Moreover, there were no capital requirements set against the off-balance-sheet activities of banks. As a result, bank regulators sought ways to adjust the capital standards to explicitly incorporate risk considerations.

The New Capital Requirements

If banking markets operated without deposit insurance, depositors would require a combination of higher interest rates and reduced bank debt (more equity) to offset increases in business risks. Bankers would accept additional risk only as long as investments yielded adequate, risk-compensating returns. Depositor pressures to limit risk-taking by bank managers

are substantially reduced under a system of deposit insurance. Indeed, when a bank fails, insured depositors only face the inconvenience of transferring business to another depository and the possibility of receiving lower rates of interest. Risk-based capital standards seek to replace depositor pressures to limit bank risk-taking with regulator-required increases in equity capitalization as a bank's operations become more risky.⁷

Risk-based capital standards require a determination of the types of risk that will be considered, as well as how to measure those risks. There are several categories of risks banks face that, if serious enough, could lead to insolvency.⁸ Credit risk refers to the risk of an individual borrower defaulting on obligations to the bank. Concentration risk refers to risks associated with loan concentrations, typically geographic and product concentrations. Interest-rate risk refers to potential decreases in the value of fixed-income assets due to rising interest rates. Additionally, interest-rate fluctuations may cause adverse changes in banks' net interest income if there is a significant mismatch in the maturities of assets and liabilities. Liquidity risk refers to potential difficulties in meeting current liabilities out of current assets. Operating risk refers to losses resulting from mistakes and inefficiencies in bank operations. Country-transfer risk refers to potential difficulties in receiving payment from foreign borrowers due to economic and political events in those countries. Fluctuations in foreign-exchange rates may add additional risks to loans to foreigners when such loans are denominated in local

⁶For a detailed description of the 1985 capital requirements, see Federal Deposit Insurance Corporation, 12 CFR Part 325, Capital Maintenance, *Federal Register*, Vol. 50, No. 53, March 19, 1985.

⁷The FDIC recently adopted a risk-related insurance assessment system to replace the traditional flat-rate premium structure. The risk-based premium and capital systems should complement each other, inducing bankers to reduce risk. For a discussion of the complementarity issue, see Hirschhorn (1987).

⁸The discussion of banking risks presented here draws upon that given in Vojta (1973).

currencies. Finally, fraud has been a factor in a substantial number of bank and thrift failures. Because many of these risks are interrelated, bank failures are usually attributed to a combination of risks.⁹ In recent years, high concentrations of loans in traditionally risky areas such as commercial real estate and land development have been a leading cause of bank failures.

The risk-based capital standards address credit risk in a limited fashion and make crude adjustments for country-transfer risk. This is accomplished by assigning assets to risk categories, based upon the type of collateral, guarantees, and the identity of the obligor. Off-balance-sheet commitments are first converted to credit-equivalent amounts, then assigned to risk categories on the same basis as bank assets. Capital requirements are set against the value of risk-weighted assets, which are computed as the sum of risk-weighted balance-sheet assets and off-balance-sheet commitments. Assets and credit-equivalent amounts of off-balance-sheet commitments considered to possess little or no credit risk are given risk-weights of zero percent and thus require no capital backing. Riskier assets and off-balance-sheet commitments are assigned higher risk-weights of either 20, 50, or 100 percent. The risk-weights of various bank assets and off-balance-sheet commitments are given in Appendix B.

A bank's capital requirements are determined by total risk-weighted assets. After a phase-in period which ended at year-end 1992, banks must have at least 4 percent Tier 1 capital and 8 percent total risk-based capital, where both capital ratios are measured as a percent of risk-weighted assets. Tier 1 capital is composed of common equity capital, noncumulative preferred stock, and minority interests in consolidated subsidiaries, minus intangible assets other than purchased mortgage servicing rights and credit-card receivables. Total risk-based capital is composed of Tier

1 capital, plus Tier 2 capital, where the qualifying amount of Tier 2 capital cannot exceed the level of Tier 1 capital. Tier 2 capital is composed of cumulative perpetual and long-term and intermediate-term preferred stock, qualifying subordinated debt and mandatory convertible debt, and general loan- and lease-loss allowances in amounts up to 1.25 percent of risk-weighted assets. As with the former primary and secondary capital constraints, bank supervisors were given the ability to set higher minimum risk-based capital requirements for banks that were not considered well-run or in sound condition. Again, however, no formal guidelines were established on how these minimums would be adjusted with increased risks.¹⁰

The risk-weightings of assets and off-balance-sheet commitments contain several important distinctions, many of which did not appear in early proposals for risk-based capital standards. First, in order to account for country risk, all assets and credit-equivalent amounts of off-balance-sheet commitments are classified according to whether they are obligations of institutions within member nations of the Organization for Economic Cooperation and Development (OECD), of which the United States is a member.¹¹ Obligations of institutions (government and private) located in OECD member nations are given the same risk-weights, within asset groups. Claims on institutions located within an OECD member nation were considered less-risky than those in non-OECD countries, and therefore, receive lower risk-weightings. Long-term credit extended to non-OECD-based borrowers generally receives a 100 percent risk-weight. Second, all obligations of OECD nations' central governments, including government-backed agency obligations, are given zero risk-weights. Third, first mortgages on 1-to-4 family residential properties require half the capital backing that commercial, consumer, and most other loan categories require. Each of these risk-weightings is based upon

credit-risk or country-risk considerations. The lack of consideration of most other risks in banking, as well as the apparent arbitrariness of the risk-weight categories themselves, resulted in much criticism of the new standards. Federal bank regulators, however, continue to work toward improving the risk-based capital standards by refining and broadening risk coverage. Important future additions to the standards will be explicit adjustments for interest-rate risk, as well as adjustments for credit-concentration risk, which regulators are required to have in place by 1993.¹²

In addition to the risk-based capital standards, banks also must meet leverage constraints. Upon adoption of the risk-based standards, the Federal Reserve Board stated that supplementary leverage constraints may be needed due to gaps in the risk-based standards. Specifically, the lack of an interest-rate risk adjustment, as well as exclusion of several other types of risk, could result in some institutions having low required risk-based capital levels despite the presence of substantial risks. Institutions were, therefore, still required to meet the primary and secondary capital leverage constraints in 1990. To avoid confusion, as well as to address shortcomings in these leverage constraints, all three federal bank regulators subsequently revised the leverage constraints, basing them upon Tier 1 capital. The new leverage constraints, effective

⁹For example, substantial increases in interest rates can increase the costs associated with liquidity risk when banks are forced to liquidate long-term assets at new lower market prices in order to meet current obligations.

¹⁰See Federal Deposit Insurance Corporation, 12 CFR Part 325, Capital Maintenance; Final Statement of Policy on Risk-Based Capital, *Federal Register*, Vol. 54, No. 53, March 21, 1989.

¹¹Added to the group of OECD nations are nations that have established special lending arrangements associated with the International Monetary Fund's (IMF) General Arrangements to Borrow.

¹²The Federal Deposit Insurance Corporation Improvement Act of 1991 requires regulators to amend the risk-based capital standards to incorporate interest-rate risk, concentration risk, and "the risks of nontraditional activities" by June 1993. See Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law 102-242, (December 19, 1991), 105 STAT. 2355.

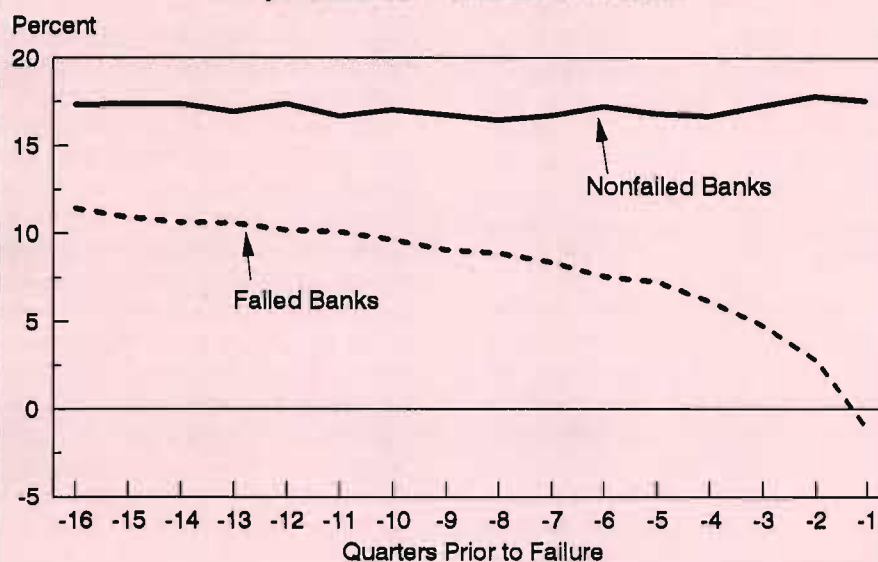
beginning 1991, also increase with the riskiness of the bank.

To measure risk, regulators use bank examiners' composite ratings of banks' capital adequacy, asset quality, management, earnings, and liquidity, known as CAMEL ratings (an acronym derived from the five areas reviewed). Composite CAMEL ratings range in integer values from 1 to 5, with "1" being the best rating and "5" the worst rating.¹³ Under the new leverage constraints, banks that have a CAMEL rating of "1" must have a minimum Tier 1 capital-to-assets (leverage) ratio of at least 3 percent.¹⁴ Banks that have CAMEL ratings poorer than "1" will have their minimum Tier 1 leverage ratios increased by 100 to 200 basis points (and perhaps more for banks with the worst ratings). The new leverage standards do not explicitly spell out how the leverage ratio changes for CAMEL ratings poorer than "1." The rules imply that the majority of banks will have minimum leverage ratios of at least 4 to 5 percent (with an absolute minimum of 4 percent). Indeed, since it is very rare for a bank with under 4 percent leverage capital to receive a CAMEL rating of "1," the effective minimum leverage ratio for the industry is 4 percent.¹⁵ The importance of the leverage constraints is discussed at the end of the next section.

Have Capital-Adequacy Standards Improved?

If capital standards are to be successful they must prevent banks from operating on too thin a level of equity capital. Unfortunately, it is difficult to evaluate what constitutes adequate capital for a particular bank. The capital-adequacy measures should, at a minimum, fluctuate with the likelihood of insolvency and indicate capital deficiencies. Further, the minimum capitalization rates should not be so low as to allow banks to move quickly from compliance with the standards to insolvency. These last two statements provide the basis for the tests of the new standards used in this section.

Figure 1
Median Total Risk-Based Capital Ratios
Comparison of 119 Failed and Peer Banks



Discussions of data sources and limitations are contained in Appendix A.

Capital-Adequacy Measurement

One way to assess the performance of capital-adequacy measures is to compare the trends in failing banks' regulatory capital ratios. The several regulatory capital ratios used in recent years vary in definition, which may result in some measures responding to a broader set of factors affecting the underlying adequacy of capital than others. Strong evidence in support of this supposition is presented below. Therefore, in order to gauge the relative degree of responsiveness of the capital-adequacy measures, this study uses the rates of change in the measures as banks approach failure.

Figure 1 presents the median total risk-based capital ratios for a sample of 119 commercial banks that failed or received open-bank assistance (henceforth referred to as failed banks) between January 1991 and September 1992.¹⁶ In order to control for general trends in industry capitalization, a peer group of 119 nonfailed banks was selected for comparison. The peer group was composed of nonfailed banks of similar asset size, location, as well as timing of financial data, as the 119 failing banks.

Figure 1 shows that the median total risk-based capital ratios for the group of 119 failed banks declined continuously over the four-year period prior to failure. The failed banks' median total risk-based capital ratio declined from 11.4 to -1.18 percent over the period. The median total risk-based capitalization rate for the peer group remained fairly stable, varying between 17.8 and 16.4 percent. The peer group capitalization rates were fairly stable for all the capital measures presented below.

Figure 2 compares three median capitalization rates for the same group

¹³For information on the assignment of CAMEL ratings, see *Manual of Examination Policies* (1986) Federal Deposit Insurance Corporation, Division of Supervision.

¹⁴More precisely, the new leverage standards are based upon the ratio of a bank's Tier 1 capital to average assets for the calendar quarter. In addition, any intangible asset deducted from Tier 1 capital is deducted also from average assets.

¹⁵As of September 1992, there were 136 commercial and savings banks whose Tier 1 leverage ratio was less than 4 percent. None of these institutions had composite CAMEL ratings of "1," two banks were rated "2," four banks were rated "3," 31 banks were rated "4," and 99 banks were rated "5."

¹⁶Between January 1991 and September 1992, 204 banks failed and 3 banks received FDIC open-bank assistance. The 35 mutual savings bank failures were excluded from the analysis in order to ensure comparability of the data. An additional 53 commercial bank failures were excluded due to incomplete data.

Figure 2
Median Capital Ratios
for 119 Failed Banks in 1991 and 1992

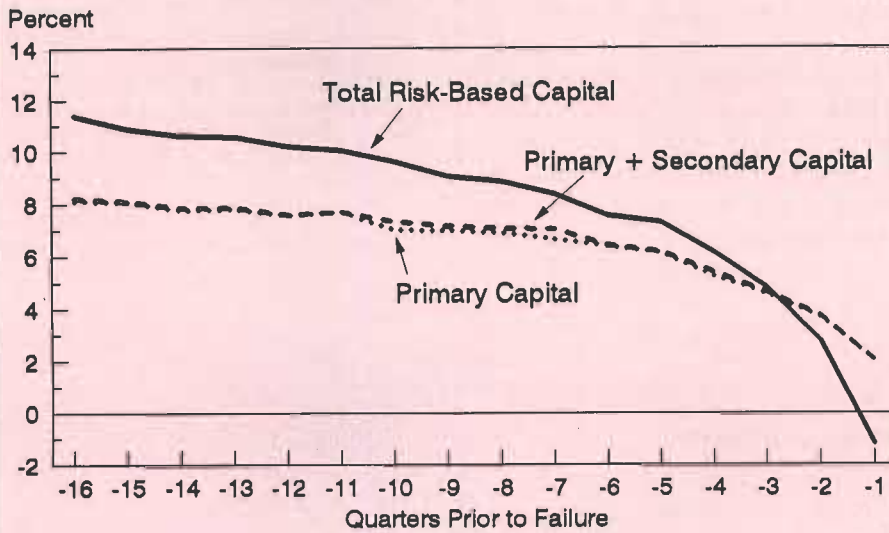
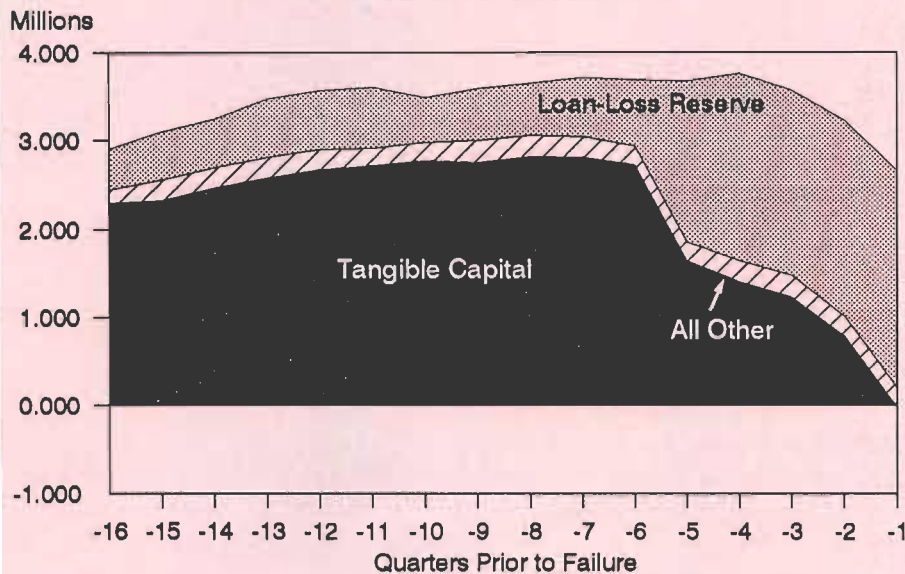


Figure 3
Composition of Primary Capital
for 119 Failed Banks in 1991 and 1992



of 119 failed banks: total risk-based capital, primary plus secondary capital, and primary capital alone. To check compliance with the risk-based standards one need only look at total risk-based capitalization. Because Tier 2 capital may comprise no more than half of total risk-based capital, any bank with 8 percent or higher total risk-based capital must have at least 4 percent or higher Tier 1 capital.¹⁷ Under the former primary and secondary cap-

ital standards, however, it was possible for banks to have 6 percent primary plus secondary capital, yet not meet the minimum 5.5 percent primary capital requirement.¹⁸ Figure 2 indicates that the primary and secondary capital measures were less responsive to the declining condition of the failing banks than was total risk-based capitalization. Both the median primary and primary plus secondary capital ratios declined 75 percent over the

four years prior to failure, compared to the 110 percent decline in total risk-based capital. In addition, the median primary and primary plus secondary capital ratios did not fall below their respective 5.5 percent and 6 percent minimums until four quarters before failure, compared to six quarters for median total risk-based capital. This does not mean many failing banks were necessarily meeting their capital requirements shortly before failure because regulators may well have raised the standards of these weakened banks.

The reasons for the differences in the rates of change in the various capital measures can be found by comparing the composition of the ratios. To help focus the analysis, first consider the differences between the former primary capital standard and the current Tier 1 capital standard. While primary capital is composed of many of the same elements as Tier 1 capital, an important difference, particularly among failing banks, is that primary capital includes all of the loan- and lease-loss reserves, while Tier 1 capital excludes the loss reserves. As a result, when failing banks increase their loan-loss reserves, as is typically needed for growing expected losses, the resultant reduction in equity capital is offset by the inclusion of the increased loss reserves in primary capital. This change in the composition of failing banks' primary capital is shown clearly in Figure 3. Figure 3 partitions the combined primary capital of the 119 failing banks into three components: loan-loss reserves, tangible equity capital, and "all other" components. As shown in Figure 3, as this group of banks approached failure, the composition of primary capital shifted from tangible capital toward loss reserves.

¹⁷For simplicity, this discussion employs the final risk-based capital standards that became effective at year-end 1992. When these 119 banks failed in 1991, they were actually subject to the lower, interim risk-based standards of 7.25 percent total risk-based capital and 3.6 percent Tier 1 capital.

¹⁸This occurs because the amount of secondary capital components banks were permitted to count toward total leverage capital (primary plus secondary capital) could be as much as 50 percent of available primary capital. As a result, a bank with only 4 percent primary capital could still have 6 percent total leverage capital if it had sufficient secondary capital.

This offset does not occur with Tier 1 capital due to its exclusion of loan-loss reserves. Therefore, one finds a larger proportionate decline in failing banks' Tier 1 capital levels than in their primary capital levels. There is the potential for this offset to occur in Tier 2 capital (and hence, total risk-based capital) because banks may include a portion of the loan-loss reserve in Tier 2 capital. The amount of loss reserves that may be included in Tier 2 capital is limited, however, to 1.25 percent of risk-weighted assets.

Fluctuations in the level of risk-weighted assets will affect also failing banks' risk-based capital ratios. Risk-weighted assets can change either due to changes in overall asset levels or due to changes in the composition of bank assets and off-balance-sheet commitments. Failing banks typically experience some decrease in total assets due to loan losses, as well as deliberate attempts to consolidate operations. In addition, risk-weighted assets have the potential to fluctuate without changes in total book assets. Troubled banks have, at times, sold off certain assets in order to generate income from capital gains, as well as to downsize the bank. Among the assets most easily sold are a bank's security portfolio and other liquid, high-quality assets. If these types of sales occur, risk-weighted assets should rise relative to book assets.

In order to investigate whether this occurred, one can use the ratio of risk-weighted assets to book assets. Over the four-year period prior to failure, the median ratio of risk-weighted assets to book assets exhibited a slight upward trend, rising from an average of 71 percent in the fourth year prior to failure to 74 percent in the last year before failure. Based upon these averages, a bank whose dollar Tier 1 (or total) risk-based capital and book assets remained unchanged would still incur a 4.1 percent decline in its Tier 1 risk-based capital ratio, due to the change in its risk-weighted assets.¹⁹ For the 119 failed banks studied, therefore, changes in portfolio composition appear to be a factor, albeit a small

one, in explaining movement in risk-based capital ratios.

While the evidence from failing banks indicates that the risk-based capital standards are an improvement over the former primary and secondary capital standards, additional improvement in regulatory capital-adequacy measures may be possible. Marino (1984) showed that it is possible to greatly improve the responsiveness of

measures of capital adequacy by simply incorporating information on bank asset quality. Marino computed an "adjusted-capital ratio" by deducting

¹⁹To see this, consider a bank with \$8 in total risk-based capital and \$100 in total assets. Further assume no changes in either capital or asset levels. If this bank's ratio of risk-weighted assets to book assets rose from 71 percent to 74 percent, then its total risk-based capital ratio would decline from 11.27 percent to 10.81 percent. The rise in the risk-weighted assets reduced total risk-based capitalization 4.1 percent.

Figure 4
Median Capital Levels
for 119 Failed Banks in 1991 and 1992

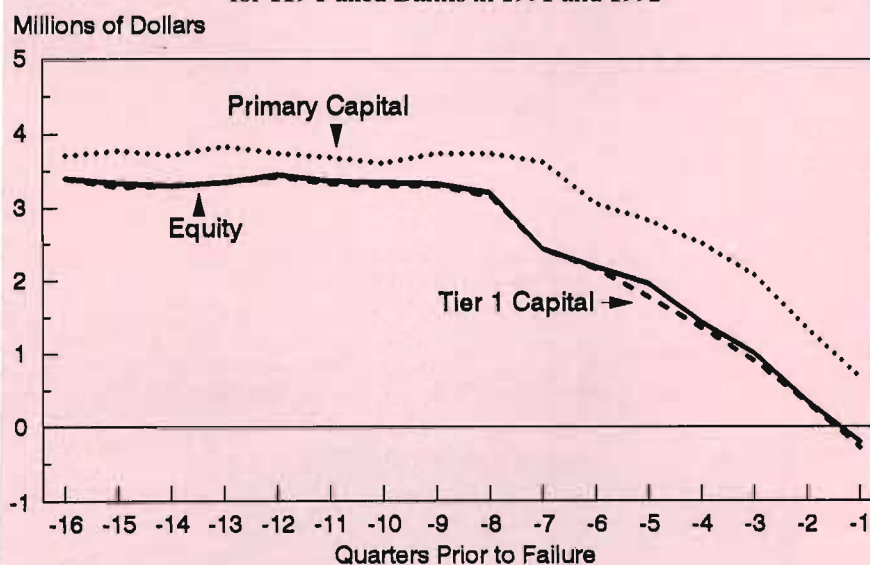


Figure 5
Median Asset Levels
for 119 Failed Banks in 1991 and 1992

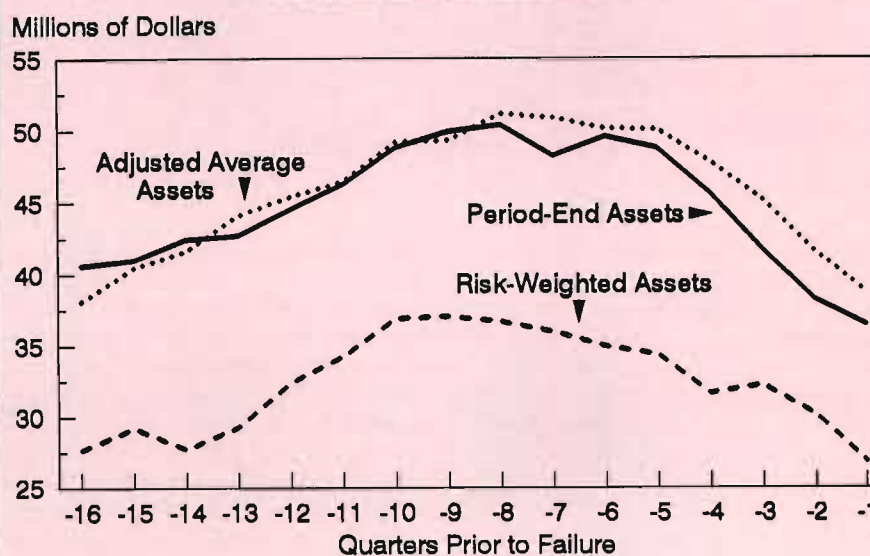
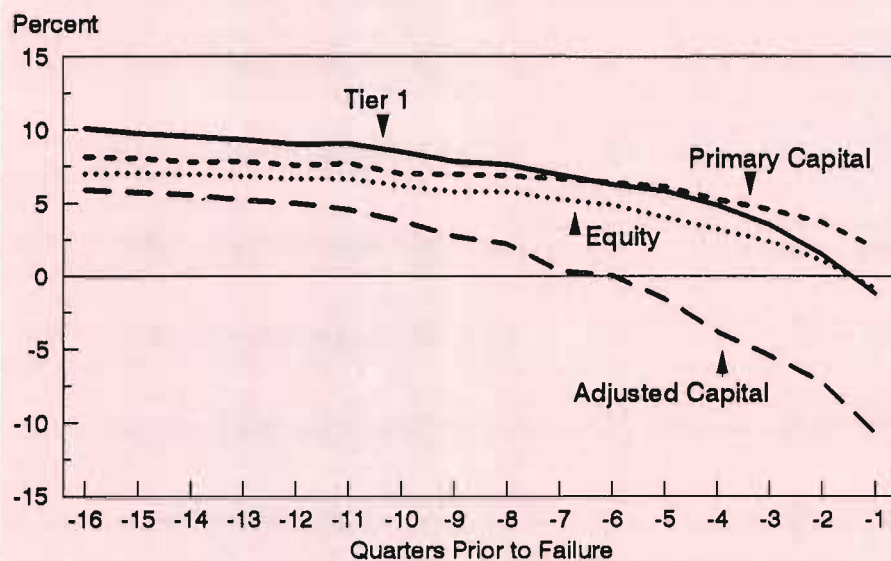


Figure 6
Median Capital Ratios
for 119 Failed Banks in 1991 and 1992



all past-due and nonaccrual loans and leases from primary capital. Figure 6 presents trends in an adjusted-capital ratio that is somewhat more broadly defined than Marino's. Adjusted capital was defined as equity capital plus loan-loss reserves and allocated transfer-risk reserves,²⁰ minus the sum of nonperforming assets and other real estate owned. Nonperforming assets include all loans and leases past-due 90 days or more, plus nonaccrual loans and leases. Other real estate owned includes any real estate repossessed by the bank as part of a loan foreclosure.

The trends in Figure 6 clearly indicate that the adjusted-capital measure is more responsive to the declining condition of failing banks than any of the regulatory capital-adequacy measures. Indeed, the median adjusted-capital ratio declined 282 percent over the four-year period prior to failure, compared to 75 percent for primary capital and 110 percent for Tier 1 capital. While the adjusted-capital measure would be useful in assessing capital-adequacy trends, it may be difficult to design a minimum regulatory capitalization rate based upon such a measure. This is because the ultimate losses

generated by nonperforming assets vary due to a number of factors, such as the composition of nonperforming assets. For example, losses from loans secured by residential properties experience much lower loss rates than unsecured consumer loans.²¹ As a result, there may be substantial variability in the potential losses associated with a given level of nonperforming assets. Moreover, if regulatory capital standards were based upon an adjusted-capital measure, there would be greater incentives for managements of weak banks to understate asset-quality problems.

Bank-Failure Prediction

The preceding trend analysis indicates clearly the differences in the responsiveness of several capital-adequacy measures to the changing condition of failing banks. One might infer from these trends that the greater the responsiveness of a capital-adequacy measure to the condition of a bank, the better its ability to predict bank failures. This section tests this supposition by comparing the predictive ability of alternative capital-adequacy measures in models of bank-failure prediction. It should

be pointed out that the development of sophisticated models for predicting bank failures is beyond the scope of this study. Nevertheless, the predictive power of capital-adequacy measures can be compared by incorporating them in simple models of failure prediction.

An extensive literature on business-failure prediction exists, offering a variety of economic models and statistical techniques. This study uses an approach similar to that used by Bovenzi, Marino and McFadden (1983), Gajewski (1989), and others. Specifically, the probability of a bank failing in a given year is said to be largely dependent upon its financial condition in a prior period. The key financial measures tested include the alternative measures of capital adequacy. Capital adequacy, however, cannot be judged in isolation. Therefore, additional financial measures were added to the models in order to control for factors relevant to capital-adequacy assessments and to help explain the reasons for the differences in the explanatory power of the capital-adequacy measures. The financial measures considered included measures of asset quality and liquidity. Asset quality was measured by the level of nonperforming assets, defined as the sum of all loans and leases past-due 90 days or more, nonaccrual loans and leases, and other real estate owned. Bank liquidity was measured by the level of liquid assets, comprised of all interest- and noninterest-bearing balances due to the bank from other depository institutions, plus

²⁰ Allocated transfer-risk reserves are reserves that banks are required to establish for potential losses on loans to less-developed countries. The requirements are established by the Inter-country Exposure Review Committee (ICERC), which is composed of representatives from the three federal bank regulatory agencies.

²¹ The variation in loss rates on various types of loans can be seen by comparing the ratio of annual loan charge-offs (net of recoveries) to the corresponding average nonperforming loan balance (charge-off ratio). The commercial bank charge-off ratio in 1991 for nonperforming real-estate loans was 14.1 percent. The charge-off ratio for nonperforming commercial and industrial loans was 29.5 percent, while that for nonperforming consumer loans was 53.1 percent. Nonperforming loans were broadly defined as all loans past-due 30 days or more, plus nonaccrual loans.

securities. All financial variables were measured as percentages of bank assets. While similar measures of financial condition have been included in other studies of bank-failure prediction, none of these studies has compared the predictive power of the risk-based capital measures with the previous primary and secondary capital standards.²²

Because *de novo* banks tend to have higher rates of failure than established banks, *de novo* banks were excluded from the sample of failed and nonfailed banks.²³ Specifically, all banks that were chartered after March 31, 1984, were excluded from the sample. Banks included in the sample, therefore, had been in existence for at least four and three-fourths years prior to the date of the financial data used.²⁴

Models 1 through 3 present estimates of alternative models of failure prediction using logit analysis. Logit estimation allows one to relate the observed failure or survival of banks to a set of exogenously determined explanatory variables.²⁵ For the models presented in Models 1 through 3, positive (negative) coefficient estimates, $\hat{\beta}_k$, indicate that an increase in that factor will increase (decrease) the likelihood of failure.²⁶

The models shown in Models 1 through 3 were designed to help explain any differences in the informational content of the regulatory capital ratios, both past and present. To this end, four capital ratios were used: equity capital to assets; Tier 1 plus Tier 2 capital to risk-weighted assets; primary plus secondary capital to adjusted average assets; and Tier 1 plus Tier 2 capital to assets.

