

FDIC Banking Review

Fall/Winter 1992

Vol. 5, No. 2

Acting Chairman
Andrew C. Hove, Jr.

Division of Research
and Statistics,
Director

Wm. Roger Watson

Editor

George E. French

Editorial Committee

Frederick S. Carns

Gary S. Fissel

Arthur J. Murton

Administrative
Manager

Delta Voesar

Editorial Secretary

Cathy Wright

Design and Production
Graphics and Distribution

Table of Contents

Bank Failure Resolution, the Cost Test and the Entry and Exit of Resources in the Banking Industry

by Frederick S. Carns and Lynn A. Nejezchleb

page 1

FDIC cost considerations determine the "minimum acceptable bid" for a failed-bank franchise. In competitive markets, however, the decision whether to continue operations depends upon franchise value alone. Thus, for example, the FDIC's statutory cost test may dictate a purchase-and-assumption transaction, even for an institution with negative franchise value. Using failed-bank data, the authors find that the cost test may have interfered with efficient resource adjustment in a sizable percentage of recent cases. While this conflict cannot be completely avoided, the authors argue that a more explicit consideration of resource-adjustment effects could help to strike an appropriate balance between the conflicting policy objectives.

The Bank Insurance Fund: Trends, Initiatives, and the Road Ahead

by Panos Konstas

page 15

The changes to the financial condition of the Bank Insurance Fund (BIF) that have occurred over the past decade and the recent measures taken to restore the BIF to financial viability are discussed in this article. The author recommends that a "moving-average" approach to assessment policy be implemented after the BIF reserve reaches its target ratio of 1.25 percent of insured deposits.

Acquisitions of Failed-Bank Deposits: In-Market vs. Out-of-Market Cost Effects

by Neil B. Murphy

page 24

Banks seeking to acquire an insured-deposit franchise from the FDIC establish their bids based upon expected net future earnings from the acquisition. Does a high bid from an in-market bank reflect cost efficiencies or gains from reducing the number of competitors in the market area? Using standard econometric techniques and simulations of specific transactions, the author finds that in-market bidders who close redundant branches can achieve substantial cost efficiencies. While there may not be economies of scale as a bank expands, there appear to be economies of scale as the typical branch expands.

Recent Developments Affecting Depository Institutions

by Benjamin B. Christopher

page 34

This regular feature of the *FDIC Banking Review* contains information on regulatory agency actions, state legislation and regulation, and articles and studies pertinent to banking and deposit insurance issues.

The views expressed are those of the authors and do not necessarily reflect official positions of the Federal Deposit Insurance Corporation. Articles may be reprinted or abstracted if the *FDIC Banking Review* and author(s) are credited. Please provide the FDIC's Division of Research and Statistics with a copy of any publications containing reprinted material.

Single-copy subscriptions are available to the public free of charge. Requests for subscriptions, back issues or address changes should be mailed to: *FDIC Banking Review*, Office of Corporate Communications, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

Bank Failure Resolution, the Cost Test and the Entry and Exit of Resources in the Banking Industry

by Frederick S. Carns and Lynn A. Nejezchleb*

Introduction

Between year-end 1986 and 1991, the FDIC closed or assisted over 900 commercial banks with assets totaling about \$170 billion. That amount is roughly twice the total failed-bank assets handled by the FDIC during the previous 53 years of the Agency's existence. Stated differently, in just five years more than five percent of the banking industry's total assets moved through the FDIC's failure-resolution process.

With numbers like these, it is little wonder that the failure-resolution process is receiving considerable attention. Most of this attention has focused on the costs of bank failures, as reflected in the Bank Insurance Fund balance. A number of interested persons have pointed to closure policies that provide *de facto* insurance to uninsured depositors or to the lack of timely closures of insolvent institutions as being primarily responsible for high insurance losses.

Another area of attention concerns the effects of the failure-resolution process on the remaining financial institutions. Frequently, banks complain that the failure-resolution process creates unfair competitive advantages for the acquirers of failed banks.¹ A few

studies have looked at the effects of the FDIC bidding procedures for failed banks on the winning bidders.² A general question addressed in these studies is whether the FDIC's auction procedures result in wealth transfers from the insurance fund to the acquirers of failed banks. While the findings have been mixed, the studies suggest that competitive bidding procedures would ensure that the FDIC receives the highest revenues and, at the same time, would eliminate possible subsidies to the acquirers of failed banks, thereby eliminating any unfair advantages over surviving competitors.

These two aspects of failure resolution — the cost of failures to the insurance fund and their effect on the acquirers and remaining market participants — are two sides of the same coin. The sale of a failed-bank franchise has implications for both the insurance fund and the remaining financial institutions in the affected market.

The sale of any failed firm's franchise is the result of an interaction between sellers and buyers. The sale of a failed-bank franchise, however, involves a unique restriction on the seller. The minimum price the FDIC

will accept must meet a statutory cost test. The cost test requires that the minimum acceptable bid be such that the cost of a franchise sale is less than the cost the FDIC would incur if it paid off only the insured deposits and liquidated the assets itself.³

*The authors are Senior Economist in the Division of Research and Statistics and Special Assistant to the Vice Chairman of the FDIC, respectively. The authors thank Thomas Yeatts for expert research assistance and John Bovenzi, Gary Fissel, George French, Alton Gilbert, Eric Hirschhorn, Arthur Murton, participants in the Office of Thrift Supervision's Seminar Series and the staff of the FDIC's Division of Research and Statistics for valuable comments and suggestions. An earlier version of this paper was presented at the Federal Reserve Bank of Chicago's 1992 Conference on Bank Structure and Competition.

¹For example, in an *American Banker* article this was referred to as a "survivor's hell." See "Recapitalizing Failed Banks Creates a 'Survivor's Hell'," *American Banker*, 3 January 1991, p. 4. Also see "FDIC's Hospital Plan a Bitter Pill for Some," *The Washington Post*, 1 March 1992, p. H1.

²See, for example, Christopher James and Peggy Wier (1987), and John O'Keefe (1992).

³In addition, the FDIC Improvement Act of 1991 (FDICIA) introduced an additional requirement. A sale of the failed-bank franchise must not only be less expensive than a payoff, it must also be the least expensive type of franchise sale. See Footnote 4 for a more complete explanation.

In calculating the minimum acceptable bid, the FDIC must estimate the costs of liquidation and the losses that would be borne by uninsured depositors if the institution were paid off and liquidated. But, in bidding for a failed-bank franchise, neither the FDIC's liquidation costs nor the distribution of losses between the uninsured depositors and the FDIC are a direct concern to potential acquirers. Instead, bidders are concerned with the failed bank's potential franchise value, *i.e.*, its potential income stream relative to market returns.

This study argues that the FDIC's statutory cost test may encourage the acquisition of failed banks with negative franchise value and may discourage the acquisition of failed banks with positive franchise value. If the FDIC estimates that its liquidation costs are high under a payoff scenario, high relative to the costs an acquirer would incur if the assets were resolved in the acquired institution and high relative to the losses that would be shared with uninsured depositors, then cost considerations may cause the FDIC to subsidize the acquisition of a negatively valued franchise in order to avoid its potential liquidation costs. On the other hand, if the losses that would be shared with uninsured depositors are large relative to any cost differences between the FDIC and a potential acquirer, then the FDIC may require a minimum bid that acts as a tax on a positively valued, failed-bank franchise. As a result of these cost considerations in handling failure resolutions, adjustments in particular banking markets to over- or underbanking may be impeded. In effect, this study argues that there is an inherent conflict between the two policy objectives of minimizing costs to the FDIC under the statutory cost test and efficient resource adjustments in banking markets to over- or underbanking.

Moreover, competitive bidding procedures do not eliminate the problem associated with a potential subsidy. Competitive bidding only ensures that any subsidy is reduced to the point that the combined return from the franchise value and the subsidy yields a market rate of return to the acquiring institution. The subsidy, nonetheless, permits the continued employment of banking resources that would otherwise exit the industry.

Cost Test and Franchise Value

The source of the conflict discussed above arises because the FDIC and the "market" use different decision rules to determine whether a failed-bank franchise continues or expires. Whereas the FDIC's decision whether to sell a failed franchise or liquidate the franchise is based on a statutory cost test, potential acquirers of failed banks are primarily interested in the failed entity's franchise value as a going concern, *i.e.*, the future income stream that results from the acquisition. We will refer to this as the market's decision rule. In this section, we will develop these two decision rules and describe the potential conflicts between the cost test and efficient resource adjustments in banking markets.

The FDIC's Decision Rule

In order for the FDIC to sell a failed-bank franchise (or provide open-bank assistance), the transaction must meet a statutory cost test which requires that it be less costly than paying off the deposits and liquidating the bank's assets (a payoff).⁴ The cost of a payoff to the FDIC is:

$$(1) \quad \text{Cost of Payoff} = -(GC + LIQ) - [-(GC + LIQ) \times UINS];$$

where $GC < 0$, $LIQ < 0$ and:

GC is the imbedded loss or going-concern deficit; it is the value of the failed bank's assets and liabilities after adjusting (a "mark-to-market") for interest-

rate movements and credit-quality problems on a going-concern basis. GC is not observable directly from the bank's financial statement; it will be derived based on assumptions concerning LIQ ;

LIQ is the "liquidation differential," that is, the decrease in value (if any) of the bank's assets and liabilities that results from liquidating them, rather than leaving them in a going concern; and

$UINS$ is the proportion of total deposits⁵ that is uninsured.

Equation (1) states that the cost of a payoff to the FDIC is equal to the sum of the going-concern deficit and the liquidation differential (the negative values of GC and LIQ are translated into costs with the negative sign), less the amount of losses borne by uninsured depositors. The sum of the two cost components, GC and LIQ , is equal to the total loss in the bank that would occur in a liquidation scenario. While the total loss is estimated in an actual failure situation, it is difficult to determine the distribution of loss between these two

⁴FDICIA adds a new requirement. It requires that the FDIC choose the least costly transaction. For example, if two different types of franchise sales are both less expensive than a payoff, the FDIC will be required to choose the sale option that is least expensive. One option might be to sell all the assets and transfer all deposits (including uninsured) to an acquirer. Another option might be to sell all the assets and only transfer the insured deposits to an acquirer. Under the old rule, the FDIC was free to choose either sale option in this example, provided both were less expensive than a payoff. Under the new rule, the FDIC must choose the least costly approach. However, under either rule, the payoff is still the baseline upon which to decide whether there will be a payoff or some form of a franchise sale.

⁵To simplify the discussion, it is assumed that all liabilities are deposits.

components (and, in fact, the FDIC does not do so). Subsequently in this study various assumptions regarding LIQ will be specified in order to make some judgments about potential conflicts.

The liquidation differential may reflect two kinds of losses in value that result from liquidating a failed bank. One type of loss is unavoidable; the other is potentially avoidable. The unavoidable loss in value results from disruption of the borrower-lender relationship which occurs in a liquidation. Many mid- and lower-level staff of the failed bank, who have information and expertise on loan customers and who ordinarily would be retained by new ownership, may not be present under a liquidation scenario. This information and staff expertise, when combined with a going-concern context where loan restructurings and credit extensions are an integral part of the business, may enhance returns above those that could be obtained in a liquidation. In addition, loan customers may be less cooperative in a liquidation scenario because a banking relationship is no longer at stake. The unavoidable component occurs regardless of the efficiency of the liquidator and

reflects the information-intensive nature of banking assets.

The other type of loss in value that may be represented in the liquidation differential is potentially avoidable. This loss in value represents any difference in efficiency in liquidating assets between the public and private sectors. In addressing questions concerning collections, loan restructurings, foreclosures and other legal actions, an acquiring institution may face fewer constraints and have stronger financial incentives to pursue least-cost solutions than does the FDIC. Thus, an acquiring institution may be able to liquidate problem assets more efficiently than the FDIC.

An alternative to a payoff and FDIC liquidation is to sell the failed-bank franchise. The cost of a franchise sale⁶ where all of the depositors of the failed institution are made whole is:

$$(2) \quad \text{Cost of Franchise Sale} = -GC - \text{Premium};$$

where Premium is the amount the potential acquirer is willing to pay for a failed bank after having been compensated for the going-concern deficit (GC) and after the potential acquirer has adequately capitalized the new bank. The premium is the bidder's estimate of the failed bank's franchise value.⁷

Equation (2) states that the FDIC's cost of a franchise sale is equal to the amount of money needed to compensate the acquirer for the going-concern deficit, less any premium paid to the FDIC by the acquiring bank. No loss-sharing by uninsured depositors is included because it is assumed that, in this case, the transaction makes all depositors whole.

If uninsured depositors share losses with the FDIC in a franchise sale (*i.e.*, the acquirer does not assume the uninsured deposits), then the cost becomes:

$$(3) \quad \text{Cost of Franchise Sale with } \textit{pro rata} \text{ Loss} = -GC - [-(GC + \text{Premium}) \times \text{UINS}] - \text{Premium}.$$

The second term, $[-(GC + \text{Premium}) \times \text{UINS}]$, represents the losses borne by the uninsured depositors given the acquirer's bid for the franchise.

The definitions of GC, LIQ, and Franchise Value are illustrated by the example of a failed bank in Chart 1. In the left-hand T-account, the bank has been declared insolvent because its regulatory capital (book equity) has been depleted. However, when its assets and liabilities are marked-to-market for interest-rate movements and credit-quality problems (the "mark" or GC in the T-accounts) and when we take into account that the assets are worth less in a liquidation than in a going concern (LIQ), the liquidation value of the failed bank is a negative \$20. Franchise value is not considered in either the book or liquidation T-accounts. Franchise values, such as core deposits, customer loyalty, or other attributes that give this franchise some ability to earn above-market returns (below-market returns in the case of a negatively valued franchise), are not considered when determining regulatory capital and are of no value in a liquidation.

The going-concern value is shown in the third T-account. The going-concern value is equal to the sum of the going-concern deficit (or, again, the "mark") and any franchise value. That is, the going-concern value is the total market value of the bank (GC + Franchise Value) evaluated on a going-concern basis. In this example, the going-concern value is a negative \$12, compared to a liquidation value of a negative \$20.

⁶The term "franchise sale" in this study denotes a hypothetical transaction where the failed-bank franchise is sold to an acquirer who is compensated for the going-concern deficit and who is required to inject capital into the failed bank so as to bring the level up to the minimum, regulatory capital requirement. In this hypothetical transaction, it is also assumed that the FDIC and the acquirer both know and agree on the amount of the going-concern deficit. This hypothetical franchise sale most closely resembles an actual whole-bank transaction, in which nearly all of the failed bank's assets and liabilities are sold to an acquiring bank. However, the conclusions that follow from the hypothetical franchise sale are also applicable, but to a lesser extent, to transactions in which fewer assets are sold to the acquirer, *i.e.*, purchase-and-assumption transactions. The actual structure of failed-bank transactions is discussed later.

⁷The term "premium" is used here to refer to the potential acquirer's estimate of franchise value. The term "bid" is used more generally to refer to the total amount the acquirer will pay to or receive from the FDIC. For example, if acquirers must estimate GC and include that amount in their bid, then the bid is the sum of the GC and the premium.

Chart 1
Failed-Bank Example

Book Value		Liquidation Value		Going-Concern Value	
Assets	Liab.	Assets	Liab.	Assets	Liab.
\$150	\$150	\$150	\$150	\$150	\$150
	Equity	Mark -15	FDIC Loss=	Mark -15	GC+Fran.=
	\$0	LIQ -5	(-15)+(-5)	Fran. +3	(-15)+(+)3

The Cost Test or FDIC Decision Rule. In order to accept a franchise sale, it must be less costly to the FDIC than a payoff. Thus, when all uninsured depositors are made whole in a franchise sale the rule concerning the minimum acceptable premium is:

$$\begin{aligned} &\text{Cost of Franchise Sale} < \text{Cost of Payoff;} \\ &- \text{GC} - \text{Premium} < -(\text{GC} + \text{LIQ}) - [-(\text{GC} + \text{LIQ}) \times \text{UINS}]; \\ &\text{or} \end{aligned}$$

$$(4) \quad \text{Premium} > \text{LIQ} + [-(\text{GC} + \text{LIQ}) \times \text{UINS}].$$

Equation (4) states that in order for a bid to be accepted the premium must be greater than the liquidation differential plus the costs shared by the uninsured depositors. Since LIQ is negative, the required premium could also be negative where the absolute value of LIQ is greater than $[-(\text{GC} + \text{LIQ}) \times \text{UINS}]$. In other words, the cost test could require the FDIC to compensate an acquirer for the going-concern deficit and pay additional funds in order to avoid costs associated with the liquidation differential. From (4), the factors that determine the minimum required premium are the size of the going-concern deficit, the proportion of deposits that is uninsured, and the size of the liquidation differential.

In cases where uninsured depositors incur *pro rata* losses in a franchise sale, the rule concerning the minimum acceptable premium would be:

$$\begin{aligned} &\text{Cost of Franchise Sale with } \textit{pro rata} \text{ Loss} < \text{Cost of Payoff;} \\ &-\text{GC} - [-(\text{GC} + \text{Premium}) \times \text{UINS}] - \text{Premium} \\ &< -(\text{GC} + \text{LIQ}) - [-(\text{GC} + \text{LIQ}) \times \text{UINS}]; \\ &\text{or} \end{aligned}$$

$$(5) \quad \text{Premium} > \text{LIQ}.$$

In other words, when the uninsured depositors share in the losses in a franchise sale, just as they do in a payoff, the required premium to meet the cost test must be greater than the liquidation differential. Here again, since LIQ is negative, a negative premium would be acceptable to effect a transaction. That is, after compensating an acquirer for the going-concern deficit, the FDIC would be willing to pay an acquirer additional funds up to the costs associated with the liquidation differential in order to avoid them.

A requirement under the least-cost rule is that, in addition to being less costly than a payoff, the franchise sale must be the least costly of all franchise-sale options. In the two cases just presented, if the uninsured depositors are to be made whole in a franchise sale (*versus* not making them whole in a franchise sale) the purchaser must be willing to pay an additional premium to acquire the uninsured, such that the FDIC is compensated for the losses the uninsured would otherwise bear.⁸

Market's Decision Rule to Continue Franchise

Unlike the FDIC, a market participant is not concerned about the relative share of losses borne by uninsured depositors and the FDIC or the value of banking assets outside a going concern.⁹ Rather, the participant is concerned about the bank's franchise value.

In bidding on a failed institution a market participant is faced with the following hypothetical situation: The FDIC has agreed to eliminate the failed institution's going-concern deficit by compensating the acquiring institution in some fashion. The winning bidder will be required to capitalize the bank to bring

it up to the minimum, regulatory capital requirements. Given this situation, what premium would a market participant be willing to bid?

Obviously, the premium would depend on the future income stream which the potential acquirer expected to receive from the capital investment. If the potential acquirer expected to receive above-market returns on the required capital investment, the premium would be positive. If below-market returns were expected, the premium would be negative. Expectations of normal returns would elicit a premium of zero, *i.e.*, the potential acquirer would only be willing to put up the required capital investment.

Conflict Between Cost Test and Efficient Entry and Exit

The cost test currently employed by the FDIC, on the other hand, has the potential to distort this outcome. Uneconomic decisions may be encouraged or forced because the FDIC would be willing to accept negative premiums in cases where the costs associated with the liquidation differential are high or would require positive premiums in excess of the franchise value where a large proportion of total deposits is uninsured. In the former case (where negative premiums are acceptable minimum bids), too many resources may continue to be devoted to banking. In the latter case (where positive premiums in excess of franchise value would be required), too few resources would be devoted to banking.

The conflict between the FDIC's cost test and the efficient employment

⁸During the first four months of 1992, acquirers were willing to pay an additional premium to cover the uninsured in over 50 percent of the cases in which a failed bank was acquired.

⁹This presumes that the participant plans to operate the franchise as a going concern.

of resources in banking markets occurs in the following situations:

1. *The highest bid passes the FDIC's cost test, but the franchise value is negative. This could occur where: the minimum acceptable premium [see Equation (4) or (5)] < franchise < 0.* In situations where the franchise value is less than zero and the minimum acceptable premium is less than the franchise value, the franchise could still be sold and excess resources would continue to be employed in this particular market. The transaction would make sense from the FDIC's perspective where the FDIC's costs associated with the liquidation differential are high and the losses shared with the uninsured depositors are relatively low. In this case, in addition to compensating the acquirer for the GC deficit the FDIC would be willing to pay the acquirer additional funds in order to avoid costs associated with the liquidation differential. This may result in excess resources continuing to be employed in this particular market.

2. *The highest bid fails the cost test, but the franchise value is positive. This could occur where: the minimum acceptable premium [see Equation (4) or (5)] > franchise > 0 and where the positive franchise value derives from the uninsured deposits.* In situations where the failing institution has a positive franchise value but the minimum acceptable premium is greater than the franchise value, the franchise would not be awarded to a bidder, assuming no one would offer a premium worth more than the franchise value. Yet, from an economic perspective it would be desirable to continue to employ the resources of the failed bank in this particular market. This situation could occur where the losses shared by the uninsured depositors in a liquidation (payoff) were large relative to the FDIC's costs associated with the liquidation differential and where the positive franchise value derives from the uninsured deposits.¹⁰

While it makes sense from the FDIC's perspective to liquidate or pay off the failed bank, the existence of a positive franchise value is evidence that consumers would benefit if those resources could continue to be employed in this market.¹¹

With regard to the first case, it is legitimate to ask why an acquirer would choose to operate a negatively valued franchise as a going concern. Why not pocket the FDIC subsidy and liquidate the losing franchise? One plausible explanation involves managerial incentives and the so-called "agency problem" in the relationship between managers and owners. For various reasons, stockholders may have difficulty in directing managers to maximize the long-run value of firm shares.¹² Often, managerial compensation and career prospects are tied more closely to firm size and short-run financial performance. Thus, managers may favor a going-concern mode for the acquired franchise even if this does not maximize long-run returns to shareholders. Another possibility is that managers do not view franchise value as fixed or wholly beyond their control. In some cases, managers may envision changes in operating strategy or other firm characteristics that could enhance the acquired bank's franchise value.

The point is not that all acquirers will necessarily operate negatively-valued franchises as going concerns. If some acquirers are more efficient liquidators than the FDIC, they may purchase failed-bank franchises merely to liquidate them, pocketing the difference between their own liquidation costs and those of the FDIC.¹³ Or an acquirer may purchase a franchise and avoid liquidation costs altogether by simply winding down the operations of the acquired bank. Though we observe such outcomes in few, if any, failed-bank acquisitions, they are nevertheless possibilities. Our point is only that plausible reasons exist for acquirers to operate negatively-valued franchises as going concerns, thus retaining excess resources in certain banking markets.

Cost Test in Practice

In small-bank resolutions, franchise sales run along a continuum from the sale of nearly all of a failed bank's assets and liabilities (whole-bank transaction), to the sale of the liabilities and only the highest-quality assets (clean purchase-and-assumption transaction). The terms of large-bank transactions tend to be less uniform and are not as neatly categorized as small-bank transactions.

In a whole-bank transaction, potential acquirers are bidding for the right to assume the failed bank's deposit liabilities and purchase all of the bank's assets. Potential acquirers are given the opportunity to perform asset reviews on the failing institution in order to estimate the institution's

¹⁰Under the least-cost rule, acquirers have the option not to take the uninsured deposits if they are unwilling to pay an incremental premium that would cover the uninsured depositors' loss-sharing. Thus, under the new least-cost rule, the only situation in which the cost test would prevent a positively valued franchise from being acquired would be when the positive franchise value derives from the uninsured deposits and, yet, the amount the acquirer must pay to make up for the FDIC's foregone loss-sharing is greater than the positive franchise value. It is likely that this situation would occur in only a limited number of cases. Prior to the least-cost rule, however, acquirers did not have the option to take only the insured deposits in a franchise sale. If the loss-sharing was large relative to the liquidation differential and the premium was insufficient to cover the loss-sharing, then the failed bank would be paid off. Our analysis of potential conflicts (depicted in Chart 3) was based on failed-bank data prior to the implementation of the least-cost rule, a period when the potential for this particular conflict was greater than it now is.

¹¹It could be argued that the first conflict ($MAP < Franchise < 0$) is more serious than the second conflict ($MAP > Franchise > 0$). In the second situation, other operating institutions could expand their operations to meet the banking needs of the new bankless consumers or a new bank could be chartered. However, in the first situation ($MAP < Franchise < 0$), the subsidized employment of excess resources will have detrimental effects on other industry participants for some time to come. This will impose losses on other industry participants, which could eventually threaten their solvency and, thereby, impose future losses on the insurance fund.

¹²See Jensen and Meckling (1976) and Gorton and Rosen (1992).

¹³This point is attributable to Alton Gilbert.

going-concern deficit (GC, the same definition as used in Equation (1)) and its franchise value (Premium). Thus, a bid for a whole bank is:

$$(6) \quad \text{Bid} = \text{GC} + \text{Premium.}$$

Since the going-concern deficit is normally large relative to the premium, the bid on a whole-bank transaction is normally negative, *i.e.*, the bidders are stating the amount of cash the FDIC must pay them to take over the failed bank's assets and liabilities.

In calculating the minimum acceptable bid for a whole-bank transaction, the FDIC conducts an on-site review of the failed bank to determine its resolution cost. This cost is an estimate of the total loss in the bank if it were liquidated by the FDIC, less any losses borne by the uninsured depositors.

Using the terminology developed in this study, the minimum acceptable bid (MAB) in a whole-bank transaction is:

$$(7) \quad \text{MAB} = (\text{GC} + \text{LIQ}) - [(\text{GC} + \text{LIQ}) \times \text{UINS}].$$

Since the bid must be greater than the MAB, the cost test for a whole-bank transaction is:

$$\text{Bid} > \text{MAB};$$

$$(8) \quad \text{GC} + \text{Premium} > (\text{GC} + \text{LIQ}) - [(\text{GC} + \text{LIQ}) \times \text{UINS}],$$

if the uninsured deposits are acquired and made whole;

or

$$(8.1) \quad \text{GC} + \text{Premium} > \text{GC} + \text{LIQ},$$

if the acquirer elects not to take the uninsured deposits.¹⁴

In the following section, information on whole-bank transactions is utilized to make inferences about the effect of the FDIC's decision rule on the efficient entry and exit of resources from banking markets. The analysis was limited to whole-bank transactions because of the difficulties in drawing inferences about franchise value in other types of transactions. For example, the use of putbacks, loss-sharing provisions and extensive replacement of bank assets with cash make it difficult to infer franchise value from bid information.

Evidence From Whole-Bank Bids

Methodology

Ideally, the goal would be to locate evidence indicating whether FDIC resolution decisions have interfered with efficient exit and/or entry in banking markets; but because good estimates are unavailable for market-determined franchise values and for the FDIC's liquidation differential, the evidence will of necessity be circumstantial. While it cannot be determined with confidence whether banking resources were *actually* misallocated as a result of past resolutions, the FDIC's cost-test calculations and whole-bank bids received by the FDIC may contain certain clues that are suggestive.

The FDIC makes resolution decisions on the basis of its own estimates of loss in a failed bank. As noted in Equation (1), this estimated loss may be viewed as having two components: the going-concern deficit, GC (going-concern losses imbedded in failed-bank assets), and the liquidation differential, LIQ. Given certain bold assumptions, a measure of GC may be extracted from FDIC data and an implied franchise value for the failed institution may then be derived by netting GC from whole-bank bids.

To be more explicit, our approach is to make "reasonable" assumptions about the value of LIQ and then solve Equation (7) to determine the size of the implied GC. For the "minimum acceptable bid" (MAB) and the "uninsured liabilities" (UINS) in Equation (7), we use the actual values presented to the FDIC Board in each case. Given an assumption about LIQ, GC is easily inferred. We use four alternative assumptions about the size of LIQ to obtain a range of plausible values for GC in each case. Next, assuming that bidders use these same estimates of the going-concern deficit in making their bids, we deduct GC from the winning (or highest) bid in Equation (6) to reveal the imbedded premium, our estimate of franchise value (four estimates for each case).

Finally, we use the estimates of franchise value to observe whether any positively valued franchises were extinguished (*i.e.*, whole-bank bids with positive premiums were rejected) or any negatively valued franchises were preserved (*i.e.*,

¹⁴Because acquirers generally did not purchase the whole bank and leave the uninsured deposits behind prior to FDICIA, Equation (8) is relevant for the subsequent analysis.

whole-bank bids with negative premiums were accepted).¹⁵ For example, suppose a particular failed-bank case shows the following:

Total Assets (book)	Total Liab.	Uninsured Liab.	MAB	Highest Bid Received
\$21.3MM	\$20MM	\$200M	-\$5MM	-\$4MM

Suppose also that $LIQ = .08 \times (\text{total assets})$ which, in this case, is equal to $-\$1.7\text{MM}$. Then using Equation (7) we get:

$$-5\text{MM} = (\text{GC} - 1.7\text{MM}) - [(\text{GC} - 1.7\text{MM}) \times (200\text{M}/20\text{MM})];$$

$$\text{GC} = -\$3.35\text{MM}.$$

Substituting this value into Equation (6) produces:

$$-4\text{MM} = -\$3.35\text{MM} + \text{Premium};$$

$$\text{Premium} = -\$650\text{M}.$$

In this hypothetical case, the FDIC would accept the bid because it exceeds MAB, but our methods show a derived franchise value that is negative.

Given the heroic assumptions necessary for this exercise and the resulting potential for large measurement errors, an estimated premium that is only marginally negative (and accepted) or marginally positive (and rejected) probably should not be viewed as credible evidence of anything. Some indicator of economic "significance" is required for a duly cautious interpretation of results. We scale the estimated premiums by bank asset size and consider certain *ad hoc* thresholds (e.g., one or two percent of total assets) that might permit a reasonably secure inference. In the example above, the negative premium exceeds three percent of total assets, which seems substantial.

This implied franchise value may be "incorrect" (i.e., it may differ from the bidder's estimate of franchise value, which is unobservable), and so we cannot know whether a given resolution actually interfered with economic efficiency.¹⁶ It might be argued that bidders' estimates of the going-concern deficit are likely to be larger than indicated in this exercise. Bidders may have less information about borrowers and loan quality than does the FDIC. Given this, the bidders may use higher discount rates than those implied here in valuing future return streams from existing failed-bank assets. If so, this analysis will underestimate the deficit component and overestimate the premium component of whole-bank bids. For example, in cases where negative whole-bank bids are accepted, the methodology may indicate negative premiums when the franchise value as perceived by bidders is actually positive. It could be the case that the bidder's estimate of GC is lower (more negative) than the FDIC's by such an amount that, when the FDIC's GC is deducted from the whole-bank bid [Equation (6)], this gives the false appearance of a negative premium. We can never be sure whether the method is simply mistaking the difference between the bidder's GC and the FDIC's GC for a negative franchise value.

There is no avoiding this problem and, as indicated above, this is one reason we cannot determine whether past resolutions actually interfered with efficiency. Despite this limitation of the methodology, we maintain that a persistent finding of significant negative premiums on accepted bids would have important implications. If the premiums in these cases reflect actual franchise values, then the conflict between the cost test and efficiency becomes more explicit *via* our calculations. The findings then provide some basis for a deliberate weighing of stakes in the trade-off between cost-saving and market efficiency.

On the other hand, if the premiums merely reflect large differences in GC estimates used implicitly by the FDIC and private bidders, this may indicate a potential for large gains by narrowing such differences. If the FDIC is believed

to have better information and thus a more accurate estimate of GC, then perhaps FDIC costs could be lowered through information-sharing. With better information made available to bidders, uncertainty could be reduced and banking assets may be discounted less heavily in the bidding process. For many bids, this may spell the difference between failing or passing the cost test and, perhaps, becoming the least-cost resolution. Moreover, fewer positively valued franchises would be extinguished. Conversely, if private estimates of GC are closer to the mark (bidders are more appropriately discounting banking assets given market uncertainties), this implies that the FDIC may be rejecting whole-bank bids that would both reduce FDIC costs and preserve positively-valued franchises.¹⁷ Clearly, some effort to adjust FDIC estimates would be indicated in this event.

In short, a finding that negative premiums are often accepted, or positive premiums are often rejected, may be interesting and important even if

¹⁵When whole-bank bids with positive premiums are rejected, the failed bank is not necessarily resolved with a liquidation and payoff. It may be resolved with a P&A or a deposit transfer, and some of the franchise value may, thus, be preserved. We refer to the original, whole-bank franchise as being "extinguished" since it is not preserved in its original form, but this does not necessarily mean that all franchise value is lost.

¹⁶The bidder's estimate, if observable, would be a proxy for the market-determined (efficient) price of the franchise. Yet, problems with this measure would remain: The so-called "winner's curse," as well as other forms of strategic behavior, and a host of potential problems posed by inefficient auction processes suggest that bids may reflect more than purely objective valuations.

¹⁷For example, suppose the highest bidder estimates that $\text{GC} = -\$10\text{MM}$ and includes a premium of $+\$3\text{MM}$, so that the best whole-bank bid is $-\$7\text{MM}$. If the implied FDIC estimate of GC is $-\$5\text{MM}$ and the MAB = $-\$6\text{MM}$, the FDIC will reject the bid. Suppose the failure is resolved with a payoff and liquidation. If it turns out that the bidder's estimate is more accurate and the true GC is roughly $-\$10\text{MM}$, the payoff and liquidation will cost the FDIC far more than the $\$7\text{MM}$ whole-bank sale. Moreover, a franchise with positive value will be extinguished with the liquidation.

these "premiums" do not represent true franchise values. Moreover, we believe the view provided by our methods may help to frame some proper questions, even if it fails to reveal any conclusive answers.

Data and Findings

The sample consists of 90 recently failed banks for which whole-bank bids were received. The easily accessible data for failed-bank cases are consistent only from December 1989 going forward, so we examined all failed-bank cases from December 1989 through December 1990, the latest date for which reliable data were available. After deleting cases which contained obvious errors or inconsistencies that could not readily be explained, the result was 45 cases in which whole-bank bids were accepted and 45 cases in which all such bids were rejected.

Most of the failed banks in the sample are small, under \$100 MM in assets. The largest bank in the sample shows assets of \$1.6 billion, and the average asset size is \$94.2MM. The size distribution is as follows:

Asset Size	Number of Banks
<100MM	68
\$100MM - \$500MM	17
\$500MM - \$1B	3
>\$1B	2

As noted earlier, an assumption about the liquidation differential (LIQ) is necessary to generate franchise values from our data. The larger the assumed liquidation differential, the smaller will be the portion of the FDIC's loss attributed to the going-concern deficit. In turn, the smaller the portion of any bid that can be attributed to the need to compensate the acquirer for the going-concern deficit, the more likely that the cash payment demanded of the FDIC must be attributed either to a negative franchise value or a risk premium. In effect, the higher the assumed value of LIQ, the greater the bias toward finding negative franchise values. For this

reason, we use what we believe are conservative assumptions concerning the size of LIQ.

There is little evidence on which to base any assumption about the value of LIQ. In the past, officials at bank regulatory agencies have stated publicly that bank assets lose about ten percent of their value when they are removed from a going concern. In the spirit of being conservative, we opted for $LIQ = .05 \times (TOTAL\ ASSETS)$ as a first assumption. To provide further assurance that any interesting results are not due to an exaggeration of LIQ, we chose the value of $LIQ = .01 \times (TOTAL\ ASSETS)$ as a more conservative second case to be examined. The other two assumptions represent LIQ as a fraction of the FDIC-estimated total loss in the failed bank ($GC + LIQ$). One rule of thumb mentioned occasionally is that liquidation costs account for roughly one quarter of the total estimated loss in the average failed bank. Our third assumption is then $LIQ = .25 \times (GC + LIQ)$. Finally, we examine the data using $LIQ = .08 \times (GC + LIQ)$ as another conservative assumption. The figure .08 was chosen arbitrarily.

Franchise values are derived under each of these assumptions and the findings are presented in the format of Chart 2. Cells II and III are of particular interest because they represent the two situations of conflict between the cost test and efficient resource adjustments in banking markets. We construct one figure for each LIQ assumption and report the number of cases (out of 90) falling into each cell. In cells II and III, we also indicate the number of cases in which the derived franchise value was at least one percent of total assets.

The findings are presented in Chart 3, where each of the four sections (Charts 3.1 through 3.4) reflects the results for a particular LIQ assumption. All of the charts show entries in both cells II and III, meaning that we find negatively-valued franchises among the accepted bids and posi-

tively-valued franchises among the rejected bids regardless of the assumption concerning LIQ.

Cell III of the charts shows that, of the 45 rejected bids, as few as six (Chart 3.1) or as many as 14 (Chart 3.3) may have contained positive premiums. The average number of entries in cell III among our figures is ten, and nearly all of the derived franchise values for these entries exceeded two percent of total assets.

The major finding is the preponderance of negative franchise values among accepted whole-bank bids (cell II). Chart 3.4 shows the lowest total for cell II, with 20 of the 45 accepted bids (or 44 percent) having negative franchise values. In Chart 3.1, where $LIQ = .05 \times (total\ assets)$, 84 percent of the accepted bids include a negative franchise value. Moreover, a high percentage of the negative values in cell II appear "significant" relative to total assets. These findings are especially interesting if one believes, as we do, that all of the LIQ assumptions are relatively low. As explained above, if we had used higher estimates of LIQ, we would have estimated a higher proportion of accepted bids with negative franchise values.

Our methods suggest that a majority of the 90 banks in the sample had negative franchise values (54 in Chart 3.4 is the lowest total, and 77 in Chart 3.1 is the highest). Is it plausible that bids were submitted for so many losing franchises? We are reluctant to concede that bidders would not bid on negatively valued franchises. As our earlier discussion makes clear, if inherent liquidation costs are large enough and there is little opportunity for loss-sharing with uninsured creditors, cost considerations may lead the FDIC to pay a substantial amount in order to avoid a liquidation.

However, even if one concedes that our finding of a large number of negatively valued franchises may be due to the bidders and the FDIC placing different values on the going-concern deficit (GC), rather than a true indication of the bidders' estimate

Chart 2
Cost Test and Franchise Value

Market Decision Rule	FDIC Decision Rule	
	Passes Cost Test: Prem > LIQ + Loss-sharing	Fails Cost Test: Prem < LIQ + Loss-sharing
Positive Franchise Value	I Bids Accepted	III No Bid Accepted MAP > Fran. > 0
Negative Franchise Value	II Bids Accepted MAP < Fran. < 0	IV No Bid Accepted

of franchise value, we believe that the results reported in Chart 3 are still important. As indicated earlier, if the large number of derived negative values are symptomatic of the FDIC and bidders' systematically placing different values on the going-concern value of failed-bank assets, then a reconciliation of these differences could either lower FDIC costs or promote efficient resource adjustments, or both.