The four capital-adequacy measures tested use varying definitions of "capital" as well as assets (numerators and denominators, respectively). Equity capital is the narrowest measure of capital, excluding the debt instruments and loan-loss reserves included in the regulatory capital measures. Total risk-based capital is more narrowly defined than the primary plus secondary capital measure, primarily

due to the limited amount of loan-loss reserves that may be included in the risk-based measure. Because the equity capital ratio and primary plus secondary capital ratio employ similar asset measures, comparisons of these two ratios indicate the importance of using narrower capital measures in failure prediction. Finally, the ratio of total risk-based capital to assets was included in order to learn the extent to which risk-weighted assets are important in failure predictions.

Models 1 through 3 present results of logit estimations based upon a sample of bank failures that occurred between June 30, 1991 and June 30, 1992; the explanatory variables were measured as of December 31, 1990. In all instances the capitalization measures were significantly negatively related to the probability of failure. Model 1 shows that the Tier 1 plus Tier 2 capital-to-risk-weighted assets ratio (total risk-based capitalization) provided more explanatory power than all other capital measures tested. This is seen by comparing the pseudo R^2 statistics for the alternative models.²⁷ The pseudo R^2 statistic takes on a value of 1 when the model is a perfect predictor of bank failures, and zero when the explanatory variables impart no useful information. Between these two extremes, the pseudo R^2 statistic can be thought of as measuring "the percent of uncertainty in the data explained by the empirical results."²⁸ The pseudo R^2 statistic for the model that employed total risk-based capitalization was .4163, while the corresponding values for the equity capital and primary plus secondary capital ratios were 0.4063 and 0.3421, respectively. These results indicate that capital-adequacy measures that are more narrowly defined, particularly those excluding loan-loss reserves, had greater explanatory power in failure-prediction models. In addition, Model 1 shows that much of the greater explanatory power of the risk-based capital ratios is due to the use of risk-weighted assets, not merely the narrower capital

measures. This is seen with the decline in the pseudo R^2 that occurred when Tier 1 plus Tier 2 capital is expressed as a percent of book assets (Tier 1 plus Tier 2 leverage ratio) rather than risk-weighted assets.

Models 1 through 3 also present information on the accuracy with which the alternative models predicted bank failures. Specifically, estimated failure probabilities were obtained for each sample period using the logit estimations. Banks whose estimated probabilities of failure were above the specified criteria were designated as likely failures or "in-sample" failure forecasts. Between January 1987 and June 1992, the average bank-failure rate was 1.35 percent. Therefore, banks with estimated failure probabilities above 1.35 percent were predicted to

²²Gary Fissel of the FDIC's Division of Research and Statistics has made such comparisons as part of an internal FDIC analysis (unpublished) of the FDIC's risk-related deposit insurance system.

²³To see this, define recently-established (*de novo*) banks as banks that have been in existence for 5 years or less as of a point in time. The failure rate for these banks can be defined as the number of *de novo* bank failures in a year, divided by the number of *de novo* banks in existence at year-end. Between 1984 and 1991, the average failure rate among *de novo* banks was approximately 1.80 percent, compared to 1.14 percent for all other banks. For banks in existence 10 years or less, the average failure rate for this period was 2.34 percent, compared to 0.98 percent for all other banks.

²⁴Other studies of bank-failure prediction have also excluded *de novo* banks. The 4.75 year period used here was somewhat arbitrarily chosen, but is not dissimilar from approaches used in other studies.

²⁵A more complete description of logit analysis can be found in Maddala (1983).

²⁶The precise interpretation is that an estimated coefficient, $\hat{\beta}_k$, indicates how a change in the factor it is associated with, x_k , changes the natural logarithm of the ratio of the probability of failing, to the probability of not failing, i.e.,

$$\ln\left(\frac{p_i}{1-p_i}\right) = \hat{a} + \sum_{k=1}^K \hat{\beta}_k x_{ki} + \hat{u}_i$$

²⁷The pseudo R^2 statistic is defined here as 1 minus the ratio of the log of the likelihood function maximized with all the explanatory factors included in the model, to the log of the likelihood function maximized in the model with none of the explanatory factors included (only the intercept term). See Maddala (1983).

²⁸See Judge, G. G., W. E. Griffiths, R. C. Hill, H. Lutkepohl, and T. Lee (1985), p. 767.

fail.²⁹ Model 1 shows that the highest proportion of actual failures was correctly predicted when total risk-based capitalization was employed in the models. Approximately 89.2 percent of actual failures were predicted when total risk-based capitalization was used, compared to the 75.4 percent accuracy achieved with the primary plus secondary capital ratio. The model using total risk-based capitalization was less precise in forecasting nonfailures than the model based upon the primary plus secondary capital ratio; the predictive accuracies were 93.8 percent and 94.5 percent, respectively. Stated differently, the risk-based capitalization model incorrectly predicted 80 more nonfailed banks to fail than did the model using the primary plus secondary capital ratio.

Model 2 shows that the likelihood of failure rises with the proportion of nonperforming assets. Moreover, the inclusion of information on asset quality substantially increased the explanatory power of the models. The model using total risk-based capitalization as the measure of capital adequacy, however, still provided more explanatory power than all other capital-adequacy measures tested. In addition, the model using total risk-based capitalization continued to predict bank failures more accurately than any of the comparison models, although it less accurately forecasted nonfailures.

Model 3 shows that when information on bank liquidity was added to the models, the pseudo R^2 obtained when total risk-based capitalization is used was equal to that obtained with the primary plus secondary capital ratio and less than that obtained with simple equity capitalization. One possible reason for this is that the proportion of liquid assets held is already measured, to some extent, by risk-weighted assets. Banks that are more liquid will have lower risk-weighted asset levels and

²⁹The choice of the failure criteria (critical probability) was somewhat arbitrary. The arithmetic average failure rate was used because of its intuitive appeal. The criteria designate a bank as a likely failure if its estimated probability of failure is greater than the overall average failure rate.

Table 1
Logit Estimation of Failure-Prediction Models
(June 1991 - June 1992 Failures Predicted with December 1990 Data)

MODEL 1				
Explanatory Variables	Estimated Coefficients (Standard Errors)			
	Version 1	Version 2	Version 3	Version 4
Intercept	0.290 ns (0.261)	0.577 * (0.299)	2.279 (0.406)	0.400 ns (0.292)
Capitalization Measure	-0.895 (0.056)	-0.534 (0.036)	-1.002 (0.066)	-0.799 (0.051)
Pseudo R^2	0.4063	0.4163	0.3421	0.3635
Correct Predictions				
Failed	55 (84.6%)	58 (89.2%)	49 (75.4%)	53 (81.5%)
Nonfailed	10,303 (95.7%)	10,096 (93.8%)	10,176 (94.5%)	10,300 (95.7%)
Incorrect Predictions				
False Failures	462 (4.3%)	669 (6.2%)	589 (5.5%)	465 (4.3%)
Missed Failures	10 (15.4%)	7 (10.8%)	16 (24.6%)	12 (18.5%)

MODEL 2				
Explanatory Variables	Estimated Coefficients (Standard Errors)			
	Version 1	Version 2	Version 3	Version 4
Intercept	-1.256 (0.442)	-1.036 (0.444)	-0.263 ns (0.522)	-1.548 (0.431)
Capitalization Measure	-0.731 (0.067)	-0.435 (0.040)	-0.769 (0.072)	-0.621 (0.057)
Nonperforming Assets	0.153 (0.033)	0.155 (0.031)	0.231 (0.028)	0.195 (0.030)
Pseudo R^2	0.4302	0.4428	0.4113	0.4063
Correct Predictions				
Failed	55 (84.6%)	58 (89.2%)	51 (78.5%)	55 (84.6%)
Nonfailed	10,329 (95.9%)	10,241 (95.1%)	10,341 (96.1%)	10,357 (96.2%)
Incorrect Predictions				
False Failures	436 (4.1%)	524 (4.9%)	424 (3.9%)	408 (3.8%)
Missed Failures	10 (15.4%)	7 (10.8%)	14 (21.5%)	10 (15.4%)

MODEL 3				
Explanatory Variables	Estimated Coefficients (Standard Errors)			
	Version 1	Version 2	Version 3	Version 4
Intercept	0.910 ns (0.583)	0.160 ns (0.551)	2.407 (0.698)	0.789 ns (0.572)
Capitalization Measure	-0.731 (0.070)	-0.427 (0.041)	-0.808 (0.078)	-0.626 (0.059)
Nonperforming Assets	0.113 (0.034)	0.141 (0.030)	0.179 (0.029)	0.147 (0.031)
Liquid Assets	-0.076 (0.015)	-0.050 (0.015)	-0.083 (0.015)	-0.079 (0.015)
Pseudo R^2	0.4679	0.4579	0.4579	0.4491
Correct Predictions				
Failed	57 (87.7%)	59 (90.8%)	55 (84.6%)	57 (87.7%)
Nonfailed	10,244 (95.2%)	10,172 (94.5%)	10,252 (95.2%)	10,239 (95.1%)
Incorrect Predictions				
False Failures	521 (4.8%)	593 (5.5%)	513 (4.8%)	526 (4.9%)
Missed Failures	8 (12.3%)	6 (9.2%)	10 (15.4%)	8 (12.3%)

Note: Unless stated otherwise, all estimated coefficients were significant at the 1 percent level.

* denotes significant at the 5 percent level.

ns denotes not significant, i.e., significance level above 10 percent.

These estimations were based upon 10,830 observations.

hence higher risk-based capitalization, other things being equal. Therefore, while the measure of liquidity added information to the models not employing risk-weighted assets, little was added to the model using risk-weighted assets. The higher pseudo R^2 obtained in the model using equity capitalization in Model 3, relative to that obtained with total risk-based capitalization (0.4679 and 0.4579,

respectively), indicates the contribution of the narrower capital measure. It should be pointed out, however, that a higher proportion of failures was correctly predicted in Model 3 when total risk-based capitalization was used than was achieved with primary plus secondary capital ratios.

In order to test the robustness of these results, the tests were repeated

using different sample periods and prediction intervals. In general, those results support the conclusions concerning the explanatory power of risk-based capitalization *versus* the former primary plus secondary capital leverage ratios.

In sum, the results in Models 1 through 3 are consistent with the earlier graphical analysis. When considered in isolation, the risk-based capitalization measures appear to be more responsive to the changing condition of failing banks than the former primary and secondary capital standards. This reflects additional information embodied in the risk-based measures, as demonstrated by the fact that the superior predictive ability of the model using risk-based capitalization is largely eliminated as more information is added to the alternative models.

Figure 7
Proportion of Banks in Compliance with Capital Rules, 119 Failed Banks

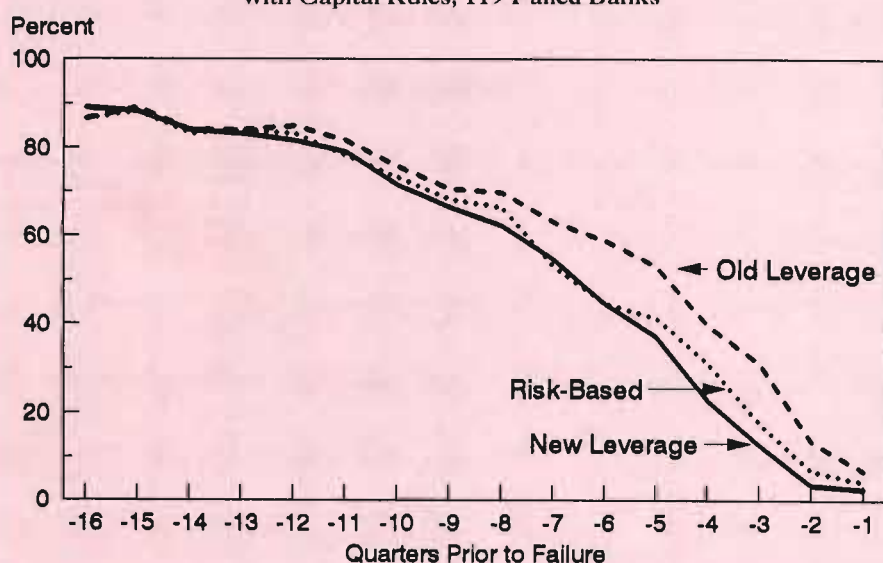
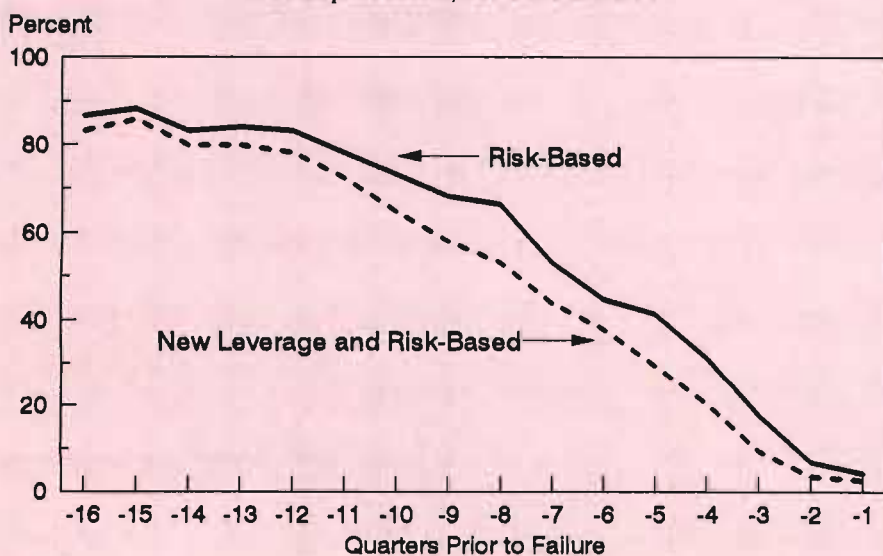


Figure 8
Proportion of Banks in Compliance with Capital Rules, 119 Failed Banks



Compliance with Minimum Capitalization Requirements: Are Supplementary Leverage Constraints Necessary?

As stated previously, failure to comply with minimum capitalization requirements is perhaps the most obvious indication of capital inadequacy, as defined by bank regulators. The trends in median capitalization rates presented above provided partial information on compliance. This section looks at compliance in greater detail, beginning with the same group of 119 failed banks.

As a group of banks approaches failure, one can reasonably expect that an increasing proportion of the group will fail to comply with *minimum* regulatory capitalization requirements.³⁰ This was indeed the case for the regulatory standards tested. Figure 7 presents data on compliance for three regulatory capital standards: the former 5.5 percent primary capital and 6 percent

³⁰This section used the statutory minimum capitalization rates to test compliance. It is expected that some banks may have had higher individual standards set by bank supervisors; however, compliance rates with statutory minimums are still instructive.

primary plus secondary capital standards (old leverage constraints); the 8 percent risk-based standards; and the new Tier 1 capital leverage constraints (new leverage constraints).³¹ Figure 7 indicates that the group of 119 failing banks generally found it more difficult to comply with the new leverage standards than with either the risk-based or old leverage requirements. Five quarters prior to failure, only 44 (37 percent) of the 119 failing banks met the new Tier 1 leverage standards, compared to 63 (53 percent) for old leverage standards and 49 (41 percent) for the risk-based standards.³²

The new leverage standards supplement the risk-based standards, *i.e.*, banks are expected to meet both sets of standards. Figure 8 shows that when used jointly, the new leverage and risk-based capital standards are better at identifying failures than either of the standards alone. Five quarters prior to failure, only 35 (29 percent) of the 119 failing banks met both risk-based and new leverage capital standards. These results offer support for the idea that the leverage constraints provide a useful supplement to the present risk-based capital requirements.

Figure 9 looks at compliance rates for all banks, failing and nonfailing. Figure 9 shows that the vast majority of banks are in compliance with the new capital standards.³³ Moreover, the trend has been toward increased compliance in recent years. Finally, as was the case for the sample of failing banks, one finds that the joint risk-based and new leverage standards are more stringent than either of the standards alone.

Compliance with the capital standards has varied across bank size groups. In order to give an indication of the differences in compliance across banks' asset size groups,

³¹The new leverage constraints vary a bank's minimum Tier 1 capital-to-assets ratio with its most recent composite CAMEL rating (see Federal Deposit Insurance Corporation, 12 CFR Part 325, Capital Maintenance, *Federal Register*, Vol. 56, No. 47, March 11, 1991). Because the published standards only provide a general framework for how the standards vary

Figure 9
Proportion of Banks in Compliance
with Capital Rules, (All Banks)

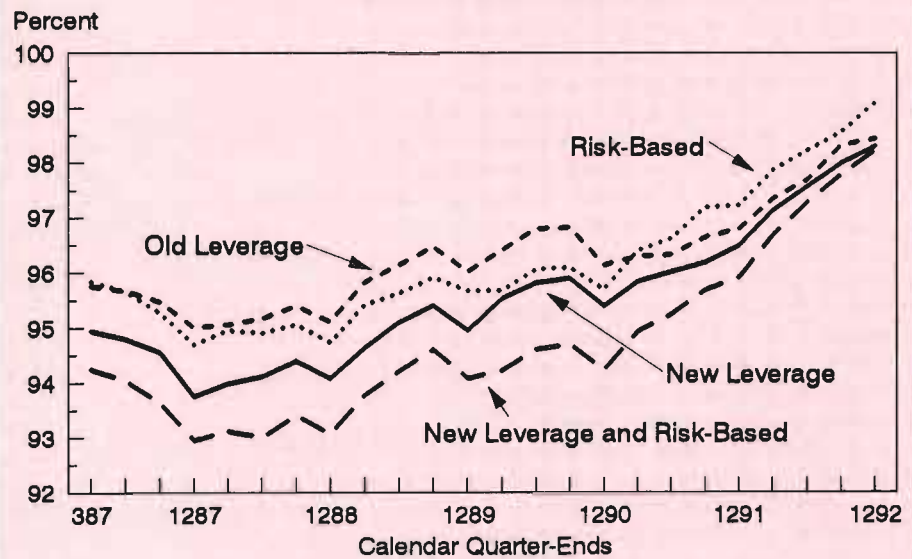
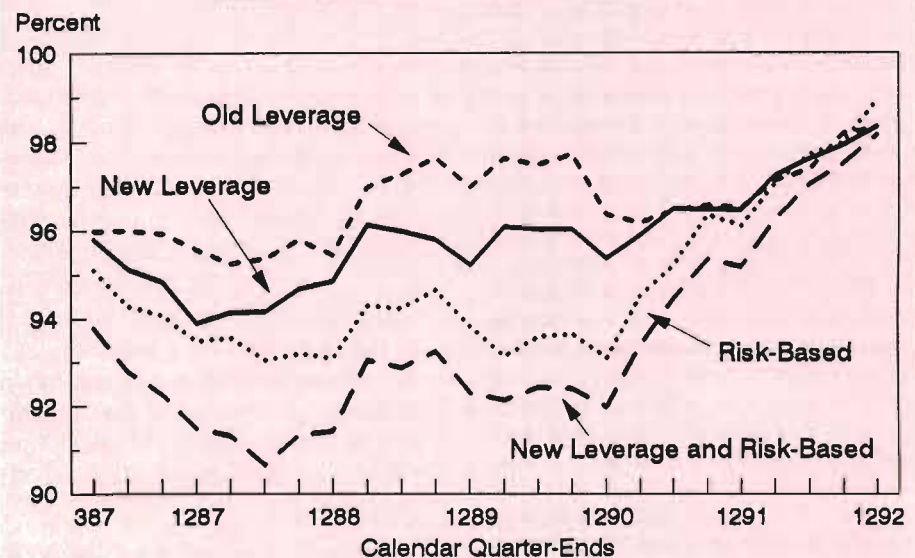


Figure 10
Proportion of Banks in Compliance
Banks with Assets of \$100 Million or More



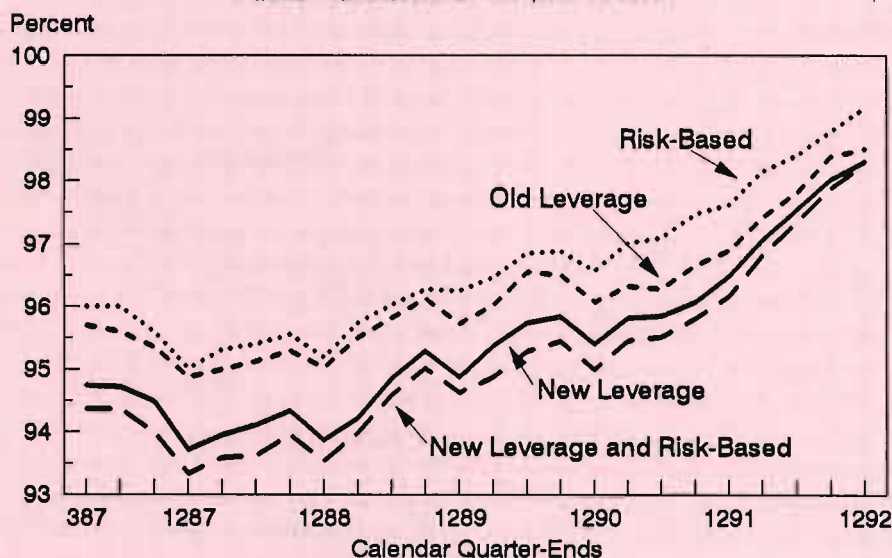
with banks' CAMEL ratings, an approximation, based upon the published standards and discussions with FDIC bank supervisory staff, was used here. Specifically, for those banks whose most recent composite CAMEL rating was "1" or "2," the minimum Tier 1 capital-to-assets ratio was 4 percent. Banks with CAMEL ratings of "3" were required to have a minimum Tier 1 ratio of 4.5 percent. Banks rated "4" were required to have a minimum of 5 percent Tier 1 capital, while banks rated "5" were required to have Tier 1 capital ratios of at least 6 percent.

³²Banks' Tier 1 leverage requirements were estimated each calendar quarter, using their

most recent composite CAMEL ratings. While most banks are examined annually, there may be longer intervals between examinations, particularly for the most highly-rated banks. FDIC policy in the late 1980s permitted examination intervals of up to three years for the most highly-rated banks. Therefore, this study used banks' most recent exam ratings for intervals up to, but not exceeding, three years.

³³Figure 9 includes all commercial banks for which data on compliance were available. A small number of banks (less than one percent) were deleted due to incomplete information on capitalization and/or examination ratings.

Figure 11
Proportion of Banks in Compliance
Banks with Assets Under \$100 Million



compliance rates were measured for several bank size groups. For brevity, Figures 10 and 11 present results for two bank size groups, banks with assets of \$100 million or more and banks with assets under \$100 million. Among banks with assets of \$100 million or more, compliance rates were higher for the new leverage standards than for the risk-based standards. The opposite was true for banks with assets of less than \$100 million, where compliance with the risk-based standards was higher than for the new leverage standards.

Conclusions

This study assessed the performance of risk-based capital standards as measures of bank capital adequacy, using a variety of approaches. The overall conclusion is that the risk-based standards are an improvement over the primary and secondary capital constraints they replaced. This improvement is due to two factors. First, the "quality" of the regulatory capital measures is improved under the risk-

based standards. This is primarily due to the exclusion of loan- and lease-loss reserves from Tier 1 capital (and its limited inclusion in Tier 2 capital). Second, the use of risk-weighted assets appears to offer advantages over simple book assets when assessing the adequacy of capital levels. These conclusions were drawn from tests that showed that the risk-based measures exhibited greater responsiveness to the changing condition of failing banks when compared to the former primary and secondary capital standards. Moreover, risk-based capital ratios exhibited greater explanatory power in models of bank-failure prediction than the former capital standards.

While the risk-based standards are an improvement over the former primary and secondary capital constraints, supplementary leverage constraints (based upon Tier 1 capital) may be beneficial. Data on healthy and failing banks' compliance with various capital standards showed that the addition of the Tier 1 leverage constraints to the risk-based standards provided a

more stringent test of capital adequacy. The leverage standards do not obviate the risk-based standards for all banks, however. Data on compliance with capital standards for various bank size groups showed that among banks with assets of \$100 million or more, the risk-based standards were, on average, a more stringent test, as measured by compliance rates, than the new leverage standards. Conversely, among banks with assets of less than \$100 million, the new leverage standards provided a more stringent test of capital adequacy than the risk-based standards.

Some observers have argued that after the risk-based measures have been amended to incorporate interest-rate risk, as well as loan-concentration risk, the leverage constraints will become unnecessary. Although these amendments will undoubtedly improve the risk-based capital measures, leverage constraints may still serve a useful purpose. There are at least two factors that argue for the continued use of supplementary leverage constraints. First, it is very difficult to obtain accurate measures of both interest-rate risk and concentration risk in banking. The fact that it will be over five years after the adoption of the risk-based standards before interest-rate risk and concentration risk adjustments are to be added to the system is sufficient evidence of the aforementioned difficulties. Second, as shown above, a joint test of capital adequacy is more effective in identifying failures than the risk-based standards alone. Also, the burden on the industry of complying with the current joint standards does not appear unduly severe, because over 97 percent of the industry was in compliance with the joint standards as of June 1992.

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APPENDIX A

Data Limitations

Data on commercial banks' risk-based capitalization were obtained from quarterly Reports of Income and Condition which banks are required to file with federal bank regulators. Data on banks' risk-based capital ratios are limited in two ways. First, not all banks are required to report their actual risk-based capitalization. In order to reduce the reporting burden of computing risk-weighted assets, only those banks with assets of \$1 billion or more (as of the reporting period), as well as those banks that fail a simpler 8 percent total risk-based capital-to-adjusted assets test, must report actual risk-based capitalization.³⁴

The result is that as of year-end 1991, only 20 percent of commercial banks, with 79.6 percent of industry assets, reported their risk-based capitalization. Estimated risk-weighted asset values and estimated risk-based capital ratios for the remaining banks were, however, made available by the Federal Financial Institutions Examination Council (FFIEC). The FFIEC has developed an algorithm for estimating risk-weighted assets, using available financial data, for those banks that do not report risk-weighted assets.

A second limitation arises from the fact that banks only began reporting risk-based capital ratios in March

1990. In order to obtain somewhat longer histories of banks' risk-based capitalization, the FFIEC algorithm was modified to obtain estimated risk-based capital ratios from 1987 to 1989. Modifications to the FFIEC algorithm were necessary due to differences in the detail of banks' financial reports in the prior periods. Additional reporting deficiencies in periods prior to 1987 prevented estimation of risk-based capitalization for periods before 1987. Comparisons of estimated risk-based capital ratios for the 1987 to 1989 and 1990 to 1992 periods indicated a close agreement between estimates obtained under the two algorithms.

³⁴The adjusted asset definition used for this test is defined as total assets minus the sum of cash, U.S. Treasury securities, U.S. Government agency obligations, and 80 percent of U.S. Government-sponsored agency obligations, plus the loan-loss allowance and certain off-balance-sheet commitments.

APPENDIX B**FDIC Risk-Weightings of Assets and Off-Balance-Sheet Commitments*****Balance-Sheet Items***

Risk-Weight	Risk-Asset Variable
0%	Cash and balances due from Federal Reserve Banks and other OECD central banks.
0%	Direct claims on, and portions of claims unconditionally guaranteed by, the U.S. Government and its agencies or other OECD central governments.
0%	Direct local currency claims on, or guaranteed by, non-OECD central governments.
0%	Gold bullion and Federal Reserve Bank stock.
20%	Cash items in the process of collection.
20%	All claims on U.S. depository institutions and other OECD depository institutions and short-term (remaining maturity one year or less) claims on non-OECD banks and non-OECD central banks.
20%	Portions of loans and other claims conditionally guaranteed by the U.S. and other OECD countries' central governments.
20%	Securities and other claims on U.S. Government-sponsored agencies (<i>i.e.</i> , not explicitly U.S.-backed).
20%	Portions of loans and other claims collateralized by securities issued or guaranteed by the U.S. Government, or by U.S. Government agencies or Government-sponsored agencies or other OECD central governments.
20%	Portions of loans and other claims collateralized by cash on deposit in the lending bank.
20%	General obligations backed by the full faith and credit of U.S. state and local governments and political subdivisions of other OECD governments.
20%	Claims on official multilateral lending institutions or development institutions.
20%	Privately-issued mortgage-backed securities representing indirect ownership of a U.S. Government agency or U.S. Government-sponsored agency.
20%	Investments in the shares of mutual funds whose portfolios contain assets qualifying for 0% or 20% risk-weight.
50%	Loans fully secured by first mortgages on 1-to-4 family residential properties (if made in accordance with prudent lending practices).
50%	Certain privately-issued mortgage-backed securities representing indirect ownership of a pool of residential mortgages which meet the criteria for the 50% risk-weight.
50%	Revenue bonds and similar obligations, including loans and leases, that are obligations of U.S. and other OECD municipal governments.
50%	Credit-equivalent amounts of interest-rate swaps and foreign-exchange rate contracts.
100%	All remaining assets or portions of assets not falling into above categories.

Off-Balance-Sheet Items

Note: Off-balance-sheet obligations are first converted to credit-equivalent amounts, then assigned to risk-weight classes based upon the identity of obligor or guarantor or collateral used.

Credit Convrsn. Factor	Off-Balance-Sheet Variable
100%	Direct credit substitutes backing financial claims.
100%	Participants in bankers' acceptances.
100%	Forward agreements (excluding those involving foreign-exchange rate contracts).
100%	Securities lent (where the lending bank faces some risk of loss).
50%	Transaction-related contingencies.
50%	Unused commitments with an original maturity exceeding one year.
20%	Short-term, self-liquidating, trade-related contingencies.

The Bank and Thrift Crises

— A Retrospective

by David S. Holland*

The years since 1980 have been a tumultuous period for the U.S. banking and thrift industries and their regulators. Indeed, not since the Depression of the 1930s have the nation's depository institutions been so severely buffeted. The overlapping and interacting causes of the turmoil have been many and varied, as have been the responses of the industries and of government authorities in both the legislative and executive branches.

Recent improvements in bank and thrift industry profitability and declines in the number of bank and thrift failures, however, give reason to believe that the worst may be over. Whether the more favorable outlook will last or will prove to be only temporary is, of course, impossible to know beforehand. But the recovery does provide a respite in which to review what has transpired and to cogitate a bit on the future. Those tasks are what this article strives to do.

The almost decade and a half of turmoil can be summarized as follows:

- High and volatile interest rates in the late 1970s and early 1980s undermined the decades-old approach to profitability in thrift institutions, which was: borrow for

short terms at low rates, lend for longer terms at higher rates.

- In the late 1970s and throughout the 1980s, both banks and thrifts experienced increasing levels of competition from nonbanks. For example, growing use of commercial paper as a funding source for nonfinancial corporations eroded banks' traditional commercial lending niche. And money-market mutual funds attracted substantial amounts of liquid funds that formerly would have been deposits in banks and thrifts.
- To aid the thrift industry, Congress and federal and state regulatory authorities in the early 1980s relaxed restrictions on activities. The thrifts' enthusiastic embrace of the new powers was not constrained by adequate supervisory oversight.
- The thrift industry suffered massive losses and eventually required a huge taxpayer bailout. The federal regulator and the federal insurer of S&Ls — the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation — were legislated out of existence. The FHLBB was replaced by the Office of Thrift Supervision. The insurance function was given to the FDIC.
- As the thrift industry was experiencing its explosive expansion and

implosive contraction, the banking industry and its regulators were hit by a rolling series of difficulties. Troubles in less-developed countries and in the energy, agricultural, and real-estate sectors of the U.S. economy all had negative impacts on the health and profitability of banks.