For example, in our sample of banks if the bidders' estimates of GC were larger (more negative) than the FDIC's by five percent of total assets, then 34 of the 77 negative franchise values reported in Chart 3.1 would

Chart 3
Failed-Bank Cases in Which Whole-Bank Bids Were Received 12-89 through 12-90
(90 observations, using highest bid)

Chart 3.1: LIQ = 5% of Total Assets

Market Decision Rule	FDIC Decision Rule	
	Passes Cost Test	Fails Cost Test
Positive Derived Franchise Value	7 Accepted	6 Rejected Pos. Franchise Value at least 1% of TA:06; and at least 2% of TA:06.
Negative Derived Franchise Value	38 Accepted Neg. Franchise Value at least 1% of TA:33; and at least 2% of TA:30.	39 Rejected

Chart 3.2: LIQ = 1% of Total Assets

Market Decision Rule	FDIC Decision Rule	
	Passes Cost Test	Fails Cost Test
Positive Derived Franchise Value	23 Accepted	8 Rejected Pos. Franchise Value at least 1% of TA:08; and at least 2% of TA:07
Negative Derived Franchise Value	22 Accepted Neg. Franchise Value at least 1% of TA:13; and at least 2% of TA:02.	37 Rejected

Chart 3.3: LIQ = 25% of (GC + LIQ)

Market Decision Rule	FDIC Decision Rule	
	Passes Cost Test	Fails Cost Test
Positive Derived Franchise Value	15 Accepted	14 Rejected Pos. Franchise Value at least 1% of TA:12; and at least 2% of TA:11.
Negative Derived Franchise Value	30 Accepted Neg. Franchise Value at least 1% of TA:28; and at least 2% of TA:21.	31 Rejected

Chart 3.4: LIQ = 8% of (GC + LIQ)

Market Decision Rule	FDIC Decision Rule	
	Passes Cost Test	Fails Cost Test
Positive Derived Franchise Value	25 Accepted	11 Rejected Pos. Franchise Value at least 1% of TA:09; and at least 2% of TA:08.
Negative Derived Franchise Value	20 Accepted Neg. Franchise Value at least 1% of TA:18; and at least 2% of TA:05.	34 Rejected

carry the wrong sign; that is, the bidders' estimates would indicate that these 34 franchise values were actually positive rather than negative. Moreover, assuming the bidders' estimates of GC were correct, at least five of the 45 rejected deals would have been accepted had the FDIC used the bidders' estimates of GC. Those five failed banks represented 22 percent of the total assets in the 45 rejected deals and, had the bids for those banks been accepted, up to \$1.2 billion in failed-bank assets may have remained in the private sector, rather than being placed in the FDIC's liquidation portfolio.

On the other hand, if we assume that the FDIC's estimate of GC were the correct one, then substantial savings would have resulted if the FDIC could have conveyed this information to bidders and reduced their five percent error to zero. In addition to the gains just described for rejected bids, improving the acquirers' bids by five percent of total assets would have reduced the FDIC's costs by \$113 million on the 45 accepted bids.

Conclusions and Policy Implications

This study identifies a potential conflict between the FDIC's statutory cost test and the efficient entry and exit of resources in banking markets. In situations where the FDIC's liquidation costs are relatively high, cost considerations may cause the FDIC to subsidize the acquisition of failed banks with negative franchise value in order to avoid the high costs of liquidation. On the other hand, in situations where substantial compensation is required by the FDIC for transferring the uninsured deposits in whole to the acquiring bank, the cost test may prevent the acquisition of failed banks with positive franchise value.

An important concept in this paper is the "liquidation differential," by which we mean the loss in value resulting from removing banking as-

sets from a going concern and liquidating them. To the extent that the high liquidation costs result solely from removing "bankable" assets from a going concern, these conflicts between the cost test and efficient resource adjustments in banking markets are unavoidable. Moreover, competitive bidding procedures only ensure that the acquirers do not receive above-market returns on their capital investment. A subsidy could still remain, permitting a market rate of return on those banking resources that otherwise would have exited the industry.

However, to the extent that the liquidation differential arises because the public sector liquidates bank assets less efficiently than the private sector, one aspect of the conflict is potentially avoidable. If these costs are not inherent costs associated with removing "bankable" assets from a going concern, but are avoidable either on a going-concern basis or in a liquidation scenario, then there would be no rationale for paying an acquirer to avoid them. Policies designed to reduce such costs would result in fewer conflicts between the statutory cost test and efficient resource adjustments in banking markets.

Using information on failure resolutions where the FDIC received bids on whole-bank transactions and assuming reasonable liquidation differentials, we attempted to identify instances in which the cost test impeded the efficient entry and exit of resources in banking markets. Circumstantial evidence exists that the statutory cost test may have interfered with efficient resource adjustment in a sizable percentage of recent failed-bank transactions. According to the estimates in this study, even though franchise sales may have minimized FDIC costs, banking market efficiency would have improved if many of these failures had been handled as payoffs.

These results could be heavily biased if potential acquirers discount the going-concern value of "bankable"

assets more heavily than does the FDIC. This could happen if potential acquirers attached greater uncertainty to the going-concern value than the FDIC, so that the acquirers' estimates of franchise value were higher than those derived in our analysis. We know no way of determining the degree to which this may be true. However, even if the analysis overstates the extent of the conflict between the cost test and efficient resource adjustments in banking markets, the conflict may still occur in a significant number of cases.

The perspective provided by the analysis has several policy implications. First, the analysis highlights the importance of efforts to minimize liquidation costs. The FDIC's willingness to pay to avoid high liquidation costs is the fundamental source of the conflict between efficient resource adjustments and the cost test.

Other policy implications relate to the source of possible errors in our derived franchise values. We noted that our derived franchise values may be in error if acquirers attach greater uncertainty to the value of the "bankable" assets than does the FDIC. This greater uncertainty may be due to the acquirers having less information than the FDIC on the loan portfolio (the FDIC's estimate of GC is correct) or it may be due to the FDIC inappropriately discounting future market developments with respect to the value of failed-bank assets (the acquirers' estimate of GC is correct). Regardless of the reason for any difference, reconciling these differences would result in more bids meeting the cost test, fewer failed-bank assets retained by the FDIC, and lower FDIC resolution costs. In effect, even if one has trouble believing that so many acquirers were interested in failed banks with negative franchise values, we believe the results of this study have important implications.

The major policy implication of the analysis is that, to the extent there

is an inherent or unavoidable liquidation differential, there is an unavoidable conflict between the cost test and efficient resource adjustments in banking markets. A logical question is: How do we strike an appropriate balance between these conflicting policy objectives? We maintain that the cost test should be more flexible so that regulatory decision-makers can

consider the effect of a failure resolution on banking markets, subject to a degree of public scrutiny to ensure that the regulatory process adheres to its public-policy mandates. We doubt that there is any way to precisely measure the costs and benefits of making trade-offs between these objectives. But we maintain there are instances where the costs of not allowing bank-

ing markets to adjust to over- or underbanking are large and where the savings in insurance costs are relatively small. In these cases, economic welfare would be better served if the regulatory authorities had greater latitude to make informed judgments concerning the appropriate trade-off.

REFERENCES

- Carns, Frederick S. and Lynn A. Nejezchleb. "Bank Failure Resolution, the Cost Test and the Entry and Exit of Resources in the Banking Industry." In Federal Reserve Bank of Chicago *Proceedings: The 28th Annual Conference on Bank Structure and Competition*, pp. 101-20. Chicago: n.p. 1992.
- Gorton, Gary and Richard Rosen. "Corporate Control, Portfolio Choice, and the Decline of Banking." Presented at Office of Thrift Supervision, Seminar, June 3, 1992.
- James, Christopher and Peggy Wier. "An Analysis of FDIC Failed Bank Auctions." *Journal of Monetary Economics* 20 (1987): 141-53.
- Jensen, Michael and William Meckling. "The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3 (October 1976): 305-60.
- O'Keefe, John. "Bank Failure Resolutions: Implications for Banking Industry Structure, Conduct and Performance." *FDIC Banking Review* 5 (Spring/Summer 1992): 17-35.

APPENDIX

Failed-Bank Data

The data used in our analysis are presented in this appendix. There are some questions concerning these failed-bank data, and all results should therefore be interpreted cautiously. One issue concerns the choice of a proper value to represent the winning, and/or highest, whole-bank bid in each case. In some cases, "whole-bank" is somewhat of a misnomer because all bank assets are *not* necessarily included in the "whole-bank" bid package. Some assets are regularly excluded from the bidding, but are subsequently purchased by the acquirer. Any extra costs incurred by the FDIC in the sale of these assets are later added to the best bid in order to estimate the full cost of the sale. This sum is referred to as REQUIRED OUTLAY (for Winning Bid) in the FDIC data, and

its value is closer to the actual transaction price than is the reported amount of the winning bid. We use REQUIRED OUTLAY in Equation (6).

The REQUIRED OUTLAY reported for several whole-bank deals reflected a cost that was three (or more) times larger than that suggested by the MAB. In some cases, this implied such a high percentage of assets excluded from the bidding that "whole-bank deal" seems to mischaracterize these transactions. For present purposes, this problem was skirted by excluding such cases from the sample.

Zeros in the MAB column typically indicate that the bid package excluded many problem assets, as discussed above. In these cases, MAB is not directly comparable to Best Bid

(REQ. OUTLAY), and thus the magnitude of the DERIVED PREMIUM is negatively biased. However, the table shows the correct sign on the DERIVED PREMIUM for all such cases, and only the sign is relevant for our analysis. Zeroes appearing in the Highest Bid column occur when the bid implies no cash outflow or a net gain (cash inflow) to the FDIC as a result of the deal. In some of these cases, the DERIVED PREMIUM is again biased downward but the sign appearing in the table is correct.

Columns with the word "derived" contain data that were based on the assumption concerning LIQ (e.g., $LIQ = .05 \times ASSETS$) or derived from Equations (6) and (7) as outlined in the text.

Bank Failure Resolution

WHOLE-BANK DEALS
(Dollars in Thousands)

Total Assets	Loss in Bank -(GC+LIQ) <i>Derived</i>	Going- Concern Deficit (GC) <i>Derived</i>	LIQ (.05 x TA) <i>Derived</i>	Proport. of Liab. Uninsured (UINS)	Minimum Acceptable Bid (MAB)	Winning Bid (REQ. OUTLAY)	Premium <i>Derived</i>
33,706	5,513	-3,828	-1,685	.045	-5,264	-5,264	-1,436
7,433	586	-215	-372	.000	-586	-586	-371
81,351	6,880	-2,812	-4,068	.003	-6,857	-6,857	-4,045
19,085	5,179	-4,225	-954	.013	-5,113	-3,724	+501
4,516	709	-483	-226	.000	-709	-712	-229
13,631	1,723	-1,041	-682	.015	-1,697	-1,697	-656
42,324	7,860	-5,744	-2,116	.031	-7,614	-5,748	-4
37,776	4,742	-2,853	-1,889	.018	-4,655	-3,091	-238
12,519	815	-189	-626	.006	-810	-242	-53
16,468	2,809	-1,986	-823	.016	-2,766	-2,195	-209
18,264	3,563	-2,650	-913	.021	-3,490	-3,058	-408
32,628	2,068	-437	-1,631	.005	-2,058	-1,119	-437
12,297	3,400	-2,785	-615	.039	-3,267	-3,267	+482
10,695	1,768	-1,233	-535	.018	-1,736	-1,717	-484
359,393	789	+17,181	-17,970	.014	-778	-247	-17,428
95,751	9,467	-4,679	-4,788	.075	-8,755	-3,143	+1,536
133,387	2,007	+4,662	-6,669	.000	-2,007	-1,695	-6,357
33,778	6,898	-5,212	-1,689	.000	-6,898	-6,898	-1,686
27,339	4,324	-2,957	-1,367	.022	-4,230	-4,162	-1,205
8,168	1,978	-1,570	-408	.042	-1,895	-1,573	-3
11,546	3,022	-2,445	-577	.021	-2,957	-2,941	-496
24,399	5,517	-4,297	-1,220	.042	-5,283	-3,632	+665
12,162	753	-145	-608	.003	-751	-212	-67
9,407	910	-440	-470	.041	-873	-608	-168
45,407	7,824	-5,554	-2,270	.035	-7,554	-6,427	-873
21,179	1,897	-838	-1,059	.002	-1,893	-1,691	-853
64,313	22,440	-19,224	-3,216	.038	-21,595	-15,796	+3,428
5,099	1,013	-758	-255	.000	-1,013	-843	-85
7,984	498	-99	-399	.000	-498	-448	-349
16,064	3,279	-2,476	-803	.013	-3,237	-3,237	-761
28,643	5,234	-3,802	-1,432	.036	-5,045	-1,353	+2,449
17,517	2,814	-1,938	-876	.001	-2,811	-2,811	-873
176,748	36,285	-27,448	-8,837	.018	-35,646	-35,326	-7,878
44,107	-7,084	-4,879	-2,205	.008	-7,031	-5,864	-985
28,544	4,414	-2,987	-1,427	.001	-4,410	-4,247	-1,260
16,026	3,379	-2,578	-801	.003	-3,370	-3,879	-1,301
40,744	10,181	-8,144	-2,037	.026	-9,915	-9,574	-1,430
406,922	75,716	-55,370	-20,346	.088	-69,054	-49,499	+5,871
17,030	1,712	-860	-852	.038	-1,646	-1,468	-608
89,327	18,911	-14,445	-4,466	.024	-18,466	-21,965	-7,520
44,597	11,627	-9,397	-2,230	.059	-10,941	-7,148	+2,249
22,080	4,548	-3,444	-1,104	.013	-4,487	-4,466	-1,022
11,724	4,232	-3,646	-586	.000	-4,232	-4,125	-479
34,461	1,680	+43	-1723	.005	-1,671	-1,671	-1,714
64,457	30,983	-27,760	-3,223	.006	-30,805	-29,607	-1,847

REJECTED WHOLE-BANK DEALS
(Dollars in Thousands)

Total Assets	Loss in Bank -(GC+LIQ)	Going-Concern Deficit (GC)	LIQ (.05 x TA)	Proport. of Liab. Uninsured (UINS)	Minimum Acceptable Bid (MAB)	Highest Bid (REQ. OUTLAY)	Premium
	<i>Derived</i>	<i>Derived</i>	<i>Derived</i>				<i>Derived</i>
169,668	38,465	-29,982	-8,483	.063	-36,025	-49,094	-19,112
20,773	3,362	-2,323	-1,039	.019	-3,297	-4,704	-2,381
510,853	0	+25,543	-25,543	.078	0	0	-25,543
57,085	9,024	-6,170	-2,854	.020	-8,841	-33,971	-27,801
30,331	0	+1,517	-1,517	.021	0	-10,334	-11,851
15,903	2,444	-1,649	-795	.013	-2,412	0	+1,649
22,571	0	+1,129	-1,129	.038	0	-15,458	-16,587
27,732	7,682	-6,295	-1,387	.087	-7,012	-21,418	-15,123
67,052	11,093	-7,740	-3,353	.011	-10,967	-16,977	-9,237
35,530	7,037	-5,260	-1,777	.028	-6,840	-8,776	-3,516
35,206	2,609	-849	-1,760	.046	-2,489	-5,260	-4,411
24,629	2,014	-783	-1,231	.007	-2,000	0	+783
101,889	0	+5,094	-5,094	.084	0	0	5,094
13,141	1,840	-1,183	-657	.134	-1,594	0	+1,183
25,204	3,265	-2,005	-1,260	.021	-3,197	0	+2,005
14,328	1,930	-1,214	-716	.001	-1,929	-9,180	-7,966
44,135	0	+2,207	-2,207	.021	0	-37,397	-39,604
35,818	7,616	-5,825	-1,791	.019	-7,468	-8,668	-2,843
3,057	0	+153	-153	.044	0	-909	-1,062
33,521	6,227	-4,551	-1,676	.022	-6,093	0	+4,551
75,736	0	+3,787	-3,787	.024	0	67,069	-70,856
13,690	2,568	-1,883	-685	.002	-2,563	-3,723	-1,840
17,898	0	+895	-895	.034	0	-3,475	-4,370
115,098	17,180	-11,425	-5,755	.020	-16,836	0	+11,425
118,680	17,015	-11,081	-5,934	.019	-16,693	-16,762	-5,681
52,318	0	+2,616	-2,616	.056	0	-40,187	-42,803
30,273	0	+1,514	-1,514	.010	0	-1,417	-22,931
47,449	0	+2,372	-2,372	.018	0	28,834	-31,206
90,431	0	+4,522	-4,522	.066	0	-51,561	-56,083
23,085	6,549	-5,395	-1,154	.029	-6,362	-18,482	-13,087
10,745	0	+537	-537	.047	0	-2,546	-3,083
16,559	1,573	-745	-828	.002	-1,570	-6,331	-5,586
67,075	12,202	-8,848	-3,354	.043	-11,674	-9,158	-310
109,261	8,520	-3,057	-5,463	.100	-7,669	-20,941	-17,884
46,557	6,430	-4,102	-2,328	.065	-6,011	-36,567	-32,465
117,630	0	+5,882	-5,882	.126	0	-72,343	-78,225
1,642,874	0	+82,144	-82,144	.049	0	-404,244	-486,388
127,878	28,354	-21,960	-6,394	.118	-24,999	-31,938	-9,978
292,859	48,194	-33,551	-14,643	.052	-45,698	-217,822	-184,271
395,666	82,270	-62,487	-19,783	.006	-81,752	-104,740	-42,253
12,908	2,353	-1,708	-645	.043	-2,252	-9,281	-7,573
143,111	34,348	-27,192	-7,156	.034	-33,195	-31,662	-4,470
13,633	1,446	-764	-682	.015	-1,425	-2,751	-1,987
359,397	788	+17,182	-17,970	.052	-747	-6,537	-23,719
10,422	0	+521	-521	.042	0	-2,552	-3,073

The Bank Insurance Fund

Trends, Initiatives, and the Road Ahead

by Panos Konstas*

At year-end 1991, the Federal Deposit Insurance Corporation's Bank Insurance Fund (BIF) recorded a deficit of \$7.0 billion. This was the first time in its history that the Fund's net worth was negative. This deficit occurred against a backdrop of premium increases for insured institutions, expanded and more intensified examination policies by the regulators, and far-reaching deposit insurance reform legislation. These developments, coupled with the underlying issue of what to do about the Fund deficit, not only raise new concerns about the viability of the deposit insurance system but also pose major challenges to the operating policies of both the FDIC and insured institutions.

The present study examines the drastic changes to the BIF balance sheet and income statement that have occurred over the past decade, the financial characteristics of the BIF, and the measures in place to restore it to financial viability. Congress has designated a reserve target for the BIF which must be attained within a specified period. After this target is achieved, the FDIC must adjust premiums annually to keep the BIF at or above the target ratio. If the BIF ratio

falls below the target, the FDIC must either raise premiums to restore the proper ratio within one year, or promulgate a recapitalization schedule projected to reach the target ratio within 15 years. Specific issues raised by these requirements are examined in this study.

Section one of the analysis describes the current financial condition of the BIF, including revenues, insurance losses, cash flows, and fund liquidity. Section two reviews key provisions in the recent legislation regarding the BIF. Section three evaluates the assessment policy required by the FDIC Improvement Act of 1991 after the BIF has attained the designated ratio of 1.25 percent of insured deposits. Finally, section four recommends the implementation of an alternative, moving-average assessment approach after the BIF reaches the target ratio.

Background and Current Status of the BIF

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) renamed the FDIC's deposit insurance fund as the "Bank Insurance Fund."¹ At the same time, the FDIC was given responsibility for

operating two other funds, the Savings Association Insurance Fund (SAIF), and the FSLIC (Federal Savings and Loan Insurance Corporation) Resolution Fund, which was established to wind up the affairs of the former FSLIC. The SAIF insures former FSLIC-insured institutions as well as any new savings and loan associations. The ensuing discussion is generally limited to the BIF.

As of December 31, 1991, the BIF had assets of \$26.4 billion and liabilities of \$33.4 billion, for a net worth of minus \$7.0 billion. The BIF decreased by \$11.0 billion during 1991, and ended the year with a negative ratio to insured deposits (-0.36 percent) for the first time in its history.

The ratio of the BIF to insured deposits has exhibited noticeable stability over long stretches of time, although the long-term trend generally has been downward. The ratio was at its highest levels during the first ten

*Panos Konstas is a senior economist in the FDIC's Division of Research and Statistics. Colleagues who generously contributed comments and suggestions to this paper include: Richard Brown, Frederick Carns, Benjamin Christopher, Gary Fissel, George French, Jay Golter, Arthur Murton, Lynn Nejezchleb, Robert Storch, and Delta Voesar.

¹The term "BIF" is used in this article to refer to both the Bank Insurance Fund and its predecessor before 1989.

Table 1
Results from BIF Insurance and Investment Operations, 1981-91
(Dollars in Millions)

	Assessments	Insurance Losses	Other Income	Assessments as Percent of Losses	Interest on U.S. Securities	Rebates
1981	\$1,039	\$721	\$37	144%	\$1,116	\$117
1982	1,109	870	142	127	1,370	96
1983	1,215	834	173	146	1,404	164
1984	1,322	1,848	282	72	1,495	-
1985	1,433	1,779	352	81	1,600	-
1986	1,517	2,783	109	54	1,634	-
1987	1,696	3,066	88	55	1,535	-
1988	1,773	7,364	178	24	1,396	-
1989	1,885	4,132	238	46	1,372	-
1990	2,855	12,803	147	22	855	-
1991	5,160	16,578	158	31	471	-

lion in interest income on its portfolio of Treasury securities, representing just over eight percent of the BIF's total annual revenue. A much lower proportion of total revenue is now derived from investments than in the early 1980s due to the decline in the FDIC's holdings of Treasury securities. In 1981, for example, 51 percent of total FDIC revenue came from investments. "Other" income of \$158 million, representing mainly returns on assets from failed and assisted institutions, constituted the remainder of the non-assessment revenue in 1991.

Losses. Insurance losses, amounting to less than \$1 billion per year in 1981-1983, more than doubled in 1984 to surpass assessment income. In 1988, insurance losses rose to \$7.4 billion — more than double the 1987 level and four times the 1985 level. For the first time in its history the FDIC experienced a net operating loss for the year. In 1991, insurance losses rose to \$16.6 billion — a record high.

years of the FDIC's existence, peaking at 1.96 percent in 1941. From the mid-1940s to the late 1960s the ratio fluctuated between 1.3 and 1.5 percent, and hovered around 1.2 percent during the 1970s and early 1980s. It was not until the large losses of the late 1980s that the BIF-to-insured deposits ratio declined precipitously. As late as 1987, the ratio stood well above the one percent mark.

Income and Insurance Losses

Assessments. The BIF's assessment income in 1991 was \$5,160 million (see Table 1). This amount constituted 89.1 percent of the BIF's total income

versus 74.4 percent in 1990. The increase was largely the result of changes in the assessment rate. This rate was raised to 12 basis points (\$0.12 per \$100 of deposits) in 1990 from its longstanding level of 8.33 basis points. The rate was raised to 19.5 basis points for the first half of 1991 and to 23 basis points during the second half.

Interest on U.S. Securities. Section 13 of the Federal Deposit Insurance (FDI) Act provides that FDIC monies not otherwise employed shall be invested in obligations of the United States or in obligations guaranteed as to principal and interest by the United States. In 1991, the FDIC received \$471 mil-

Balance-Sheet Changes

Assets. In 1981, 92.4 percent of the BIF's assets consisted of U.S. Treasury securities, including small amounts of cash, as shown in Table 2. Ten years later this figure had dropped to 19.3 percent. During the same interval, assets

Table 2
Assets, Liabilities, and Net Worth of BIF, Year-end 1981-91
(Dollars in Billions)

	ASSETS							LIABILITIES					NET WORTH			
	Cash and U.S. Securities		Net Claims from Assisted and Failed Banks		Other*		Total	For Estimated Cost of Future Bank Failures		Incurred from Bank Failures and Borrowings		Other**	Total	Percent of Balance Assets		
	amt.	%	amt.	%	amt.	%		amt.	%	amt.	%					
1981	\$12.2	92.4	\$0.9	6.8	\$0.1	0.8	\$13.2	N.A.	\$0.8	80.0	\$0.2	20.0	\$1.0	12.2	92.4	
1982	13.5	88.8	1.5	9.9	0.2	1.3	15.2	N.A.	1.4	93.3	0.1	6.7	1.5	13.8	90.9	
1983	14.0	82.8	2.0	11.8	0.9	5.3	16.9	N.A.	1.3	86.7	0.2	13.3	1.5	15.4	91.1	
1984	14.4	64.4	6.6	30.0	1.0	4.5	22.0	N.A.	4.7	97.9	0.1	2.1	4.8	17.1	77.7	
1985	15.9	71.9	5.1	23.1	1.1	5.0	22.1	N.A.	4.0	97.6	0.1	2.4	4.1	18.0	81.4	
1986	16.6	74.1	4.6	20.5	1.2	5.4	22.4	N.A.	3.9	92.9	0.3	7.1	4.2	18.2	74.6	
1987	16.1	71.9	5.3	23.7	1.0	4.5	22.4	\$1.2	29.3	2.8	68.3	0.1	2.4	4.1	18.3	81.7
1988	16.2	71.4	5.7	25.1	0.8	3.5	22.7	3.9	45.3	4.6	53.5	0.1	1.2	8.6	14.1	62.1
1989	13.7	67.5	6.2	30.5	0.4	2.0	20.3	3.8	53.5	3.1	43.7	0.2	2.8	7.1	13.2	67.3
1990	6.9	34.5	12.8	64.0	0.3	1.5	20.0	7.8	48.8	8.1	50.6	0.1	0.6	16.0	4.0	20.0
1991	5.1	19.3	21.0	79.5	0.3	1.1	26.4	16.3	48.8	16.9	50.6	0.2	0.6	33.4	(7.0)	-

*Includes accrued interest receivable on assets and the value of property and buildings.

**Includes mainly accounts payable, accrued liabilities, and estimated losses from litigation, depositors' claims unpaid, and funds held in trust.

Table 3
BIF Cash Flows, 1987-91
(Dollars in Billions)

Year	CASH INFLOW FROM:					CASH OUTFLOW FOR:					CASH BALANCE DEC. 31
	Assessments	Interest on U.S. Securities	Recoveries from Resolutions and from Borrowings	Deer. (Incr.) in Investments	Total Inflows	Adm. and Operating Expenses	Disbursements for Failed Banks	Payment of Outstanding Debts	Total Outflows	Net Flow (Outflow)	
1987	\$1.7	\$1.6	\$3.1	(\$0.4)	\$6.0	\$0.2	\$4.9	\$1.8	\$6.9	(\$0.9)	\$1.3
1988	1.8	1.5	4.5	1.4	9.2	0.2	6.8	0.5	7.5	1.7	3.0
1989	1.9	1.6	4.6	4.3	12.4	0.2	6.8	3.5	10.6	1.8	4.8
1990	2.9	1.0	2.7	3.2	9.8	0.2	0.1	3.1	13.4	(3.6)	.2
1991	5.2	0.6	18.5	2.4	26.7	0.7	19.6	5.8	26.1	0.6	1.8

acquired in the course of failure and assistance transactions increased from 6.8 percent of the total to 79.5 percent. This shift in portfolio mix from highly liquid Treasury issues to low-liquidity assets from failed institutions caused the BIF's overall liquidity to decline. Liquidity is important because it is primarily through the liquid assets in the BIF and borrowing authority that assistance to failing banks and the payment of insured deposits can be carried out.

Liabilities. The BIF's three major liability categories are estimated liabilities for unresolved cases, debt to the Treasury's Federal Financing Bank (FFB), and liabilities incurred from failed or assisted banks. The first item represents the estimated cost to the BIF of probable losses from those banks that have not yet failed, but which the regulatory process has identified as either equity insolvent or "in-substance" equity insolvent. At the end of 1991, the expected cost to the BIF of this liability item was estimated at \$16.3 billion, out of \$33.4 billion total liabilities. Liabilities to FFB arise when the FDIC arranges failure resolutions in a manner that minimizes cash outlays from the BIF. On such occasions the FDIC has used borrowed funds (mostly from FFB in recent years), in lieu of cash, in order to pay the acquirer of the failed institution. At the end of 1991, \$10.7 billion was owed to the FFB by the BIF. The third category, totalling \$6.1 billion, represents liabilities incurred from failure

resolutions. The bulk of this item (\$5.6 billion) consists of funds held in escrow by the BIF on behalf of receiverships. Escrowed funds arise in resolution transactions when the failed bank's deposit liabilities are assumed by another institution. If, in such instances, all of the failed bank's assets are assigned to the receivership, the FDIC must compensate with cash the acquiring institution for the amount of the assumed deposits. In most cases, however, the acquirer agrees to take a portion of the compensation in the form of failed-bank assets in lieu of cash from the FDIC. The amount of cash freed by the acquirer's acceptance of assets is placed then by the FDIC in an escrow account in the name of the receivership. The receiver, in turn, may draw upon this account for various specified purposes, such as repurchasing assets under put options, paying off preferred and secured claims, meeting receivership expenses, and declaring dividends to general creditors, including the BIF.

Cash Flows

Beginning in 1987, the FDIC's financial statements have included information on cash flows in response to specific provisions issued by the Financial Accounting Standards Board. As might be expected, accounts and transactions relating to failed-bank resolutions have become dominant factors in the BIF's cash flow. As shown in Table 3, cash inflows from recoveries of failed or assisted banks plus bor-

rowings accounted for \$18.5 billion (out of a total of \$26.7 billion) in 1991, or about three-and-a-half times the level of assessment revenue. Another \$2.4 billion was derived from reducing investments. Cash from interest on securities, which in the past had been a major source of cash inflows for the BIF, amounted to only \$0.6 billion in 1991.

For 1991, cash disbursements for bank assistance and failures (\$19.6 billion), for payment of outstanding liabilities such as notes to acquiring banks (\$5.8 billion), and for covering administrative and operating expenses (\$0.7 billion) accounted for \$26.1 billion in total cash outflow. This left the BIF with a cash balance on December 31, 1991, of \$1.8 billion.

Legislative Initiatives

Assessment Policy

Prior to FIRREA, insured banks paid assessments at a basic annual rate of 1/12 of one percent of assessable deposits which are, roughly speaking, total deposits in domestic offices. Legislation in 1950 provided for a rebate to banks of a portion of their assessments in the form of an assessment credit payable in the following year. As amended by legislation in 1980, insured banks were rebated 60 percent of the amount of the FDIC's assessment income in excess of its administrative and operating expenses and provision for insurance losses.

FIRREA made several important changes in the system of assessments. Beginning in 1990, the basic assessment rate was increased to 0.12 percent (from 0.0833), and the FDIC was given additional flexibility to adjust assessment rates and pursue reserve targets.

FIRREA provided that the FDIC could increase the assessment rate to prevent a decrease in the BIF-to-insured deposits ratio. However, a bank's total assessment could not exceed 0.325 percent of its deposit base. After the BIF reached the reserve ratio of 1.25 percent, interest earned on additional reserves was to be paid out as dividends to insured banks. However, the FDIC could set the "designated reserve ratio" as high as 1.50 percent, if necessary, to meet a risk of substantial future losses to the BIF.

Borrowing Authority

From its inception, the FDIC has had authority to borrow to meet liquidity needs. The Banking Act of 1933 explicitly authorized the FDIC to issue "notes, debentures, bonds, or similar obligations . . ." necessary to conduct insurance operations. The Banking Act of 1935 directed the Secretary of the Treasury to purchase up to \$975 million of these obligations, although none were ever bought in this connection. In 1947, the specific authority to issue obligations to the Treasury was deleted, but specific authority to borrow up to \$3 billion directly from the Treasury was granted.

FIRREA increased the FDIC's line of credit with the Department of the Treasury to \$5 billion. Additionally, FIRREA provided that the FDIC may borrow against illiquid assets, but only so long as it maintained a fund balance or net worth of at least ten percent of total assets. In borrowing for either the BIF or the SAIF, the FDIC ". . . may not issue any note or similar obligation, and may not incur any liability under a guarantee or similar obligation, with respect to

either the Bank Insurance Fund or the Savings Association Insurance Fund if, after reduction for the estimated cost of the obligation or guarantee, the net worth of the affected insurance fund would be less than 10 percent of assets." This net worth cushion was designed to absorb losses if acquired assets were sold for less than originally estimated.

In October 1990, Congress enacted the Omnibus Budget Reconciliation Act of 1990, which changed a number of existing FIRREA provisions and added new statutory requirements. Most notably, the Act authorized the FDIC to set premiums for insured banks as necessary to maintain the actual reserve ratio of the BIF at the designated level, allowed the FDIC to make midyear adjustments in assessment rates, and eliminated the 1.50 percent designated reserve ratio ceiling. At the same time, the Act permitted the FDIC, on behalf of either the BIF or the SAIF, to borrow from the Federal Financing Bank.

FDIC Improvement Act of 1991 (FDICIA)

By the end of 1990, the need to take decisive action to bolster BIF finances and enlarge the borrowing authority of the FDIC had become a matter of utmost urgency. Proposals for BIF recapitalization developed by the Department of the Treasury were introduced in Congress early in 1991. In November, Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991, which was designed primarily to ensure that the FDIC, in resolving failures, did not run out of cash — not to immediately restore equity in the BIF. The key provisions of FDICIA pertaining to the BIF are summarized below.

Borrowing from the Department of the Treasury. The FDIC's \$5.0 billion line of credit from the Department of the Treasury is increased to \$30.0 billion. The FDIC may employ any funds drawn under this provision on behalf of either the BIF or the SAIF, and the borrowings will become a liability of

the fund to which they are employed. Consent by the Department of the Treasury is necessary, as well as an agreement on how the borrowings will be repaid. The required repayment schedule must demonstrate that assessment income will be sufficient to ensure repayment of principal and interest of the debt. The FDIC can impose special assessments on insured institutions to make up any shortfall. Such assessments must be allocated between BIF members and SAIF members according to which of the two funds has employed the proceeds of the loan from the U.S. Treasury.

Limitation on Outstanding Obligations. FDICIA also redefined the limit on FDIC borrowings. FIRREA tied this limit to the net worth of the BIF. FDICIA provides, instead, that the FDIC's outstanding obligations may extend up to the total of its cash, 90 percent of the fair market value of assets (other than cash) held by the FDIC, and the aggregate amount authorized to be borrowed from the U.S. Treasury. This change means that the FDIC can borrow outside the Treasury even if the BIF becomes insolvent.

The Act defines "obligation" to include also any guarantee issued by the FDIC (other than deposit guarantees), as well as any contingent liability. The latter must be valued at its expected cost to the FDIC.

With respect to borrowing from BIF members, such as notes issued to acquiring institutions, FDICIA imposes conditions on both parties to the transaction. With respect to the FDIC, it is required that proceeds from the borrowing be used solely for BIF-related functions; the interest rate paid to the lender cannot exceed the rate that the FDIC would have paid if the borrowing were effectuated through the U.S. Treasury; and the amount required to pay interest and repay principal on the obligations cannot exceed assessment income. For BIF members purchasing obligations or making loans to the FDIC, it is required that the purchase

money or the money loaned be derived from the members' capital or retained earnings.

Assessment Rates. The Act stipulates, so long as the BIF's reserve ratio equals or exceeds the designated reserve ratio, that the FDIC Board set the semiannual assessment rates for members as necessary to maintain the reserve ratio of the BIF at the designated 1.25 percent level. This implies generally, so long as the investment yield on the BIF balance is at the same rate as the rate of growth in insured deposits, that the FDIC must implement a "pay-as-you-go" assessment policy, *i.e.*, the assessment revenue raised annually must be sufficient to fully cover total BIF expenses (insurance losses plus operating costs) for the year.

Special Rules for Recapitalizing an Undercapitalized BIF. A different assessment approach is envisioned, however, when the reserve ratio of the BIF is less than the designated ratio, as is currently the case. The FDIC is given two alternatives: (a) it can impose semiannual assessment rates to generate sufficient revenue to raise the BIF ratio to the designated target within a year after such rates have been set or (b) it can promulgate through regulation a schedule of assessment rates that would allow up to 15 years before the designated 1.25 percent reserve goal is reached. When the second option is selected the FDIC Board is required to set assessment rates for members in accordance with a time schedule that specifies, at semiannual intervals, target reserve ratios for the BIF, culminating in the designated reserve ratio within 15 years.² The FDIC may, by regulation, amend a previously promulgated schedule, but such an amendment must not extend the deadline for achieving the designated ratio.

FDICIA Assessment Policy Appraised

As discussed above, FDICIA provides two options to the FDIC after

the target ratio is reached: (a) charge premiums sufficient to maintain the BIF at or above the target ratio; or (b) failing this, set forth a recapitalization schedule designed to restore the BIF to its target within 15 years. The first option will be referred to as "pay-as-you-go." Both of these options have drawbacks.

The Nature of the Problem

It is important to note that assessment-setting encompasses two distinct types of problems and uncertainty. The first complexity relates to the requirement that the ratio of the BIF to insured deposits must be at least 1.25 percent. There is no widely accepted method of determining the optimum size of the BIF, either in terms of an absolute amount or in relation to some measure of exposure. The BIF has to be sufficient to cover losses and meet cash needs. Beyond that, however, its proper size depends upon the contingencies the BIF is expected to handle and public perception regarding the FDIC's ability to meet its obligations under alternative economic scenarios.

The second set of complexities arises from the unpredictable nature of bank failures and the erratic incidence of insurance costs to the BIF. Neither failures nor insurance losses are spread evenly over time. Rather, in banking both tend to occur simultaneously. Under these conditions, a premium structure with the flexibility to deal with the varying loss situations over time becomes a necessity. If such a system requires insurance assessments on banks in whatever amounts are necessary to keep the BIF ratio at the desired level, the higher assessment premiums are likely to be charged when many banks are least able to afford them. The problem is, of course, compounded if the assessment revenue that must be raised in a given year must also be allocated among banks according to each bank's risk status. High-risk banks then will be subjected to higher costs when they can least afford it, both from a business-

cycle standpoint and in relation to competitors designated as better risks.

Premium-Setting Through Recapitalization Schedule

When losses have caused the BIF to fall below its target ratio, and the FDIC does not charge an assessment sufficient to restore the BIF to its target within one year, it must promulgate a recapitalization schedule allowing up to 15 years to reach the target. This approach has the advantage of allowing the banking industry to absorb the burden of extraordinary losses over time. It does have certain drawbacks, however.

First, the recapitalization schedule, by necessity, relies on assumptions about future insurance losses and deposit growth. Assumptions are open to debate, and hence the premium-setting process can become highly political. In turn, this makes the process uncertain and makes it difficult for insured institutions to plan ahead.

In the next section, a moving-average approach to premium-setting is recommended when the BIF reaches its target. This would reduce the uncertainties and ambiguities associated with the use of recapitalization schedules.

Premium-Setting Under the "Pay-As-You-Go" Approach

As shown in Table 4, had the pay-as-you-go procedure been implemented in 1940, the assessment rate necessary to cover insurance losses plus operating expenses for that year would have amounted to slightly over one basis point. For the next 30 years this rate would have remained less than one basis point. Subsequently, the necessary assessment charge would have increased gradually, but not until 1984 would it have moved above the then-maximum statutory assessment of 8.33 basis points. During the late 1980s,

²It is this second option that is being implemented by the FDIC currently. The proposed schedule indicates a 1.25 percent ratio for the BIF by the year 2002.