- The real-estate-related difficulties were the most widespread. The difficulties began in Texas and the Southwest and spread to the Northeast, the Southeast, and finally the West Coast.
- The banking industry's difficulties severely tested the FDIC and the bank deposit insurance system. Congress responded by significantly buttressing the bank supervisory system and by providing taxpayer backing for the Bank Insurance Fund.
- Not all of the trends and events concerning the banking system were negative. One significant development was the partial relaxation of the longstanding interstate bank and thrift restrictions that were increasingly confining the industries. This relaxation contributed to a consolidation trend in which the numbers

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of bank and thrift organizations declined.

- Congress' efforts since 1980 to deal with the turmoil in the bank and thrift industries have resulted in five major, occasionally contradictory, laws: the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA); the Garn-St Germain Act of 1982; the Competitive Equality Banking Act of 1987 (CEBA); the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA); and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

This summary is expanded upon in the remainder of this article. The discussion begins with a brief review of pre-1980 developments. Next, the thrift industry's expansion and contraction are described. Then, the banking industry's difficulties are examined. Finally, some thoughts on future prospects are presented.

Background

Any attempt to understand the financial turmoil of the last dozen years should begin with a look at the structure of the bank and thrift industries at the inception of the period. Two limitations with roots deep in American history determined to a great extent what that structure was. The first limitation was geographic. The second pertained to products and services.

Regarding the geographic limitation, banks and thrifts were largely prevented from conducting banking operations in more than one state. For banks, the 1927 McFadden Act and state laws and attitudes prevented the establishment of branches across state lines. And the 1956 Bank Holding Company Act prohibited the creation of interstate banking organizations consisting of separately chartered banks in more than one state, although there were a few grandfathered exceptions. For savings and loan associations, the policies of state and federal regulators prevented

interstate branching, and interstate S&L holding companies were prohibited by the 1967 Savings and Loan Holding Company Act.

Concerning products and services, a variety of state and federal laws, including the 1864 National Bank Act, the 1933 Glass-Steagall Act, the 1933 Home Owners' Loan Act, the 1934 National Housing Act, and the 1956 Bank Holding Company Act — and their many amendments — largely confined bank and thrift organizations to the taking of deposits and the making of loans. Lending was usually further circumscribed. Most S&L loans, as a leading example, had to be for residential real-estate purposes. And interest rates on bank and thrift deposits were subjected to regulatory caps, or in the case of demand deposits, prohibited altogether.

Depending on its structure and the applicable law, a bank or thrift organization could engage in some financial activities beyond just the taking of deposits and the making of loans, but the scope of the activities was narrowly drawn. And importantly, two significant financial businesses were for the most part off-limits: the securities business and the insurance business.

As a result of the geographic and product limitations on banks and thrifts, the U.S. depository institutions industry was, in comparison to the industry in other nations, unconcentrated and segmented. Thousands of institutions existed in semi-protected markets, enjoying only minimal competition from similar institutions. The activities restrictions hindered innovation by banks and thrifts regarding products and services. Meanwhile, non-depository institutions not constrained by the pervasive geographical and product limitations applicable to banks and thrifts were impinging more and more on the latter's areas of business.

Technology was contributing to the assault on the competitive barriers — the statutory geographic and product

restraints. Computers and computerized communications were making credit, market, and product information much more accessible, and the delivery of financial services much less dependent on customer or institution location.

Capacity is a difficult thing to measure in the banking world, where the ultimate product is an intangible — money. Nevertheless, one could argue that the U.S. bank and thrift industries had by the 1970s become burdened by a large measure of overcapacity. The overcapacity was due to the restraints on competition — the geographic and product limitations — that had been controlling the development of industry structure for well over a century. The difficult-to-quantify overcapacity was evidenced by the large numbers of depository and non-depository financial institutions competing in regard to both sources and uses of funds.¹

Economically and financially, the 1970s were a decade of increasing instability. Early in the decade, the Bretton Woods fixed exchange-rate regime, which had been a foundation of international economic and financial activity since the end of World War II, came to an end. The fixed-rate system was dependent on international faith in an unchanging value for the U.S. dollar. That faith was undermined by economic growth outside the United States, by persistent U.S. balance of payments deficits, and by inflationary fiscal policies in the United States during the Vietnam conflict. The fixed-rate system was replaced with a floating-rate system. One consequence was a substantial increase in currency trading activities. International banks were significant participants in the increase.

An economic shock with far-reaching ramifications occurred in 1973. The major oil-exporting countries imposed a fourfold increase in the price of a fundamental component of 20th

¹One might also argue that overcapacity in the U.S. financial industry is, in 1993, still a concern.

Century economic activity — oil. Further increases came as the decade progressed.

One almost immediate result of the oil-price increase was an enormous increase in the wealth of oil-exporting countries, far too much to be absorbed internally. A large amount of it was recycled, to use the term that became common, through international banks to less-developed countries. The competition among banks to participate in this recycling process led to lax lending standards and eventually the less-developed-country debt crisis of the 1980s.

Another consequence of the oil-price increases was a contribution to increases in inflation rates and interest rates, which were under upward pressure during these years because of expansionary monetary policies. The largest annual increase in the consumer price index in the 1960s had been 5.5 percent, in 1969. During 1974, the first full year after the initial oil-price boost by the oil-exporting countries, the CPI rose 11 percent. The annual increase fell to 5.8 percent in 1976 but returned to double digits by the end of the decade. For 1979, 1980, and 1981, the CPI increases were 11.3, 13.5, and 10.3 percent, respectively.²

Interest-rate statistics show a similar trend. The annual rate on new issues of 3-month U.S. Treasury securities reached 10.0 percent in 1979, its first foray into double digits. The yield on new-home mortgages went from 7.7 percent in 1971 to 10.8 percent in 1979, 14.7 percent in 1981, and 15.1 percent in 1982. The prime rate charged by banks hit 18.9 percent in 1981; in 1971 it had been 5.7 percent.³

The flexible currency exchange-rate system that followed the demise of the Bretton Woods fixed-rate scheme aided and abetted the rise in inflation and interest rates by making it easier for governments to avoid adopting tough, restrictive monetary and fiscal policies. Inflation under a fixed-rate regime often leads quickly to pressure on a currency that in turn

spurs the government to adopt non-inflationary policies. Inflation under a flexible-rate regime, on the other hand, can merely result, at least initially, in the depreciation of the currency, which a government is often willing to tolerate as the lesser of evils.

Thus the 1970s were a decade of considerable change and flux in the environment within which banks and thrifts operated. The environmental upheavals added to the pressures on the government-created barriers to competitive adjustment. Two financial phenomena can serve to highlight the changing marketplace and the deteriorating position of depository institutions in the 1970s. For a significant proportion of larger corporations, the issuance of commercial paper was becoming an alternative to borrowing funds from banks. And money-market mutual funds, which were not subject to the interest-rate caps restraining banks and thrifts, were attracting large amounts of funds that previously would have resided in those depository institutions.

The Thrift Industry

The story of the thrift industry since 1980 is a story of crisis, and the crisis was a two-step affair. The first step was relatively straightforward, its immediate cause relatively easy to pinpoint. That cause was high interest rates. The second step was significantly more complex and eventually much more severe. It concerned the sometimes contradictory responses of the industry, the industry's regulators, and Congress to those high interest rates and the various difficulties that ensued.

As institutions whose principal mode of operation was to fund long-term loans with short-term deposits, thrift institutions were detrimentally affected by the prolonged period of high interest rates that occurred in the late 1970s and early 1980s. Thrifts sustained losses by having to pay higher rates on the short-term deposits than they were earning on the long-

term loans. And the interest-rate caps then in existence made keeping old deposits and acquiring new ones exceedingly difficult. In 1981, for example, the profits for the thrift industry were a negative \$4.6 billion,⁴ and FSLIC-insured institutions suffered net deposit withdrawals of \$25.4 billion.⁵

Congress' initial answer to the problems created by the high interest rates was to provide for the phasing out of interest-rate controls. This was done in the Depository Institutions Deregulation and Monetary Control Act of 1980. The relaxation and eventual elimination of the controls enabled both thrifts and banks to stem the loss of deposits due to the inability to pay market rates of interest. Paying market rates of interest, however, only exacerbated the major difficulty facing a large proportion of thrifts: supporting low-rate, long-term loans with high-rate, short-term liabilities.

Parenthetically, DIDMCA contained another provision, little noticed at the time, that in hindsight exemplifies the attitude with which much of the financial industry and its regulators entered the 1980s. With very little analysis or debate, Congress raised the federal deposit insurance limit for both banks and thrifts from \$40,000 to \$100,000. This action itself may not have contributed much to the problems that were to come. But the almost carefree more-than-doubling of the federal deposit guarantee indicated a certain optimism and lack of apprehension regarding the prospects of the depository institutions industry.

To help the thrift industry both overcome the interest rate-caused threat to its viability and meet other difficulties arising from changes in the

²*Economic Report of the President* (Washington, DC: U.S. Government Printing Office, February 1992), Table B-59, p. 365.

³*Ibidem.*, Table B-69, p. 378.

⁴Office of Thrift Supervision, *Supervising Today's Thrift Industry*, December 1992, p. 1.

⁵Federal Home Loan Bank Board, *Annual Report, 1986*, p. 6.

financial marketplace, Congress and the Federal Home Loan Bank Board — the federal regulator of S&Ls — took a number of steps. In total, the actions came to be referred to as “deregulation.” To generalize, deregulation consisted of (1) the relaxation of capital and accounting standards and (2) the expansion of lending and investment powers. Of great significance, the increased flexibility and freedom granted to the thrifts were not matched by increased supervisory efforts or resources. Indeed, a major cause of the subsequent troubles was inadequate supervision.

The relaxation of capital and accounting standards occurred in a variety of ways. One of the first major steps was the FHLBB’s reduction in 1980 of the statutory reserve requirement — one of several measures of thrift capital — from 5 percent to 4 percent of insured deposits. The requirement was further reduced in 1982 to 3 percent. In 1981, the FHLBB authorized thrifts to defer and amortize losses on the sale or other disposition of mortgage loans, mortgage-related securities, and debt securities. Previously, such losses had to be recognized immediately. Also in 1981, the FHLBB permitted troubled institutions to issue income capital certificates to bolster their capital positions. The certificates were purchased by the FSLIC with either cash or interest-bearing notes.

In the Garn-St Germain Act of 1982, Congress appropriated the income capital certificate concept by authorizing a net worth certificate program for both banks and thrifts. The program improved the financial appearance of banks and thrifts with low net worth by permitting the institutions to count promissory notes from the appropriate federal regulator as capital. Among the FHLBB’s actions in 1982 was an increase from ten to 40 years of the period during which goodwill in merger transactions could be amortized. The effect was to significantly increase the reported, but

not the real, income and capital of the thrift industry.

A retreat from the standards relaxation trend began the following year, 1983, but several major capital-diluting steps still lay ahead. In 1985, the FSLIC began a Management Consignment Program to reorganize and recapitalize troubled institutions. The recapitalizations were largely paper transactions, being accomplished through the issuance of capital certificates. And in the Competitive Equality Banking Act of 1987, Congress instituted supervisory forbearance for “well-managed” undercapitalized thrifts.

Regarding the expansion of thrift lending and investment powers, DIDMCA in 1980 was an important early step. In that Act, Congress removed a geographic limit on thrift lending, allowed thrifts to buy corporate debt and commercial paper up to 20 percent of assets and to invest up to 3 percent of assets in service corporations, and expanded thrift authority to make acquisition, development, and construction (ADC) loans. Meanwhile, several states, notably California, Texas, and Florida were aggressively broadening the powers of state-chartered institutions.

In 1980 and 1981, the FHLBB allowed thrifts to lend with loan-to-value ratios greater than 90 percent, to accept less than a first lien on mortgage loans, and to hedge with financial futures. In addition, thrift service corporation powers were expanded. In 1982, and on the liabilities side of the ledger, the FHLBB removed restrictions on brokered deposits.

Congress also made significant liberalizing contributions in 1982, in the Garn-St Germain Act. Prohibitions or limitations on nonresidential real-estate lending, consumer lending, commercial lending, and personal property leasing activities were relaxed.

It should be emphasized that these many steps to expand the powers of thrift institutions were not in themselves, and considered individually, necessarily “bad.” Indeed, in view of

the changes taking place in the financial marketplace, some of them may have been unavoidable, even desirable. The liberalizing steps, however, were not accompanied by adequate oversight. Many thrift executives reacted to the freer environment like small children turned loose without parental oversight in the Halloween candy. The unrestrained gorging was unsurprising, and the unpleasant consequences were not unforeseeable.

The resources and efforts of government supervisors were insufficient to halt a rapid growth in imprudent lending and investing. Moreover, fraud and insider abuse began surfacing with unsettling frequency. Attempts by supervisors to handle troubled institutions with a minimum initial outlay of government funds compounded the difficulties. Acquisitions of such institutions were permitted in which acquirers put little or no capital at risk. Unhindered by either government supervision or fear of losing their investments, more than a few such acquirers treated their acquisitions as spigots on the pipelines of the nation’s financial flows.

One further major ingredient interacted with the loosened capital and accounting standards, expanded lending and investment powers, and inadequate supervision to produce the thrift debacle of the latter half of the 1980s. That ingredient was an exaggerated swing of the real-estate cycle. Real-estate markets expanded rapidly in the early and mid-1980s and contracted precipitously as the decade neared its end. A portion of the expansion and contraction was undoubtedly the natural workings of the marketplace. The pent-up demand that the high interest rates of the early 1980s had produced led to overbuilding, which in turn caused retrenchment. Just as important in the swing, however, were government actions and policies that first encouraged and then discouraged flows of funds to real estate.

For some time, the quasi-government mortgage agencies — the Federal National Mortgage Association,

the Government National Mortgage Association, and the Federal Home Loan Mortgage Corporation — had been bringing forth, in conjunction with private-sector participants in the capital markets, a variety of innovative mortgage packaging techniques and products. The innovations widened the circle of potential real-estate investors.

Congress contributed to the upswing in the real-estate cycle by tax cuts in 1981 and through the Secondary Mortgage Market Enhancement Act in 1984. The tax cuts in 1981 contained accelerated depreciation provisions and investment tax credits that made real-estate investments extremely attractive. The 1984 law reduced state barriers to investment in mortgage-related securities.

On the other hand, as many real-estate sectors were probably getting ready to cool of their own accord, Congress, inadvertently, accelerated the downturns with the Tax Reform Act of 1986. That law reduced depreciation benefits, restricted passive loss deductions, and eliminated favorable treatment for capital gains. The reduction in the attractiveness of real estate as an investment was both substantial and abrupt. Over the next few years, real-estate values in many areas declined significantly. Commercial properties were particularly hard hit. Thrifts that had helped fuel the speculative binges of the early 1980s found themselves burdened with defaulting borrowers and falling collateral values. Although many of the post-1986 thrift failures were undoubtedly already foreordained, the Tax Reform Act of 1986, by suddenly altering the real-estate investment climate, did the industry no favors.

By the middle of the decade, thrift executives were making extensive use of the increased powers they had been given by Congress, state legislatures, and the regulators. Assets of FSLIC-insured institutions grew from \$600 billion in 1980 to over \$1 trillion in 1985.⁶ The share of the nonresidential mortgage loan market controlled

by thrifts in 1980 was 11 percent. By 1985, the thrifts' proportion had risen to 30 percent.⁷ Home mortgage loans — the traditional mainstay of thrifts — fell from 67 percent of thrift assets in 1980 to 42 percent in 1985.⁸ One hundred thirty-three new thrift charters were issued in 1984; the number the following year was 173.⁹

Also by mid-decade, signs of the coming disaster were surfacing, rapidly. In 1978, the mortgage delinquency rate for FSLIC-insured institutions had been under 1.5 percent. In 1986, it was 5 percent.¹⁰ Thrift industry profits for 1986 were an anemic \$131 million. The previous year they had been \$3.7 billion.¹¹ By one count, 46 FSLIC-insured thrifts with assets totaling \$12 billion failed in 1986.¹² At an estimated cost of \$3.1 billion, these failures rendered the FSLIC fund insolvent.¹³ In 1987, the thrift industry suffered a loss of \$7.8 billion.¹⁴ Forty-seven institutions with assets of \$11 billion failed, at an estimated cost of \$3.7 billion.¹⁵

Reaction to the developing crisis was increasing, but the taking of effective corrective steps was severely hindered by a number of factors. There was a general disbelief that the problems were really as bad as they seemed. The complexity and esoteric nature of the difficulties discouraged examination by the media. A politically powerful thrift industry lobby vehemently fought any reexamination of the liberalizing moves of the early 1980s and even the smallest attempt at increased supervision. Involvement of both political parties in industry problems — at the policy as well as individual levels — discouraged Congressional and Executive Branch action, particularly during the 1986 and 1988 election years.

Congress' first effort to deal with the snowballing situation was tentative. The Competitive Equality Banking Act of 1987 authorized a \$10.8 billion recapitalization of the FSLIC and called for supervisory forbearance for "well-managed" undercapitalized institutions. The Act did little to

stanch the hemorrhaging that was taking place in the thrift industry, and the \$10.8 billion was quickly perceived as inadequate. In 1988, 205 thrifts with assets of \$100 billion failed. The estimated cost of the failures was \$31.2 billion.¹⁶ The FSLIC reported a deficit of \$75 billion.¹⁷

Tentative was not how the next Congressional effort could be characterized. Shortly after taking office in 1989, President Bush sent a massive, complex thrift industry restructuring bill to Capitol Hill. The resulting legislation was the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The FHLBB and the FSLIC were abolished. Thrift industry oversight was moved to the Department of the Treasury, being placed in the newly created Office of Thrift Supervision (OTS). The FSLIC's insurance functions were transferred to the FDIC. Responsibility for dealing with failed thrifts was given to another newly created organization, the Resolution Trust Corporation, which was to accomplish its task and go out of existence by 1996.

A few of FIRREA's provisions may have gone too far, thus compounding the difficulties. For example, thrifts were required to dispose quickly of their junk-bond inventories. In complying, some thrifts sustained what might have been unnecessary losses,

⁶James R. Barth, *The Great Savings and Loan Debacle* (Washington, DC: The AEI Press, 1991), p. 25.

⁷Prudential-Bache Capital Funding, Financial Strategies Group, *A 1980s Retrospective of the Savings and Loan Crisis*, Wall Chart (Prudential-Bache Capital Funding, 1990).

⁸Barth, p. 25.

⁹Prudential-Bache.

¹⁰Prudential-Bache.

¹¹Barth, p. 25.

¹²*Ibidem.*, p. 32.

¹³Federal Home Loan Bank Board, *Annual Report, 1986*, p. 25.

¹⁴Federal Home Loan Bank Board, *Annual Report, 1987*, p. 5.

¹⁵Barth, p. 32.

¹⁶*Ibidem.*

¹⁷Federal Home Loan Bank Board, *Annual Report, 1988*, p. 36.

and the already weakened junk-bond market may have received an additional unnecessary jolt.

From the perspective of midyear 1993, the S&L crisis appeared to have moved past its peak. Most of the thrift institutions destined for the RTC had found their way there, and the agency had disposed of almost three-fourths of the failed-thrift assets in its inventory. The agency, however, was still awaiting an additional amount of approximately \$25 billion from Congress to complete its work. The total cost to the taxpayer of the S&L crisis was expected to be close to \$200 billion.

The portion of the thrift industry remaining in private-sector hands consisted of, at year-end 1992, 1,855 OTS-supervised institutions with assets of \$795 billion, down from 3,092 institutions with assets of \$1,284 billion in June of 1988. In 1991, the private-sector portion of the industry had earned its first annual profit since 1986, \$1.83 billion. Primarily because of declining interest rates, private-sector industry profits for 1992 were a record \$5.14 billion.¹⁸

What the future held for the industry survivors was impossible to foretell, however. Over a period of little more than a decade, the industry had first been severely threatened, had then enjoyed enormous growth, and had next been virtually decimated. In light of this recent history and the fallibility of government policymakers, government regulators, and industry executives, cautious optimism appeared to be the most favorable view that an observer should be willing to entertain.

The Banking Industry

The difficulties that have beset the banking industry in the years since 1980 have differed in several important respects from the problems of the thrift industry. First and foremost, the rise in interest rates in the late 1970s and early 1980s was much less a problem for banks than it was for thrifts.

Although banks were subject to the interest-rate caps on deposits and consequently experienced some outflow of funds, they were not burdened with large proportions of long-term, fixed-rate assets. Bank assets generally had much shorter maturities than did the mortgage loans of the thrifts. Consequently, banks could adjust upward the price of loans and other assets as the cost of funds — the rates paid on deposits — increased in response to market forces.

Second, the credit-related problems that beset banking were regional or sectorial in scope. Thus, the entire industry was not hit by difficulties at once. The industry and its regulators were able to deal with troubles in more manageable portions than were the thrift industry and its regulators.

Finally, the supervisory system for banks was generally superior to the system for thrifts. The primary federal thrift regulator, the FHLBB, was charged with being both a supervisor of S&Ls and a promoter of the home-financing industry. This dual focus probably increased the thrift supervisory system's susceptibility to the badgering and entreaties of what was at the time one of Washington's most powerful — and myopic — lobbies.

In the years since 1980, four major sets of difficulties have challenged the banking industry and its regulators. These four sets of difficulties concerned less-developed-country, agricultural, energy, and real-estate lending, with the last being the most damaging. The four areas have a similarity. Bank involvement in each was characterized by an exuberance fueled in part by the enthusiasm of other banks — the bandwagon effect. The exuberance and enthusiasm clouded the reality that there can be too much of a good thing. After the initial burst of bank lending in each area, further funds were chasing fewer viable projects and were advanced with inadequate attention to changing macroeconomic conditions.

The less-developed-country debt crisis was the outcome of massive flows of funds to the LDCs in the 1970s. Fueled in large measure by the "petrodollars" that the oil-exporting countries placed in international banks following the oil-price rises during the decade, the lending was based on increasingly tenuous assumptions about LDC growth. The LDCs simply could not make *bona fide* economic use of the financial largess coming their way. The lending resulted in large increases in LDC external debt.

Mexico's announcement in August 1982 that it would be unable to meet its debt payments to foreign creditors brought an abrupt end to unrestrained lending and an abrupt start to the LDC debt crisis. Within the U.S. banking industry, the largest banks were the ones with the greatest LDC exposure and consequently the most affected. As a percent of equity capital and reserves, the non-trade exposure of the average U.S. money-center bank to LDCs was 227 percent in 1982.¹⁹

The announcement by Mexico began a multi-year workout effort involving banks, governments in both debtor and creditor countries, and international organizations during which much of the LDC debt was restructured. The crisis' impact on U.S. banks was slow to be acknowledged in financial statements. Eventually, however, the piper had to be paid. In 1987 and again in 1989, U.S. money-center banks added substantially to reserves to provide for LDC debt losses. The effect in 1987 was especially noticeable, the increase in reserves being largely responsible for a decline in the return on assets for the banking industry from 0.61 percent in 1986 to 0.09 percent in 1987.²⁰

¹⁸Office of Thrift Supervision: (1) Press Release, March 11, 1993; (2) *Supervising Today's Thrift Industry*, December 1992, p. 35.

¹⁹Gary S. Fissel, "The Anatomy of the LDC Debt Crisis," *FDIC Banking Review*, Vol. 4, No. 1, Spring/Summer 1991, p. 10.

²⁰Calculated from Federal Deposit Insurance Corporation, *Historical Statistics on Banking, 1934-1991*, Tables CB-7, CB-12.

By the early 1990s, the LDC debt crisis appeared to have abated. The external debt burden for many of the LDCs had been eased through various forms of debt restructurings. The economies of the countries had generally stabilized, and for most the International Monetary Fund was projecting healthy growth. As for banks, their exposure to LDC debt problems had been reduced. For example, the ratio of LDC non-trade exposure to equity capital and reserves for the average U.S. money-center bank had fallen from 227 percent in 1982 to 91 percent in 1989.²¹

Regarding agricultural lending, difficulties had surfaced by 1984 and were to be a concern for the next several years. The difficulties had their immediate origins in the previous decade. Led by export growth and rising commodity prices, the farming sector of the economy in the 1970s enjoyed one of its more expansive periods. The boom had a substantial effect on the price of farm land, causing it to rise significantly. Expecting the good times to continue, many farmers borrowed heavily to expand operations, using the inflating real-estate values to support the increases in debt.

As booms are wont to do, however, the agricultural boom of the 1970s came to an end. The particular macro-economic forces that had helped produce it — strong growth in demand in the industrial economies, a cheap dollar, high inflation, and low real interest rates — suffered reversals as the new decade began. The value of farmers' main asset, land, plunged.²² Farmers who had used rising real-estate values to finance operations were forced to rely on cash flow from operations. In many instances, the cash flow, which was reduced because of the general fall in demand, was not sufficient to enable debt service obligations to be met.

In consequence, farm lenders experienced large loan losses, and many of them failed. Agricultural banks,

defined as banks in which agricultural loans amount to 25 percent or more of total loans, accounted for 32 percent of bank failures in 1984 (25 of 79), 54 percent in 1985 (65 of 120), 41 percent in 1986 (57 of 138), 30 percent in 1987 (56 of 184), and 14 percent in 1988 (28 of 200).²³ Fortunately from the standpoint of the banking system and its regulators, most of the failed agricultural banks were relatively small. Thus, considered in isolation, the problems in agricultural lending, though significant, were not system-threatening.

Energy-related lending difficulties, centered in the Southwest but reverberating nationwide, were to pose a more formidable challenge to banking and its overseers. As was the case with agriculture, the energy-related lending difficulties of the 1980s had their origins in boom conditions in the 1970s. The boom was due to the huge increase in energy prices. The real price of domestic crude oil more than tripled during the decade, from \$8 to \$28 per barrel in constant (1982) dollars.²⁴ Assuming that the OPEC cartel's ability to set world oil prices would continue, many forecasters envisioned a barrel's cost at \$50 or more before too long.

Such projections colored the lending decisions at many Southwest banks and thrifts. The oil-price outlook implied strong economic growth and in-migration for the region. Banking institutions responded by lending aggressively to businesses that stood to benefit from these trends, principally oil and gas producers, construction firms, and real-estate developers. A sizeable oil-price hike in 1981, from \$24 to \$34 per barrel in current dollars, appeared to confirm the prevailing outlook for ever-increasing energy prices.²⁵

But 1981 was the oil-price apogee. Prices began falling in the latter half of the year and did not find a bottom until past mid-decade. The 1986 price per barrel was \$15.²⁶ The prognosticators had failed to foresee the

increase in supply from non-OPEC producers and the significant reduction in demand due to conservation measures. They also had failed to discern the fragility of OPEC's own production agreements. As oil prices began falling, OPEC members sought to maintain their revenues by ignoring production quotas and raising output. This further increased supply and accelerated the downward movement of prices.

Economic growth in the Southwest slowed, stopped, and turned negative. Real-estate values collapsed, and lenders of all types began feeling the effects. From 1980 through 1989, 535 banks failed in Texas, Oklahoma, and Louisiana, a total that was 50 percent of all U.S. bank failures during the period.²⁷ Some of the failures were of agricultural banks, but the majority succumbed to energy-related difficulties. By the end of the decade, nine of the ten largest banking organizations in Texas had been recapitalized with FDIC or other outside assistance.²⁸ Factors that combined with the energy boom-bust to produce the Southwest banking debacle included inadequate portfolio diversification, poor underwriting standards, weak internal controls on lending decisions, infrequent supervisory examinations, and unrealistic real-estate valuations.

²¹Fissel.

²²See John Rosine and Nicholas Walraven, "Drought, Agriculture, and the Economy," *Federal Reserve Bulletin*, January 1989, p. 7.

²³Total bank failures for each year are from *FDIC Annual Report, 1991*, Table A, p. 127. Agricultural bank failures are from the following *FDIC Annual Reports: 1986*, p. 8; *1987*, p. xvi; *1988*, p. xvi.

²⁴John O'Keefe, "The Texas Banking Crisis: Causes and Consequences, 1980-1989," *FDIC Banking Review*, Vol. 3, No. 2, Winter 1990, Table 5, p. 17.

²⁵*Ibidem*.

²⁶*Ibidem*.

²⁷Gregory K. Gibbs, "Distribution of Failed Banks by State and by Type of Transaction," unpublished paper prepared in the Banking Statistics Section, Division of Research and Statistics, Federal Deposit Insurance Corporation, March 16, 1990.

²⁸O'Keefe, p. 1.

The effects of the energy-related lending difficulties were not confined to the Southwest. Indeed, the largest U.S. bank failure, that of Continental Illinois National Bank and Trust Company in 1984, with assets of \$33.6 billion, can be traced to troubles in the Oil Patch. Continental had purchased hundreds of millions of dollars of energy loans from Penn Square Bank, N.A., Oklahoma City, which failed in 1982. The large losses on these loans led in May of 1984 to a massive run on Continental, sparked by withdrawals of several billion dollars in deposits by European and Japanese depositors. Quick action by the FDIC and the other bank regulators stanching the run. A permanent reorganization and recapitalization, involving significant monetary assistance by the FDIC, was accomplished later in the year.²⁹

Energy-related lending and the difficulties it encountered also contributed to the most recent assault on the banking industry's well-being — the collapse of the nationwide real-estate boom. An important part of the Southwest's energy euphoria in the early years of the decade was a surge in construction and real-estate development. That surge outlived the energy boom itself and spread to much of the rest of the nation. The surge continued long after economic indicators should have persuaded perceptive real-estate lenders and investors that a degree of caution was in order.

For example, the vacancy rate for office buildings in 31 major markets rose from 4.9 percent in 1980 to 13.5 percent in 1983 to 16.5 percent in 1985. Yet, the funds continued to flow. By 1991, the vacancy rate was 18.8 percent.³⁰

Banks and thrifts were important providers of funds for the real-estate boom. Thrift involvement was discussed earlier. For banks, real-estate loans rose from 14.5 percent of their assets in 1980 to 24.5 percent a decade later.³¹ And as was the case with thrift real-estate activity, the composition of bank real-estate lending shifted toward

riskier endeavors. The safer home mortgage lending became relatively less important, displaced by more volatile construction and commercial real-estate lending. Furthermore, the underwriting standards for construction and commercial real-estate lending were relaxed. High loan-to-value ratios, no take-out commitments, and reduced recourse to corporate strength became common.