Table 4
BIF Cost Coverage Under Alternative Assessment Methods
 (Amounts in Millions of Dollars)

Year	Assessment Base	Actual BIF Costs	Rate to Cover Actual Costs (basis points)	BIF Costs per 6-year Method	Rate to Cover 6-year Costs (basis points)	Costs: 6-year Less Actual
1991	\$ 2,428,471	\$ 16,862	69.4	\$ 8,006	33.0	\$ -8,856
1990	2,379,417	13,003	54.6	5,522	23.2	-7,482
1989	2,262,905	4,346	19.2	3,688	16.3	-658
1988	2,128,451	7,588	35.7	3,125	14.7	-4,463
1987	2,036,014	3,271	16.1	2,027	10.0	-1,244
1986	1,821,008	2,964	16.3	1,623	8.9	-1,341
1985	1,720,768	1,958	11.4	1,143	6.6	-815
1984	1,586,435	1,999	12.6	832	5.2	-1,167
1983	1,458,463	970	6.7	524	3.6	-446
1982	1,331,212	1,000	7.5	381	2.9	-619
1981	1,247,299	848	6.8	250	2.0	-598
1980	1,142,737	84	0.7	125	1.1	41
1979	1,057,623	94	0.9	138	1.3	44
1978	972,509	149	1.5	140	1.4	-9
1977	877,911	114	1.3	125	1.4	11
1976	811,645	212	2.6	116	1.4	-96
1975	769,868	98	1.3	88	1.1	-9
1974	705,162	159	2.3	78	1.1	-81
1973	635,534	108	1.7	56	0.9	-52
1972	562,785	60	1.1	43	0.8	-17
1971	500,840	60	1.2	36	0.7	-24
1970	443,337	46	1.0	30	0.7	-16
1969	437,215	35	0.8	25	0.6	-9
1968	401,561	29	0.7	22	0.6	-7
1967	363,866	27	0.8	20	0.5	-8
1966	341,297	20	0.6	17	0.5	-2
1965	312,725	23	0.7	16	0.5	-7
1964	285,954	18	0.6	14	0.5	-4
1963	264,826	15	0.6	13	0.5	-2
1962	244,178	14	0.6	12	0.5	-1
1961	226,771	15	0.7	12	0.5	-3
1960	216,567	13	0.6	11	0.5	-2
1959	213,926	12	0.6	10	0.5	-2
1958	200,240	12	0.6	9	0.5	-2
1957	191,236	10	0.5	9	0.4	-1
1956	186,675	9	0.5	8	0.4	-1
1955	181,873	9	0.5	8	0.4	-1
1954	173,109	8	0.5	7	0.4	-1
1953	166,507	7	0.4	7	0.4	-0
1952	157,263	8	0.5	7	0.4	-1
1951	149,220	7	0.4	6	0.4	-1
1950	147,539	8	0.5	6	0.4	-2
1949	147,299	6	0.4	5	0.3	-2
1948	143,217	6	0.4	4	0.3	-2
1947	137,335	5	0.4	4	0.3	-1
1946	128,451	4	0.3	4	0.3	-0
1945	112,485	4	0.3	4	0.4	1
1944	97,119	4	0.4	6	0.6	2
1943	84,034	4	0.5	6	0.7	2
1942	67,827	4	0.6	6	0.9	2
1941	61,705	4	0.7	7	1.1	2
1940	55,462	7	1.3	7	1.2	-0

Clearly, the practical effect of such assessments on the industry is a crucial issue. A 55 basis-point assessment in 1990 and a 69-point levy in 1991, for example, would have meant accrued costs for banks equal to 80 percent of their 1990 profits and 90 percent of their profits in 1991. Of course, not all of that cost would have fallen on profits, because part of it would have been deducted from taxes and probably another portion would have been passed on to bank customers.

Alternative Solutions

As an alternative to the assessment system discussed above, consider a system where the annual assessment is based on a moving average of past losses and expenses. The general idea is that so long as insurance costs are high and rising, banks in a given year will be assessed at a lower rate than necessary to cover insurance costs. The reverse would be true when costs are falling.

The Internal Revenue Code offers an example for a possible moving-average formulation. Currently, small commercial banks (assets under \$500 million) may use for tax purposes the so-called "bank experience method" to compute additions to the reserve for loan losses. The allowed bad-debt reserve for a bank using the experience method is calculated on the basis of a six-year average, whereby the taxable year's losses on loans are averaged with those of the previous five years. This six-year average is the maximum ending reserve balance permitted for the year.

A similar approach may be adopted to allocate assessment premiums among members of the insurance fund. As indicated in Table 4, if annual premiums were based on a six-year moving average, the resulting assessment premiums would tend to be lower than the premiums necessary to cover actual BIF costs when the latter are high and rising, as was the case during the 1980s. Thus, for 1991, instead of 69 basis points under

however, the assessment rate would have skyrocketed: 36 basis points for 1988, 19 points the next year, and 55

and 69 points, respectively, for 1990 and 1991 (about three times the actual assessment rate applied in either year).

a pay-as-you-go system, banks would have paid only 33 points under the six-year formula. In other years, however, when actual costs were falling, as during 1979 and 1980, the assessment rates under the six-year method would have exceeded the rates of the pay-as-you-go plan.

The difference in realized revenue between an assessment policy aimed at capturing the actual costs in the BIF and one based on capturing costs as suggested by the six-year formula is shown in the far right column of the table. For a given year, a negative difference implies a deficit in the FDIC budget, while a positive difference implies a surplus. The trend since the early 1980s has been for insurance losses to consistently exceed assessments, resulting in budget deficits throughout this period. Indeed, if the surpluses and the deficits shown in the far right column of Table 4 were added together, the BIF would have accumulated a deficit of some \$28 billion by 1991. If, however, the BIF

losses change course in the years ahead, under the moving-average policy the collection of larger revenues than necessary to cover actual losses would tend to reduce to zero the \$28 billion deficit, at which point the budget would become balanced. This occurred, for example, in 1940, when budget costs and revenues according to the six-year average both equaled \$7 million. For the next five years after 1940, the budget had surpluses. It became balanced in 1946, and following six years of deficit, the budget reached balance again in 1953. Thus, under a moving-average policy, deficits and surpluses should tend to cancel each other out in the long run, and the budget should tend to gravitate toward balance.

Applications

A moving-average system of assessments should result, over time, in a tendency for the BIF ratio to gravitate towards the ratio in effect when the system is implemented. Thus, if a moving-average approach were imple-

mented when the BIF was negative, the BIF would tend over time to remain negative. For this reason, given the Congressional mandate to achieve a 1.25 percent BIF ratio, it would be inappropriate to implement a moving-average assessment policy until that ratio is achieved. After the target is attained, however, the moving-average assessment approach offers advantages over both the pay-as-you-go and the forecasted methods of setting premiums.

Insights into the merits of such a policy may be gained by applying it to a past period when the BIF reserve ratio was actually at the 1.25 percent level. Using 1970 as a starting point, when the BIF reserve ratio stood exactly at 1.25 percent, three different moving averages — a six-, a four-, and a two-year average — have been calculated for subsequent years.³ The pay-as-you-go method has been applied also to the same data. It has been assumed in the calculations that whenever the BIF at year-end shows a positive net worth, it will realize an investment return of 8.5 percent on that net worth, and that when the year-end balance is negative, the BIF will incur an interest expense also equal to 8.5 percent on funds borrowed to finance the negative balance.⁴

The assessment revenue implied by each of the four different assessment methods, as well as the corresponding year-end BIF balances, are shown in Table 5. If, from 1969 onward, assessments were collected on the basis of a six-year moving average of actual BIF costs, the BIF would have accumulated a deficit of \$10.7 billion by 1991. Under the four-year average, the BIF would have almost broken even, while the two-year and the pay-as-you-go policies would have generated BIF surpluses of \$13.9 billion and \$24.4 billion, respectively, by the end of the period. In general, the more years included in a moving-average formulation, the greater will be

³In all years before 1970 the ratio exceeded 1.25 percent.

⁴8.5 percent is approximately the same rate as the average yield on the BIF's investment portfolio during the period 1970-91.

Table 5
Revenues and Year-end Balances of the BIF
Under Alternative Assessment Methods
(In Millions of Dollars)

Year	Revenue/Assessment Method				BIF Balance/Assessment Method			
	6-year average	4-year average	2-year average	Pay-as you-go	6-year average	4-year average	2-year average	Pay-as you-go
1991	\$8,006	\$10,450	\$14,933	\$16,862	-\$10,677	-\$886	\$13,898	\$24,379
1990	5,522	7,052	8,675	13,003	-1,678	5,093	14,587	22,469
1989	3,688	4,542	5,967	4,346	5,349	10,179	17,434	20,709
1988	3,125	3,945	5,430	7,588	5,537	9,201	14,574	19,087
1987	2,027	2,548	3,117	3,271	9,217	11,838	15,422	17,591
1986	1,623	1,973	2,461	2,964	9,641	11,577	14,355	16,213
1985	1,143	1,482	1,979	1,958	10,121	11,583	13,694	14,943
1984	832	1,204	1,485	1,999	10,079	11,115	12,602	13,772
1983	524	725	985	970	10,365	10,977	12,090	12,693
1982	381	506	924	1,000	9,964	10,342	11,129	11,699
1981	250	294	466	848	9,754	9,987	10,327	10,782
1980	125	110	89	84	9,541	9,715	9,870	9,938
1979	138	142	121	94	8,755	8,930	9,092	9,159
1978	140	143	131	149	8,029	8,186	8,354	8,442
1977	125	146	163	114	7,408	7,550	7,716	7,780
1976	116	144	155	212	6,817	6,929	7,066	7,171
1975	88	106	128	98	6,372	6,449	6,566	6,609
1974	78	97	134	159	5,881	5,936	6,023	6,091
1973	56	69	84	108	5,495	5,528	5,574	5,614
1972	43	50	60	60	5,112	5,132	5,160	5,174
1971	36	42	53	60	4,727	4,738	4,756	4,769
1970	30	34	40	46	4,379	4,384	4,390	4,395
1969	25	28	32	35	4,051	4,051	4,051	4,051

the potential deficit in the BIF during cyclical downturns, when failure costs are on the rise. But, by the same token, the longer average would tend to produce higher BIF surpluses when conditions improve and failure losses begin to decline.

Figure 1 shows the assessment rates necessary under each of the four methods named previously and the cor-

responding reserve ratio for each method. Only the pay-as-you-go method would have maintained the BIF ratio at 1.25 percent through 1991. This result, however, would have required relatively high assessment rates. Under the two-year average, the BIF ratio would have remained positive, and the assessment rate would have been considerably less than under the pay-as-you-go method. The other two methods

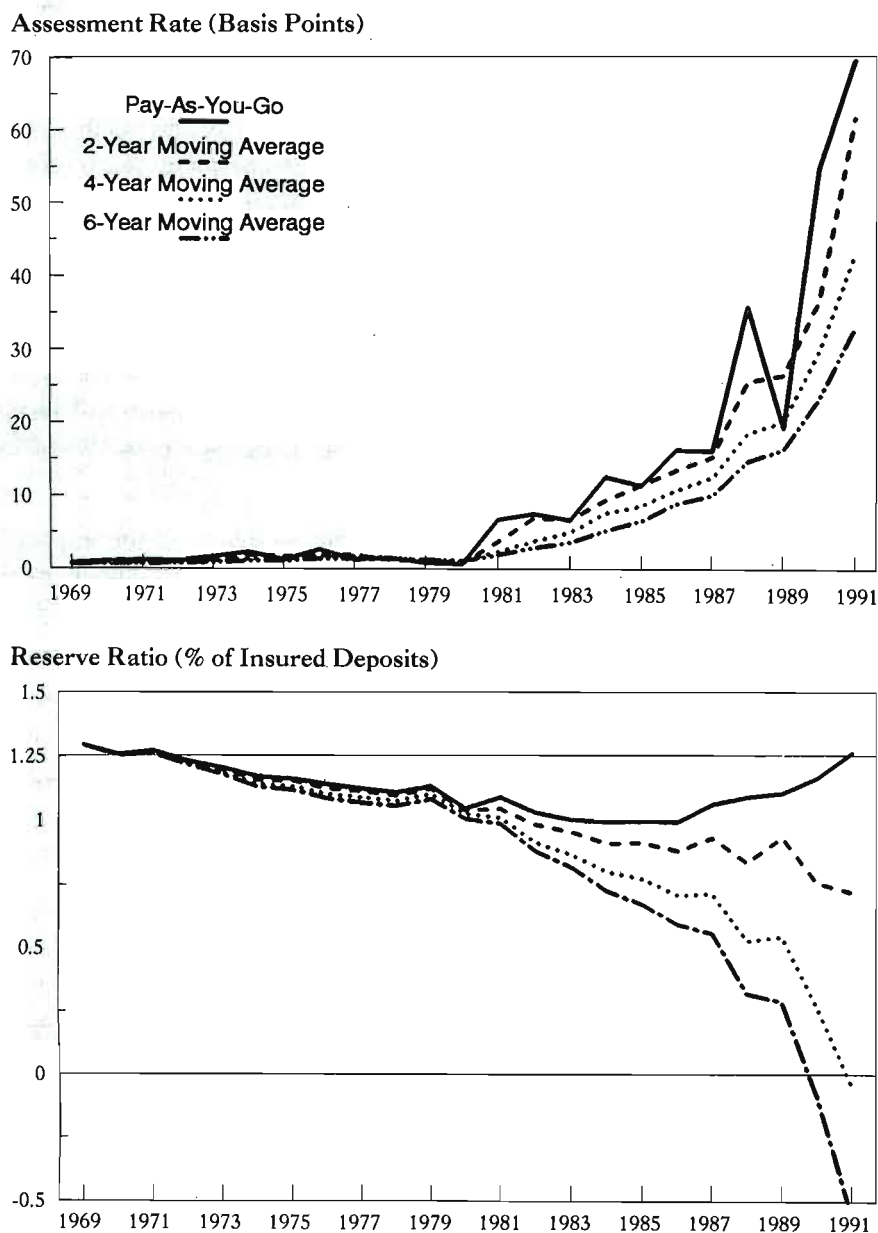
would have resulted in negative BIF ratios by the end of the period, as well as lower assessment rates. As noted previously, so long as the BIF and insured deposits both grow at the same rate, the reserve ratio will tend to stay at the 1.25 percent level. This did not happen during 1970-91 because Congress raised the insurance coverage twice — in 1974 to \$40,000 from \$20,000, and again in 1980 to \$100,000 — which caused insured deposits to grow faster than the BIF. In general, the longer the moving-average interval under consideration, the less will be the year-to-year variability in assessment rates and the larger will be the deviation of the BIF reserve ratio above or below the 1.25 percent line.

Allocating assessment costs on an "average" rather than on a pay-as-you-go basis would in the long run be expected to generate enough revenue to fully pay for the insurance costs accruing to the BIF. The BIF itself will not get balanced every single year at the designated ratio, but over time it should average out to a 1.25 percent ratio. The ultimate objective of this approach would be to balance the BIF budget on a long-term basis, thereby easing the economic burden to BIF members.

As emphasized above, periods of heavy losses to the BIF tend to coincide with periods of poor earnings for the industry as a whole. A moving-average assessment approach will, thus, tend to have a countercyclical effect on bank income. From this perspective, the current risk-based assessment policy will be rendered less burdensome to the industry, thus making it easier for the FDIC to sustain such a policy. Simply put, as compared to the pay-as-you-go method, an assessment policy based on a moving average is likely to render the assessment costs to BIF members more predictable and stable from year to year, and less of a burden during hard economic times. In the long run, of course, costs should average out to the same figure under either approach.

Finally, the use of a moving-average approach after the BIF target is attained would avoid the use of

Figure 1
Premium Rates and BIF Reserve Ratios
Under Alternative Assessment Methods



assumptions and forecasts implicit in a 15-year recapitalization schedule. Because a moving-average approach would rely on a predetermined formula, premium-setting would be insulated from the political process and would become more predictable.

Concluding Comments

Assessment revenue raised by the FDIC since the early 1980s fell far short of the amounts required to cover the costs of bank failures during this period. In order to pay for insurance losses and provide assistance to troubled institutions, the FDIC was forced to liquidate securities and to borrow. As a result, both BIF liquidity and cash balances have been reduced substantially. Most of the portfolio assets in the BIF (once almost totally

consisting of Government securities) are currently in the form of claims against receiverships or loans to assisted banks — assets that generally are difficult to sell or liquidate quickly. Unfortunately, even though in the last three years the assessment rate has almost tripled, the revenues realized have not fully covered the insurance costs to the BIF.

There are, to be sure, compelling arguments as to the level of assessments that banks can absorb, or at what point increased premiums become counterproductive from the standpoint of industry viability. These limits, however, have not been tested — Congress did not require the FDIC to adhere to a strict “pay-as-you-go” policy in response to the large insurance losses in recent years.

Instead, concurrent with the authority to raise premiums, Congress increased the FDIC’s ability to borrow from the Department of the Treasury and other sources. Thus, two-thirds of the insurance losses in 1991 were financed through borrowings from the Federal Financing Bank.

This paper has proposed that when the BIF reaches its target ratio, assessments should be based on a moving average of past losses. Such an approach would avoid both the potential burden on the banking industry implicit in a pay-as-you-go approach, and the reliance on assumptions and forecasts implicit in a 15-year recapitalization schedule. Annual assessments would be determined, instead, on the basis of a fixed formula, known and understood ahead of time by all concerned.

REFERENCES

- Congressional Budget Office. *Budgetary Treatment of Deposit Insurance: A Framework for Reform*. Washington, D.C.: Congressional Budget Office, May 1991.
- Federal Deposit Insurance Corporation Improvement Act of 1991. Pub. L. No. 102—242.
- Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Pub. L. No. 101—103.
- Office of Management and Budget. *Budgeting for Federal Deposit Insurance*. Washington, D.C.: Office of Management and Budget, June 1991.

Acquisitions of Failed-Bank Deposits

In-Market vs. Out-of-Market Cost Effects

by Neil B. Murphy*

In the past several years, the banking industry has undergone substantial consolidation. This occurs as banks eliminated by mergers, acquisitions, and failures exceed the number of new banks chartered. Many observers believe that this consolidation is beneficial. Banks are thought to become more efficient, and a larger geographical lending area allows them to benefit from risk diversification. That is, banks with wider geographical operations are less vulnerable to specific industry or local economic downturns. This diversification has occurred as the restrictions on interstate banking have been removed during the past decade.

There are, however, some skeptics on the alleged efficiency benefits from consolidation. Many studies have found that economies of scale in banking are confined to very small banks, and, indeed, some studies even find diseconomies of scale at high levels of output. These skeptics suggest that bigness does not necessarily indicate efficiency.

Another concern arising from the consolidation of the banking industry

is the effect on competition. Does the removal of competitors indicate that the public may not receive the benefits of a vigorous, competitive process?

A related question arises for the Federal Deposit Insurance Corporation (FDIC) as it resolves failed-bank situations. In most cases, the insured deposits of a failed bank have greater value to another bank than to the FDIC. That is, it is usually cheaper for the FDIC to "sell" the insured deposits of a failed bank to another bank than it is to pay off the depositors. In most cases, the FDIC seeks to find a bidder (or bidders) for the insured deposits (and some of the failed bank's assets) that will result in the lowest overall cost in resolving the failure. If some of the bidders are located in the same market area while others are located elsewhere, then there is a possible dilemma. Acceptance of the bid from the in-market bank results in fewer remaining competitors than would be the case if a bid from an out-of-market bank were accepted.

Does a high bid from an in-market bank reflect ability to manage the insured deposit base more efficiently or does it reflect a desire to reduce the number of competitors in the market area? In this article, the potential efficiency impact is evaluated. Using standard econometric analysis, it is found that in-market bidders who systematically close redundant and overlapping branches can indeed manage the insured deposit activity more efficiently. This result occurs because *while there may not be economies of scale as banks expand, there usually are economies of scale as the typical branch expands*. This is a subtle but important distinction that pervades the literature on bank costs for the past four decades and is verified by the econometric analysis in this article. In the next section, possible reasons for the existence of costly branch systems are discussed. Following that discussion, the results of many previous studies of bank costs and branching

*Neil B. Murphy is Professor of Finance, and Chairman, Department of Finance and Insurance, Virginia Commonwealth University, Richmond, Virginia. This article was prepared while the author participated in the FDIC's Visiting Scholar Program.

are summarized. The section following the summary contains the results of an econometric analysis along with a simulation of several mergers to show the possible cost savings from closing branches. The last section is the summary and conclusions.