In hindsight, discerning what happened regarding the real-estate boom-bust of the 1980s — as well as the boom-busts regarding LDC, agricultural, and energy lending — is relatively easy. Determining why it happened is more difficult and not susceptible to much in the way of quantifiable answers. The ultimate "why" raises issues of human psychology, specifically the mind-sets that produce economic booms and busts. Charles Kindleberger discussed the human propensity for economic folly in his classic *Manias, Panics, and Crashes: A History of Financial Crises*.³² More recently, James Grant described the 1980s in his book, *Money of the Mind*, in terms that give rise to visions of credit run amuck.³³

Certainly there was a reduction in caution and an increase in risk-taking in the financial world of the 1980s. Being part of the financial world, banks were infected by these attitudes. Banks also were influenced by the changing nature of their business. For example, many corporate customers found cheaper financing elsewhere, such as in the commercial paper market. As they lost customers and saw more competition in some of their traditional areas of activity, banks turned to other fields, such as the risky world of real-estate development.

Bank troubles grew throughout the decade. Insured bank failures from 1934 through 1981 totalled 586, an average of 12 a year. On a decade basis, 358 banks failed from 1934 through 1940, 61 banks in the 1940s, 28 in the 1950s, 50 in the 1960s, and

79 in the 1970s. The 1980s started normally enough, with 10 banks failing in 1981. In 1982, however, the figure jumped to 42. From 1982 through 1992, 1,480 banks failed, an average of over 130 a year and more than two and one-half times the number of failures in the previous 48 years.³⁴ In 1984, Federal Deposit Insurance Corporation insurance assessments on banks were, for the first time since the agency's founding, less than insurance outlays.³⁵

Still, the banking system, including the industry's deposit insurance fund, appeared to be in reasonably good shape through the end of the decade, particularly when compared to the S&L industry and its defunct insurance fund. Despite insurance assessments not keeping pace with insurance costs after 1984, the bank insurance fund continued to increase, reaching its apogee, \$18.3 billion, in 1987.³⁶ The increases were due to interest on the fund's investments in U.S. Treasury securities. There were declines to \$14.1 billion in 1988 and \$13.2 billion in 1989, but attention at the time was focused on the thrift industry and its problems. The FDIC was still respected enough in Congress to be given responsibility for overseeing the organization and operation of the RTC, the S&L cleanup agency. That mandate came in the Financial Institutions Reform,

²⁹See Federal Deposit Insurance Corporation, *Annual Report, 1984*.

³⁰CB Commercial/Torto Wheaton Research. Vacancy rates are reprinted in various issues of *The Real Estate Report*, Division of Research and Statistics, Federal Deposit Insurance Corporation.

³¹Calculated from Federal Deposit Insurance Corporation, *Historical Statistics on Banking, 1934-1991*, Tables CB-12 and CB-14.

³²Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Basic Books, 1978).

³³James Grant, *Money of the Mind* (New York: Farrar Straus Giroux, 1992).

³⁴Calculated from Federal Deposit Insurance Corporation, *Annual Report, 1991*, Table A, p. 127.

³⁵*Ibidem*, Table D, p. 133.

³⁶*Ibidem*.

Recovery, and Enforcement Act of 1989 (FIRREA).³⁷

Within a very short time, however, the possibility of an S&L-type disaster in the banking industry moved to center stage. The reason for the concern was increasing awareness of the enormity of the real-estate problems. The Southwest's difficulties had been known for some time. But as the 1990s dawned, the abysmal state of New England real-estate markets became apparent. And it soon became obvious that conditions in the Southeast and on the West Coast were also poor. Lenders, including banks, suffered heavy losses. The FDIC fund declined to \$4.0 billion in 1990, and expectations of further massive declines rapidly became widespread.

Fears that the banking industry was going the way of the thrift industry quickly grew. Also attracting adherents was a belief that the bank regulatory agencies' performance in controlling bank risk-taking had been inadequate. This was reflected in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). A general thrust of that law was to curtail supervisory discretion. One important way this was done was to require that certain corrective actions be taken as an institution's capital ratios decline. The Act also, among other things, (1) provided a Treasury line of credit for the deposit insurance system, (2) mandated annual examinations for banks and thrifts, (3) established a least-cost standard to be followed by the FDIC in resolving failing institutions,³⁸ (4) required the adoption of a risk-related deposit insurance assessment system, and (5) restricted the activities of state banks.

For 1991, the FDIC reported a balance for the bank deposit insurance fund of a negative \$7.0 billion, which included a large General Accounting Office-mandated reserve for future failures. The negative result confirmed for a number of observers the severity of the situation. Predictions of continued troubles and further declines in

the fund were heard throughout 1992 and even surfaced prominently as an issue in the presidential election campaign in the Fall.

The Future

Nineteen ninety-one was the low-point, however. Due in part to low interest rates, 1992 turned out to be a year of record profits for the industry. The number of bank failures was considerably less than what had been predicted. By midyear 1993, the banking industry appeared to be well out of the real-estate crisis that had engulfed it in 1990-91, that had led to the devastation of the bank deposit insurance fund, and that had provided the impetus for the enactment of FDICIA. Preliminary data indicated that the bank fund had a positive balance at the end of 1993's first quarter. The question was whether the upturn was the start of a long-term trend, or whether it was merely a brief respite before the reappearance of problems emanating from deep-seated structural difficulties and, perhaps, industry overcapacity.

One key to answering the question may be the considerable consolidation that both the bank and thrift industries have undergone over the last dozen years or so. The number of banks dropped from 14,758 at year-end 1980 to 11,875 at year-end 1992, a decline of 20 percent.³⁹ During almost the same period, year-end 1980 to September 1992, the number of banking organizations — bank holding companies and independent banks — declined 28 percent, from 12,572 to 9,095.⁴⁰ For thrifts, the decline from year-end 1980 to year-end 1992 was 54 percent, from 4,005 to 1,855.⁴¹

An important reason for this consolidation has been the growth of interstate operations. In 1980, interstate bank and thrift organizations were largely prohibited by law. The various marketplace changes and crises, however, prompted efforts to overcome or reduce the legal hurdles. Although not completely successful in removing the barriers to interstate organizations,

the efforts have had a significant impact.

The OTS now permits nationwide branching by healthy thrift associations. Federal and state laws still for the most part prevent banks from branching across state lines, but interstate bank holding companies are commonplace and have reshaped the rankings of banking organizations. For example, of the 25 largest U.S. bank holding companies at year-end 1980, only 14 were still in the group at year-end 1992. The 11 newcomers all had substantial presences in more than one state. In 1980, no bank holding company headquartered in the Southeast was in the top 25; in 1992, 5 were.⁴²

Interstate acquisitions accounted for a sizeable number of failed thrift and bank resolutions. Without the existence of interstate acquirers, the thrift and bank cleanups might have been even more costly. Over the long term, interstate operations should increase competition and help to reduce any overcapacity that the industries may have. And by making institutions less vulnerable to economic declines in a single state or region, interstate

³⁷The FDIC's oversight of the RTC was removed by the Federal Deposit Insurance Corporation Improvement Act of 1991.

³⁸Section 141 of FDICIA, 12 U.S.C. §1823(c)(4), requires the FDIC to use the "least costly" method of resolving failed or failing banks. There is a systemic-risk exception for large institutions. The least-cost standard replaced the cost test that the FDIC had been using since 1951 and that had been codified in the 1982 Garn-St Germain Act. Under the cost test, financial assistance provided by the FDIC to aid in the acquisition of a troubled bank by another institution could not exceed the cost of liquidating the bank and paying off only its insured deposits.

³⁹1980 number: Federal Deposit Insurance Corporation, *Historical Statistics on Banking, 1934-1991*, Tables CB-1, SB-1. 1992 number: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, Fourth Quarter 1992. Numbers include both commercial and savings banks insured by the FDIC.

⁴⁰Division of Banking Supervision and Regulation, Federal Reserve Board.

⁴¹1980 number: *Savings Institution Sourcebook, 1990*, p. 43. 1992 number: Office of Thrift Supervision, Press Release, March 11, 1993.

⁴²*American Banker*, April 21, 1981, and February 3, 1993.

operations should enhance industry safety and soundness.

Nevertheless, the thus far partial removal of barriers to interstate operations is only a portion of what is needed to increase the chances that banking's current favorable performance will be lasting. In the years ahead, the health of the banking industry, on which the health of the supervisory system ultimately depends, will be affected by continuing marketplace and technological changes and the ability to adapt to them. Public policymakers responsible for the banking system must deal with two imperatives and one fact.

The first imperative is that, as profit-seeking risk-taking entities in a free-market economy, banking organizations require the freedom to

respond to a changing world. The necessary freedom has both product and geographic aspects. Banking organizations must have flexibility regarding the types of products and services they offer. And banking organizations must not be unduly constrained by economically inefficient geographic restrictions.

Imperative number two concerns those entrusted with the responsibility both to protect insured depositors and to maintain the viability of a significant portion of the financial intermediation process. These bank supervisors need the tools, the judgment, and the discretion to ensure that bankers' exercise of their necessary freedom does not become system-threatening.

And as for the fact that public policymakers should be cognizant of, the

achievement of social goals by placing responsibilities on private-sector entities is not cost-free. Profit-making lending institutions that must accomplish such legislatively imposed tasks as injecting funds into low-income areas can have their profits detrimentally affected, which in turn can reduce overall financial strength.

Striking the proper balance among these three often conflicting considerations — the imperatives regarding bank freedom and adequate supervision and the fact of social goals entailing costs — is no mean task. The degree of success attained by policymakers in the effort to reconcile the conflicts will be a significant determinant regarding the future health of the banking industry.

Commercial Real-Estate Problems:

A Note on Changes in Collateral Values Backing Real-Estate Loans Being Managed by the Federal Deposit Insurance Corporation

by James L. Freund and Steven A. Seelig*

Many of the failed-bank assets passed in recent years to the Bank Insurance Fund of the Federal Deposit Insurance Corporation have been loans that were secured by real assets or foreclosed collateral itself. In fact, many of the bank failures resulted from lending based on underwriting criteria that gave undue weight to anticipated inflation in collateral values rather than current cash flow and debt coverage analysis. When deflation replaced inflation in several key sectors of the economy, many loans fell into nonperforming status and were inadequately collateralized.

This was the case in the early 1980s when oil prices plunged after a period of rapid increases. In the mid-1980s, declining land prices and weakening agricultural earnings caused numerous farm loans to sour. The most recent economic dislocation to affect the banking system, and consequently the FDIC, is the major downturn of commercial real-estate markets in many areas of the country. This note reports on the effect that the collapse of commercial real-estate markets has had on some typical FDIC assets.

Origins of the Commercial Real-Estate Problems Facing the FDIC

The commercial real-estate problems currently facing the FDIC are the culmination of more than a decade of changes in the financial and regulatory environment affecting banks' commercial real-estate lending activities. FDIC-insured commercial banks traditionally devoted a relatively small part of their portfolios to real-estate lending. In 1950, real-estate loans accounted for only 8 percent of commercial bank assets. Real-estate lending increased slowly during the subsequent three decades, rising to 14.5 percent by 1980. Thereafter, growth in real-estate lending accelerated at commercial banks (Chart 1). By 1992, real-estate loans had risen to almost 25 percent of total assets, thereby replacing commercial and industrial loans as the largest component of bank lending activity. Commercial banks held \$269 billion in real-estate loans in 1980; by 1992, the total had increased to almost \$870 billion.

The composition of real-estate lending also changed during the 1980s. Traditionally, the most important type of commercial bank real-estate loan has been permanent mortgages on 1-to-4 family residences. Such lending grew from \$148 billion in 1980 to \$390 billion at the end of the first quarter of 1993. However, during the early 1980s, commercial banks also were aggressive lenders for other types of real estate. For instance, construction lending by banks surged from \$37 billion in 1980 to \$107 billion by 1986. Construction lending peaked in 1989 at \$136 billion. Permanent financing for commercial real-estate projects also grew rapidly throughout the 1980s, climbing from \$64 billion in 1980 to \$238 billion a decade later. Unlike construction lending, permanent commercial mortgage loans on the books of banks have continued to rise, totaling more than \$260 billion in March 1993.

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Chart 1
Real-Estate Lending at Insured Commercial Banks:
Real-Estate Loans Outstanding

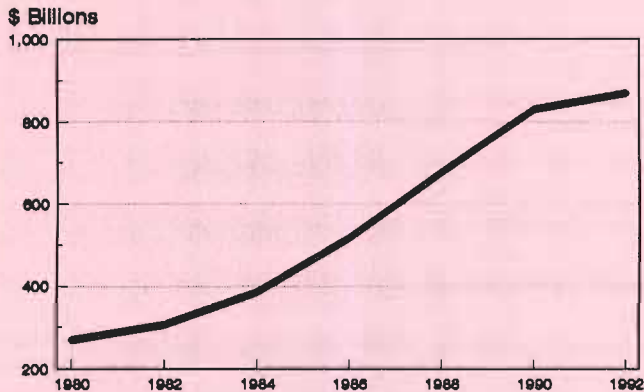
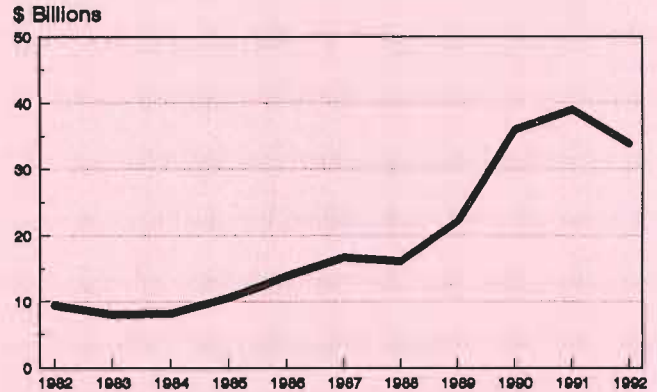
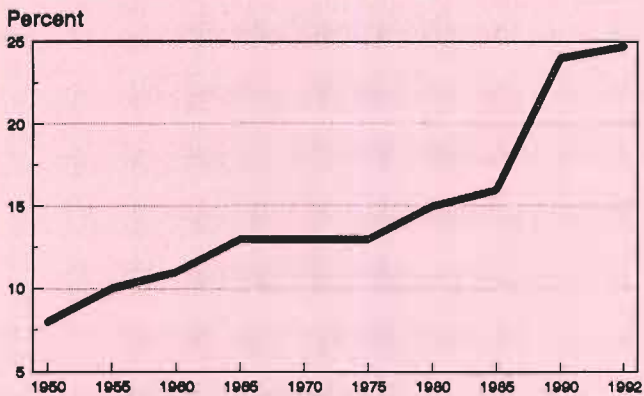


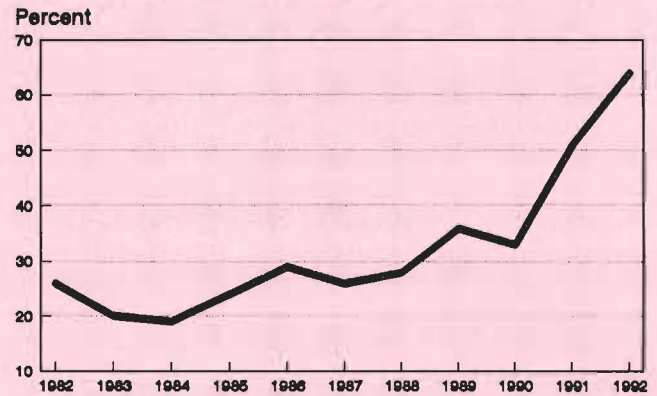
Chart 2
Nonperforming Real-Estate Loans
at BIF-Insured Institutions



Real-Estate Loans as a Percent of Total Assets



Nonperforming Real-Estate Loans as a Percentage
of Total Nonperforming Loans and Leases



The problems of the commercial real-estate market are well-known. In both industrial and retail commercial real-estate markets new supply outpaced demand in the 1980s. However, office-building markets suffered the most from overbuilding. According to data gathered by CB Commercial/Torto Wheaton Research, the office-building vacancy rate in major U.S. markets averaged just under five percent at the end of 1980.¹ After a decade in which new construction far exceeded demand, the office-building vacancy rate climbed to nearly 20 percent in the early 1990s. In Texas, for instance, office-building vacancy rates rose to almost 28 percent in Dallas during the mid-1980s. In Houston and Austin, vacancy rates soared to 32 percent and 40 percent, respectively. As one would expect, prices of com-

mmercial real estate in many areas fell sharply in response to the overbuilding.

The combination of aggressive lending and subsequent overbuilding caused severe asset-quality problems at commercial banks (Chart 2). Problem real-estate loans (loans 90 days or more past due, plus those no longer accruing interest for accounting purposes) rose from \$9.4 billion in 1982 to \$16.7 billion in 1987. By the end of 1990, this figure totaled \$39 billion. Problem real-estate loans as a proportion of total nonperforming loans rose from 19 percent in 1983 to almost 65 percent in 1992. Moreover, reposessed real estate resulting from loan foreclosures (OREO) doubled from \$4.4 billion in 1982 to \$8.8 billion in 1986. OREO continued to increase sharply, peaking at over \$27 billion at the end of 1991.

Many of these problem real-estate assets were passed to the FDIC when banks failed. As of late 1992, approximately one-half of the \$40 billion in assets being liquidated by the FDIC were either mortgages, loans backed by real-estate collateral, or owned real estate.

How Much Did Falling Commercial Real-Estate Prices Affect the Insurance Fund?

The risk of a real-estate loan to a bank — and ultimately to the FDIC — largely depends on the terms on which the original loan was underwritten. Loans can have provisions that reduce their overall riskiness: pre-lease

¹CB Commercial/Torto Wheaton Research, Boston, MA.

or pre-sale requirements, "take-out" commitments for construction loans, or prohibitions on adding interest to loan balances. Other provisions are aimed at ensuring that, if the borrower is garnering all the positive returns, he or she also assumes the bulk of the risk. For instance, lenders can — and often do — insist on recourse to a borrower's other assets in the event of problems. In addition, by diversifying loan portfolios an institution can avoid the risk of severe losses if economic problems develop that disproportionately threaten particular types of credit.

Perhaps the most universal way that lenders seek to avoid losses, however, is by requiring collateral that can be sold to satisfy any outstanding loan balance and interest obligation. To provide effective protection, the initial valuation of the collateral must be realistic. Moreover, the size of the initial loan relative to the value of the collateral must be low enough to accommodate declines in the collateral's value due to external economic forces or to problems associated with the specific property.

While systematic data are not available, it is generally agreed that underwriting standards for commercial real-estate loans were loosened considerably in the 1980s. In 1982, the Congress released national banks from the regulations that governed the basic terms under which commercial real-estate credits could be written. Moreover, many thrift institutions, faced with serious profitability and capital problems, lent aggressively on terms favorable to many borrowers.

As the real-estate "boom" turned to a "bust," many loans soured and property values declined. Loans that were made with high loan-to-value ratios — and those where lenders assumed earlier collateral price inflation would continue unabated — were the first to experience difficulty. However, even conservatively underwritten loans experienced difficulties in markets in which commercial price declines were substantial.

While it is widely thought that commercial property values have fal-

len as much as 30 to 40 percent in the past several years, limited data exist to document that decline. The most often used source of information — the Russell-NCREIF data on unleveraged, income-producing properties owned by pension funds and trusts — shows that property values fell by just over 26 percent during the past six years.² These data are not likely to reflect the FDIC's experience, however, because pension funds and trusts typically hold better-than-average quality properties.

To obtain evidence on declines in collateral values that would be typical in failed banks, commercial real-estate-backed loans held by the FDIC were studied. By quantifying the decline in value of collateral backing commercial real-estate loans the FDIC holds, this study attempts to measure the degree of the exposure that the Bank Insurance Fund can face when commercial real-estate markets sour. The data source is unique in that it brings together two pieces of hard-to-obtain information: the reported value of the collateral when the loan was originated and the current value of the collateral.

Data

Because the FDIC's Division of Liquidation maintains information on individual assets, changes in collateral values on a loan-by-loan basis can be analyzed. Bank records (where they were adequately kept) can be used to identify the estimated collateral value at the time a commercial real-estate loan was originated. To document changes in collateral value, these estimates must be matched with either the sales prices the FDIC received or with current appraised values. The use of sales proceeds has the advantage of employing actual market-determined prices. However, reconstruction of the original bank records for assets sold in liquidation is often quite difficult. In contrast, historical records are readily available for nonperforming loans currently being held, and such loans are required by FDIC policy (by virtue of their nonperforming status) to have current appraisals on

file. For that reason, this study focused on such loans.

When this study commenced in the Summer of 1992, the FDIC held approximately 6,000 nonperforming commercial real-estate loans inherited from failed banks and thrift institutions. A random sample of approximately 400 loans was selected, with the only constraint that they be evenly distributed regionally. The FDIC liquidation specialist in charge of monitoring each loan at the appropriate field office obtained the appraised value of the collateral and related information at the time of loan origination.

In addition, the liquidators were asked to provide the most current information available on each loan: current loan balance, type of collateral, and current appraised value. Appraised values were provided by independent fee appraisers, who were asked to value the properties in accordance with industry market-value appraisal standards. That is, value was defined as the price that was estimated to hold in functioning markets under normal sale conditions — rather than in the case of forced liquidation or distressed sale. Complete information on 224 commercial real-estate loans was received.

Study Results

The loss of collateral value was measured by the ratio of current appraised value to the original value estimated by the bank at the time of loan origination. If the current valuation is accurate, this ratio could be less than one for either (or both) of two reasons. First, economic conditions may have caused the value of the commercial properties to decline. Alternatively, valuations at the time of loan origination may have been too high. On average for the 224 loans reviewed, the current value of the collateral was just over one-half (54 percent) of the valuation at the time the

²See *The Russell-NCREIF Real Estate Performance Report*, published by the National Council of Real Estate Fiduciaries and the Frank Russell Co., Tacoma, WA, various issues.

Chart 3
Loss of Collateral Value on FDIC-Managed Real-Estate Loans

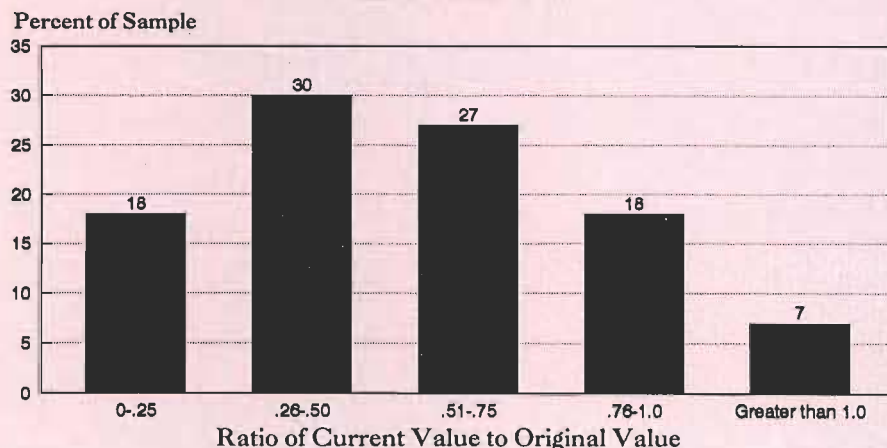


Table 1
Loss of Collateral Value on FDIC-Managed Real-Estate Loans

	Number of Loans	Ratio of Current Value to Original Value			
		Average	Median	75th Percentile	25th Percentile
<i>Total</i>	224	.54	.51	.74	.28
<i>By Type of Loan</i>					
Construction	27	.53	.51	.73	.22
"Mini-Perm"/Short Term	124	.56	.52	.77	.30
Permanent Financing	60	.49	.44	.64	.25
Other	13	.58	.61	.74	.31

Users' Note: Results are from a sample of nonperforming loans managed by the FDIC's Division of Liquidation. Permanent financing includes loans with a term to maturity greater than 5 years. "Mini-Perm" includes loans with maturities of less than 5 years. Both categories refer to loans not specifically designated for the purpose of constructing real estate.

Table 2
Loss of Collateral Value on FDIC-Managed Real-Estate Loans

By Major Collateral Type	Number of Loans	Ratio of Current Value to Original Value			
		Average	Median	75th Percentile	25th Percentile
Land	54	.53	.53	.74	.19
Office	33	.56	.53	.82	.32
Multifamily Residential	25	.51	.42	.78	.27
Retail	35	.51	.42	.76	.32
Commercial/Industrial	36	.49	.50	.65	.34
Mixed Use	16	.68	.57	.84	.30
Other	15	.48	.28	.68	.25

Users' Note: Results are from a sample of nonperforming loans managed by the FDIC's Division of Liquidation. Commercial/Industrial category includes hotels and motels. Retail category includes "mini-warehouse" self-storage facilities.

loan was originated. As shown in Chart 3, the current collateral value was at least 25 percent below the original evaluation for three-quarters of the loans. In almost one-half of the cases, the collateral lost at least 50 percent of its assigned value. In contrast, only 7 percent of the collateral appreciated in value after the loan was originated.

The study also examined whether any loan types resulted in greater losses than others. Loans were divided into three basic categories. Construction loans were identified separately. Other loans were divided between mini-perms (defined in this study as having maturities of five years or less) and permanent (longer-term maturity) loans. The average loss of collateral value did not differ significantly among categories (see Table 1). On average, permanent loans experienced more loss of value than other types of loans. However, many construction loans suffered severe loss of value, with the current collateral values of one-fourth of the loans being less than 22 percent of the original estimated value. This result is not unexpected because collateral values for construction loans typically are projected values of the finished project rather than the valuation of an existing structure under contemporaneous market conditions.

As shown in Table 2, the real-estate collateral that secured the loans ranged from office buildings to unimproved land. The differences in loss of collateral value among different types of real estate were not striking. Land loans, which were the most common type examined, experienced an average loss of 47 percent — somewhat more than the average for the total sample. Land loans also had the largest concentration of catastrophic losses, with one-fourth of the properties currently valued at less than 19 percent of the comparable figure at time of origination. Mixed-use projects held their value the best, on average losing only 32 percent of value.

Regional Differences

A question often posed is whether losses to the FDIC on real-estate loans are worse in real-estate markets that are highly depressed. A poorly underwritten loan can lose money under any circumstance, but prosperous real-estate markets can — at least partially — mask bad decisions. Eighty percent of the loans in the sample financed real-estate ventures in seven states; statistics describing their change in value are shown in Table 3.

In states that have experienced serious commercial real-estate problems, collateral values generally have sustained the largest losses. Looking at the median loss, one-half of the loans in Connecticut lost 63 percent or more of their original valuation. Likewise, one-half of the properties in Texas and Louisiana lost at least 58 percent of their value since loan origination; in Oklahoma the median loss of value was 53 percent. In contrast, for California and Florida — where downturns in commercial real estate during the sample period were not as severe and extended — the median loss in value was 30 percent and 34 percent of original appraised value, respectively.

Cost to the Bank Insurance Fund

One measure of the FDIC's loss exposure on such loans is the difference between the current loan balance and the current value of the collateral. In more than 60 percent of the loans studied, the current balance exceeded

Table 3
Loss of Collateral Value on
FDIC-Managed Real-Estate Loans

	Number of Loans	Ratio of Current Value to Original Value			
		Average	Median	75th Percentile	25th Percentile
Texas	83	.51	.42	.69	.29
Massachusetts	33	.48	.51	.62	.26
Louisiana	20	.45	.42	.64	.25
Oklahoma	17	.47	.47	.59	.27
Florida	14	.66	.61	.83	.48
Connecticut	7	.48	.37	.74	.24
California	5	.70	.71	.87	.51

the value of the collateral. In aggregate, the current value of the collateral only covered \$49.8 million of the \$125.3 million in loan balances, a loss rate of 60 percent before foreclosure costs. If the cost of collection were considered, or if uncollected but accrued interest were added to the loan balance, the proportion of loans imposing losses on the FDIC — and the cost of such losses — would be even higher.

Conclusions

A randomly drawn sample taken from almost 6,000 nonperforming commercial real-estate loans being resolved by the FDIC shows that most of the collateral backing such loans currently is valued far below the original value assigned to them when the loans were made. In fact, the sample suggests that collateral values are commonly less than current loan

balances by a substantial amount in the aggregate, completely mitigating the protection that the collateral was designed to provide.

On the one hand, the fact that the FDIC inherited these assets suggests they were of poor quality, poorly underwritten, or both. This implies that the declines in collateral value that occurred were not necessarily typical of bank real-estate loans. On the other hand, they illustrate the risk that in a severe real-estate downturn many real-estate assets can, and do, lose substantial value. When a bank fails, the Bank Insurance Fund looks toward the market value of the failed bank's assets to offset the deposit insurance claims it has paid. Declining collateral values of the magnitude suggested by the sample in this study therefore contribute substantially to the FDIC's insurance losses.

Recent Developments Affecting Depository Institutions

by Benjamin B. Christopher*

Regulatory Agency Actions

Inter-Agency Actions

Federal Bank and Thrift Regulatory Agencies' Joint Actions

The federal bank and thrift regulatory agencies are engaging in joint or coordinated efforts in a number of regulatory areas that are mentioned specifically in this issue of the *Review*, among which are: "prompt corrective action," real-estate lending standards, real-estate appraisals, enforcement of fair lending laws, enforcement of money-laundering laws, programs for increasing credit availability, "fair value" disclosures, and reducing regulatory burden.

See the discussions under the headings of the individual agencies and the Federal Financial Institutions Examination Council (FFIEC).

Federal Deposit Insurance Corporation

Recapitalization Schedule for the BIF; Adequacy of Assessment Rates

The FDIC is revising its existing schedule for increasing the reserve ratio of the Bank Insurance Fund (BIF) to the designated reserve ratio of 1.25 percent. Under Section 7(b) of the FDI Act, the Board must set semiannual assessment rates for BIF members in accordance with the BIF

recapitalization schedule promulgated by the FDIC. The FDIC is retaining the current assessment rates applicable to members of the BIF and members of the Savings Association Insurance Fund (SAIF) for the semiannual period beginning July 1, 1993. The current assessment rates range from 23 cents to 31 cents per \$100 of domestic deposits, depending on the institution's risk classification.

When the FDIC adopted the original BIF recapitalization schedule and set assessment rates for BIF and SAIF members in September 1992, the Board agreed to monitor the schedule and the adequacy of assessment rates over six-month intervals. Since then the condition of the banking and thrift industries has continued to improve, although areas of concern remain. The FDIC's assumptions affecting each fund's projected balance have been revised accordingly. In particular, the short-term projected annual level of failed-bank and -thrift assets has been lowered. Also, the loss rate relative to failed-bank and -thrift assets has been lowered. By maintaining current deposit insurance assessment rates, the FDIC projects that the BIF will be recapitalized by the year 2002, rather than 2006 as projected last September. Although a lower average assessment rate would recapitalize the BIF over the original 15-year period (*i.e.*, by 2006), the Board believes that even at current assessment rates the BIF's ratio of

reserves to insured deposits would remain below the statutorily required 1.25 percent target for nine years. The Board also believes that if it is possible to recapitalize the BIF sooner than 15 years without placing an undue burden on the industry, it is in the public interest to do so. *FIL-26-93, FDIC, 4/13/93; FR, 4/5, p. 17533; 6/1, p. 31150.*

BIF First Quarter 1993 Financial Results

As of March 31, 1993, the BIF amounted to \$1.2 billion, up from a negative \$101 million at year-end 1992 (preliminary figures), and a negative \$7.0 billion at year-end 1991. The increases reflected net income to the Fund of \$1.3 billion in the first quarter and \$6.9 billion in the year 1992.

Reporting for 1992, the FDIC said that a favorable interest-rate environment for banks, and other economic conditions, were the primary reasons for the BIF's improved results. These conditions resulted in a lower projected loss from future bank failures and a reduction in the estimated loss from past bank failures. The Fund's losses from banks that failed in 1992 totaled \$4.7 billion and reserves previously established for specific failures exceeded the losses the FDIC expects

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Reference sources: *American Banker* (AB); *Wall Street Journal* (WSJ); *BNA's Banking Report* (BBR); and *Federal Register* (FR).

to incur. These and other factors resulted in a net reduction of \$5.5 billion in the amount set aside at year-end 1992 to absorb the costs of banks that are expected to fail, to \$10.8 billion from the \$16.3 billion at year-end 1991. Loss reserves were further reduced to \$10.6 billion as of March 31, 1993.

Failures of insured banks in the first quarter of 1993 totaled only seven, compared to 122 in the year 1992 and 127 in 1991. Assets of the institutions that failed in 1992 were \$44.2 billion, and in the first quarter of 1993 were \$731 million. *Summary Financial Management Report, First Quarter 1993, FDIC, PR-43-93, 5/4/93.*

Risk-Related Assessments

The FDIC is required to establish a system, effective January 1, 1994, wherein insured institutions will pay deposit insurance assessments according to the risks to the insurance fund from the institution. The FDIC proposed to amend its assessments regulation to establish a new risk-related premium assessment system. Under the proposed system, as under the transitional assessment system (see this *Review*, Fall/Winter 1992, p. 34), depository institutions would be assigned to one of nine assessment classifications. The assessment rate applicable to each classification would remain unchanged from the rate in effect under the transitional system. *FIL-1-93, FDIC, 1/11/93; FR, 12/31/92, p. 62503.*

The FDIC approved revisions to the "transitional" risk-related premium system adopted in September 1992 to provide a transition between the previous flat-rate system and the risk-related system that must be implemented in accordance with the FDIC Improvement Act of 1991 (FDICIA). The revisions are effective October 1, 1993, for the assessment period beginning January 1, 1994, and are those proposed in December 1992, with minor modifications. *FIL-48-93, FDIC, 7/2/93; FR, 6/25, p. 34357.*

Assistance to Operating Insured Depository Institutions

The FDIC adopted a revised policy, largely reflecting changes mandated by FDICIA, on the criteria the agency will follow in considering requests for financial assistance from institutions in danger of failing. These include a possibility of "early resolution" of institutions that are troubled and the requirement that failing institutions generally be resolved in the manner that is the least costly to the deposit insurance fund. The latter means that the FDIC Board can grant open assistance only if that option would be more cost-effective than resolving the institution if and when it closes. The revised policy statement also addresses provisions of FDICIA that require the FDIC to make certain findings with respect to the ongoing management of the institution.

The revised policy statement stresses the importance of the timing of requests for assistance, and the FDIC is encouraging an institution's management to submit any proposals for open assistance "well before grounds first exist for the institution's closure."

The FDIC receives many requests for open assistance but rarely grants this aid. A total of 75 banks have received open assistance since the authority first was used in 1981. Open assistance has become more rare as a result of statutory and other changes that enhanced the FDIC's options for dealing with problem institutions, such as bridge bank authority. There have been no assistance transactions thus far in 1993. Only two were approved in 1992 and three in 1991, with none of the banks exceeding \$30 million in total assets. *PR-170-92, FDIC 12/8/92; FR, 12/18, p. 60203; FIL-3-93, FDIC, 1/13/93.*

Prompt Corrective Action

The FDIC approved a final rule, effective December 19, 1992, implementing a requirement of FDICIA that the banking regulators take specified

"prompt corrective action" when an insured institution's capital falls to certain levels. On January 26, 1993, additional regulations were approved that concern applications to conduct certain activities or to seek exceptions from certain restrictions. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) have adopted final PCA rules.

The statute provides a framework of supervisory actions based on the capital level of an insured depository institution. It establishes five capital categories, ranging from "well-capitalized" to "critically undercapitalized." The federal banking agencies are required to specify, by regulation, the levels at which an institution would be within each of these five categories. The law requires an insured institution to submit a capital restoration plan when it becomes undercapitalized. Certain activities are subject to restrictions or prohibitions, which become more severe as an institution's capital level declines, beginning with measures such as restrictions on dividends and management fees (if the payments would result in the institution becoming undercapitalized), and ultimately ending in the closing of institutions that are critically undercapitalized. The stated purpose of the PCA provisions is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund.

Under the FDIC's final rule, a "well-capitalized" institution is defined as having a total risk-based capital ratio (the ratio of total capital to risk-weighted assets) of at least ten percent, a Tier 1 risk-based ratio (the ratio of Tier 1 or "core" capital to risk-weighted assets) of at least six percent, a leverage ratio (the ratio of Tier 1 capital to total assets) of at least five percent *and* is not subject to any written agreement, order or directive from the FDIC to meet and maintain a specific capital level. A "critically

undercapitalized" institution has a "tangible equity"-to-total assets ratio of two percent or less. Tangible equity combines elements of core capital and cumulative perpetual preferred stock, minus all intangible assets except for limited amounts of purchased mortgage servicing rights. The ratio for this capital category is specified in the statute.

A procedure is established for an institution to notify the appropriate agency if any event occurs that would cause a reclassification of the institution to a lower capital category. Under the bank regulatory agencies' uniform procedures, an institution will generally be provided advance notice when the appropriate agency proposes that the institution take one or more of the actions committed to agency discretion under Section 38. The final rules also implement the statutory requirement that officers and directors dismissed as a result of an agency order issued under Section 38 be afforded agency review of the dismissal, including an opportunity for an information hearing. *FIL-70-92, 10/5/92; 12-93, 2/22/93; FR, 9/29/92, p. 44866; 2/12/93, p. 8210.*

Safety-and-Soundness Rule Proposed

The FDIC proposed a rule, under Section 132 of FDICIA, that would require insured depository institutions to meet general safety-and-soundness standards in several regulatory areas. An insured depository institution or company that fails to meet any of the prescribed standards would have to submit and implement an acceptable plan to achieve compliance. Failure to submit or implement such a plan within the time allowed would result in an order to correct the deficiency.

The FDIC and the three other federal bank and thrift regulatory agencies issued an advance notice of proposed rulemaking in July 1992 (see this *Review*, Fall/Winter 1992, p. 35). The proposed standards do not represent a change in the agencies' policies. These standards instead formalize the fundamental standards already used by

the FDIC when supervising institutions. *PR-65-93, FDIC, 6/9/93.*

Capital Standards

The FDIC will seek comment, pursuant to Section 305 of FDICIA, on revisions to its capital rules to ensure that banks measure and monitor their interest-rate risk and maintain capital adequate to the risk. In August 1992, the three bank regulatory agencies issued a proposal (see this *Review*, Fall/Winter 1992, p. 36).

An institution's exposure to interest-rate risk would be measured by the change in its capital that occurs as interest rates change, using a supervisory model. Internal models could be used for this purpose when available and approved during the bank examination process. For institutions that have high levels of interest-rate risk, alternative methods are proposed for determining what amount of additional capital, if any, a bank may be required to have for such risk. To limit paperwork and other burdens on the industry, the agencies would exempt banks that are potentially low-risk from additional reporting requirements. *PR-66-93, FDIC, 6/9/93.*

The FDIC proposed revisions, pursuant to Section 305 of FDICIA, to its capital rules under which the concentration of credit risk and the risks of nontraditional activities — as well as an institution's ability to manage these risks — would be specifically cited as important factors in assessing an institution's overall capital adequacy. No mathematical formulas or explicit capital requirements for these risks are incorporated in the proposal. *PR-52-93, FDIC, 5/11/93.*

The FDIC amended its risk-based capital guidelines, effective December 31, 1992, to lower from 100 percent to 50 percent the risk-weight assigned to certain loans to builders to finance the construction of presold 1-to-4 family residential properties. To qualify for the lower risk-weight, such loans must be first liens, must be made in accordance with prudent underwriting standards, and must not be past due 90 days or more or carried in non-

accrual status. Among other criteria, the loans to builders will be considered prudently underwritten only if the bank has obtained sufficient documentation that the buyer of the home intends to purchase the home, and has the ability to obtain a mortgage loan sufficient to purchase the home. *FR, 3/3/93, p. 12149; FIL-19-93, 3/19/93.*

The FDIC adopted amendments, effective March 1, 1993, concerning intangible assets under its capital maintenance regulation. Limited amounts of purchased mortgage servicing rights (PMSRs) and purchased credit-card relationships (PCCRs) may be recognized for purposes of calculating Tier 1 capital under the FDIC's leverage capital and risk-based capital standards. However, all other intangible assets, including goodwill and core deposit intangibles, will continue to be deducted in determining the amount of Tier 1 capital. The aggregate amount of PMSRs and PCCRs that may be recognized for regulatory capital purposes will be limited to no more than 50 percent of Tier 1 capital. Certain other conditions and restrictions will also apply. The FDIC's action was coordinated with the staffs of the other federal banking agencies in an effort to achieve convergence in the way intangibles are treated by the agencies for regulatory capital purposes. *PR-2-93, FDIC, 1/12/93; FIL-8-93, 2/4; FR, 1/28, p. 6363.*

Guidelines for Bank Directors and Officers

The FDIC issued a statement intended to clarify the duties of bank directors and officers and to outline the factors the FDIC considers before filing a personal liability lawsuit after a bank fails. The FDIC said it will not bring civil suits against those who fulfill their responsibilities "and who make reasonable business judgments on a fully informed basis and after proper deliberation." Lawsuits only follow "detailed investigations" by the FDIC, are approved by the agency's Board of Directors, and "are not brought lightly or in haste."

The statement recognizes the importance of having knowledgeable and responsible bank directors and officers, especially when an insured institution becomes troubled. However, the statement also stresses that directors and officers have numerous responsibilities, including "duties of loyalty and care," that the FDIC expects will be carried out. The statement notes that "directors must require and management must provide the directors with timely and ample information to discharge board responsibilities." FDIC lawsuits are authorized only if a breach of duty is uncovered. The guidelines also comment on the differences in the way the FDIC analyzes claims against inside directors *versus* those against outside directors, and recognizes that outside directors generally do not participate in the day-to-day business operations of the bank. The most common suits brought against outside directors involve "insider abuse" (such as preferential loans or contracts) and the failure to implement corrective measures after being warned of problems at the bank. *PR-166-92, FDIC, 12/14/92; FIL-87-92, FDIC, 12/17.*

"Gross Negligence" Rejected as the Standard in D&O Liability

The U.S. Supreme Court let stand a ruling by a U.S. appeals court (*McSweeney v. FDIC, 6/1/93*) which rejected "gross negligence" as a standard in suits involving personal liability of bank directors and officers. The issue of whether simple or gross negligence is the standard centered on the interpretation of Section 212(k) of FDICIA. *BBR, 6/7/93, p. 854.*

Real-Estate Lending Standards

The FDIC, FRB, OCC, and OTS adopted a final uniform rule on real-estate lending by insured depository institutions, effective March 19, 1993, implementing Section 304 of FDICIA. The rule prescribes standards that require each insured depository

institution to adopt and maintain comprehensive written real-estate lending policies that are consistent with safe-and-sound banking practices. The policies must address certain lending considerations, including loan-to-value limits, loan administration procedures, portfolio diversification standards, and documentation, approval, and reporting requirements. The policies also must be appropriate to the size of the institution and the nature and scope of its operations, and must be reviewed and approved by the institution's board of directors at least annually. The policies adopted by the institution also should reflect consideration of the Interagency Guidelines for Real-Estate Lending Policies established by the agencies in conjunction with the final rule. *FIL-2-93, FDIC, 1/12/93; FR, 12/31/92, p. 62890.*

Affordable Housing

The FDIC will provide assistance for the purchase of certain affordable single-family homes in its inventory of properties retained from failed institutions. This will implement provisions of FDICIA requiring the FDIC to establish an affordable housing program, to operate for three years, in connection with the agency's disposition of property. Last Fall, Congress appropriated \$5 million for the FDIC's affordable housing program. These funds will be used to provide discounts and rebates to low- and moderate-income home buyers and to administer the program. The FDIC estimates that about 1,500 single-family residential properties in its nationwide inventory are available under the affordable housing program. The properties include single-family detached homes (including 1-to-4 unit residential properties), condominiums and townhouses. Qualified purchasers include low- and moderate-income buyers, non-profit organizations and government agencies.

Upon acquiring the property as receiver, the FDIC will restrict the sale

of qualified properties to low- and moderate-income buyers for 180 days. After 180 days, properties can be sold to anyone. Rebates and discounts will be limited to ten percent of the purchase price. FDIC assistance can be used in one or more of several specified ways. *PR-159-92, FDIC, 11/20/92.*

Enforcement of Fair Lending Laws

FDIC Acting Chairman Andrew C. Hove, Jr., announced two actions intended to strengthen the monitoring and enforcement of fair lending laws at commercial and savings banks supervised by the agency. At the direction of Chairman Hove, a Fair Lending Working Group of senior-level staff from around the country has been appointed to analyze the FDIC's existing programs and procedures for preventing, detecting and correcting discriminatory credit practices. The FDIC also has revised the procedures its examiners must follow in monitoring a bank's adherence to the Fair Housing Act of 1968 (FHA), which prohibits discrimination in making loans involving housing because of race, color, religion, sex, national origin, familial status or handicap. Examiners are being given more specific direction and guidance in three basic areas: collecting and evaluating various information; analyzing samples of approved and denied loans and loan applications for possible signs of discrimination; and reaching conclusions about the institution's compliance with the fair housing and equal credit opportunity laws.

There are now 250 field examiner positions plus an Assistant Regional Director and examination review staff in each of the FDIC's eight regional Division of Supervision offices, with specific responsibility for compliance. Also, there are staff in each regional office whose primary mission is to promote a better understanding of fair lending laws through outreach to bankers, local citizens, government officials and others. *PR-44-93, FDIC, 5/5/93.*

Advance Notice by Banks of Branch Closings

The FDIC issued a proposal to implement Section 228 of FDICIA which, in general, requires an insured institution to give its federal regulator a 90-day advance notice of a proposed branch closing, including a detailed statement of the reasons for closing the branch and any supporting information. The law also requires a mailing at least 90 days before the branch closing, and a conspicuous notice at the branch at least 30 days prior to the proposed closing. A bank that temporarily operates a branch of a failed bank or savings association but does not purchase or lease the branch would be excluded from the advance notice requirements if it closes the branch before the end of any contractual option with the FDIC to retain the branch. One reason for the proposed policy is to encourage acquirers that are unsure about the future status of a branch to keep it open temporarily rather than close it immediately for fear of triggering the 90-day advance notice requirements.

The FRB, OCC, and OTS already have proposed similar policies for the institutions they regulate. The FDIC also is asking for public comment on whether the advance notice requirements should apply to closings of automated teller machines and certain branch relocations. The agency's proposal on branch closings would apply to each state nonmember bank with one or more branches. If an FDIC-supervised bank has no branches, it would be required to adopt a policy for branch closings before establishing its first branch. *PR-142-92, FDIC, 10/13/92; FR, 10/19, p. 47657.*

Final Rule for Outside Audits of Insured Banks and Thrifts

The FDIC adopted regulatory requirements and interpretive guidelines, implementing provisions of FDICIA, to require each insured institution over the threshold set by the FDIC — total assets of \$500 million or more — to have an annual audit of

its financial statements by an independent public accountant. Also, each institution subject to the audit requirements is required to establish an audit committee composed entirely of outside directors who must review the annual audit findings with management and the outside accountant. Any change in an outside auditor also by law must be brought to the attention of the FDIC.

The new audit and reporting requirements, effective July 2, 1993, will apply to about 1,000 of the approximately 14,000 FDIC-insured banks and thrifts, with about 75 percent of combined industry assets. Among the information that the annual report must contain is: an assessment by the institution's management of the effectiveness of its internal controls for financial reporting and its compliance with safety-and-soundness laws and regulations. The law mandates that "large institutions," defined by the FDIC as those having \$3 billion or more in total assets, have more stringent requirements for their audit committees. There are an estimated 240 of these institutions. For these banks and thrifts, the audit committee must include at least two members with banking or related financial management expertise, "large customers" with significant credit or other relationships are prohibited from serving on the audit committee, and the committee must have access to its own outside counsel independent of management.

About 96 percent of the institutions with \$500 million or more in assets are known to already engage an independent public accountant to perform annual audits, while the rest use independent accountants for more limited audit work. Therefore, the new rule and the use of the guidelines approach should not impose undue burdens on the affected institutions. The FDIC is urging all insured institutions to voluntarily have audits by independent public accountants and establish audit committees. *PR-49-93, FDIC, 5/11/93; FR, 6/2, p. 31332.*

Restrictions on State-Chartered Banks

The FDIC approved final rules, effective December 9, 1992, implementing provisions of FDICIA restricting the ability of state-chartered banks to own corporate stock and mutual fund shares, and to have equity ownership in investments such as real-estate development projects. FDIC-insured state banks will be under the same restrictions on equity investments, whether they are members of the BIF or the SAIF.

FDICIA prohibits insured state-chartered banks from making equity investments of a type or amount not permitted for national banks, and mandates divestiture of these investments by December 19, 1996. However, the law provides a partial exception for stock and mutual fund ownership by an institution meeting certain conditions. An institution that meets the conditions can retain or acquire new qualifying stock or mutual fund ownership if it notifies the FDIC of its intention and receives the agency's approval. FDICIA states that a bank receiving FDIC approval to continue making stock or mutual fund equity investments will be subject to an aggregate maximum limit equal to the institution's capital. An institution that holds prohibited equity investments is required to submit to the FDIC a plan to divest such holdings as quickly as can be prudently done.

Under the new regulations, a bank that was lawfully engaging in insurance underwriting on November 21, 1991, or a bank that had a subsidiary that was lawfully underwriting insurance on that date is exempt from a general prohibition in FDICIA on insurance activities but must give notice to the FDIC. Notice procedures are specified which institutions must follow if they wish to continue the insurance activities. *PR-147-92, FDIC, 10/27/92; FR, 11/6, p. 53211.*

The FDIC proposed a second phase of new statutory restrictions on the activities of insured state-chartered banks. The regulation, which went into effect December 9, 1992, primarily

relates to a ban on certain equity investments. The FDIC Board now is proposing a rule that would establish procedures and criteria for state banks to seek approval to engage in otherwise prohibited activities. The FDIC proposal would clarify that the law does not impose new restrictions on activities where the bank is not acting "as principal" (*i.e.*, the bank is acting as an agent for a customer). This means there would be no change in a state bank's ability to operate insurance agencies, securities brokerage firms, real-estate agencies, travel agencies, financial planning services or certain other agencies if authorized by state law, even if national banks cannot engage in these activities.

FDICIA prohibits a state bank from engaging as principal in an activity either directly or through a majority-owned subsidiary that is not permissible for a national bank unless the bank meets its minimum capital requirements and the FDIC determines that the activity does not present a significant risk to the insurance funds. The proposal includes a tentative list of activities that would not present a significant risk to the funds, including certain guarantee activities (such as a credit-card program in which a bank guarantees the obligations of its retail banking customers), activities that are "closely related to banking" (as defined by the FRB), and securities activities conducted in a subsidiary. *PR-1-93, FDIC, 1/12/93; FIL-9-93, 2/4; FR, 1/29/93, p. 6448.*

The FDIC requested comment on whether to amend its regulations governing insurance underwriting by well-capitalized insured state banks and their subsidiaries to provide that excepted insurance underwriting activities may only take place in the state in which the bank is chartered and in the state in which the bank's insurance underwriting subsidiary is incorporated. The result of this change would be to narrow the exception for insurance underwriting activities. *FR, 4/29/93, p. 25953.*

Applications by Savings Associations

The FDIC proposed amendments concerning applications and notices by savings associations, relating to the definitions of "significant risk" and "equity security." Insured state savings associations would be allowed to conduct activities and make investments without the FDIC's prior approval provided that the activities and/or investments were found by the OTS to be permissible for federal savings associations. This change would also place insured state savings associations on a par with the treatment accorded insured state banks under the FDIC's regulations. *FIL-37-93, FDIC, 5/14/93; FR, 5/3, p. 26259.*

Insurance Rules on Employee Benefit Plans

The FDIC approved final deposit insurance rules, implementing Section 311 of FDICIA, affecting certain individual retirement accounts (IRAs), self-directed Keogh accounts and other self-directed employee benefit plan accounts.

Among the several rule changes are: a) Retirement account coverage: As specified in FDICIA, effective December 19, 1993, an individual's deposits at the same institution in any combination of IRAs, self-directed Keogh Plan accounts, "457 Plan" accounts, and self-directed defined contribution plan accounts will be protected by federal insurance up to \$100,000 in the aggregate. This is a reduction from the maximum of \$400,000 in insurance coverage now provided for deposits in these four types of retirement plan accounts. The existing insurance coverage remains in effect for certain time deposits under grandfather provisions; b) "Pass-through" insurance: The new law also continues "pass-through" insurance coverage for most employee benefit plans (*i.e.*, \$100,000 per individual participant, not \$100,000 per plan). However, certain employee benefit plan accounts kept in undercapitalized institutions and other institutions not authorized by the FDIC to accept brokered deposits will be

covered only up to \$100,000 per plan, not \$100,000 per participant. FDICIA made this provision of the law effective December 29, 1992.

Each insured institution is required to inform customers of the new rules in a one-time mailing by October 10, 1993, using a brief notice developed by the agency. Institutions are being given the option of mailing the notice to all depositors or only those customers who have the types of accounts affected by the rule changes. *PR-51-93, FDIC, 5/11/93; FR, 5/25, p. 29952.*

Excess Deposit Insurance

General Reinsurance Corporation will offer insurance policies to cover bank deposits in excess of the \$100,000 general limit on FDIC deposit insurance. The policies, to be sold by a subsidiary of General Reinsurance, will cost 25 to 30 cents per \$100 of deposits insured, or \$500 to \$600 a year for the minimum \$200,000 policy. A customer wishing to know if the insurance is available for deposits in a particular institution would obtain this information and apply for coverage through a local insurance agent. The program could be of use particularly to depositors such as professional persons who hold funds in escrow for clients, small companies that need to keep more than \$100,000 in an account, for example, to meet payrolls, or to savers with money held in higher-yielding certificates of deposit. The risks to the insurer are controlled by limiting the coverage to \$5 million in any one bank, a ceiling which may be increased as the program grows, and limiting the term of policies to six-month periods, subject to nonrenewal if an institution gets into difficulty. Under state insurance rules the policies appear not to be available at present to residents of seven states, including New York, California and Florida. *The New York Times, 3/10/93, p. D4; AB, 3/15, p. 15.*

Deposit insurance in excess of the FDIC's limit of \$100,000 per depositor is now available to banks in Kansas through Kansas Bankers Surety Co., which has offered banks a variety of

crime insurance policies since 1922. Premiums for excess deposit insurance are paid by the bank, which also determines which large deposit accounts are to be insured by the insurance company. *Bank News*, 6/93, p. 26.

Erroneous Information About FDIC Insurance Coverage

The FDIC, OCC, FRB, and OTS issued an advisory to insured banks indicating the agencies' concern that bank and thrift employees — when asked by depositors — may sometimes be providing erroneous information about deposit insurance coverage. The agencies are encouraging all institutions to make certain that their employees, especially those who have front line contact with depositors, have an understanding of federal deposit insurance to ensure that customers are accurately informed about coverage.

A basic source of information is the FDIC's "Your Insured Deposit," a pamphlet that helps explain the limits on FDIC coverage and circumstances where coverage over \$100,000 is provided. Institutions are reminded that FDICIA made certain changes in deposit insurance coverage, effective 1992 and 1993, mostly in the area of pension and other employee benefit plan accounts. These changes (see above) were explained in the FDIC's letter to all insured institutions dated November 6, 1992 (*FIL-78-92*). *FIL-7-93*, *FDIC*, 2/3/93.

Among other educational activities in this area, the FDIC is starting a quarterly newsletter that will address deposit insurance questions.

Environmental Liability

The agency issued guidelines to FDIC-supervised commercial and savings banks advising that the institutions should have in place appropriate safeguards and controls to limit exposure to potential environmental liability associated with real property held as collateral. The guidelines contain information and recommendations about implementing an environmental risk program that can be tailored to the needs of the lending institution.

Among the topics discussed are training, policies, environmental risk analysis and assessment, loan documentation, and monitoring.

Examiners will review an institution's environmental risk program as part of the examination of its lending and investment activities. When analyzing individual credits, examiners will review the institution's compliance with its own environmental risk program. Failure to establish or comply with an appropriate environmental program will be criticized and corrective action required. *FIL-14-93*, *FDIC*, 2/25/93.

Foreign Banks' Activities

The FDIC proposed to amend its regulations to implement Section 202 of FDICIA, which provides that after December 19, 1992, a state-licensed insured branch of a foreign bank may not engage in any activity that is not permissible for a federal branch of a foreign bank without the approval of both the FRB and the FDIC. In the event an application to engage in such activity is denied or the foreign bank elects not to continue the activity, a plan of divestiture or cessation must be submitted and such divestiture or cessation must be completed within one year, or sooner if the FDIC so directs. *FR*, 3/2/93, p. 11992.

Certain Requirements Waived in Disaster Areas

Section 2 of the Depository Institutions Disaster Relief Act of 1992 (DIDRA) authorizes the FDIC, OCC, FRB, OTS, and National Credit Union Administration (NCUA) to make exceptions to their requirements relating to appraisals for transactions that involve real property in major disaster areas when the exceptions would facilitate recovery from the disaster and would not be inconsistent with safety and soundness. Any such exceptions would expire no later than three years after the disaster is declared by the President. Under this authority, relief was granted from the provisions of Title XI of FIRREA

and the agencies appraisal regulations promulgated under it for any real-estate-related financial transaction requiring an appraisal involving real property located in an area designated eligible for federal assistance by the Federal Emergency Management Agency as a result of Hurricanes Andrew or Iniki or of the Los Angeles civil unrest in May 1992. For eligibility it is further required that the real property involved was directly affected by the major disaster, or that the real property involved was not directly affected by the major disaster but the institution's records explain how the transaction would facilitate recovery from the disaster. *FR*, 11/17/92, p. 54173.

The FDIC determined that recovery from Hurricanes Andrew and Iniki and from the Los Angeles civil unrest in May 1992 would be facilitated by exempting from publication requirements certain transactions involving establishing a branch or relocating a branch or main office in the areas directly affected by those disasters. The FDIC's publication requirements were suspended for a period of 180 days beginning October 23, 1992, and ending April 21, 1993, with respect to applications filed by FDIC-insured state nonmember banks whose principal place of business is within, or with respect to activities within, an area designated eligible for federal assistance by the Federal Emergency Management Agency as a result of the hurricanes or civil unrest indicated above. *FR*, 12/15/92, p. 59284.

Survey Shows Real-Estate Markets Continuing to Improve

Residential and commercial real-estate markets continued to improve in the three months ending in April 1993, according to the FDIC's most recent survey. The national composite index of survey responses was 66, the same level as in January, and up from 57 in October 1992. The national residential index rose to 74 in April from 73 in January and 63 in October, while the commercial index was the

same in January and April at 57, increasing from 51 last October.

The surveys began in April 1991, and are based on interviews across the country with nearly 500 senior examiners and liquidation personnel at federal bank and thrift regulatory agencies. Values of the index above 50 indicate that more respondents believed conditions were improving than declining, compared to the previous quarter, while values below 50 indicate the opposite.

The South remained the strongest region in the country in April for the seventh consecutive survey. There was significant continuing improvement in the Midwest, particularly in residential real estate. Real-estate markets in the Northeast posted gains in April, matching January's, which were the most positive to date for this region. In California, nearly half of the respondents observed declines in both commercial and residential real-estate conditions. In contrast, in the West outside California, commercial and residential markets reportedly outperformed the national average. Among other indications of improvement nationally, less than half of the respondents reported an excess supply in their local housing markets for the second consecutive survey. Also, more respondents cited increasing prices of existing homes than in any survey to date. *Survey of Real Estate Trends, FDIC, October 1992; January, April 1993.*

Pilot Reinsurance Program

The FDIC solicited public comments on a Pilot Reinsurance Program pursuant to Section 322 of FDICIA, which requires the agency, in consultation with the Secretary of the Treasury and individuals from the private sector, to conduct a study of the feasibility of establishing a private reinsurance system. The study must include a demonstration project, consisting of a simulation, by a sample of private reinsurers and insured depository institutions, of the activities required for a private reinsurance system. These activities include: a) establishing a pricing structure for risk-related premiums; b) formulating

insurance or reinsurance contracts; and c) identifying and collecting information necessary for evaluating and monitoring risks in insured depository institutions.

Section 322 authorizes the FDIC to engage in actual reinsurance transactions as part of the demonstration project. As part of the new risk-related assessment system, the FDIC is authorized to obtain private reinsurance covering not more than ten percent of any loss the FDIC incurs with respect to an insured depository institution and to base that institution's semi-annual assessment, wholly or partially, on the cost of the reinsurance.

The FDIC asked for comment on all aspects of a PRP, including the reinsurance process, the terms and conditions of participation by private reinsurers, the appropriate criteria for determining which insured depository institutions may be included in the PRP, and alternate methods of structuring a PRP. *FR, 2/3/93, p. 6996; FIL-11-93, FDIC, 2/17; FR, 4/27, p. 25644.*

Private Reinsurance Study

The FDIC submitted a report to the Congress as required by Section 322(b) of FDICIA. In order to ascertain whether establishing a private reinsurance system is feasible, the FDIC has initiated a Pilot Reinsurance Program as part of the demonstration project required under the section. While the demonstration project has not been concluded, the preliminary results of the study in part are: a) combining private reinsurance with federal deposit insurance requires introducing and establishing a financial market that currently does not exist; b) potential reinsurers have shown limited interest in engaging in reinsurance contracts on terms acceptable to the FDIC thus far; and c) further discussions are necessary to develop a consensus regarding the goals, limitations, and feasibility of a PRP.

The FDIC will continue to seek the counsel of a number of parties in order to arrive at a reasonable approach to a Pilot Reinsurance Program. The FDIC envisions a Pilot Program with

three phases. After completing each phase, the FDIC will decide whether to continue on this course. First, the FDIC will determine the general terms under which it is willing to obtain reinsurance and will solicit participation of parties willing to provide reinsurance. The FDIC will work with these parties to develop a detailed and final reinsurance contract. Second, the reinsurers will conduct their analysis of banks and submit bids indicating the prices at which they are willing to reinsure banks. Third, the FDIC and the reinsurers will enter into reinsurance contracts. The third phase will end when the term of the reinsurance contracts terminates. *Private Reinsurance Feasibility Study, FDIC, June 1993.*

Report on Development of Deposit Tracking System

Section 311 of FDICIA requires the FDIC to conduct a study of the cost and feasibility of tracking the insured and uninsured deposits of any individual and the exposure of the U.S. Government with respect to all insured depository institutions. A detailed technical analysis must be conducted of the costs and benefits associated with the least expensive manner of implementing the tracking system. As part of the study, the FDIC must investigate and evaluate: a) the data systems that would be required to track deposits in all insured depository institutions; b) the reporting burdens of such tracking on individual depository institutions; c) the system that exists or that would be required to be developed to aggregate such data accurately; d) the privacy implications of such tracking; and e) the manner in which systems would be administered and enforced.