Reasons for Existence of Costly Branch Systems

Before proceeding, a question arises. Why would banks institute a more costly system of delivering services by establishing a large number of small branches if it is indeed true that there are economies of scale in the size of branches? There are two logical reasons. First, the measurement of economies of scale is concerned with operating costs at various branch sizes. A larger number of small branches may increase the banks' operating costs, but this may be offset by consumers' increased willingness to pay for conveniences such as reduced travel time and reduced time spent waiting for service. Consumers may pay for such services either by accepting lower interest returns on their deposits or paying higher service fees or interest charges on loans than otherwise would be the case. Second, an historical reason for the establishment of a large number of branches was the existence of controls on interest payments that banks could make to consumers on their deposits. This set of controls, commonly referred to as Regulation Q, indirectly encouraged banks to compete for deposit funds by non-price means. One way of attracting funds in such an environment is the provision of convenience, as a substitute for interest payments, through the establishment of many attractively located branches. Prior to the passage of legislation removing the deposit interest ceilings, there were times during the 1970s when banks were constrained to pay five percent to depositors while the prime rate exceeded 20 percent. While such spreads were not prevalent during the entire period of 1966 to the early 1980s, it was generally the case that banks

had incentives to offer their depositors more than the regulated ceiling. This included giveaways, such as blankets and toasters; reduced service charges and fees; provision of loans to deposit customers at preferential rates; and establishment of conveniently located branches.

There have been a number of developments that have changed in the past decade. First, banks now offer services that are not as tied to specific locations. More people are changing the way they conduct their banking business. The spread of automated teller machines (ATMs) and direct deposit means that many customers do not go to branches for the conduct of usual banking business. Moreover, surveys of customer usage consistently show that ATM users are "upscale" consumers possessing, among other things, higher incomes than non-users. These desirable customers have little need to place much value on the existence of an extensive branch network. Banks' competitors have been very successful in developing substitutes for deposits without establishing costly branch networks. Money-market mutual funds have grown dramatically, offering a service that is substantially the same as a bank deposit, without the need of a branch network. In this case, the telephone and mail systems are a low-cost substitute delivery system. Insurance companies and credit unions have effectively marketed financial services in and through the workplace without having to construct a brick-and-mortar delivery system. Thus, consumer attachment to the branch system has eroded over time through a combination of technology and innovation.

Another recent development is elimination of ceilings on interest rates. For many reasons, it became clear that these restrictions hurt both consumers and banks. Consumers were deprived of the benefits of price competition for their deposit funds, and banks saw numerous competitors, especially money-market mutual funds, take business away from them because they

were constrained by regulation from paying a competitive interest rate to their depositors. In 1980, legislation was passed to remove all these ceilings, and, with the aid of companion legislation in 1982, all such regulations are now relegated to history.

This leaves the banking industry in a difficult position. On the one hand, the banks must compete on a price basis with their competitors. On the other hand, consumers have grown accustomed to having branches in convenient locations. Banks have had to adapt to an environment in which they faced increased deposit costs through most of the 1980s with no easy way to reduce their operating costs through the closing of branches. In addition, banks have not charged the full cost of their transactions and other services to their customers, a practice understandable in the Regulation Q environment. Customers have grown accustomed to this as well, making it difficult to raise charges and fees. Nonetheless, banks have slowly tried to rationalize their delivery systems and pricing of services in the new environment. One way of rationalizing the delivery system is to carefully consider closing redundant and overlapping branches in the wake of a merger.

Results of Previous Studies

There have been studies of costs in banking for almost four decades. These studies reveal a pattern of results over time that supports the notion that many bank branches are too small to be efficient. Early studies were conducted by Alhadeff (1954) and Horvitz (1963). In these studies, the authors compared costs within asset size categories for banks with and without branches. There was a consistent pattern of higher costs for branch banks. These studies have been criticized on the grounds of lumping all branch banks together, not adjusting for product mix, and not having an explicitly-derived cost model. Nonetheless, these authors first suggested that branching was more expensive and set the stage for subsequent studies.

A number of studies followed, utilizing a different data source and a different methodological approach. Benston (1965) and Bell and Murphy (1968) utilized the Federal Reserve's Functional Cost Analysis (FCA) data for their studies.¹ The question of product mix was addressed by breaking the bank into a set of products (functions) and examining the cost-output-branching question using an explicit cost model known as the Cobb-Douglas production function. These authors found that branching was more costly for several functions, especially the deposit-gathering functions. That is, the same output produced at a large number of small offices is more expensive than when produced at a single larger facility. In a separate article, Bell and Murphy (1969) used their econometric model to simulate the cost structure of banks in a number of Northeastern metropolitan areas, and they found that higher branch costs for large banks largely offset the economies of scale for banks found at that time. Longbrake and Haslem (1975) expanded the sample, refined the specification of the branching variable, and considered the cost effects of other organizational variables. Using the same basic approach as Benston and Bell-Murphy, they confirmed the earlier findings.

In a study of banks in New Jersey, New York, and Connecticut, Nelson (1985) used a single equation, linear model with several outputs and branching as variables. He found declining average costs at the branch level, implying that efficiencies could be achieved by increasing the average size of branch.

Most of the studies in this area have used the individual bank as the basis of analysis. That is, costs for the bank are compared to other banks' costs using appropriate statistical techniques. However, some authors have examined costs within a single bank using the individual

branch as the basis of the analysis. Murphy and Orgler (1982) examined the cost structure of 127 branches of a large Israeli bank and found substantial scale economies. In a study of a Greek bank, Pavlopoulos and Kouzelis (1989) found that there are U-shaped cost curves, implying an optimal size branch. That is, average costs at first decline as output increases and, then, after a point begin to rise. The point of the lowest cost is the optimal size branch. In a related study, Fields and Murphy (1989) examined the cost structure of life insurance agencies. These are similar to bank branches in that they deliver financial services "manufactured" elsewhere. They found substantial scale economies to the life insurance agency, usually a single office delivery point for insurance services provided by insurance companies. The results of these studies are generally supportive of the existence of scale economies to the branch office although the evidence is indirect; one from another financial-service industry and two from Mediterranean countries.

In the 1980s, new techniques were applied to the data to test for the existence of scale economies in banking and the effect of branching. The new techniques, referred to as flexible, multiproduct cost functions, are usually estimated using a cost equation known as the transcendental logarithmic function, or the translog. In applying this model, Berger, Hanweck, and Humphrey (1987) estimate scale economies for two situations. First, a measure is computed if it is assumed that output expands and branches do not. Second, a measure is computed assuming that output expansion is accompanied by branch expansion at the rate found in their sample. They find that measures of scale economies always show that expansion of output without expansion of branches leads to lower costs than otherwise would be the case. That is, increasing the average size of branch almost always lowers

cost, holding constant the level of output and other pertinent variables. It also should be noted that they find some branches that are too large, showing diseconomies of scale, implying a U-shaped cost curve and an optimal size of branch. The existence of branches that are larger than the optimal size is confined to large banks in unit banking states. However, for our purpose, the analysis is designed for branch banking states in which it is unlikely that many branches are larger than the optimal size. It also should be noted that the trend for state legislation is to expand the ability of banks to branch, reducing the number of unit banking states.

In summary, the results of many studies show that banks have excess productive capacity at many of their branches. The forces of deregulation of interest ceilings and technological change, noted above, push banks in the direction of attempting to rationalize their delivery systems. Thus, a merger that resulted in closing of redundant and overlapping branches presents an opportunity to pursue cost savings in most instances. From the perspective of the bidder on a failed bank's insured deposits, this implies that an in-market bidder could reduce costs by closing branches without adversely affecting its market position. Hence, such a bidder would find the failed bank's deposits more valuable and would be motivated to make a higher bid than an out-of-market bidder. This higher bid occurs because of possible efficiencies in operating the deposit functions rather than any increased concentration in the market. This result is robust in that the findings of these studies are similar over time and with different approaches to estimating the cost functions. The results of the studies are summarized in Table 1.

¹ This data source is utilized in this article and is described in greater detail below.

Table 1
Summary of Previous Studies on Costs and Branching

Author(s)	Method/Unit of Observation	Findings
Alhadeff (1954)	Tabular/Banks	Branching more expensive
Horvitz (1963)	Tabular/Banks	Branching more expensive
Benston (1965)	Cobb-Douglas/Banks	Branching more expensive
Bell and Murphy (1968)	Cobb-Douglas/Banks	Branching more expensive
Bell and Murphy (1969)	Simulation of Cobb-Douglas/Banks	Branching offsets scale economies
Longbrake and Haslem (1975)	Cobb-Douglas/Banks	Branching more expensive
Nelson (1985)	Linear Model/Banks	Branching more expensive
Murphy and Orgler (1982)	Cobb-Douglas/Branches	Large branches more efficient
Pavlopoulos and Kouzelis (1989)	Translog/Branches	Some branches are too small, others too large
Fields and Murphy (1989)	Translog/Individual Insurance Agent Offices	Large offices more efficient
Berger and Humphrey (1987)	Translog/Bank	Some branches are too small, others too large

Complete citations are shown in the list of references.

Estimation of the Impact of Branching on the Operating Costs of the Deposit Functions

In order to update the studies discussed above and to estimate a model that is specifically relevant for the question posed in this article, a separate econometric analysis was performed. A bank that is considering making a bid to acquire the deposits of a failed bank must consider the cost of operating and servicing the accounts that are acquired. For purposes of this article, such an insured-deposit base will be referred to as an "insured-deposit franchise."

Thus, such a cost model should represent the costs of operating an insured-deposit franchise with special emphasis on the impact of branching. The data for the study are computed from the Federal Reserve's Functional Cost Analysis Program, which is a voluntary program conducted by the twelve Federal Reserve Banks for commercial banks and savings banks in their districts. Each bank agrees to participate and provide data according to an agreed-upon format. The banks themselves participate in the development of the format so it reflects their interests rather than those of a regulator. Each bank allocates costs to a number of different product lines (functions) according to accounting rules upon which all agree. In addition, data are gathered reflecting

the number of accounts in each function, the dollar volume in each activity, the number of transactions, the number of employees and officers involved in the provision of services, and the number of branches operated by the bank. Each participating bank submits the data to its Federal Reserve Bank. The Reserve Bank then processes the data and provides the bank with reports on their comparative costs.

This source of data has some desirable characteristics for the purposes of this study. First, it is the only data source that would permit the analysis of the insured-deposit franchise separately. Second, it is the only data source that has information on physical items such as number of accounts and number of transactions. It is reasonable to assume, for example, that it is more costly to service 10,000 deposit accounts of \$500 each rather than 5,000 accounts of \$1,000 each, even though the total dollar volume is \$5,000,000 in both cases.

However, there are some drawbacks to using this data source. The major drawback is the size distribution of the sample. Both very small and very large banks are underrepresented in the sample, which limits the usefulness of the results. It is difficult to extrapolate the results of the analysis beyond the size distribution of banks found in the sample. Recognizing the

limitations of the data, the benefits are sufficient to make the analysis worthwhile.

In this cost model, banks' costs of providing demand deposits and time deposits are estimated as a function of the number and size of accounts, the number of branch offices, and the wage rates of bank personnel (Table 2). The purpose is to estimate scale economies in providing deposit services at the franchise and the branch level. Each of the two equations estimated has a dependent variable and a group of independent variables. Movement of the independent variables explains the movements of each of the two dependent variables. There is an estimated coefficient associated with each independent variable that measures the response of the dependent variable to changes in that independent variable, holding constant the influence of all other independent variables. The scale economy measures indicate what happens to expenses if output variables increase by a certain percentage. That is, if there is a ten percent increase in output, it is said that economies of scale exist if cost increases by less than ten percent. An increase of exactly ten percent in cost is referred to as constant returns to scale, while an increase of more than ten percent is known as diseconomies of scale.

Table 2
Description of Variables

Variable	Description
EXPDA	Total direct expenses allocated to the demand deposit function, including regular checking, special checking, and interest-bearing checking
EXPTA	Total direct expenses allocated to the time deposit function, including regular savings accounts, club accounts, money-market deposit accounts, retirement accounts, and certificates of deposit under \$100,000
NDA	Total number of demand deposit accounts
NTA	Total number of time deposit accounts
ANDA	Average size of demand deposit account
ANTA	Average size of time deposit account
WEDA	Average annual wage rate of all employees in the demand deposit function
WODA	Average annual wage rate of all officers in the demand deposit function
WETA	Average annual wage rate of all employees in the time deposit function
WOTA	Average annual wage rate of all officers in the time deposit function
B	Total number of offices the bank operates

Source: All banks participating in the Federal Reserve's Functional Cost Analysis Program in 1987, 1988, 1989.

Advances in the theory of cost and production indicate that some transformation of the variables is necessary before the cost equations are estimated.

First, all variables are transformed into logarithms. Second, squared and cross-product terms are added to the independent variables. Third, some

Table 3
Cost Functions

Demand Deposits		Time Deposits		
Dep. Var.	LOGEXPDA	LOGEXPTA		
Ind. Var.	CONSTANT	CONSTANT		Coefficients
	LOGNDA	LOGNTA		A1
	LOGNDASQ	LOGNTASQ		.5(B1)
	LOGNDA*LOGNTA	LOGNDA*LOGNTA		C1
	LOGANDA	LOGANTA		A2
	LOGANDASQ	LOGANTASQ		B2
	LOGWEDA	LOGWETA		D1
	LOGWEDASQ	LOGWETASQ		E1
	LOGWODA	LOGWOTA		D2
	LOGWODASQ	LOGWOTASQ		.5(E2)
	LOGB	LOGB		F1
	LOGBSQ	LOGBSQ		.5(G1)
	LOGNDA*LOGANDA	LOGNTA*LOGANTA		H1
	LOGNDA*LOGWEDA	LOGNTA*LOGWETA		J1
	LOGNDA*LOGWODA	LOGNTA*LOGWOTA		J2
	LOGNDA*LOGB	LOGNTA*LOGB		K1

Where $D1 + D2 = 1$ and
 $J1 + J2 = 0$

restrictions are imposed on some of the coefficients of the resulting equations. These are all necessary to estimate a multiproduct cost function, and this particular model is known as the transcendental logarithmic cost function, or the *translog* cost function. Those cost functions are shown in Table 3.

The equations were estimated simultaneously using a technique known as "seemingly unrelated regression," or SUR, the standard procedure for such models. The results may then be interpreted to determine whether scale economies are present as well as the effect of branching on the results. For that purpose, two general measures are computed. First, the measured scale economies are calculated assuming that expansion of output occurs with no increase in the number of branches. This is referred to as returns to the "plant," each office being viewed as a separate plant producing deposit services. Second, the scale economies measure is calculated assuming that output expansion is accompanied by branch expansion at the rate found in the sample. That is, higher output is generally associated with more branches, and the nature of that association is obtained from the sample banks. The first measure is called returns to scale, plant effect; the second is called returns to scale, franchise effect. In the literature on production and cost, the second measure is usually known as the "firm effect," but here the emphasis is on the deposit franchise. Hence, it is called the "franchise effect."

The results are shown in Table 4. The scale measures, or elasticities, are calculated from the estimated equations. Because there are squared and cross-product terms in the equation, a single measure of scale economies does not emerge from the model. Rather, scale economy measures are computed at different levels of output. In Table 4, the scale economy calculations are made at the mid-point of each quartile of sample output and at the median value of sample output. For example, at the median level of output in 1987, the scale economy measure, franchise, is .8901. This indicates that a ten percent increase in output, along with the branch expansion observed in such a situation,

is accompanied by an 8.9 percent increase in costs. The scale economy measure, plant, is .8357. This indicates that an expansion of ten percent in output with no change in branches is accompanied by an 8.4 percent increase in cost. The interpretation is as follows:

1. The franchise effect measures the percentage increase in costs in the situation where the number of branches expands in relation to output at the same rate as is found in the sample. Since there is a positive relationship between output and branching in the sample, expanding output is accompanied by a larger number of branches. Hence, the average size of branch does not increase as much as is the case when the plant effect is measured. The results show that average cost is reduced in this situation, *i.e.*, there are some economies of scale.
2. The plant effect measures the percentage increase in costs in the situation where total bank output expands, but the number of branches stays the same. Thus, by definition, branch size is increasing more than is true for case "1." The reduction in average costs in this situation is greater than in case "1." One concludes that there are greater potential scale economies for banks that can expand output by increasing branch size.

Inspection of Table 4 shows that in all cases the returns to scale, plant, elasticities are lower than those of the returns to scale, franchise. This means that expanding output without increasing the number of branches leads to lower costs than expanded output accompanied by more branches. This is consistent with the findings of previous studies discussed above.

In the normal course of events, banks may find it difficult to close branches to achieve efficiencies. That is, concerns about adverse customer reaction and unfavorable community response would make most banks hesitant about closing branches in most situations. The move to more efficient size is more likely to be accomplished through growth of existing

branches. However, the acquisition of a failed-bank franchise represents a unique opportunity to acquire a source of funds and close branches at the same time. In many cases, the customers of the failed-bank branches would have another branch of the acquiring bank nearby, and closing the branches of a failed bank is not likely to have the same customer and community reactions, especially if nearby substitutes are available.

Merger Examples: Two Simulations

Because the results derived from the cost function estimated here depend upon the level of output, there is no general finding that can be reported regarding the magnitude of savings from acquiring a failed-bank deposit franchise and closing branches. Therefore, two examples are given with simulated data using the estimated cost model.

For the first simulation, a bank is considering bidding for the deposits of a failed bank within its market area. The values for this simulation are taken as representative values based upon author judgment. Total deposits in the failed bank are \$62,323,767, with 20.85 percent in demand deposits and 79.15 percent in time and savings deposits. There are 3,852 demand deposit accounts and 5,759 time and savings deposit accounts delivered at three branch offices. The potential bidder is a larger bank with total deposits of \$160,335,072, with 23.03 percent in demand deposits and 76.97 percent in time deposits. There are 8,728 demand deposit accounts and 10,492 time and

savings deposit accounts at five branch offices. The procedure for determining the cost effects is as follows: Holding constant the impact of wage rates, consider the incremental annual costs of operation, indicated by the model, of acquiring the deposits if none, one, or all three branches are closed after the acquisition.

The results of the cost simulation are shown in Table 5. The acquiring bank's costs are calculated before and after the acquisition. The incremental cost of the acquisition is then shown under different assumptions about the closing of branches. In each case, the closing of branches is accompanied by a reduction in costs. Maximum cost savings occur when all three branches are closed, averaging 18.3 percent for each of the three years. Even closing one branch is associated with cost reductions of six percent using the 1987 model, 4.5 percent for the 1988 model, and five percent for the 1989 model.

For the second example, consider two banks of equal size, one of which has failed. Each bank has total deposits of \$96,175,535, with demand deposits comprising 24.3 percent and time deposits 75.6 percent, respectively, of the total. Each bank has 6,552 demand deposit accounts, 8,406 time deposit accounts, and operates three branch offices. The results of the simulated acquisition are shown in Table 6. In each case, the closing of branches after the acquisition is accompanied by a reduction in the annual operating costs. Savings from closing one branch are an average of 4.4 percent for each of the three years

Table 4
Ray Scale Economies, Franchise and Plant, 1987-1989

Year	1987(F)	1987(P)	1988(F)	1988(P)	1989(F)	1989(P)
Mid-point 1st Quartile	.8490	.8469	.9968	.9943	.9567	.9507
Mid-point 2nd Quartile	.8865	.8378	.9880	.9460	.9273	.8701
Median	.8901	.8357	.9909	.9434	.9293	.8669
Mid-point 3rd Quartile	.8884	.8327	.9922	.9386	.8979	.8311
Mid-point 4th Quartile	.8607	.8278	.9824	.9035	.7809	.7296

while savings from closing all three acquired branches are an average of 15.3 percent for each of the three years.