The FDIC sought public comment on the desirability, cost and feasibility of developing such a tracking system, and to evaluate the privacy implications, and examine the possibilities and implications of simplifying the rules governing deposit insurance coverage.

The study as required by FDICIA was completed in June 1993. It describes several possible uses for a

tracking system and concludes that each of them is of limited value, and may be achieved with less-costly alternatives, or is of dubious merit. The costs to insured depository institutions to develop and implement a simple deposit tracking system would range from \$950 million to \$1.3 billion, with annual recurring costs exceeding \$100 million. In addition, the FDIC would incur \$30.5 million in initial and first-year costs, with annual recurring costs of \$20 million. Furthermore, the study concludes that the development of a deposit tracking system would represent an unwarranted infringement of depositors' privacy.

Because many of the above costs would be driven by the complexity of the current deposit insurance coverage rules, the study analyzes potential modifications to the rules and the potential consequences that could occur if these modifications were adopted. The study also concludes that the FDIC should carefully consider the possibility of simplifying insurance coverage rules. *FIL-15-93, FDIC, 2/26/93; FR, 2/3/93, p. 6903; Costs, Feasibility and Privacy Implications of Tracking Deposits, FDIC, June 1993.*

Study of "Two-Window" Deposit System

The FDIC completed a study, as required by Section 321 of FDICIA, on the feasibility of authorizing insured depository institutions to offer both insured and uninsured deposit accounts to customers.

As discussed in this study, the "two-window" approach involves bank restructuring designed to insulate the deposit insurance funds from unnecessary risks and to free banking organizations from unnecessary, anti-competitive constraints. Bank risk-taking is confined by further restricting the activities that may be funded with insured deposits. Activities deemed improper for funding with insured deposits are permitted for uninsured affiliates (perhaps subsidiaries) within the same banking organization, but the insured entity is insulated from nonbank risks through

separate capitalization and a set of reinforcing "firewalls" to maintain effective legal and financial separation. All ownership, product-line, and location restrictions now applied to banking organizations are lifted so that new capital may be attracted and banking organizations may compete on a more level playing field with nonbank and foreign firms.

The "two-window" system has similarities to the "narrow-bank" concept. Some differences are the criteria used for determining acceptable uses of insured deposits, the restrictions imposed on nonbank-affiliate activities, and the structural design of the banking organization as a whole.

The study concludes that "this probably is not the appropriate time to implement a significant change in the rules that govern the operations of the nation's banking system." FDICIA is intended to strengthen the deposit insurance system through a variety of reforms, including capital-based supervision, prompt corrective action for troubled institutions, and implementation of risk-related assessments. In addition, banking companies are being allowed to compete in an expanding number of product markets. If these developments do not ultimately result in a healthy and viable banking system, it will be time to revisit the two-window proposal. *Report to the Congress on the Findings and Recommendations Concerning the "Two-Window" Deposit System Proposal, FDIC, September 1992.*

Resolution Trust Corporation

Smaller Sales Offerings of Hard-to-Sell Assets

Interim Chief Executive Officer Roger C. Altman announced that the RTC will begin decreasing the size of its asset offerings and will subject large-scale sales proposals to a more rigorous pre-offering review as it proceeds with the marketing of its remaining inventory of largely hard-to-sell assets. The emphasis on smaller transactions will not interfere with offerings that are now moving into the marketplace, such as the RTC's Land

Fund and Multiple Investor Funds. However, any new proposals of large transactions, generally in excess of \$50 million, will be reviewed to ensure that there is adequate staff and contractor support to move the proposals smoothly through the formative stage to a sale. The emphasis on smaller transactions, settlements and workouts will also extend to offerings of the RTC's private-sector asset managers.

Mr. Altman said that in the months ahead there will be more auctions with smaller pools of assets and more individualized asset offerings reaching the market through brokers and other traditional mechanisms. In addition to reducing stress to the agency's internal controls and contracting program, this approach will create opportunities for the investor who has felt left out of the competition for the major pools sold in the past. *The RTC Investor, May 1993, p. 1.*

New Loan Sales Directive

In respect to mortgages and other loan assets, various "wholesale" programs have proven to be the most successful in both disposing of assets rapidly and maximizing recovery values. These programs include securitization, multiple investor fund (MIF) transactions, structured sales, whole-loan sales and national loan auctions.

A new directive requires that: a) securitization will be the primary and priority sales method for all performing 1-to-4 family mortgages, multifamily and commercial mortgages, and consumer and other nonmortgage loans; b) MIF transactions (including both publicly offered MIFs and privately placed MIFs, or N-series transactions) will be the primary and priority method of sale for nonperforming multifamily and commercial mortgages; and c) structured sales, whole-loan sales and national loan auctions conducted by the National Sales Center will be the primary and priority methods of disposition for nonperforming 1-to-4 family mortgages, nonperforming consumer loans and all other mortgage and loan

assets deemed not suitable for securitization or MIF transactions.

As a result of the directive, all loan sales will be centralized in Washington, D.C., enabling the RTC to better coordinate its loan sales activities and maintain a steady flow of products into the marketplace. The RTC's field offices, managing agents, financial institution specialists and asset managers will continue to play a vital role in identifying assets available for sale, assisting with the due-diligence process, locating and delivering asset-related documents, and providing other necessary support. These groups also will continue to have primary responsibility for the sale of real estate owned, other assets, loan-servicing rights (in cooperation with the National Sales Center) and workout and settlement of distressed loan assets.

Borrower workouts and settlements of individual assets prior to sale will continue until they are "frozen" for a national sales effort. In some cases, performing mortgages and other performing loans may be sold in conjunction with resolution transactions.

The RTC Investor, February 1993, p. 6.

Asset Sales Will Utilize Partnership Structure

The RTC will dispose of judgments, deficiencies, and charge-offs (JDCs), and some nonperforming consumer loans having balances of under \$50,000, through the use of a limited partnership structure. The RTC will be the limited passive partner. The general partner, which will be the collection team, will manage and collect on the JDCs and pay for all the costs of the partnership, receiving for these services a specified percentage of gross collections. Some preference will be given to minority- and women-owned investors who are interested in participating. The RTC has encouraged firms to form teams to meet the various requirements that will apply to participants in the partnerships. *The RTC Investor, March 1993, p. 2.*

Secondary Market Support Program

The RTC has become a major presence in the market for mortgage-backed and asset-backed securities, having sold (through September 1992) 52 issues of securities with an aggregate book value of more than \$28 billion. The agency's secondary market support program provides investors with increased information about the performance of the collateral underlying the securities, thus enhancing the liquidity and pricing of the securities. The program consists of: a) monthly statistical reports on the performance of the mortgage or asset pool underlying each issue of the securities; b) periodic meetings to be begun with investors and rating agencies, and c) an automated telephone access line (1-202-416-4300) which has been established on a trial basis. The RTC intends to revise and expand the reports to include a summary of the structure of each transaction, delinquency statistics, and other information. *The RTC Investor, November 1992, p. 10.*

National Land Fund

The RTC solicited partnership proposals for the National Land Fund, which will be the agency's first use of a partnership for the disposition of a large portfolio of distressed real-estate assets. An official said the partnership structure would allow the RTC to privatize ownership of ten percent of its land holdings while retaining the opportunity to recover funds for the taxpayer in the future if land values rise above current levels.

Approximately 60 to 70 percent of the fund will be comprised of performing, subperforming and nonperforming loans; the remainder will be real estate owned. The assets are located primarily in Arizona, California, Colorado, Florida and Texas and will be divided into four to six regional pools.

Investors will contribute a minimum of 25 percent of the bid price in cash to the partnership. The agency's

contribution of the land will represent its equity interest in the partnership. The land portfolio is expected to have a book value of \$2 billion and a general partner will be selected based on the highest qualified bid submitted to the RTC. The RTC will act as a passive limited partner. Once selected, the private investor group as general partner will have broad authority for managing the Fund. *The RTC Investor, December 1992, p. 1.*

Amended Policy on Contracting with Firms with Related Entity Defaults

The RTC issued, in July 1992, a policy statement restricting RTC contracting with firms whose related entities are in default on financial obligations to the RTC, FDIC, or FSLIC in any of their capacities (the Default Policy — see this *Review*, Fall/Winter 1992, p. 40). The RTC is revising the Policy to exclude from its coverage contractor firms whose affiliated business entities have defaulted on RTC post-intervention nonrecourse seller financing, provided, in the sole discretion of the RTC, that no material dispute exists between the RTC and the contractor firm itself regarding the asset. *FR, 11/19/92, p. 54503.*

Real-Estate Appraisals

The RTC amended, effective December 2, 1992, its real-estate appraisal regulations to identify additional transactions for which the services of an appraiser are not required. The final rule eliminates the requirement for depository institutions under the conservatorship or receivership of the agency to obtain appraisals by certified or licensed appraisers for real-estate-related financial transactions having a value of \$100,000 or less. Also, it permits regulated institutions to use appraisals prepared for loans insured or guaranteed by an agency of the U.S. Government under certain conditions. *FR, 11/21/92, p. 49382.*

FNMA to Purchase Multifamily Properties

The Federal National Mortgage Association (Fannie Mae) will buy up to \$100 million in permanent financing for RTC multifamily properties in which 35 percent of the units will be set aside at restricted rents for low-income families. The RTC also will provide second mortgages to non-profit organizations and government agencies, which allows such buyers to purchase the properties with minimum down payments of five percent; for-profit purchasers will be required to put down 30 percent.

This is a joint effort of the RTC's Affordable Housing Disposition Program (AHDP) and Fannie Mae's \$10 billion initiative to help address the nation's unmet affordable housing needs. AHDP requires that 15 percent of the total project units be occupied by "lower-income" families earning less than 80 percent of the area median income, and 20 percent of the total project units must be occupied by "very low-income" households earning less than 50 percent of the area median income. Most of the nearly 300 RTC-owned apartment properties available for financing under the RTC/Fannie Mae plan are located in Arkansas, Arizona, California, Colorado, Florida, Georgia, Kansas, New Mexico, Oklahoma and Texas. *The Silver Lining, RTC, Fall 1992/Winter 1993, p. 1.*

Special Resources Clearinghouse

The RTC established a Special Resources Clearinghouse to serve as a central point for disseminating information on RTC properties that have natural, cultural, recreational or scientific values of special significance. Examples include properties with nationally significant wetlands, endangered species or historic sites. As of August 13, 1992, the RTC had identified 739 individual properties with special resources. The Clearinghouse service is available to both public and private parties. *The RTC Investor, November 1992, p. 9.*

Operations Update

Through April 30, 1993, the RTC resolved 654 institutions with one resolution occurring during March and none in April. The RTC added one institution into its conservatorship program to bring the number of conservatorships to 85 at the end of April.

As of March 31, assets under RTC management, including both conservatorships and receiverships, totaled \$91 billion. This asset inventory is the lowest the RTC has held since it was created in August 1989. The 84 conservatorships (as of March 31) held \$36 billion in gross assets, of which cash and securities (including a substantial amount of short-term securities purchased with the proceeds of asset sales) represented 35 percent; performing 1-to-4 family mortgages, 18 percent; other performing loans, 20 percent; delinquent loans, 8 percent; real estate, 7 percent; investments in subsidiaries, 3 percent; and other assets, 9 percent. Assets in receiverships remaining from the 654 institutions closed by the RTC amounted to \$55 billion on March 31. Because many of the relatively marketable assets have been sold before an institution enters a receivership, most of the assets retained by the RTC in receivership consisted of lower-quality, less-marketable assets. Thus, real estate and delinquent loans represented 44 percent of receivership assets, while cash, securities, and performing 1-to-4 family mortgages represented only 13 percent. The \$55 billion excludes approximately \$15 billion in cash, liquid investments, and accounts receivable accumulated from receivership collections.

From inception through March, the RTC collected \$130 billion from securities, \$94 billion from 1-to-4 family mortgages, \$43 billion from other mortgages, \$25 billion from non-mortgage loans, \$12 billion from real estate, and \$16 billion from other assets. Book value asset reductions were \$350 billion, and the RTC recovered 92 percent on these collections. The RTC has recovered 98 percent from securities, 97 percent from 1-to-4 family

mortgages, 85 percent from other mortgages, 93 percent from non-mortgage loans, 59 percent from real estate, and 77 percent from other assets. The RTC has collected \$15.1 billion in receiver-ship income.

As of the end of April, RTC resolutions had protected 21.9 million deposit accounts from financial loss. Estimated resolution costs for the 654 closed thrifts totaled \$84.4 billion, before taking into account the reduction in loss estimates for already resolved institutions confirmed by GAO's preliminary audit of the RTC's 1992 financial statements. The \$84.4 billion represented 34 percent of the total liabilities of these closed institutions at the time of resolution. If the insured deposits of all 654 institutions had been paid out to depositors, the estimated resolution cost would have been \$87.6 billion. The \$3.2 billion difference represented the estimated savings, or premiums, over insured deposit payout costs.

From its inception through March 31, 1993, the RTC obtained \$122 billion in funds from external sources as follows: \$50 billion in FIRREA appropriations, \$37 billion in loss funds authorized by 1991 Acts of Congress, and \$35 billion in Federal Financing Bank borrowings. The RTC also obtained \$85 billion in recoveries from receiverships. *RTC Review, May 1993.*

Federal Reserve Board

Review Criteria for Bank Holding Company Applications

The FRB issued a final rule to carry out provisions of FDICIA that affect bank holding companies and foreign banking organizations with operations in the U.S. The final rule, which is effective February 4, 1993, replaces an interim rule, adopted in April 1992, and amends Regulation Y to specify additional factors that the FRB must consider in acting on applications submitted under the Bank Holding Company Act to acquire a bank. Section 202(d) of FDICIA provides that the FRB must disapprove

an application if: a) the bank holding company fails to provide the FRB with adequate assurances that it will make available such information on its operations or activities, or those of affiliates, as the FRB may require; or b) in the case of an application involving a foreign bank, the foreign bank is not subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in the bank's home country. The FRB's consideration of the managerial resources of a bank holding company or bank includes evaluating the competence, experience and integrity of their officers, directors and principal shareholders. *Press Release, FRB, 1/5/93; FR, 1/6, p. 471.*

International Banking Operations

The FRB issued a final rule implementing portions of the Foreign Bank Supervision Enhancement Act of 1991, and amending its Regulation K to reflect the FRB's new authority to supervise and regulate foreign banks that conduct or seek to conduct a banking business in the U.S. The rule requires in part that foreign banks seeking to conduct direct banking operations in the U.S. must be subject to comprehensive supervision by their home country authorities on a consolidated basis. An amendment to Regulation Y requires a foreign banking organization to file an application with the FRB in order to acquire more than five percent of the share of a U.S. bank or bank holding company. The rule is effective immediately and replaces an interim regulation issued in April 1992. *Press Release, FRB, 1/12/93; FR, 1/28, p. 6348.*

FBSEA provides in part that, after December 19, 1992, a state-licensed branch or agency of a foreign bank may not engage in any type of activity that is not permissible for a federal branch, unless the FRB has determined that such activity is consistent with sound banking practice, and, in the case of a state-licensed insured branch, the FDIC has determined that the activity would pose no significant risk to the deposit insurance fund.

The FRB proposed procedures for state-licensed branches and agencies to request the FRB's permission to engage in or continue an activity that is not permissible for a federal branch, and the requirements for divestiture and cessation plans. *Press Release, FRB, 12/31/92; FR, 1/6/93, p. 513.*

Enforcement of Fair Lending Laws

To address the concern that some minority consumers and small-business owners are experiencing discrimination by lenders, federal bank and thrift supervisors reiterated their commitment to effective enforcement of fair lending laws. The regulators mentioned specifically 11 fair lending activities, among which are: a) use of an internal second review system for consumer, mortgage and small-business loan applications that would otherwise be denied; b) enhanced employee training that engenders greater sensitivity by financial institution management, and employees, to racial and cultural differences in our society; c) training of loan application processors to ensure that any assistance provided to applicants in how to best qualify for credit is provided consistently to all loan applicants; d) efforts to ensure that all persons inquiring about credit are provided equivalent information and encouragement; e) and use of flexible underwriting and appraisal standards that preserve safety-and-soundness criteria while responding to special factors in low- and moderate-income and minority communities.

The agencies will continue to strengthen and refine their fair lending enforcement activities. Examiners will routinely use HMDA data, as well as other information, to identify cases which require closer examination. Examiners will then conduct detailed reviews and comparisons of loan and application files to examine for compliance with fair lending laws and regulations. The agencies will continue to develop and refine computer-based programs to facilitate and improve this process. *FRB, OCC, OTS, FDIC, Joint Release, 5/27/93.*

Revenue Limit on Securities Activities of BHC Subsidiaries

In July 1992, the FRB requested comment on alternative methods to adjust the ten percent revenue test limiting ineligible securities activities of Section 20 subsidiaries of bank holding companies (see this *Review*, Fall/Winter 1992, p. 42). Since the revenue test was last considered in 1989, changes in the level and structure of interest rates have had unforeseen effects on the measure of whether a Section 20 subsidiary is "engaged principally" in ineligible securities activities. One possible alternative test suggested was a revenue test that is indexed to interest-rate changes. The method proposed was to adjust current interest and dividend revenue in order to calculate the revenue that would have been earned in the current period if the Treasury yield curve were as it was in September 1989.

Effective January 26, 1993, the Board will allow Section 20 subsidiaries to measure compliance with the "engaged principally" test on the basis of the indexed revenue test on which comment was requested. To use that method as an alternative to the current revenue test, Section 20 subsidiaries must notify the FRB of such an election and may not alter that election for two years. *FR, 7/29/92, p. 33507; 7/31, p. 33961; 5/18/93, p. 28963; Federal Reserve Bulletin, 3/93, p. 227; 4/93, p. 360.*

Capital Guidelines

The FRB modified its risk-based capital guidelines, effective December 30, 1992, for state member banks and bank holding companies to lower the risk-weight from 20 percent to zero for certain transactions that are collateralized by cash and OECD central government securities, including U.S. Government agency securities, provided the transactions meet specified criteria. *Press Release, FRB, 12/23/92; FR, 12/30/92, p. 62180.*

The FRB issued a final rule to lower from 100 to 50 percent the risk-weight on loans to finance the

construction of 1-to-4 family residences that have been presold. The rule, which implements a section of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRIA), is effective April 26, 1993. *Press Release, FRB, 4/20/93; FR, 5/14, p. 28491.*

The FRB is revising its capital-adequacy guidelines for bank holding companies and state member banks, effective March 15, 1993, to provide explicit guidance on the types of intangible assets that may be included in the Tier 1 capital calculation for risk-based and leverage capital purposes. The revision was formulated in conjunction with the staffs of the FDIC, OCC, and OTS and, when made final by the other agencies, will achieve greater consistency among the agencies with respect to the capital treatment of intangible assets. *FR, 2/11/93, p. 7973.*

Appraisals

The FRB proposed to revise its Regulation B to implement an Equal Credit Opportunity Act amendment enacted as part of FDICIA. The proposed revisions would define the appraisal provision to cover applications to be secured by a lien on a residential structure containing 1-to-4 family units, set time limits for an applicant to request a copy of an appraisal report and for a creditor to provide a copy, and require most creditors to notify applicants in writing of the right to receive a copy of an appraisal report. Comment is specifically requested on whether a more limited approach should be adopted or whether any regulations at all are desirable to implement the statute. *FR, 12/7/92, p. 57697.*

Loans to Member Banks' Officials and Principal Shareholders

The FRB requested comment on whether it should retain, modify, or terminate a provision in its Regulation O which permits smaller banks to increase their aggregate insider lending limit. Under authority granted by FDICIA, the FRB amended the Regulation, effective May 18, 1992, to

permit banks with deposits under \$100 million to increase their lending limit from 100 percent up to 200 percent of unimpaired capital and unimpaired surplus, if they followed certain procedures. The smaller bank was required to declare to the FRB that, on the basis of the bank's lending experience, a higher limit was prudent and necessary to attract or retain directors or to prevent restricting credit.

The higher lending limit, scheduled to extend for one year through May 18, 1993, was extended for an additional six months. *Press Release, FRB, 5/7/93, 1993; FR, 5/4, p. 26507; 5/14, p. 28492.*

Home Mortgage Disclosure

The FRB issued a final rule, effective January 1, 1993, amending Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). FDICIA authorized the FRB, in consultation with the Department of Housing and Urban Development, to develop a new exemption standard for nondepository mortgage lenders that is comparable to the exemption for depository institutions. Under the standard that has been adopted, a nondepository mortgage lender with an office in a metropolitan area is covered if it meets either an asset-size test or a lending activity test. Such a lender continues to be covered if its assets exceed \$10 million. Any nondepository mortgage lender is covered if it originated 100 or more home purchase loans (which includes refinancings of home purchase loans) in the preceding calendar year. This dual standard maintains coverage for all nondepository mortgage lenders that currently report under HMDA and extends coverage to firms that are active mortgage lenders despite their smaller asset size. The FRB also has revised the instructions for reporting loan applications received through a loan broker or correspondent, applicable to all lenders covered by HMDA. *FR, 12/2/92, p. 56963.*

The FRB adopted amendments, effective March 1, 1993, to implement HMDA as amended by the Housing and Community Development Act of 1992. Financial institu-

tions are required to make their loan application register data available to the public beginning March 31, 1993, after the register is modified in accordance with the FRB's regulations. Also, they must make their disclosure statement, to be compiled by the FFIEC later in the year, available to the public within three business days — down from 30 days now required — after receiving it from the FFIEC. *FR, 3/11/93, p. 13403.*

Mellon Can Provide Administrative Services to Mutual Funds

The FRB gave permission to Mellon Bank Corp. to provide administrative services to mutual funds, an approval said to be the first of its kind by the FRB. Mellon will indirectly acquire TBC Advisors, Boston, which provides administrative and advisory services to almost 100 open-end and closed-end investment firms. Among the conditions of the approval, Mellon will be able to have a representative from its subsidiary fund administrator serve as a director on a fund's board. However, that only applies to the administration side, and no such representation will be allowed on funds that are both advised and administered by the subsidiary. *BBR, 4/26/93, p. 559.*

Disaster Area Relief

The FRB granted temporary relief, as authorized by the Depository Institutions Disaster Relief Act of 1992, from certain provisions of Regulation Z governing waivers by consumers of the right to rescind certain home-secured loans, so that borrowers in disaster-affected communities in Florida, Hawaii, Louisiana, and California can gain easier access to loan funds for emergency purposes. The use of preprinted forms for consumers to waive the right of rescission is permitted, if the home securing the extension of credit is located in the disaster area. A consumer must still provide the creditor with a signed, dated waiver statement that a personal financial emergency exists. The order became effective on November

12, 1992, and expires for the different areas on dates specified. *FR*, 11/12/92, p. 53545.

Money-Laundering Policy Statement

The FRB, as recommended by the FFIEC, issued a policy statement to address the problem of the use of large-value funds transfers for money laundering. To the extent practicable, the FRB is encouraging all domestic banking offices to implement the recommendations of the Financial Action Task Force (FATF) when sending a payment order over any funds transfer system, including Fedwire, CHIPS, SWIFT, and any proprietary networks. The FATF is primarily developing international guidelines to facilitate the identification and prosecution of money-laundering activities, and has developed recommendations to provide more complete information about the parties to a funds transfer. *Press Release and Policy Statement, FRB*, 12/23/92.

Interbank Liabilities

The FRB issued a new Regulation F, implementing Section 308 of FDICIA, to require banks, savings associations, and branches of foreign banks with deposits insured by the FDIC to develop and implement prudential policies and procedures to evaluate and control exposure of their correspondent banks. The rule also establishes a regulatory limit that requires that a bank ordinarily limit its overnight credit exposure to an individual correspondent that is less than "adequately capitalized" to not more than 25 percent of the exposed bank's total capital. Credit exposure to correspondents that are at least "adequately capitalized" is subject to prudential policies and procedures, which go into effect on June 19, 1993. The regulatory limit on credit exposure to an individual correspondent is phased in, with the limit set at 50 percent of the exposed bank's capital for a one-year period beginning on June 19, 1994, and reduced to 25 percent as of June 19, 1995. *Press Release, FRB*, 12/17/92; *FR*, 12/18, p. 60086.

Daylight Overdrafts and Payments System Risk

The FRB is adopting an amendment to its Regulation J to require paying banks that receive presentment of checks from a Federal Reserve Bank to settle for those checks as soon as one hour after receipt of the checks. This amendment is necessary in order to measure daylight overdrafts accurately under the FRB's payments system risk-reduction program. The intent of the program is to reduce both Federal Reserve and overall payments system risk. Effective: October 14, 1993.

The FRB is adopting a policy under which Reserve Banks will charge a fee for average daily intraday overdrafts in reserve and clearing accounts. A fee of 60 basis points (annual rate) multiplied by the fraction of the day Fedwire is scheduled to operate will be phased in over three years (under current Fedwire operating hours the fee will equal 25 basis points (annual rate) when fully phased in). Reserve Banks will deduct from the gross fee an amount equal to 10 percent of qualifying capital valued at the fee for a 10-hour operating day. Fees of \$25 or less in any two-week period will be waived. The intent of the fee is to induce behavior that will reduce risk and increase efficiency in the payments system. Effective: April 14, 1994.

The FRB is adopting new procedures for posting debits and credits to depository institutions' accounts at Federal Reserve Banks in order to measure daylight overdrafts accurately. Accurate measurement of daylight overdrafts is necessary in order to assess fees for the use of Federal Reserve intraday credit. Effective: October 14, 1993. *FR*, 10/14/92, pp. 46950, 47084, 47093.

Netting Eligibility for Financial Institutions

The FRB requested comment on including certain entities under the definition of "financial institution" for coverage by the netting provisions of FDICIA. Parties to a netting contract agree that they will pay or

receive the net, rather than the gross, payment due under the netting contract. The Act provides certainty that netting contracts will be enforced, even in the event of the insolvency of one of the parties. The Act's netting provisions, effective December 19, 1991, were designed to promote efficiency and reduce systemic risk within the banking system and financial markets.

In the FRB's view, the netting provisions should extend to all financial market participants that regularly enter into financial contracts, both as buyers and sellers, where the failure of the participant could create systemic problems in financial markets. The proposal sets out a two-part test for market participants, one regarding the nature of its market activity and one regarding the volume of its activity. *FR*, 5/19/93, p. 29150.

Improved Check Settlement Procedures

New procedures approved by the FRB, effective January 3, 1994, to implement same-day settlement of checks, include: a) primary and alternate presentment point services for payor banks; b) supplementary payor bank information services for checks not collected through the Reserve Banks; and c) a new Fedwire product code to facilitate settlement for checks presented to payor banks directly by private-sector banks. The fee structures for the presentment point and information services will include daily minimum and variable fees. A paying bank will be required to settle for checks presented by 8 a.m. local time at a location designated by the paying bank on the same business day without charging a presentment fee unless it returns the checks before the time for settlement. Regulation CC allows banks to vary provisions of the regulation by agreement. *FR*, 6/3/93, p. 31525; *BBR*, 5/31, p. 794.

Withdrawals From a Priced Service Line

The FRB adopted factors for evaluating Federal Reserve Banks'

requests to withdraw from a priced Federal Reserve service line, effective October 29, 1992. Normally, these factors would be applied after a Reserve Bank determines that it can no longer comply with the FRB's pricing principles. The Monetary Control Act of 1980 requires that fees for Federal Reserve-priced services be established on the basis of all direct and indirect costs, including a Private-Sector Adjustment Factor.

The withdrawal factors are unchanged from the factors proposed by the FRB in July 1992 (see this *Review*, Fall/Winter 1992, p. 44). They are listed as: a) it is likely that other service providers would supply an adequate level of the same service, in respect to access, price, and quality, in the relevant market(s) if the Federal Reserve withdraws from the service; b) if other service providers are not likely to provide an adequate level of the same service in the relevant market(s), it is likely that users of the service could obtain other substitutable services that could reasonably meet their needs; c) withdrawal from the service would not have a material, adverse effect on the Federal Reserve's ability to provide an adequate level of other services, or on the System's ability to discharge other responsibilities; and d) the public benefits of continued Federal Reserve provision of the service do not outweigh the benefits of withdrawing from the service.

If any other public benefit, not addressed under the previous factors, were identified that could be achieved through continued provision of the service, the FRB would consider whether the public benefit outweighed the withdrawal benefits. *FR, 11/6/92, p. 53113; 11/12, p. 53741.*

The FRB approved the Federal Reserve Banks' proposal to withdraw from the priced definitive securities safekeeping service by year-end 1993. This withdrawal eliminates all priced safekeeping, including the safekeeping of definitive securities pledged to state and local governments, but does not affect the safekeeping of collateral

pledged to the discount window, to the Treasury Department, or to Federal Government agencies. Secondary market purchase and sale of securities, which is currently included in the definitive securities service line, will continue to be offered but will be included under another service line after 1993. *FR, 11/6/92, p. 53115.*

Office of the Comptroller of the Currency

Inter-Agency Policy on Credit Availability

The OCC, FDIC, FRB, and OTS announced a program directed at dealing with problems of credit availability, especially for small and medium-sized businesses, involving regulatory and other administrative changes which are summarized in part below.

1. Eliminating Impediments to Loans to Small and Medium-Sized Businesses. Strong and well-managed banks and thrifts will be permitted to make and carry a basket of loans with minimal documentation requirements, consistent with applicable law. To ensure that these loans are made to small and medium-sized businesses, there will be a ceiling on the size of such loans and limits on the aggregate of such loans a bank may make.

2. Reducing Appraisal Burden and Improving the Climate for Real Estate. The agencies will alter their real-estate appraisal rules so as not to require an appraisal by a licensed or certified appraiser for certain loans, when obtaining an appraisal may increase the cost of credit significantly, or cause a loan not to be made, or if the appraisal is counterproductive from a safety-and-soundness perspective. As a matter of policy, loans secured by real estate should be evaluated based on the borrower's ability to pay over time, rather than a presumption of immediate liquidation.

3. Enhancing and Streamlining Appeals and Complaint Processes. Each agency will ensure that its appeals process provides a fair and

speedy review of examination complaints and that there is no retribution against either the bank or the examiner as the result of an appeal. Complaint processes will be reviewed to improve both the care with which complaints are scrutinized and the timeliness of responses.

4. Improving Examination Process and Procedures. The agencies have agreed, in particular, to: eliminate duplication in examinations by multiple agencies, unless clearly required by law; increase coordination of examinations among the agencies when duplication is required; and establish procedures to centralize and streamline examination in multibank organizations.

5. Continuing Further Efforts and Reducing Burden. Under current practice, delinquent loans that have been partially charged off cannot be returned to performing status even when the borrower is able to, and fully intends to, pay the remaining interest and principal to the bank in a timely fashion. The agencies will work to develop common standards for determining when a loan may be returned to accrual status. *All* regulations and interpretations are being reviewed to minimize burden while maintaining safety-and-soundness standards.

The agencies will work to complete virtually all of the changes outlined above within the next three months. Once the specifics of any of the changes are agreed upon, that change will be made and published, before the completion of other changes. *Joint Release, OCC, FDIC, FRB, OTS, 3/10/93.*

The federal regulators of banks and thrifts announced additional initiatives to implement the President's program to improve the availability of credit to businesses and individuals. These initiatives include changes to regulatory reporting requirements and the issuance of joint policy statements on the valuation of real-estate collateral, use of the "Special Mention" category in reviewing loans, and improved coordination of examinations.

Joint Release, OCC, FDIC, FRB, and OTS, 6/10/93.

Inter-Agency Policy on Documentation of Loans

The OCC, FDIC, FRB, and OTS announced further details on the implementation of their March 10 program to increase credit availability. The strongest banks and thrifts, those with regulatory ratings of 1 or 2 and with adequate capital, will now be able to make and carry some loans to small and medium-sized businesses and farms with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital. These loans will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation. Each minimal documentation loan is subject to a maximum loan size of \$900,000 or three percent of the lending institution's total capital, whichever is less. If a borrower has multiple loans in the exempt portion of the portfolio, those loans must be aggregated before the maximum is applied.

The package also offers some relief for banks that do not qualify for the program, and for loans that are not in the exempt portion of a bank's portfolio. The policy statement also includes guidelines which provide institutions some additional flexibility in applying their documentation policies for small and medium-sized business and farm loans without examiner criticism. *Joint Release, OCC, FDIC, FRB, OTS, 3/30/93.*

New Procedures for Identifying Mortgage-Lending Discrimination

The OCC adopted new examination procedures, effective immediately, for use in identifying discrimination in home mortgage loans by national banks. The procedures focus on the way banks deal with a "middle group" of applicants, *i.e.*, not those who are either clearly qualified or unqualified,

but rather applicants who *might* qualify for a loan but had some problem or weakness in their loan applications. The procedures deal only with home mortgage loans, because those are the only loans for which banks are permitted to collect information about the race and national origin of the applicant. In addition, statistical analysis of loan decisions will be developed for use in augmenting the examination procedures at large banks. Also, the OCC will review bank activities to determine how potential borrowers are treated *before* they file a loan application. To that end, a pilot program will employ minority and non-minority "testers" to identify discrimination in the pre-application process. *News Release, OCC, 5/5/93.*

Inter-Agency Group to Study Mortgage-Lending Discrimination

HUD Secretary Henry G. Cisneros and Comptroller of the Currency Eugene A. Ludwig announced the formation of a working group to strengthen efforts to counter discrimination in mortgage lending. The group has 60 days to submit its report. A key feature will be a technology and information exchange. HUD will share with OCC its testing methods learned from its support of private fair housing groups and state and local fair housing agencies. OCC will share with HUD the results of its Home Mortgage Disclosure Act (HMDA) analysis. The HMDA data will be used by HUD to target lenders in three unnamed communities for pre-application testing under the Fair Housing Initiatives Program. The OCC will also be testing lenders to determine the extent of discrimination by mortgage lenders in the pre-application process. Through the working group, HUD and OCC will work to develop an inter-agency definition of what constitutes lending discrimination for purposes of the Equal Credit Opportunity Act (enforced by financial institution regulators) and the Fair Housing Act

(enforced by HUD). *Joint Release, HUD and OCC, 5/18/93.*

New Rule Proposed on Real-Estate Appraisals

The OCC, FDIC, FRB and OTS proposed amending their regulations on real-estate appraisals to reduce regulatory burden. The proposed rule would: a) increase the threshold level for required appraisals from \$100,000 to \$250,000; b) expand and clarify existing exemptions to appraisal requirements; and c) identify additional circumstances when appraisals are not required.

The proposed rule would limit direct and indirect costs of real-estate appraisals to borrowers, costs that the agencies said can restrict the availability of credit. Business loans under \$1 million secured by real estate would not require appraisals when real-estate collateral is not the primary source of repayment. The proposed rule exempts from the agencies' real-estate appraisal requirements transactions that are insured or guaranteed by a U.S. Government agency or government-sponsored agency, and reduces the number of minimum standards for the performance of real-estate appraisals. *Joint Release, OCC, FDIC, FRB, OTS, 5/26/93; FR, 6/4, p. 31878.*

Capital Treatment of Intangible Assets

The OCC amended its risk-based capital guidelines, effective March 29, 1993 to replace certain criteria used in determining qualifying intangible assets with a specific list of qualifying intangible assets. Among the amendments are increasing the limitation on all qualifying intangible assets from 25 percent to 50 percent of Tier 1 capital of which purchased credit-card relationships can consist of no more than 25 percent of Tier 1 capital. Qualifying intangible assets must be valued at least quarterly at the lesser of 90 percent of the fair market value or 100 percent of the

remaining unamortized book value. *FR*, 3/29/93, p. 16481.

Risk-Based Capital: Multifamily Housing Loans

The OCC issued a proposal, implementing RTCRRIA, to permit national banks to hold less capital against certain loans secured by qualifying multifamily residential property, by including such loans in the 50 percent risk-weight category. Certain privately issued mortgage-backed securities (MBSs) would qualify for a 50 percent risk-weight if, at the time of origination of the MBSs, they are secured by qualifying multifamily residential property loans that have performed in accordance with the terms of the loans for at least one year. *FR*, 9/17/92, p. 42901.

Changes in Directors and Executive Officers

The OCC issued a final rule, effective May 10, 1993, which continues the requirement that national banks, within certain specified categories, file notices with the OCC prior to adding or replacing members of their boards of directors or prior to employing individuals as senior executive officers or changing the responsibilities of individuals from one senior executive position to another. The OCC also requested comments on a proposed modification to the definition of change in control. *FR*, 5/10/93, p. 27443.

Prompt Corrective Action

The OCC issued procedures for implementing the "prompt corrective action" provisions of Section 38 of the Federal Deposit Insurance Act, as added by Section 131 of FDICIA. The legislation establishes a system of PCA that classifies insured depository institutions into five categories based on their relative capital levels. Regulations to implement PCA have been adopted also by the FRB, FDIC, and OTS (see this *Review*, Fall/Winter 1992, p. 36). *Banking Circular 268, OCC*, 2/25/93.

Supreme Court Upholds Banks' Power to Sell Insurance in Small Towns

The U.S. Supreme Court overturned a decision by the U.S. Court of Appeals for the District of Columbia that Congress in 1918 had repealed a 1916 law that permits banks in towns not exceeding 5,000 in population to sell insurance.

The case now returns to the Appeals Court for its consideration of a ruling by the OCC in 1986 allowing national banks to sell insurance nationwide from a branch located in a small town. *WSJ*, 6/8/93, p. A4.

The Appeals Court decided that no law prohibits the OCC from permitting the selling of insurance nationwide by national banks in towns with 5,000 persons or less. *AB*, 7/19/93, p. 1.

Securities Offerings Disclosure

The OCC proposed revising its regulations governing the disclosure requirements for offers and sales of national bank securities. Regulations detailing the contents of offering documents covering national bank securities would be eliminated, and instead offering documents would have to contain the information that would be required by the appropriate Securities and Exchange Commission (SEC) form for registration. Also proposed is the cross referencing of certain definitions and exemptions in the Securities Act of 1933 as well as a number of SEC rules. The proposal seeks to treat national bank securities more like those of other corporations and eliminate a duplicative system of regulations and forms. *FR*, 10/15/92, p. 47280.

Procedures for Bank Mergers and Consolidations

The OCC issued an interim rule, effective November 3, 1992, and requested comments on procedures for national banks to follow in undertaking mergers or consolidations with federal savings associations. This action is necessitated by FDICIA,

which authorized such transactions but did not establish procedures.

This authority to merge or consolidate with a federal savings association supplements the long-established authority of national banks to engage in purchase-and-assumption transactions with federal and state-chartered depository institutions, including savings associations, and to merge or consolidate with other national banks and with state-chartered banking institutions, including savings associations engaged in the business of receiving deposits. *FR*, 11/3/92, p. 49639.

Receiverships

The OCC is removing its receivership regulation, effective December 19, 1992. This regulation defines two possible insolvency tests the OCC may consider in determining whether to appoint a receiver for a national bank, these being a "net worth insolvency" test and a "liquidity insolvency" test. Under the regulation, the OCC may also use alternate methods to determine whether a national bank is insolvent. Section 133 of FDICIA provides the OCC, and the other federal banking agencies, with uniform grounds for appointing either a conservator or a receiver. Some of these grounds are similar to, and have the same effect as, the net worth test and the liquidity test in the regulation. *FR*, 12/14/92, p. 58972.

Proposal Would Eliminate Duplicative Reporting, Require Explanation of Mortgage Denials

A proposed rule would eliminate the monthly reports on home mortgage loan activity required for national banks subject to the reporting requirements of HMDA. The rule would require national banks to report the reason for denial of a home mortgage loan. Under the existing regulation, this information is optional. National banks also would be required to update their HMDA loan/application registers within 30 calendar days after a decision is made on a loan application. *News Release, OCC*, 5/10/93; *FR*, 5/10, p. 27484.

Deductions for Tax Losses

The documentation burdens on institutions filing for tax deductions for their loan losses are being reduced under a new procedure. In most cases, institutions have supported their bad debt deductions with internal documentation. Under an agreement announced by the OCC, FDIC, FRB, and OTS, when examiners find an institution's loan-loss classification standards to be consistent with regulatory standards regarding loan charge-offs, examiners are authorized to provide, upon request, a letter to the institution at the conclusion of the examination that expressly states this finding. The IRS will accept these "express determination" letters, enabling banks and thrifts to establish for federal income tax purposes a conclusive presumption of worthlessness for loans that have been charged off for regulatory reporting purposes. *Joint Release, OCC, FDIC, FRB OTS, PR-140-92, FDIC, 10/5/92.*

Office of Thrift Supervision

Encouraging Lending to Low- and Moderate-Income Home Buyers

In a letter to all savings institutions regulated by the OTS, Acting Director Jonathan L. Fiechter discussed steps by the agency and the thrift industry to increase the availability of home loans to low- and moderate-income home buyers.

Director Fiechter said the OTS will do the following:

- a) review the risk profile and profitability of affordable housing lending over the past several years, and identify particular techniques or characteristics that have been associated with successful programs;
- b) develop a specialized program for safety-and-soundness examiners to help them more effectively evaluate and understand affordable housing lending;
- c) continue working with an inter-agency affordable housing task force that is, among other projects, examin-

ing regulatory and other barriers to affordable housing lending;

d) explore methods to better understand the affordable housing lending performance of the thrift industry using HMDA data and other tools;

e) endeavor to improve the CRA examination process and explore how it can be made more objective and focused on lending performance, with particular mention of documentation cost and burden that hinder the delivery of credit to underserved communities; and

f) consult with industry and community groups to solicit ideas and input on OTS' initiatives. *NEWS, OTS, 5/7/93.*

Measures to Improve Credit Availability

In a move to make credit more readily available, the OTS adopted a regulation to reduce the paperwork and make it easier for many small and medium-sized businesses and farms to get loans from savings associations. The regulation implements a policy statement issued by OTS and the other federal banking regulators on March 10, 1993 (see OCC heading). While the rule is effective immediately, the OTS asked for public comment during a 30-day period. *NEWS, OTS, 5/13/93.*

Qualified Thrift Lender Test

The OTS amended its regulations governing the Qualified Thrift Lender (QTL) test to implement changes contained in FDICIA, effective December 19, 1991. The rule lowers thrifts' required "actual thrift investment percentage" (ATIP) of housing-related investments from 70 percent to 65 percent. It also expands the list of items includable as qualified thrift investments (QTI) and increases certain QTI percentage "baskets." The FDICIA amendments also changed the measuring period over which a thrift's ATIP is computed, setting a measuring period of 9 out of every 12 months.

OTS will continue to consider requests for temporary QTL waivers, on a case-by-case basis. An association

seeking such a waiver, however, must demonstrate that it is unable to comply in a timely manner with the new test safely and soundly as a result of national, regional or market sector economic conditions. *Transmittal No. 81, OTS, 3/26/93; FR, 3/19, p. 15082.*

Capital Treatment of Equity Investments

The OTS changed its risk-based capital treatment of certain equity investments to parallel the capital treatment of those investments under the rules applicable to national banks, effective April 19, 1993. Savings associations will no longer be required to deduct certain equity investments from capital and from total assets when computing their risk-based capital. Instead, such equity investments, defined as those that are permissible for both savings associations and national banks, are now placed in the 100 percent risk-weight category. Three types of equity investments most affected by the change are: Fannie Mae stock, Freddie Mac stock, and certain loans with equity participations that give lending institutions a stake in the profits of a property or project. *Transmittal No. 82, OTS, 3/26/93; FR, 3/19, p. 15085.*

Valuation and Regulatory Capital Treatment of Foreclosed Assets

The OTS is revising its policy guidance to require savings associations to use fair value rather than net realizable value for valuing foreclosed assets subsequent to acquisition, effective December 31, 1992. The OTS also is amending its capital regulation to place all assets previously assigned to the 200 percent risk-weight category, including foreclosed assets, into the 100 percent risk-weight category. The changes will make the accounting treatment of foreclosed assets consistent with generally accepted accounting principles as applied by the other federal banking agencies, and the capital treatment of certain items, including foreclosed assets, consistent with that accorded these assets by the other federal banking agencies. *FR, 1/6/93, p. 474.*

Capital: Concentration Risk and Risk of Nontraditional Activities

The OTS solicited comments, pursuant to Section 305 of FDICIA, on amending the agency's capital regulation to take adequate account of concentrations of credit risk and the risks of nontraditional activities. The statute also requires that the OTS develop a final rule on interest-rate risk, which is being treated separately. This initiative is being undertaken on a coordinated basis with the other federal banking agencies.

Among the several issues are what factors should be taken into account in defining concentrations of credit risk for risk-based capital purposes, *i.e.*, industry, geography, collateral, and loan type. Also, how risk-based capital standards should be revised, if at all, to take adequate account of concentrations of credit risk. The agencies' risk-based capital regulations will be amended to explicitly incorporate the risks of nontraditional activities. Among the issues are what the OTS should consider to be a nontraditional activity, and what factors should be taken into account when evaluating the risk of such activities. *FR, 10/5/92, p. 45757.*

Duty Guidelines for Officers and Directors

The OTS issued guidelines dealing with the responsibilities of those who serve as directors and officers of federally insured savings and loan associations. The OTS noted the need for all thrifts to be able to attract and retain experienced and conscientious directors and officers. Similar to the responsibilities owed by directors and officers of all business corporations, they have a duty of loyalty, which requires directors and officers to administer the affairs of the institution with candor, personal honesty and integrity. They are prohibited from advancing their own personal or business interests, or those of others, at the expense of the institution. The duty of care requires directors and officers to act as prudent and diligent

business persons in conducting the affairs of the institution. The OTS said it will not bring civil claims against directors and officers who fulfill their responsibilities and make business judgments on a fully informed basis and after proper deliberation. Claims against directors and officers of thrifts are made following a detailed investigation. In most cases, the OTS attempts to alert proposed defendants in advance of filing claims in order to permit them to respond to proposed charges informally and to discuss the prospect of pre-filing resolution of the proposed claims.

One factor considered in determining whether to bring an action against a director is the distinction between inside and outside directors. The most common claims brought against outside directors either involve insider abuse or situations where the directors were on notice of circumstances existing at the institution that require correction and failed to take steps to implement corrective measures after receiving such notice. *NEWS, and attached Statement, OTS, 11/16/92.*

Loans to Officials and Shareholders of Savings Associations

The OTS amended its regulations pertaining to extensions of credit by savings associations to their executive officers, directors, and principal shareholders, and their related interests. The amendments incorporate the relevant provisions of the FRB's Regulation O. Effective November 5, 1992, the rule limits individual loans to 15 percent of unimpaired capital and unimpaired surplus for loans that are not fully secured, and an additional ten percent of capital and surplus for fully secured loans. The overall lending limit to insiders would be 100 percent of unimpaired capital and unimpaired surplus, but for institutions with deposits of less than \$100 million, the limit could be as high as 200 percent of capital and surplus. The rule states, however, that "simply because a transaction satisfies the quantitative and procedural requirements . . . does not mean that an

insider participating in or benefiting from a transaction has acted in full conformity with his or her fiduciary duties."

The OTS will not adopt at this time an additional rule, also proposed, that would govern business transactions, other than extensions of credit, between savings associations and their insiders. *FR, 10/6/92, p. 45977; BBR, 10/12, p.535.*

Sales of Securities at Savings Association Offices

The OTS adopted amendments to prohibit sales of the securities of a savings association or its affiliates in any office of the association except for sales of stock in connection with the association's conversion from the mutual to the stock form of organization, and subject to certain conditions. One customer safeguard is the use of a signed acknowledgment form before purchase, stating that the securities purchaser is aware that the security is not a deposit or account, is not federally insured, and the purchaser has received an offering circular that describes the offering and its risks. *FR, 10/7/92, p. 46085.*

Operating Subsidiaries and Service Corporations

The OTS adopted regulations, effective November 30, 1992, to authorize federal savings associations to establish and acquire "operating subsidiaries." These subsidiaries may engage only in activities authorized for all federal associations to undertake directly. The conditions are specified under which a federal association may establish an operating subsidiary, certain aspects of the service corporation regulations are clarified, and some restrictions are removed involving loans and other transactions by service corporations. *FR, 10/29/92, p. 48942.*

Appeals Court Reverses Decision on Goodwill

A federal appeals court panel reversed a ruling by a U.S. claims court judge in July 1992 that FIRREA abrogated a contract between the government and Glendale Federal Bank

involving the right of thrifts to count "supervisory goodwill" as capital (see this *Review*, Fall/Winter 1992, p. 48). The claims court had ruled that the government was liable for damages or restitution for the monetary losses and loss of business suffered by Glendale. The appeals court said the lower court incorrectly applied the doctrine of sovereign immunity, and also the thrifts, in their negotiations with regulators, failed to protect themselves from the possibility that Congress would later change the accounting rules. *WSJ*, 5/26/93, p. C18.

OTS Repeals Obsolete Rules

As part of an ongoing program to balance the regulatory burden on the thrift industry with safety-and-soundness considerations, the agency has repealed a number of obsolete rules. Among the changes are: a) the number of directors required for a federal savings association is reduced from seven to five, making the thrift requirement consistent with that for national banks; b) the regulation that governs liability growth is repealed, because current OTS policy incorporates asset growth restrictions that more adequately address a thrift's safe-and-sound operations; c) a requirement that at any one time the average maturity of a federal savings association's portfolio of corporate debt securities may not exceed six years is deleted, because new capital rules and risk management policies better control this risk; and d) a regulation limiting the amount of secured debt that can be incurred by service corporations (subsidiaries) of thrift institutions is no longer needed because current capital requirements are imposed on thrifts and most service corporations on a consolidated basis. *NEWS, OTS*, 1/13/93; *FR*, 1/14, p. 4308.

Supervisory Conversions

Amendments to the agency's regulations generally are expanding the number of capital-deficient, mutual savings associations eligible to undertake voluntary supervisory mutual-to-stock conversions. The rule establishes

required post-conversion capitalization standards, revises the approval standards, and reduces the documentary burden and expense imposed by the current requirement for interim audited balance sheets and certain accounting opinions. Effective: December 2, 1992. *FR*, 11/2/92, p. 49377.

Savings Association Membership in FHLBank System

The OTS adopted a final rule under which, beginning in two years, membership in a Federal Home Loan Bank will no longer be required for state-chartered savings associations. Mandatory membership for federally chartered savings associations and savings banks will remain in effect under existing law. There are now about 1,300 federal S&Ls.

An estimated 600 state-chartered institutions would be able to leave the system, starting in 1995. About 1,300 commercial banks and 25 credit unions have joined the system since they were made eligible by FIRREA. There are also 360 state savings bank members, also voluntary, concentrated in the Northeast. Officials do not expect a mass flight of state-chartered S&L members. It is anticipated that turnover will be light, and 600 or more commercial banks will become members over the next two years. *Transmittal No. 80, OTS*, 3/26/93; *FR*, 3/18, p. 14510; *AB*, 3/19, p. 2.

S&L Charter Conversions Continue

During the last 18 months, 91 state and federal savings and loan associations have switched to savings bank charters (as of Fall 1992). Institutions converting represent about 5 percent of the total number of private-sector thrifts, and their assets aggregating \$18.5 billion are 2 percent of the industry. An additional 30 S&Ls have applications to convert pending at OTS, and another is seeking to change to a commercial bank. These 31 S&Ls have assets of \$5.2 billion. Twenty states and Puerto Rico issue savings

bank charters. Since North Carolina passed a law in 1991, there have been 29 conversions in the state, and 11 are pending. Pennsylvania has had 21 conversions, with eight pending, and in Illinois, 19 with three pending.

The deposits of converted thrifts remain federally insured; however, the institutions would change from being regulated and supervised by the OTS to regulation and supervision by the states and the FDIC. An advantage of the savings bank charter cited by some executives is the option to use "bank" in the name of an institution. Also, the conversion would save the costs of examinations charged by the OTS. For example, for a \$100-million asset S&L, the annual savings on supervisory and examination fees from conversion would be about \$25,000. *AB*, 11/2/92, p. 1.

Study of Thrift Industry Viability

A study by OTS' Research Division examines the expected profitability of thrifts in the future as adjustable-rate and as fixed-rate mortgage portfolio lenders. From 1987 to 1992, thrifts engaged in fixed-rate lending were more likely to earn higher returns than those engaged in other business strategies and were more likely to be among those institutions that consistently performed well over time. However, since then competitive pressures have driven down mortgage lending spreads. The need to control interest-rate risk further reduces the profitability of holding fixed-rate loans. The result is that while properly priced adjustable-rate lending will continue to be profitable, fixed-rate loans held in a thrift's portfolio will continue to be profitable only for lenders with tight cost controls. Stricter management controls over operating costs may achieve the needed results. Otherwise, greater efficiency may have to be realized through the economies of larger scale operations that would result from further industry consolidation. *NEWS, OTS*, 1/5/93; *The Viability of the Thrift Industry*, *OTS*, 41 p., December 1992.

Federal Financial Institutions Examination Council

Report on Regulatory Burden

The FFIEC invited public comment, and conducted a series of public meetings pursuant to Section 221 of FDICIA, in connection with a study of the regulatory burden imposed on insured depository institutions. In its report to Congress in December, the FFIEC said that the four federal banking agencies and the Treasury Department have undertaken extensive reviews of their policies, procedures, recordkeeping and documentation requirements. The Council found that the annual cost of regulatory compliance may be as high as \$17.5 billion, or up to 14 percent of total noninterest expenses of the banking industry in 1991. Over 60 specific initiatives were recommended which the agencies could undertake themselves to relieve individual burden requirements. Those initiatives are in addition to the numerous actions the agencies have taken during the past year. Many aspects of regulatory burden flow not solely from the agencies themselves, but rather are imposed through legislation. The Council's member agencies have agreed to continue meeting to identify and recommend possible statutory changes to reduce regulatory burden further. *Study on Regulatory Burden, FFIEC, 12/17/92.*

Disclosure of Estimated "Fair Values"

Section 121 of FDICIA requires the federal bank and thrift regulatory agencies to develop jointly a method for insured depository institutions to provide disclosures of the estimated "fair value" of their assets and liabilities, to the extent feasible and practicable, as supplemental information in certain reports filed with the agencies. To implement the law, the FFIEC is requesting public comment on whether it is feasible and practicable for banks and savings associations to include supplemental fair value disclosures for their on- and off-balance-sheet assets and liabilities on an

annual basis in their Call Reports and Thrift Financial Reports (TFRs). In particular, comment is requested on the additional costs (both start-up and annual) that individual institutions would expect to incur if they are required to estimate the fair values of their assets and liabilities for purposes of their Call Reports and TFRs.

The FFIEC also sought comment on whether those insured institutions that will be required to file annual reports pursuant to Section 112 should provide supplemental fair value disclosures for their assets and liabilities in these reports, in accordance with a proposed method developed jointly by the regulatory agencies. Section 112 applies to institutions with \$150 million or more in total assets or such higher amount as the FDIC may determine. Under the proposed method, institutions subject to the Section 112 annual report requirement would include in their audited, annual GAAP financial statements the disclosures about fair values of financial instruments that currently are prescribed by FASB Statement No. 107. In addition, supplemental unaudited disclosures about fair values of nonfinancial assets and liabilities would accompany the annual financial statements and would be made by applying the concepts and principles in Statement No. 107 and other relevant GAAP standards. Comment is specifically requested on whether it is feasible and practicable for institutions to provide these disclosures for nonfinancial assets and liabilities in their Section 112 annual reports. *FIL-33-93, FFIEC, 5/3/93; FR, 4/13, p. 19257.*

Policy Statement on Money Laundering

The FDIC, FRB, OCC and OTS adopted a policy statement issued by the FFIEC on the use of large-value funds transfers for money laundering. Historically, law enforcement efforts to curtail money-laundering activities have focused on the identification and documentation of currency-based transactions; however, recent investigations have focused on the use of funds transfer systems. The FFIEC is

encouraging all domestic banking offices to implement recommendations developed by the Financial Action Task Force when sending payment orders over funds transfer systems. FATF is primarily developing international guidelines to facilitate the identification and prosecution of money-laundering activities. Financial institutions should include, to the extent practical, complete originator and beneficiary information when sending payment orders over any funds transfer system, including Fedwire, CHIPS, SWIFT, and any proprietary networks. *FIL-16-93, FDIC, 3/4/93; Press Release, FFIEC, 3/11; FR, 3/17, p. 14400.*

Reporting of Small-Business and Small-Farm Lending

The FFIEC approved annual reporting requirements for insured depository institutions, including banks, thrifts, and U.S. branches of foreign banks, on loans to small businesses and small farms. The requirements, to be effective on the June 30, 1993 report date, would implement Section 122 of FDICIA.

In general, the institutions would be required to report information once each year as of June 30 on the number and amount currently outstanding of: (a) nonfarm nonresidential real-estate loans and commercial loans with original amounts of \$100,000 or less, more than \$100,000 through \$250,000, and more than \$250,000 through \$1 million and (b) agricultural real estate and agricultural loans with original amounts of \$100,000 or less, more than \$100,000 through \$250,000, and more than \$250,000 through \$500,000. Thus, business loans with "original amounts" of \$1 million or less and farm loans with "original amounts" of \$500,000 or less would serve as proxies for loans to small businesses and small farms. *FR, 11/17/92, p. 54235.*

Electronic Funds Transfer (EFT) Systems

The FFIEC issued a statement on the risks associated with switch and network services in retail electronic

funds transfer (EFT) systems. An EFT network is the combination of interconnected terminals and computers that process fund transfers and other electronic messages among participating financial institutions. The switch is the computer system that facilitates the transfer of these electronic messages between the terminals and the appropriate participants. Financial institutions are responsible for ensuring that there are sufficient controls covering switch processing, that contracts adequately define participants' liabilities and responsibilities, and that settlement procedures do not pose undue risk to an institution. The controls are listed that should be in place in an EFT switch or network services environment. Examiners will evaluate EFT switches and network services during the regular supervisory review of each institution. *FIL-30-93, FDIC, 4/29/93; Press Release, FFIEC, 4/7.*

"A Citizens Guide to the CRA"

The FFIEC issued a revised edition of its 1986 booklet that discusses the coverage of the Community Reinvestment Act, policy framework, and requirements in respect to financial institutions and supervisory agencies. It also provides information on how the public can be involved in the CRA process by communicating with their local financial institutions and the regulators, and how the agencies consider public input when acting on applications from institutions. *FIL-73-92, FDIC, 10/19/92.*

National Credit Union Administration

Truth in Savings

The NCUA proposed a new regulation to implement the Truth in Savings Act (TISA). The Act requires all credit unions to disclose fees, dividend (or interest, if applicable) rates and other terms concerning accounts to members or potential members before they open accounts. TISA requires credit unions that provide periodic statements to members to

include information about fees imposed, dividends (or interest, where applicable) earned and the annual percentage yield earned on those statements. TISA imposes substantive limitations on the methods used by credit unions to determine the balance on which dividends are calculated. Rules dealing with advertisements for accounts are also included in the law.

Section 272(b) of TISA mandates that the NCUA's regulations must be "substantially similar" to those issued by the FRB, but the NCUA may take into account the unique nature of credit unions and the limitations under which they may pay dividends. *FR, 11/30/92, p. 56686.*

Court Says Banks Have Legal Standing in NCUA Case

The U.S. Court of Appeals for the D.C. Circuit ruled that banks have legal standing to challenge decisions of the NCUA. Four North Carolina banks and the American Bankers Association had opposed the NCUA's approval of the expansion of AT&T Family Credit Union in Winston Salem, claiming that the decision violated the principle of the common bond. *The Arkansas Banker, 5/93, p.22.*

Reserves

The NCUA is amending its regulations, effective January 21, 1993, to modify the valuation of the allowance for loan losses to better conform with generally accepted accounting principles (GAAP). This change will require credit unions to provide an allowance for loan losses sufficient to cover specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses are probable, but not identifiable on a specific loan-by-loan basis.

Historically, credit unions have established a valuation for the allowance for loan losses based strictly on non-performing or delinquent loans. This practice, however, is inconsistent with GAAP. The NCUA said that greater

emphasis is needed on complying with GAAP through estimating probable losses inherent in the total loan portfolio when calculating a valuation of the allowance for loan losses. *FR, 12/22/92, p. 60720.*

Frequency of Call Reports

The NCUA will require, effective March 31, 1993, federally insured credit unions whose assets exceed \$50 million, to file with the NCUA a quarterly Financial and Statistical Report (the "call report"). All other credit unions will continue to be subject to the current requirement of filing a semi-annual call report. Credit unions whose assets exceed \$100 million as of March 31, 1992 are already required to file quarterly. *FR, 1/22/93, p. 5570.*

Supervisory Committee Audits

The NCUA proposed amending its regulations to require independent annual audits (opinion audits) for federally insured credit unions with assets exceeding \$50 million, and add a nonstatistical sampling option for independent, licensed, certified public accountants in the verification of members' accounts consistent with applicable generally accepted auditing standards (GAAS). The supervisory committee and/or its auditors would be required to provide NCUA the option to photocopy working papers supporting the audit, and failure to do so could result in NCUA rejecting the audit. Sections of the current regulation would also be amended to more properly reflect current accounting/auditing terminology. *FR, 4/6/93, p. 17809.*

Management Official Interlocks

The NCUA proposed amendments to its regulation, pursuant to the Depository Institution Management Interlocks Act, that will affect credit unions having interlocking relationships with another type of financial institution. The changes implement statutorily-mandated exceptions to the prohibitions on management interlocks. These exceptions relate to advisory directors, certain types of

savings associations and savings and loan holding companies, interlocks involving diversified savings and loan holding companies, and the extension of the grandfather period under the statute. *FR*, 3/8/93, p. 12910.