In both cases, it should be emphasized that these savings occur annually. That is, the present value of the stream of the savings would be greater than what is shown here for a single year. Of course, the present value of all future earnings is the appropriate basis for formulating a bid for a failed-bank franchise. The results of the analysis here indicate that such savings would have an important impact on the price that an in-market bidder would be willing to pay the FDIC.

Savings from branch closings in failed-bank situations most likely are greater than estimated here. A byproduct of branch closings in failing-bank situations may be the elimination of poorly-managed, high-cost branches. This type of cost savings relates to the operational efficiency, not the size, of branches before *versus* after the failure-resolution transaction. Humphrey (1987, 1991) has shown that if all banks were as efficient as the most productive ten percent of the industry, savings would exceed what is available if all banks merely reached the optimal size. Thus, if mergers, whether voluntary or not, result in the remaining bank being among the most efficient, cost savings can be substantial. Banks usually fail because of poor credit judgments, but it is reasonable to suppose that such banks are also high-cost producers as well. Limited research by Kolari and Zardkoohi (1987) and Siems (1992) support this view. Therefore, in addition to the cost savings from increasing the average size of branch, it is likely that the surviving bank would also manage the franchise more efficiently.

Summary and Conclusions

In recent years, the number of bank failures has increased substan-

Table 5
Cost Effects of Franchise Acquisition, Scenario One

	1987	1988	1989
Acquiring Bank			
# of Demand Accounts	8,728	8,728	8,728
# of Time Accounts	10,492	10,492	10,492
Branches	5	5	5
Acquired Bank			
# of Demand Accounts	3,852	3,852	3,852
# of Time Accounts	5,759	5,759	5,759
Branches	3	3	3
Incremental Cost to Acquiring Bank			
All Branches Open	\$816,672	\$740,874	\$818,873
Close One Branch	\$766,333	\$707,194	\$778,097
Close All Branches	\$646,842	\$627,955	\$665,185

Table 6
Cost Effects of Franchise Acquisition, Scenario Two

	1987	1988	1989
Acquiring Bank			
# of Demand Accounts	6,522	6,522	6,522
# of Time Accounts	8,406	8,406	8,406
Branches	3	3	3
Acquired Bank			
# of Demand Accounts	6,522	6,522	6,522
# of Time Accounts	8,406	8,406	8,406
Branches	3	3	3
Incremental Cost to Acquiring Bank			
All Branches Open	\$1,272,369	\$1,174,352	\$1,311,169
Close One Branch	\$1,207,369	\$1,132,156	\$1,253,168
Close All Branches	\$1,039,881	\$1,025,555	\$1,120,008

tially. One consequence of this process is that a large number of insured-deposit franchises are available for sale by the FDIC which attempts to capture the franchise value of these deposits in selecting bids from interested banks. Banks that acquire an insured-deposit franchise establish bids based upon expected net future earnings from the acquisition. The cost of operating the franchise is an important determinant of those benefits. Bidders that are in the same market area may have an incentive to post higher bids if they are able to close small branches in the

process. This incentive exists because of cost savings rather than an increase in market power. This is suggested by the results of previous studies on costs and branching. In this article, the cost of operating deposit functions, a proxy for the insured-deposit franchise, is examined. It is found that the branching effects of previous studies are confirmed here. Moreover, simulations of specific transactions show that the cost savings are substantial. As a practical matter such savings are largely confined to in-market bidders.

REFERENCES

- Alhadeff, David A. *Monopoly and Competition in Banking*. Berkeley: University of California Press, 1954.
- Bell, Frederick W., and Neil B. Murphy. *Costs in Commercial Banking: A Quantitative Analysis of Bank Behavior and Its Relation to Bank Regulation*. Research Report No. 41, Federal Reserve Bank of Boston, 1968.
- _____. "Economies of Scale and the Division of Labor in Commercial Banking." *Southern Economic Journal* 35 (1968):131-39.
- _____. "The Impact of Regulation on the Inter- and Intra-Area Variation in Bank Costs." *Journal of Regional Science* 9 (1969):225-38.
- Benston, George J. "Branch Banking and Economies of Scale." *Journal of Finance* 20 (1965):312-31.
- Benston, George J., Gerald A. Hanweck, and David B. Humphrey. "Scale Economies in Banking: A Restructuring and Reassessment." *Journal of Money, Credit and Banking* 14 (1982):435-56.
- Berger, Allen N., Gerald A. Hanweck, and David B. Humphrey. "Competitive Viability in Banking: Scale, Scope, and Product Mix Economies." *Journal of Monetary Economics* 20 (1987):501-20.
- Berger, Allen N., and David B. Humphrey. "The Dominance of Inefficiencies over Scale and Product Mix Economies in Banking." *Journal of Monetary Economics* 28-1 (1991):117-48.
- Cebenoyan, A. Sinan. "Multiproduct Cost Functions and Scale Economies in Banking." *Financial Review* 23 (1988):499-512.
- Fields, Joseph A., and Neil B. Murphy. "An Analysis of Efficiency in the Delivery of Financial Services: The Case of Life Insurance Agencies." *Journal of Financial Services Research* 2 (1989):343-56.
- Horvitz, Paul M. "Economies of Scale in Banking." In Deane Carson and Paul H. Cootner, editors, *Private Financial Institutions*, pp. 1-54. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1963.
- Humphrey, David B. "Cost Dispersion and the Measurement of Economies of Scale in Banking." Federal Reserve Bank of Richmond *Economic Review* 76 (1987):38-50.
- _____. "The Likely Effects of Interstate Branching on Bank Costs and Services." Washington, D.C.: U.S. Congressional Budget Office, 1991.
- Hunter, William C. and Stephen G. Timme. "Technical Change, Organizational Form and the Structure of Bank Production." *Journal of Money, Credit and Banking* 18 (1986):152-66.
- Kolari, James, and Asghar Zardkoohi. *Bank Costs, Structure, and Performance*. Lexington, MA: D.C. Heath and Co, 1987.
- Longbrake, William E., and John A. Haslem. "Productive Efficiency in Banking: The Effects of Size and Legal Form of Organization on the Cost of Producing Demand Deposits." *Journal of Money, Credit and Banking* 7 (1975):317-30.
- Murphy, Neil B. "One-Stop Financial Service Delivery Opportunities in a World of Automated Self-Service Banking: Some Evidence from the United States." In E. P. M. Gardener, editor, *The Future of Financial Systems and Services*. London: Macmillan and Co., 1991.
- Murphy, Neil B. and Yair E. Orgler. "Cost Analysis for Branching Systems: Methodology, Test Results and Implications for Management." *Journal of Financial Research* 5 (1982):181-87.
- Murphy, Neil B. and Ronald C. Rogers. "Life Cycle and the Adoption of Consumer Financial Innovation: An Empirical Study of the Adoption Process." *Journal of Bank Research* 17 (1986):3-8.
- Nelson, Richard W. "Branching, Scale Economies, and Banking Costs." *Journal of Banking and Finance* 9 (1985):177-92.
- Pavlopoulos, P. G., and A. K. Kouzelis. "Cost Behavior in the Banking Industry: Evidence from a Greek Commercial Bank." *Applied Economics* 21 (1989):285-93.
- Siems, Thomas F. "Quantifying Management's Role in Bank Survival." Federal Reserve Bank of Dallas *Economic Review* (First Quarter 1992):29-41.

APPENDIX

Table A1a
Results of SUR Estimates of Translog Cost Functions
1987

Demand Deposits Dependent Variable Is LOGEXPDA		Time Deposits Dependent Variable Is LOGEXPTA	
VARIABLE	COEFF./ST.ERR.	VARIABLE	COEFF./ST.ERR.
CONSTANT	-9.1772/4.1528	CONSTANT	8.1834/6.5048
LOGNDA	1.3096/.4396	LOGNTA	-.7048/.4877
LOGNDASQ	-.0083/.0209	LOGNTASQ	.0331/.0148
LOGNDA*LOGNTA	.0055/.0037	LOGNTA*LOGNDA	.0330/.0055
LOGANDA	.2562/.7424	LOGANTA	-1.8735/1.1071
LOGANDASQ	.0335/.0400	LOGANTASQ	.0896/.0483
LOGWEDA	-4.9965/2.7406	LOGWETA	-.9496/2.4524
LOGWEDASQ	.3216/.1496	LOGWETASQ	.0659/.1320
LOGWODA	5.9965/2.7406	LOGWOTA	1.9496/2.4524
LOGWODASQ	-.3149/.1367	LOGWOTASQ	-.0738/.1210
LOGB	.0638/.3459	LOGB	1.0727/.3012
LOGBSQ	-.0213/.0389	LOGBSQ	.0440/.0344
LOGNDA*LOGANDA	-.0505/.0296	LOGNTA*LOGANTA	.0725/.0375
LOGNDA*LOGWEDA	-.0836/.0658	LOGNTA*LOGWETA	.0089/.0570
LOGNDA*LOGWODA	.0836/.0658	LOGNTA*LOGWOTA	-.0089/.0570
LOGNDA*LOGB	.0155/.0452	LOGNTA*LOGB	-.1147/.0362

SYSTEM WEIGHTED R-SQUARE = .8395

OBSERVATIONS = 562

df = 1,096

Table A1b
Results of SUR Estimates of Translog Cost Functions
1988

Demand Deposits Dependent Variable is LOGEXPDA		Time Deposits Dependent Variable is LOGEXPTA	
VARIABLE	COEFF./ST.ERR.	VARIABLE	COEFF./ST.ERR.
CONSTANT	-4.7051/4.5507	CONSTANT	-15.0832/4.204
LOGNDA	1.0555/.4604	LOGNTA	.9235/.4541
LOGNDASQ	-.0055/.0199	LOGNTASQ	-.0042/.0151
LOGNDA*LOGNTA	.0053/.0041	LOGNTA*LOGNDA	.0345/.0060
LOGANDA	.2414/.8572	LOGANTA	1.8600/.5496
LOGANDASQ	.0137/.0506	LOGANTASQ	-.0524/.0219
LOGWEDA	1.5641/2.7799	LOGWETA	-1.1495/2.9013
LOGWEDASQ	-.0684/.1528	LOGWETASQ	.1417/.1587
LOGWODA	-.5641/2.7799	LOGWOTA	2.1495/2.9013
LOGWODASQ	.0332/.1401	LOGWOTASQ	-.1459/.1451
LOGB	.0968/.3177	LOGB	.3553/.3031
LOGBSQ	.0134/.0371	LOGBSQ	.0027/.0332
LOGNDA*LOGANDA	-.0071/.0342	LOGNTA*LOGANTA	-.0636/.0314
LOGNDA*LOGWEDA	-.0076/.0602	LOGNTA*LOGWETA	-.1326/.0594
LOGNDA*LOGWODA	.0076/.0602	LOGNTA*LOGWOTA	.1326/.0594
LOGNDA*LOGB	-.0041/.0402	LOGNTA*LOGB	-.0259/.0349

SYSTEM WEIGHTED R-SQUARE = .8241

NUMBER OF OBSERVATIONS = 493

df = 958

Table A1c
Results of SUR Estimates of Translog Cost Functions
1989

Demand Deposits Dependent Variable is LOGEXPDA		Time Deposits Dependent Variable Is LOGEXPTA	
VARIABLE	COEFF./ST.ERR.	VARIABLE	COEFF./ST.ERR.
CONSTANT	-4.1473/7.4730	CONSTANT	-2.1148/12.838
LOGNDA	.9377/.7974	LOGNTA	-.0585/.9453
LOGNDASQ	-.0084/.0299	LOGNTASQ	-.0121/.0250
LOGNDA*LOGNTA	.0048/.0060	LOGNTA*LOGNDA	.0401/0097
LOGANDA	-.7426/1.1674	LOGANTA	.0687/2.0211
LOGANDASQ	.0623/.0568	LOGANTASQ	.0014/.0793
LOGWEDA	-5.6353/3.6637	LOGWETA	-3.7015/4.3522
LOGWEDASQ	.3820/.2030	LOGWETASQ	.3991/.2373
LOGWODA	6.6353/3.6637	LOGWOTA	4.7015/4.3522
LOGWODASQ	-.3755/.1854	LOGWOTASQ	-.3955/.2166
LOGB	1.0618/.5007	LOGB	.3840/.5338
LOGBSQ	.0414/.0595	LOGBSQ	-.0037/.0663
LOGNDA*LOGANDA	.0126/.0586	LOGNTA*LOGANTA	.0259/.0772
LOGNDA*LOGWEDA	-.1627/.0923	LOGNTA*LOGWETA	-.3930/.1056
LOGNDA*LOGWODA	.1627/.0923	LOGNTA*LOGWOTA	.3930/.1056
LOGNDA*LOGB	-.1109/.0659	LOGNTA*LOGB	-.0289/.0642

SYSTEM WEIGHTED R-SQUARE = .8302
NUMBER OF OBSERVATIONS = 254
df = 480

Table A2
Regression Results for the Branch-Output Relationship
Translog Model, 1987, 1988, 1989
(Dependent Variable is LOGB)

VARIABLE	1987	1988	1989
	COEFF/ST.ERR.	COEFF/ST.ERR.	COEFF/ST.ERR.
CONSTANT	6.9603/1.0441	6.1042/1.3352	7.5692/2.1093
LOGNDA	-2.4557/.4085	-2.4763/.4617	-3.8548/.9170
LOGNTA	.6173/.2991	.8291/.3357	1.8823/.6160
LOGNDASQ	.0940/.0496	.1077/.0515	.2667/.0912
LOGNTASQ	-.1052/.0300	-.1197/.0342	-.1142/.0390
LOGNDA*LOGNTA	.1464/.0700	.1370/.0750	-.0092/.1008
R-SQUARE =	.6134	.5509	.5044
OBSERVATIONS =	562	493	254
df =	556	487	248

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 several regulatory areas, including: a) standards for banks' and thrifts' safe-and-sound operations; b) "prompt corrective action" requirements; c) identifying institutions with high interest-rate risk; d) real-estate lending standards; and e) coordination and communication between external auditors and examiners. These are summarized under the FDIC section in this *Review*. Also see the discussions under other regulatory agencies and the Federal Financial Institutions Examination Council (FFIEC).

Federal Deposit Insurance Corporation

Recapitalization of the Bank Insurance Fund

As required by Section 7(b) of the Federal Deposit Insurance Act, amended by the FDIC Improvement Act of 1991 (FDICIA), the FDIC proposed a schedule for increasing the reserve ratio of the Bank Insurance Fund (BIF) to 1.25 percent over a

15-year period. Currently, the BIF reserve ratio is significantly below that level. If the reserve ratio is less than 1.25 percent, the agency is required to take action to raise the ratio to that level. The proposed recapitalization schedule specifies a target reserve ratio for each semiannual period for the next 15 years, culminating in the requisite ratio of 1.25 percent.

In developing the proposed recapitalization, a range of assumptions was used for the amounts of failed-bank assets and resolution costs, and industry growth rates. The FDIC noted the uncertainties surrounding any schedule based on projections of economic conditions beyond the immediate future, and that the schedule may require adjustment as economic conditions change. *FR*, 6/29/92, p. 28810.

BIF-Recapitalization and Risk-Related Insurance Fees Adopted

The FDIC is amending its regulations on assessments to adopt a recapitalization schedule for the BIF, increase the deposit insurance assessment rate for certain members of the BIF or the Savings Association Insurance Fund (SAIF) during the first semiannual period of calendar year 1993 and thereafter, and adopt a transitional risk-related deposit insurance assessment system.

For the first time, the FDIC will charge higher insurance rates to those banks and savings associations that pose greater risk to the deposit insurance funds. Currently, all FDIC-insured institutions pay the same premium (23 cents per \$100 of domestic deposits) under a flat-rate system mandated by law. However, more recent laws require the FDIC to raise the reserves of BIF and SAIF, implement a risk-related premium system, and adopt a long-term schedule for recapitalizing the BIF. FDICIA mandates that a risk-related assessment system be implemented no later than January 1, 1994. Under the new rule, which goes into effect January 1, 1993, a bank or thrift will pay within a range of 23 cents per \$100 of domestic deposits to 31 cents per \$100 of domestic deposits, depending on its risk classification. The system to start this coming January is intended to provide for a transition between the current flat-rate system and the final risk-related premium system to be implemented in 1994. Although the new risk-related system and rate schedule were adopted as final, the FDIC Board will meet again later this year to

*Benjamin B. Christopher is a financial economist in the FDIC's Division of Research and Statistics.

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

consider whether changes in economic or industry conditions would warrant adjustments in the range of assessment rates to be charged in January.

To arrive at a risk-related assessment for each bank and thrift, the FDIC will place it in one of nine risk categories using a two-step process based first on capital ratios and then on other relevant information. Each institution will be assigned to one of three groups (well-capitalized, adequately capitalized, or undercapitalized) based on its capital ratios. These capital definitions are identical to those being used by the four federal bank and thrift regulators for use in the "prompt corrective action" regulation separately adopted, except the premium rule excludes references to supervisory evaluations and directives that are included in the other regulation. Each institution will be assigned also to one of three subgroups based on evaluation of the risk posed by the institution. The FDIC will make this evaluation based on reviews by the institution's primary federal or state supervisor, statistical analyses of financial statements and other information relevant to gauging the risk posed by the institution. These supervisory evaluations therefore will modify the premium rates within each of the three capital groups, the result being nine risk categories, with assessment rates ranging from 23 cents (per \$100 of domestic deposits) to 29 cents for well-capitalized institutions, 26 cents to 30 cents for adequately capitalized institutions, and 29 cents to 31 cents for undercapitalized institutions.

The FDIC projects that about 75 percent of the 12,000 BIF-insured commercial banks and savings banks (with 51 percent of the deposit base) and 60 percent of the 2,300 SAIF-insured thrifts (with approximately 43 percent of the deposit base) will be in the lowest-rate-paying group when the new system starts in January. Only about 220 banks (two percent of all insured commercial and savings banks) and 160 thrifts (seven percent of all insured thrifts) are expected to be in the group paying the highest

insurance rate. *PR-129-92, FDIC, 9/15/92; FR, 10/1, p. 45263.*

Midyear 1992 Financial Results

The BIF had net income of approximately \$1.5 billion (preliminary) for the six months ended June 30, 1992. As a result, the unaudited fund balance improved to a negative \$5.5 billion from the year-end 1991 level of a negative \$7 billion. The major factor contributing to earnings was a favorable interest-rate environment, which led to an upward adjustment to expected values on failed-bank assets in liquidation. On a current basis, insurance costs continue to exceed assessment income. The BIF's operating expenses and insurance losses for the first six months of the year totaled about \$3.3 billion, compared to assessment income of about \$2.8 billion during the period. This continues a pattern that began in 1984 where, on a current basis, actual costs have exceeded assessment revenue each year. The aggregate assessment revenue shortfall from January 1984 through June 1992 amounts to approximately \$18 billion.

Acting Chairman Andrew C. Hove, Jr. said that working capital borrowings from the Federal Financing Bank, which are repaid from asset sales, increased by \$4.5 billion to a balance of \$15.5 billion. To date, the FDIC has not borrowed any of the \$30 billion available from the U.S. Treasury to cover operating and insurance losses related to bank failures.

For the year 1991, the BIF had revenues of about \$5.8 billion, an increase from \$3.9 billion the previous year. However, insurance losses and operating expenses (including \$15.4 billion for unresolved bank failures) totaled nearly \$16.9 billion. This resulted in an \$11.1 billion net operating loss, that reduced the BIF balance from \$4.0 billion at year-end 1990 to a deficit of \$7.0 billion at year-end 1991. The FDIC handled 124 BIF-insured bank failures in 1991 with record-high assets of \$63.1 billion, and also provided financial assistance to three

small banks in danger of failing (total assets of \$83.8 million).