Securities Activities

The NCUA proposed revising its high-risk test for Collateralized Mortgage Obligations (CMOs) and Real-Estate Mortgage Investment Conduits (REMICs). CMOs and REMICs would be subject to an average life test, an average life sensitivity test (currently in use), and a price sensitivity test. The revised test would be consistent with the FFIEC's High-Risk Securities Test (HRST) for mortgage derivatives, which applies to other depository institutions (see this Review, Spring/Summer 1992, p. 51). *FR*, 1/22/93, p. 5664.

Measures to Reduce Regulatory Burden

The NCUA proposed several amendments to reduce regulatory burden: the maturity date of investments not considered risk assets would be extended from three to five years; the dollar value for determining when loans are subject to the business loan regulation to be increased from \$25,000 to \$50,000; recordkeeping requirements for business loans to be made consistent with the proposed definition of member business loans; and the *de minimus* amount for an appraisal performed by a state-certified or licensed appraiser would be increased from \$50,000 to \$100,000. *FR*, 4/26/93, p. 21953.

State Legislation and Regulation

Court Allows CU Common Bond Expansion

Colorado: A Colorado District Court judge ruled that the state District Services Commissioner had the discretionary authority under a state law to grant the 28,500-member Lowry Federal Credit Union a state charter and expanded field of member-

ship that includes the entire 222,000 population of Aurora, Colorado. *ABA Bankers Weekly*, 1/19/93, p. 5.

Branching Decision Suit Dismissed

Illinois: A U.S. District Court dismissed a suit filed by the Community Bankers Association that challenged a decision in November 1992 by the OCC permitting First of America Bank-McLean County, owned by Bank of America in Kalamazoo, Michigan, to convert a recently acquired savings and loan association into branch banks. An official of the state bankers association said the decision will allow national banks to branch statewide, regardless of home office protection, and would put state-chartered banks at a competitive disadvantage. Under the state law, a branch may not be established within 200 yards of the main office of an existing bank in any metropolitan market. *BBR*, 2/22/93, p. 234.

Limit on Deposits BHCs May Control

Kansas: A new law allows a bank holding company to control up to 15 percent of deposits in the state, an increase from the current limit of 12 percent, effective upon publication in the Statute Book.

An official of Fourth Financial Corp., the state's largest bank holding company, said the change would enable the company to add about \$1 billion in deposits to its current total of \$3.8 billion. He noted that 35 states have no such cap, and those having the cap limit control to an average of 18 percent. *BBR*, 4/19/93, p. 537.

S&L Regulatory Agency Abolished

Kansas: The Savings and Loan Department and Office of the Commissioner have been eliminated, and their responsibilities transferred to the Office of the State Bank Commissioner and the State Banking Board, effective June 18. By then the S&L agency's regulatory constituency may have ceased to exist. Of the state's

13 S&Ls, 11 have applied for federal charters, and 2 are expected to be sold. *BBR*, 3/29/93, p. 422.

CUs Must Obtain Deposit Insurance

Massachusetts: The state Banking Commissioner extended for a second time a mandate that all Massachusetts credit unions, including 33 institutions still uninsured, have federal deposit insurance. The uninsured credit unions are expected to be approved for federal deposit insurance, merge with other institutions, or be liquidated and closed by the reset deadline of mid-1993. *The Globe, Boston*, 1/12/93.

Frauds Law

Michigan: A law, effective January 1, 1993, provides that a lawsuit may not be brought against a financial institution to enforce certain promises or commitments unless the promise or commitment is in writing and signed by an authorized signor. *Legislative-Legal Bulletin, Michigan Bankers Association*, 1/13/92.

Court Upholds Out-of-State Export of Credit-Card Fees

Minnesota: The U.S. Supreme Court ruled in favor of defendant banks who claimed the right as national banks to export interest rates permitted by their home states to customers, regardless of the laws of the customers' home states. Minnesota law forbids banks from charging late fees and charges to credit-card holders for overlimits. *The Arkansas Banker*, 2/93, p. 12.

Joint Examination Agreement

Mississippi: An agreement, effective January 1, 1993, between the Department of Banking and Consumer Finance and the FDIC provides that: a) the Banking Department and FDIC will jointly develop a tentative examination schedule annually for the following calendar year; b) the Banking Department will independently examine all state-chartered banks with under \$500 million in total assets on an annual basis; c) the FDIC will conduct annual independent examinations of state nonmember banks with under \$500 million in total assets that

are a cause for supervisory concern as dictated by their CAMEL composite rating; d) the FDIC will conduct independent examinations every other calendar year of state nonmember banks with under \$500 million in total assets that are not a cause for supervisory concern; e) the Banking Department and FDIC will examine concurrently on an annual basis those banks with total assets of \$500 million or more. *The Mississippi Banker*, 1/93, p. 10.

Interstate Banking

Montana: Banks headquartered in the seven-state region surrounding Montana — Idaho, Wyoming, North Dakota, South Dakota, Minnesota, Wisconsin and Colorado — will be allowed to purchase banks in the state on a reciprocal basis, effective October 1, 1993. Banks which can be purchased must have been in existence at least six years. Any out-of-state bank holding company's share of total deposits in the state is limited to 18 percent in 1993, increasing by one percentage point annually to a peak of 22 percent in 1997. The total share of deposits in the state held by banks owned by all out-of-state holding companies cannot exceed 49 percent. *United States Banker*, 5/93, p. 14; AB, 4/14, p. 12.

Banks' Environmental Liability Is Limited

New Jersey: In foreclosures, a new law allows lenders to take any actions necessary to protect a property's value prior to sale without incurring liability for past environmental damage on the property. The lender is shielded provided it did not actively participate in the management of the property prior to foreclosing on it. *BBR*, 5/24/93, p. 762.

Low-Cost Checking

New Jersey: Effective December 1, 1992, all commercial banks, savings banks, savings and loan associations, and most credit unions, in the state are required to offer no-frills, low-cost checking accounts, to be used primarily for personal or household purposes. The required account has a \$50 initial deposit, a minimum balance

thereafter of \$1, eight free checks per month, with additional checks charged at 50 cents per item. Institutions that already offer a low-cost account are permitted to ask the Banking Department to approve such accounts based on their consistency with the general purposes of the state's new consumer banking laws. *The Star Ledger, Newark*, 12/12/92.

Foreign Banking Regulations Proposed

New York: The Banking Department proposed regulations which include a requirement that representative offices of foreign banking corporations be licensed, examined, and supervised by the state. All currently registered REP offices would have to be licensed by September 1994, and all new offices licensed immediately. Included in the activities permitted to REP offices would be the solicitation of loans, and executing loan documents for loans of \$1 million or more, but they would be prohibited from engaging in certain activities, among which are trading activities for the account of the foreign corporation, approving loans, executing loan documents for loans of less than \$1 million, and disbursing or transmitting funds. Factors to be considered by the Banking Superintendent in acting on applications to establish and maintain branch, agency or REP offices are specified. *BBR*, 11/23/92, p. 718.

Equity Investments in Community Projects

New York: Under a state Banking Department proposal, N.Y. state banks and trust companies would be permitted to make real-estate equity investments in community development projects that serve a public purpose. Investments in a single project could not exceed two percent of the bank or trust's capital stock, surplus, and undivided profits. Total investments in all community development projects could not exceed five percent. *BBR*, 11/9/92, p. 662.

Law Eliminates Depositor Priority Claims in State Bank Failures

Texas: The Governor signed legislation requiring all creditors to be treated equally when a state-chartered bank fails. Claims for payment against a failed state institution will have the same priority as such claims would have in a national bank failure under federal law. Before the new legislation, the claims of a state bank's depositors were given a priority status. This is said to have become detrimental to state banks and their creditors, because the FDIC used the priority list to prevent payments to some creditors, particularly those who had sold federal funds to the failed banks. *BBR*, 4/5/93, p. 463.

Bank and Thrift Performance

Commercial Banks' Earnings Set Record in First Quarter

Insured commercial banks earned \$10.9 billion (preliminary) in the first quarter of 1993, a record total for a quarter. Industry profits were \$3.3 billion higher than a year earlier, and \$2.4 billion above the previous quarterly record set in the third quarter of last year. For the year 1992, insured commercial banks earned \$32.2 billion, also a record high.

The FDIC cited for the first quarter three main causes for the strong earnings performance: 1) asset quality improvement, leading in part to lower provisions for loan losses; 2) continued wide net interest margins; and 3) the adoption for regulatory reporting purposes of generally accepted accounting principles that permit the recognition of larger amounts of "deferred tax assets," the effect being a one-time increase in reported income.

The average return on assets (ROA) in the first quarter rose to an annualized 1.24 percent for insured commercial banks, and excluding the accounting gains and other nonrecurring transactions was 0.96 percent — also a record high. The earnings

results were broad-based, as banks grouped by geographic region and by asset size all averaged ROAs above one percent. Almost two out of every three banks reported higher earnings than a year ago, and only one out of every twenty banks was unprofitable. Most of the growth in commercial bank assets in the quarter consisted of mortgage-backed securities, which increased by \$16.8 billion, and in U.S. Treasury securities, which grew by \$9.9 billion. Total loans held by commercial banks declined for the eighth time in the last nine quarters.

Savings banks insured by the BIF experienced their fifth consecutive profitable quarter following three unprofitable years. Nearly 96 percent of firms in the industry were profitable, up from 87 percent in the previous quarter. First-quarter net income of \$517 million was 34 percent above the previous quarter. Improved profitability resulted from lower non-interest expenses, an increase in nonrecurring extraordinary gains, and lower loan-loss provisions. The industry's return to profitability is attributable also to FDIC's resolution of troubled institutions. The industry continues to downsize through unassisted mergers and acquisitions. As of March 31, 1993, BIF-insured savings banks held \$202.7 billion in assets, down by 6 percent in the quarter. *PR-64-93, FDIC, 6/9/93; PR-18-93, 3/9; FDIC Quarterly Banking Profile, First Quarter 1993, Fourth Quarter 1992.*

S&Ls Continue Strong Financial Performance

The nation's private-sector savings and loan associations earned over \$1.7 billion in the first quarter of 1993, representing a return on assets (ROA) of 0.96 percent. These institutions earned a record \$5.1 billion in the year 1992, up from \$1.8 billion in 1991. The thrifts' continuing profitability for nine consecutive quarters reflects primarily the favorable interest-rate spreads and decline in troubled assets. The interest-rate spread, 3.02 percent in the first quarter, has steadily increased over the past two years. Troubled assets declined by \$10.4

billion over the past year to \$20.9 billion, or 2.85 percent of assets.

The thrift industry continues to shrink, as the number of private-sector S&Ls declined to 1,802 on March 31, 1993 from 2,064 a year earlier. Total assets held by these institutions were \$738 billion at the end of March, down from \$859.8 billion on the 1992 date. Ninety-six percent of the 1,802 thrifts met the capital standards set by FDICIA, including 84 percent rated "well-capitalized." Only 68 thrifts, or less than 4 percent, failed the standards in the first quarter, including 12 rated "critically undercapitalized."

OTS Acting Director Jonathan L. Fiechter said thrifts have maintained their asset holdings in traditional lending activities in 1-to-4 family and multifamily mortgages, mortgage-backed securities and consumer loans, and there is no evidence of a major shift out of thrifts' traditional lending channels into government securities. *NEWS, OTS, 3/11/93; 6/17.*

Mr. Fiechter said that 183 thrifts, with nearly 16 percent of the assets of private-sector thrifts, are on the agency's problem list. While most of these remain solvent, 75 percent are losing money. He expressed concern over the number of problem thrifts, and that so many of these are losing money, in the current favorable economic environment. *AB, 6/18/93, p. 2.*

HMDA Data Not Adequate on Banks' Mortgage Lending to Minorities, Report Says

A Consumer Bankers Association official said that Home Mortgage Disclosure Act data released by the FRB does not capture the recent progress that banks have made in their mortgage lending to minorities and low- to moderate-income consumers. According to HMDA statistics available in late October 1992, mortgage lending disparities did not change much in 1991, compared to 1990, when the FRB began releasing the data. However, many banks' programs are too new to be adequately reflected in these figures, the official said. Also,

the programs have been held back by the recession, and also possibly distorted by the surge of conventional mortgage refinancing.

The CBA surveyed its membership of banks, holding companies, and thrifts for 1991 and the first half of 1992, receiving information from 140 large and medium-size institutions on their minority and low- to moderate-income mortgage lending programs. Of the responding institutions, 91.4 percent had such programs. Of these, 94.5 percent offered special affordable mortgage products that were more flexible or more affordable to help applicants qualify. Over three-fourths of the lenders had enhanced marketing plans targeted at minority and low-income groups. Among other results of the survey, over 86 percent of lenders have a policy requiring an automatic review of rejections, typically by senior officers. This is of particular interest in view of the study by the Federal Reserve Bank of Boston (see relevant discussion under the heading entitled Recent Articles and Studies) showing the strong role played by judgment in the approval process. *Affordable Mortgage Survey, Consumer Bankers Association, June 30, 1992; BBR, 11/2/92, p. 629.*

1992 Was Good Year for Credit Unions

Deposits in the nation's federally insured credit unions grew 13.6 percent in 1992, the highest rate of growth in five years. Reserves increased at a faster rate — 20.6 percent — bringing capital to a record high of 8.1 percent. The loan portfolio grew at a rate of 5.0 percent in 1992, and the loan-to-share ratio was 60 percent on December 31.

Net earnings after reserve transfers for the nearly 13,000 federally insured credit unions rose 73 percent, to \$3.1 billion from \$1.8 billion in 1991. Delinquencies declined 16 percent to 1.3 percent at year-end, down from 1.6 percent in 1991.

Shares in troubled credit unions also declined as a percent of total insured shares, from 4.2 percent in 1991

to 2.8 percent. The 1992 ratio is less than one-third of the 6.3 percent in 1988. The number of troubled credit unions was 608 on December 31, 1992, down from 683 in 1991 and 1,022 in 1988. The National Credit Union Share Insurance Fund currently has an equity ratio of 1.26 percent. *NCUA NEWS, 2/16/92.*

Credit Union Interstate Services Network

Credit unions in 12 states will provide services to each other's customers, beginning July 1, 1993. In effect an interstate branching system, the network is expected to serve 6 million customers in 450 credit unions. States already in the network are New York, New Jersey, Pennsylvania, Virginia, North Carolina, Georgia, Tennessee, Alabama, Florida, Illinois, Louisiana, and Colorado. This will be a much more extensive sharing of interstate facilities between credit unions than has occurred previously. In Michigan, California, and Texas, credit unions have serviced each other's customers for a number of years. An NCUA official said the network does not face any regulatory obstacles. Federal law permits credit unions to share facilities. *AB, 6/8/93, p. 1.*

Recent Articles and Studies

Effects of "Prompt Corrective Action" on the Bank Insurance Fund (BIF)

A provision of FDICIA requires supervisors of depository institutions to impose limits on the activities of institutions with relatively low capital ratios, and if their ratios fall below some critical level to close the institutions promptly. In this article, R. Alton Gilbert considers the likely effects of prompt corrective action (PCA) legislation on BIF losses resulting from the failure of commercial banks.

The argument for PCA legislation is said to rest on several assumptions. First, depository institutions have an incentive to assume greater risk as their capital ratios decline. Also, the

longer an institution operates with a low capital ratio, the greater its opportunity to act on incentives to assume risk. Supervisors have been ineffective in limiting the risk assumed by poorly capitalized institutions. The insurance fund losses due to the failure of individual institutions reflect, to some extent, the risk assumed by these institutions after they became poorly capitalized. Finally, the actions mandated for supervisors in the legislation will constrain the risk assumed by poorly capitalized institutions, thereby limiting insurance fund losses if they fail.

The study utilizes a sample of 854 banks that failed in the years 1985-1990. Most of the banks were relatively small, and concentrated in certain regions. The evidence is found not to support the claimed relationship between the length of time an institution operates with a low capital ratio before failure and the BIF loss. The findings, instead, support a view that in recent years, supervisors have been effective in constraining the risk assumed by poorly capitalized banks. These results raise doubts about whether PCA legislation will reduce BIF losses. *Review, Federal Reserve Bank of St. Louis, July/August 1992, pp. 3-22.*

Derivative Instruments Source of Risk Concerns

This report, which was prepared for the central banks of the Group-of-Ten countries, focuses on the role and interaction of banks in non-traditional markets, notably the markets for derivative instruments, and linkages among various segments of the interbank markets and among the participants, and associated risk concerns.

The report observes that the changing nature of international interbank operations has significantly altered the risk environment facing banks. The participation in wholesale markets by entities subject to few disclosure requirements, as well as the growth of off-balance-sheet activities more generally (adequate details of which are rarely disclosed), has made the assessment of counterparty risks considerably more difficult. The complexity

of risks encountered in banks' derivative operations also presents major challenges. So does the management of the large intraday credit exposures and settlement positions that have arisen as a result of the increase in wholesale market trading. Cash liquidity and market liquidity risks have also become more problematic for a number of participants. Market risk, by contrast, is said to be more manageable now than in the past, owing to the efforts that firms have made in recent years to control these risks through the use of derivative instruments and other techniques. Market risks also are priced more easily than other risks.

The report calls in particular for management awareness and understanding, at all levels, of the risks being taken on by their institutions. Greater attention than in the past should be paid to the risk exposure from problems at institutions or in markets on which they rely heavily. Firms must develop contingency plans for dealing with such circumstances.

In respect to measures to strengthen the institutional underpinnings of wholesale markets, there is scope for enhancing netting schemes. Properly designed netting arrangements can reduce risks associated with a given level of activity. Market participants and central banks should encourage efforts aimed at improving and achieving some harmonization of accounting and reporting practices with respect to off-balance-sheet instruments. To the extent possible, development of accounting guidelines should be done in an internationally coordinated manner. Ways of making public disclosure of financial positions more meaningful should also be undertaken. Continuing cooperative efforts are needed to resolve uncertainties with respect to the laws affecting financial markets in individual countries and the application of various laws to international financial activities. Also, there is a strong need for better, more comprehensive and more meaningful statistics concerning derivative markets and the involvement of banks and other financial institutions

in them. *Recent Developments in International Interbank Relations, Bank for International Settlements, October 1992.*

A report by Standard & Poor's Corp. concluded that trading in swaps and options is less risky, and less capital is required, than for bank lending. *AB, 11/9/92, p. 1.*

Regulatory Costs to Community Banks

A study conducted in 1992 for the Independent Bankers Association of America analyzed the costs of compliance with regulatory areas that were considered to be the most burdensome by community banks. Community banks are defined as locally owned and operated institutions. The study focused on 13 regulatory areas. It did not extend to other areas of regulation or to institutions other than community banks, and also did not consider any of the additional regulatory requirements imposed by FDICIA.

The annual cost for community banks to comply with the 13 regulatory areas is estimated at \$3.2 billion, representing 24 percent of the banks' net income before taxes, and requiring an estimated 48 billion annual compliance hours. These results, the study says, substantiate a report by the FFIEC (see FFIEC section, above) suggesting that the annual cost to all banks of regulatory compliance may be as high as \$17.5 billion, and that the regulatory burden is greater for smaller banks. Smaller banks were found to experience the highest compliance cost in relation to total assets, equity capital and net income before taxes. Banks with assets under \$30 million incur almost three times the compliance cost per \$1 million in assets compared to banks in the \$30-65 million-asset range, and four times the cost ratio of banks with over \$65 million in assets.

The most burdensome regulatory area identified was the Community Reinvestment Act (CRA), which costs community banks annually approximately \$1 billion and 14.4 million employee hours. CRA compliance costs

the average community bank about \$1,256 for each \$1 million in total assets. The least expensive of the 13 categories was HMDA, which costs community banks an aggregate \$17.4 million annually. On a scale from least beneficial and useful to most beneficial and necessary, banks rated the 13 categories as follows: 1) CRA, 2) HMDA, 3) Geocoding-Geographic Loan Coding, 4) Expedited Funds Availability Act, 5) Real Estate Settlement Procedures Act, 6) Truth in Lending, 7) Bank Secrecy Act, 8) Equal Credit Opportunity Act, 9) Loans to Insiders, 10) Appraisal Requirements, 11) Formal Written Policies, 12) Call Reports, and 13) Regulatory Examinations. *Regulatory Burden — The Cost to Community Banks, Independent Bankers Association of America, January 1993.*

A study sponsored by the University of Wisconsin found that by eliminating unnecessary paperwork in connection mainly with the Community Reinvestment Act, Truth in Lending Act, and the Equal Credit Opportunity Act, banks could save enough to lower their loan rates by a percentage point. Almost one-fifth of surveyed banks said that CRA concerns had caused them to restrict product offerings. The study emphasizes the need for further research on the benefits to the public of the voluminous consumer disclosures currently required. Using a cost-estimation method that takes account of certain offsetting financial and social benefits, the study puts the costs of banks' compliance with 15 consumer protection and public-interest rules at 13.6 percent of pre-tax income in 1991. *AB, 4/6/93, p. 1; 4/16, p. 6.*

Racial Discrimination in Mortgage Lending

This study, by Alicia H. Munnell, Lynn E. Browne, James McEneaney and Geoffrey M. B. Tootell, explores the factors affecting the decision to approve or deny mortgage applications, using data obtained from a sample of financial institutions operating

in the Boston Metropolitan Statistical Area (MSA).

In a previous study in 1989, the Federal Reserve Bank of Boston examined the pattern of mortgage lending in the City of Boston and found that the number of mortgage originations relative to the owner-occupied housing stock was 24 percent lower in black neighborhoods than in white neighborhoods, after taking account of economic variables such as income, wealth, and other factors. That study, however, could not distinguish between discrimination in the housing market and discrimination in the mortgage market. This new study was made possible by amendments to the HMDA in 1989 which require lenders to report not only the location of loans actually made, but also the sex, race, and income of individual applicants and whether the application was approved or denied.

The Federal Reserve Bank of Boston, with the support of the other supervisory agencies, asked financial institutions operating in the Boston MSA to provide additional information on the variables that lenders have said they consider in the mortgage lending decision. This information was requested for applications for conventional mortgage loans in 1990. The study found that minority applicants, on average, have greater debt burdens, higher loan-to-value ratios, weaker credit histories, and they are less likely to buy single-family homes than white applicants, and that these disadvantages do account for a large portion of the difference in denial rates. Including the additional information on applicant and property characteristics reduces the disparity between minority and white denials from the originally reported ratio of 2.7 to roughly 1.6 to 1. The adjusted ratio implies that even after controlling for financial, employment, and neighborhood characteristics, black and Hispanic mortgage applicants are roughly 60 percent more likely to be turned down than whites.

The survey confirms a perception that a good application will seldom

be rejected simply because the applicant is a member of a minority group. However, the majority of borrowers, both white and minority, are not perfect, and lenders have considerable discretion over how they take account of these imperfections. For the same imperfections, whites seem to enjoy a general presumption of creditworthiness that black and Hispanic applicants do not, and lenders appear to be more willing to overlook flaws for white applicants than for minority applicants. Denied applications by blacks and Hispanics in most cases in the study had poorer objective qualifications than for whites' denials. As a result, a systematic bias in mortgage lending is very difficult to document at the institution level, particularly when the number of minority applications is small, as it is in the vast majority of cases. Thus, under existing examination procedures, examiners can be expected to uncover only the most flagrant abuses.

The study abstracts from discrimination that may occur elsewhere in the economy. For example, if minorities are subject to discrimination in education or labor markets, they will have lower incomes, and other loan-decision variables may be less favorable. Also, differential treatment may occur at many stages in the lending process, for example, minorities may be discouraged from applying for a mortgage loan as a result of a pre-screening process. Similarly, if blacks or Hispanics, when compared to whites, receive less "coaching" when filling out an application, they are likely to have a poorer application. *Mortgage Lending in Boston: Interpreting HMDA Data, Federal Reserve Bank of Boston, Working Paper No. 92-7, October 1992.*

Cross-Lender Variation in Home Mortgage Lending

This research by Robert B. Avery, Patricia E. Beeson and Mark S. Sniderman shows that for over 9,000 HMDA-reporting lenders that accounted for nearly 2 million home-purchase loan applications in 1990, 14 percent of applications and 12 percent of loans were associated with minority

applicants. However, about 40 percent of all the lenders reported no minority applications that year. Half of the lenders originated 8 percent or fewer of their loans to minorities, while one-fourth extended more than 18 percent.

Previous studies, such as a report published by the Federal Reserve Bank of Boston (see above), have centered primarily on the minority/low-income applicants for credit, and the actions taken on their applications. This more recent study concludes that for the U.S. as a whole, the variance across lenders in either minority or low-income originations, relative to total originations, is overwhelmingly accounted for by the variance in application rates, not by actions taken on the applications. The data show that differences across lenders in either their application flows or approval processes cannot be accounted for by variations in clientele or loan products. Also, only a small portion of the disparity can be explained by differences in the type of loan being sought (loan size, FHA/VA *versus* conventional, *etc.*), or by applicants' personal characteristics as recorded in the HMDA data (income, gender, co-applicant, *etc.*), or by geographic market served.

Lenders operating in the same market and who have high minority application rates are found to draw their relatively larger volume of minority business from a broad range of neighborhoods, rather than from predominantly minority areas alone. They may receive a relatively large proportion of minority applications as a result of aggressive promotion and product development. Although such institutions may have a relatively high minority-to-white denial ratio, actually they may be community leaders in credit originations to minority applicants. The Community Reinvestment Act, the authors emphasize, requires lenders to do more than simply grant credit on equal terms to similarly situated applicants. The law encourages banks to seek out lending

opportunities throughout their community, and to develop products and programs that meet the needs of diverse groups of people. *Federal Reserve Bank of Cleveland: "Cross-Lender Variation in Home Mortgage Lending," Working Paper No. 9219, 55 pp., 12/92; Economic Commentary, 2/12/93.*

Are Banks Departing "Traditional" Lender Role?

This article, by Jonathan A. Neuberger, notes that as a result of the recent rise in banks' holdings of government securities, their portfolios now hold a larger amount of securities than business loans. Since the start of the most recent recession in mid-1990, to the third quarter of 1992, banks' loans rose less than 3 percent, and business loans *fell* by over 4 percent, while securities, largely U.S. Government, increased by more than 30 percent. These developments have led to criticisms that banks have departed from their "proper" role of lending to consumers and to small and medium-sized businesses.

Several trends and cyclical movements are seen in the changing composition of banks' assets. In the early 1950s, securities made up almost half of total bank financial assets, and by the mid-1970s had fallen to about one-quarter. A more gradual decline occurred over the next several years followed by the more recent uptrend. Contrary to an often-heard view, the drop in the share of business loans in bank portfolios is not solely a recent occurrence, having started in the 1980s. By the third quarter of 1992, the share was less than 22 percent. The decline has reflected the increasingly competitive market for short-term business loans, as banks lost market share to nonbank financial institutions, and the rapid growth in the markets for commercial paper and other forms of "nonintermediated debt." Another trend is the steady rise in mortgage loans, as mortgages increased from less than 10 percent of banks' assets in 1951 to over 25 percent in 1990.

Business loans as a proportion of total bank assets typically decline during recessions and rise during expansions. Compared to earlier post-World War II business cycles, the recent experience differs in that the proportion of business loans fell more and the share of securities rose more than in the previous decades. The current weakness in business loans appears to be partly a continuation of the longer-term decline noted above. Among the explanations for the unusual weakness in the most recent recession are a lower than normal economic recovery and concerted effort by businesses to restructure their balance sheets from the debt overhang of the 1980s. There is evidence that regulatory capital standards have become more stringent and have had a constraining effect on loan growth. Loan-loss exposures and high problem-loan ratios may have made banks more cautious in their lending. A typical feature of earlier recessions was disintermediation as deposits left the banking system when market interest rates rose above Regulation Q ceilings. These ceilings were abolished in the early 1980s. In the most recent cycle, while banks allowed large CDs to run off, so-called core deposits stayed in the banking system. Faced with extremely weak loan demand, banks may have decided to invest these funds in safe and relatively lucrative government securities. *Weekly Letter, Federal Reserve Bank of San Francisco, March 19, 1993.*

Licensing of Financial-Services Institutions Proposed

This paper, by Jane W. D'Arista and Tom Schlesinger, proposes a system of reforms for the unregulated "parallel banking system." The larg-

est single group of unregulated intermediaries, in terms of their assets and size of individual companies, are finance companies. They function like banks, but with virtually no regulatory costs. Finance companies need not comply with capital and reserve requirements, limits on loans to single borrowers, or limits on transactions with parents and affiliates. They are not bound by community investment demands under CRA or the restrictions of the Glass Steagall Act, and they can operate nationwide.

By blanketing the parallel banking system with fee-generating guarantees, the banks also have exposed the central bank to a contingent liability domino effect of major proportions. Not only does the parallel system stretch the central bank's lender-of-last-resort function, it also may compromise its ability to implement monetary policy. A shift in lending from banks to the parallel system distorts the distribution of credit. Rising levels of institutional concentration have made it more difficult for the financial system to assist the development of small, innovative companies and processes that will help ease the disruptions caused by declining older firms and methods. The lack of capital and credit for smaller enterprises stems not only from growing institutional concentration but also from shrinking levels of competition in local lending markets.

The authors propose the establishment of a financial industry licensing system, under which all parallel-banking-system firms would be required to be licensed and to comply with the same major regulations in respect to soundness. Uniform licensing requirements would be applied to any such entity that directly accepts funds from the public for investment,

makes loans to the public or buys loans or securities using funds other than its own equity capital and retained earnings, or sells loans or third-party securities to financial institutions or investors. In respect to direct public guarantees, it is recommended that the aggregate savings of individuals be insured up to a given amount, regardless of where they are placed, rather than insuring single accounts or entire financial firms.

While the licensing proposal departs from the direction of most recent policy debates and initiatives, it has a precedent from the not-so-distant past. In 1980, responding to a Presidential directive issued under the Credit Control Act, the Federal Reserve System implemented a credit restraint program that went beyond the banking system and the usual boundaries of its scope of action. The program included a special deposit requirement of 15 percent on all extensions of consumer credit through credit cards, and certain other loans. This deposit requirement applied to all consumer lenders, not just depository institutions, and it was extended to money-market mutual funds.

The recommended approach to regulatory equality could be administered by a single regulator or regulators, whose mission is defined by industry segments, or by function. In addition, enhanced self-regulation should become a vital part of any movement toward regulatory equality. The elements of the securities industry's self-regulating organizations that have been proven successful could serve as a model. The obligation to self-regulate should supplement, not substitute for, the supervisory power of independent regulators. *The Parallel Banking System, Economic Policy Institute, 45 pp., 1993.*