Sixty-six banks with assets of approximately \$20.1 billion failed during the first half of 1992. The estimated costs to the BIF from those failures is about \$3.1 billion. Despite the increase in the fund balance at midyear, the outlook is uncertain. Banks and the FDIC are benefitting from the low interest-rate environment in recent months. Acting Chairman Hove noted that a large volume of nonperforming assets remain in banks whose future is in doubt. If these banks are unable to avoid failure, the BIF's financial position could deteriorate. *PR-86-92, FDIC, 6/2; PR-126-92, 9/9; Annual Report, FDIC, 1991.*

Deposit Insurance Coverage

The FDIC solicited public comment on deposit insurance coverage, to assist the agency in complying with a provision of FDICIA requiring the FDIC to conduct a one-year study of the rules that base insurance coverage on the "rights and capacities" in which deposit accounts are owned. In general, under existing rules all deposits maintained in the same right and capacity (*i.e.*, owned in the same manner) in one insured institution are added together and protected up to \$100,000 in the aggregate. Deposits maintained in different rights and capacities (such as funds in an individual account and funds in a joint account) are separately insured.

The FDIC is seeking comments on a broad range of issues, including the desirability of expanding or limiting the current rules for separate insurance coverage. After the review, the FDIC may revise the deposit insurance rules provided the change would protect small depositors, not unduly expand deposit insurance coverage, and be consistent with the insurance provisions of the Federal Deposit Insurance Act. *FIL-34-92, FDIC, 5/7; FR, 4/28, p. 17866.*

Standards for Banks' and Thrifts' Operations

The FDIC and the three other federal bank and thrift regulatory

agencies are seeking public comment on a broad range of issues for judging safe-and-sound operations of insured depository institutions. The agencies are required by FDICIA to prescribe certain safety and soundness standards for insured institutions and their holding companies in three main areas: 1) operations and management; 2) asset quality, earnings and stock valuation; and 3) employee compensation. Final regulations must be issued no later than August 1, 1993, and be effective no later than December 1, 1993.

Because of the range and complexity of these issues, the agencies first are seeking responses from the public to more than 50 questions. Based in part on the comments received, the agencies next plan to develop a proposed regulation that will be issued for additional public comment. The four agencies intend to work together reviewing all comments and developing joint proposals and final rules. *FIL-55-92, FDIC, 7/22; FR, 7/15, p. 31336.*

"Prompt Corrective Action" Requirements

The FDIC adopted a final rule, to become effective December 19, 1992, implementing a statutory requirement that banking regulators take specified "prompt corrective action" when an insured institution's capital falls to certain levels. Similar rules have been adopted by the Federal Reserve Board (FRB) and are in the process of being adopted (as of 9/15/92) by the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) for the institutions they supervise. FDICIA provides that restrictions and prohibitions on an insured bank or thrift are to become more severe as the institution's capital level declines. The sanctions begin with measures such as restrictions on dividends and management fees (if the payments would result in the institution becoming undercapitalized) and ultimately result in the closing of institutions that are critically undercapitalized. The FDIC's rule applies primarily to state-chartered banks and insured branches of foreign banks that are supervised by the agency, as well

as to directors, officers and employees of these institutions. However, portions of the FDIC rule also apply to all insured depository institutions that are deemed to be "critically undercapitalized."

Under the new 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* it is not subject to any written agreement, order or directive from its regulator to meet and maintain a specific capital level.

Other capital categories in the new rule are "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." FDICIA mandates that an undercapitalized institution be subject to restrictions on dividend and management fees, asset-growth restrictions, and prohibitions against making acquisitions, opening branches, or engaging in new lines of business without the prior approval of its primary federal regulator. Significantly undercapitalized institutions are subject to the restrictions that apply to undercapitalized banks and thrifts, as well as to other limitations that include mandatory prohibitions against the payment of bonuses and raises to senior executive officers without the regulator's prior approval. Critically undercapitalized institutions are subject to the restrictions that apply to the other two categories of undercapitalized institutions, as well as to other prohibitions that the FDIC has been given authority to enforce as the insurer of deposits. Under FDICIA, a critically undercapitalized institution generally is prevented from paying principal and interest on its subordinated debt and will be placed in conservatorship or receivership if its capital level is not increased within a prescribed time limit.

The FDIC estimates that about 98 percent of the nation's 12,000 insured banks (commercial and savings) and

90 percent of the 2,000 insured thrifts have capital levels fitting the statistical requirements for being well- or adequately capitalized. *PR-128-92, FDIC, 9/15/92.*

Identifying Banks with High Interest-Rate Risk

The FDIC is seeking public comment on a proposed new system for identifying banks that face excessive risk from swings in market interest rates. The proposal, still in its early stages of development by the three federal bank regulatory agencies, would require certain banks with high levels of interest-rate risk to increase their capital to cover their "excess" exposure to loss. FDICIA requires the federal banking agencies to revise existing risk-based capital standards to take adequate account of interest-rate risk. A final rule must be published by June 19, 1993. The regulators estimate that when a final rule is adopted, approximately 20 percent of the nation's commercial banks could face an additional minimum capital requirement as a result of high interest-rate risk exposure.

The plan is to expand the quarterly financial reports filed by FDIC-insured banks to give a more detailed account of the assets and liabilities scheduled to mature or undergo interest-rate adjustments in the future. This would include more information on interest-rate swaps, futures contracts and other off-balance-sheet items. A formula would project and quantify the effects of a 100-basis-point change in interest rates. A bank identified as having a high level of interest-rate risk would be required to cover its projected excess exposure with a proportional amount of capital.

The FDIC and the other regulatory agencies are seeking to balance the need for additional information with concerns about limiting paperwork and other burdens on the industry. As such, the agencies are asking for suggestions about how to implement an exemption for institutions clearly identified as having low interest-rate risk. The agencies also

are seeking general input about implementing other provisions of the 1991 law that address the risks from concentrations of credit and from non-traditional activities.

Based on the comments received, the agencies will issue a proposed regulation for another round of public comment before issuing a final rule. The plan issued by the FDIC applies only to state-chartered banks that are not members of the Federal Reserve System. It is identical to what is being developed by the FRB and the OCC for the banks they regulate. *PR-110-92, FDIC, 7/29; FIL-60-92, FDIC, 8/20; FR, 8/10, p. 35507.*

Real-Estate Lending Standards

FDICIA requires the four federal bank and thrift regulatory agencies to adopt uniform real-estate lending standards by September 19, 1992, to become effective on March 19, 1993. To implement this requirement, the regulators issued for public comment a joint proposal. It includes a plan to establish loan-to-value (LTV) ratio limitations on real-estate loans as a suitable standard for addressing lending risk. The agencies are asking for comment on two alternative approaches.

Alternative 1 would require each institution's board of directors to establish its own prudent lending standards for six categories of real-estate loans, subject to a range of maximum permissible LTV ratios proposed by the agencies. For example, the agencies have proposed that loans for raw land have a maximum permissible LTV ratio in the range of 50-to-65 percent, and that each institution be required to set its own maximum ratio within or below that range. After establishing maximum LTV ratios for each category of real-estate lending, each lender would be expected to specify criteria that would be used to qualify loans at the institution's established maximum LTV ratio levels. The expectation is that loans would be made at the upper end of the LTV ratio range only when significant positive features are present that mitigate the higher level of risk. Under Alternative 2, the agencies

would set for all institutions a maximum LTV ratio for each of the six categories of real-estate loans. For example, loans for raw land would have a maximum LTV ratio of 60 percent, and all lending institutions regulated by the agencies would be subject to that maximum. For either alternative, the proposal specifies certain transactions, for example, loans guaranteed or insured by the U.S. government or a U.S. government agency, that would be excluded from whatever LTV ratio limitations are adopted in the final rule.

Under the proposal, lenders would be authorized to make real-estate loans in excess of LTV limits if the aggregate of those loans does not exceed 15 percent of the institution's capital. Such loans would have to be reviewed by the senior management of the lending institution, reported to its board of directors and adequately documented for examiners. *FIL-56-92, FDIC, 7/22; FR, 7/16, p. 31594.*

Brokered Deposits

The FDIC adopted a final rule, effective June 16, 1992, implementing Section 301 of the FDICIA. Under the rule, a "well-capitalized" insured depository institution may accept brokered deposits without restriction. An "adequately capitalized" insured depository institution is prohibited from accepting brokered deposits unless it first obtains a waiver from the FDIC. An "undercapitalized" institution is prohibited from accepting brokered deposits.

A "well-capitalized" institution is one that has: a) a ratio of total capital to risk-weighted assets of not less than ten percent, b) a ratio of Tier 1 capital to risk-weighted assets of not less than six percent, c) a ratio of Tier 1 capital to total book assets of not less than five percent, and d) not been notified by its appropriate federal banking agency that it is in a "troubled condition." An "undercapitalized" institution is one that fails to meet the minimum regulatory capital requirements prescribed by its appropriate federal banking agency. An "adequately capitalized"

institution is one that is not a well-capitalized or undercapitalized institution.

An adequately capitalized institution desiring to obtain a waiver from the FDIC must file an application with the appropriate FDIC Regional Director. The final rule provides for a 60-day transitional period. An adequately capitalized institution that files an application by July 16, 1992, may accept, renew or rollover brokered deposits until August 16, 1992, unless otherwise notified by the FDIC.

An undercapitalized institution may not solicit deposits by offering interest rates that are significantly higher than the prevailing rates of interest on insured deposits in its normal market area or in the market area in which such deposits would otherwise be accepted. An adequately capitalized institution that obtains a waiver to accept brokered deposits is prohibited from paying an interest rate on these funds that significantly exceeds a) the rate paid on deposits of similar maturity in the institution's normal market area for deposits accepted from that area or b) the "national rate" (as defined herein) paid on deposits of comparable maturity for deposits accepted outside the institution's normal market area.

A deposit broker must register with the FDIC before it may solicit or place deposits with an insured depository institution. The broker also must maintain certain records, and, upon request from the FDIC, file quarterly written reports. *FIL-42-92, FDIC, 6/3; FR, 6/5, p. 23933.*

Restrictions on State Bank Investments

The FDIC proposed implementing new statutory restrictions on the ability of state-chartered banks to own corporate stock and mutual fund shares or to have equity ownership in other investments such as real-estate development projects.

FDICIA, with certain exceptions, prohibits a federally insured state-chartered bank from making or retaining equity investments of a type or amount prohibited for a national

bank, subject to complete divestiture by December 19, 1996. For example, since national banks generally are prohibited from owning stock or mutual fund shares, the new law prohibits these investments for state banks. A partial exception is provided if: a) a bank had ownership of qualifying stocks or mutual funds during the 14-month period from September 30, 1990, through November 26, 1991, and b) the bank's state permitted such investments as of September 30, 1991. An institution that meets these two conditions and wants to retain or acquire new qualifying stock or mutual fund shares must provide notice to the FDIC of its intention and may receive the agency's approval. The FDIC, in making its determination, is required to look at any significant risk to the insurance fund as well as the potential impact on the institution's safety and soundness. A bank receiving FDIC approval to continue making these equity investments is subject to an aggregate limit under the new law equal to no more than the institution's capital. The proposal also includes the agency's interpretation defining the limits on types of investments and calculation of the capital limitation.

An institution with equity investments not exempted from the prohibition would be required to submit to the FDIC a plan to divest such holdings as quickly as can be prudently done. A bank that was lawfully engaging in insurance underwriting as principal on November 21, 1991, or a bank that had a subsidiary that was lawfully providing insurance as principal on that date, is exempt from the general prohibition on these insurance activities but would be required to give notice of its activity to the FDIC. The law also exempts investments in certain qualifying housing projects.

The FDIC also proposed an amendment to its regulations the effect of which would be to subject SAIF member state banks and BIF member state banks to the same restrictions insofar as their equity investments are concerned. *PR-96-92, FDIC, 6/19; FR, 7/9, pp. 30435, 30433.*

Required Annual Audits of Banks and Thrifts

The FDIC will seek public comment on a proposal to implement new statutory requirements for outside audits of insured institutions and other measures to detect and prevent problems in a bank or thrift's financial management. FDICIA requires each insured institution with total assets of \$150 million or more to file with the FDIC annual financial statements audited by an independent public accountant, although the agency has the authority to raise the \$150 million threshold. The accountant also must review and attest to the effectiveness of the institution's internal controls and its compliance with safety and soundness regulations, using audit procedures agreed upon by the FDIC. Among other requirements, an institution subject to this law must establish and maintain an audit committee composed entirely of outside directors who must review the audit findings with management and the outside accountant. Audit committees of "large institutions" have more stringent requirements.

The \$150 million-level, which would cover about 3,000 of the nation's 14,000 FDIC-insured banks and thrifts, is being proposed because it is consistent with the FRB regulations for bank holding company audits and because most institutions of that size already get outside audits. In addition, banks and thrifts with assets of \$500 million or more would be considered "large" under the proposal and therefore subject to more stringent audit committee requirements. Those include a prohibition against large loan or deposit customers serving on the audit committee and a requirement that the committee have access to its own outside counsel independent of management. Auditors would be required to meet certain qualifications, including independence from the institution, and being enrolled in an accounting industry peer review program.

In general, the FDIC is attempting to implement the law and maximize

the benefits to the agency but also to limit the compliance costs for banks and thrifts. The law requires the new auditing system to be in effect for the first fiscal year after December 31, 1992. *PR-124-92, FDIC, 9/1; FR, 9/15, p. 42516.*

Coordination and Communication Between External Auditors and Federal Examiners

The FDIC, FRB, OCC, and OTS adopted a policy statement intended to improve the coordination and communication between external auditors and federal examiners. The statement clarifies and makes uniform the agencies' guidelines regarding the information a depository institution should provide to its external auditor and circumstances under which external auditors may attend meetings between examiners and an institution's management. Although this policy statement applies to banks and thrifts, the guidance also may be appropriate for FDIC-supervised insured branches of foreign banks and their external auditors.

Topics discussed in the statement are: a) coordination of external audits and examinations, b) reports and supervisory documents to be provided by a depository institution to its external auditors, c) external auditor attendance at meetings between management and examiners, d) meetings and discussions between external auditors and examiners, and e) confidentiality of supervisory information. *FIL-57-92, FDIC, 7/24.*

New Minimum Standards for International Banking Supervision

The FDIC joined with regulators in the U.S. and 11 other industrialized nations, which included Japan, Canada, and nine western European countries, on new minimum standards for authorizing and supervising international banking operations. The joint agreement is intended to improve international supervision and coordination in light of a number of recent developments, including the

widespread fraud and financial troubles at the failed Bank of Credit and Commerce International (BCCI). The Basle Committee on Banking Supervision, of which the FDIC is a member, reaffirmed previously-adopted principles for international supervision but under stronger minimum standards that each of the 12 nations on the committee will be expected to observe. In addition, the Basle Committee agreed to encourage banking supervisors from other nations to endorse these standards.

The minimum standards seek to ensure that every bank with operations in more than one country will be subject to effective, consolidated oversight by a single supervisor while still taking into account the legal and structural differences among the countries. The agreement includes provisions that consolidate the supervision of a bank or banking group's international activities under a single regulator and ensure that this regulator will have access to information about the institution's activities in other countries. Of special interest to U.S. banking agencies is that the agreement recognizes that a country may restrict or prohibit a foreign bank's operations within its borders if its regulator believes that the bank's home-country regulator is not meeting the new minimum standards for effective consolidated supervision. *PR-106-92, FDIC, 716.*

Court Upholds Director and Officer Lawsuits

Overturning a lower-court decision, the U.S. Court of Appeals for the 10th Circuit in Denver affirmed that the FDIC in suits against bank officials must prove only simple negligence, rather than gross negligence. The decision, by the full appeals court, involved former directors of the failed Tracy Collins Bank and Trust Co. of Salt Lake City. The FDIC's case was based on enforcement powers granted by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). *AB, 6/29/92, p. 1.*

Survey Finds Real-Estate Recovery Continues, But Is Slowing

The FDIC's latest survey of real-estate conditions, which was released

in late July, indicates that the recovery is continuing but had slowed since the previous survey in May. In the commercial sector, many respondents still reported excess office space and low demand in their local markets. In general, while positive views of recent developments in both residential and commercial real-estate markets outnumbered negative ones, the assessments were less favorable than in the previous survey, which had found a sharp improvement in both residential and commercial real-estate markets in all regions of the country.

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. A composite of survey findings about the residential and commercial real-estate markets is used to compile an overall index. Values of the index above 50 indicate that more respondents believed conditions were improving than declining, while values below 50 indicate the opposite. In this latest survey, the index fell to 63 from the high of 72 in May.

In residential markets, 51 percent of the respondents nationwide cited better local housing conditions during the previous three months, than in May. Only ten percent thought housing markets had declined. As in the May survey, excess housing supply was lower and more areas had average or above-average home sales compared with earlier surveys. However, the reports about commercial markets were mixed. Nearly two-thirds of the respondents said commercial real-estate conditions were unchanged from the previous three months. Another 21 percent cited improvements, but 14 percent reported worsening conditions.

Regionally, overall market responses in July were most favorable in the South, and weakest in the West. During the past year, reports of improving conditions consistently were more frequent in the Midwest and in the South than in other regions. While July assessments in the Northeast were less favorable than in May, they continue to be much improved from ear-

lier surveys. In the West, negative reports have outweighed positive ones in three of the past four surveys, and it is the only region where assessments of commercial real-estate developments have not improved. *PR-87-92, 6/02; PR-118-92, 8/27, FDIC; Survey of Real Estate Trends, May 1992; July 1992.*

Call Report Preparation Survey

The FDIC sent a questionnaire to bankers seeking their input about the required quarterly Report of Condition and Income (Call Report). The survey asks for information in three general areas: (1) the effort required in preparing Call Reports; (2) the quality of the FDIC's existing assistance programs, such as the Call Report preparation seminars, the toll-free telephone assistance lines, and the "Call Report Review" newsletter; and (3) suggestions for possible future FDIC products or services that would further assist bankers in preparing Call Reports.

The FDIC said the voluntary survey would greatly assist the agency in assessing numerous issues involving the Call Report. To ensure that each bank's response will be kept confidential and to ensure the integrity of the data, the Bank Administration Institute (BAI), a professional service organization, will process all questionnaires and provide the FDIC with aggregate results only. Aggregate statistics also will be provided to the FFIEC for possible use in its study of Call Report burden issues. The aggregate results of the FDIC survey also will be publicly available. *FIL-62-92, FDIC, 9/11/92.*

Resolution Trust Corporation and Thrift Depositor Protection Oversight Board

Operations Update

Through July 31, 1992, the RTC had resolved 652 institutions. The agency took 12 institutions into its conservatorship program in June, and seven in July, bringing to 60 the number of conservatorship institutions in June (end of month) and 66 in July.

The RTC did not close any savings associations in June, and closed one in July. In the absence of legislation to provide additional funding to the RTC, the number of conservatorships continues to grow as potential Accelerated Resolution Program (ARP) cases are placed into conservatorship.

Assets under RTC management in June, including both conservatorships and receiverships, declined from \$112 billion to \$111 billion. The reduction in assets represented the ongoing sales effort by the RTC from its conservatorship and receivership holdings. Over the past 13 months, assets under RTC management have dropped \$57 billion. The \$111 billion of assets under RTC management on June 30 consisted of: \$13 billion in cash and securities, \$15 billion in performing 1-4 family mortgages, \$25 billion in other performing loans, \$23 billion in delinquent loans, \$13 billion in real estate, and \$22 billion in other assets.

The 60 conservatorships held \$23 billion in gross assets on June 30, and the 651 receiverships held \$88 billion, excluding from the latter approximately \$15 billion in cash, liquid investments, and accounts receivable accumulated from receivership collections. 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 37 percent of receivership assets. A substantial amount of the securities and performing mortgages in receivership were junk bonds or pledged for secured borrowings or substandard loans.

As of the end of June, RTC resolutions had protected 21.7 million deposit accounts from financial loss. These accounts had an average account balance of \$9,000. Thrifts closed since the start of the RTC held \$215 billion in assets at the time of closure.

Estimated resolution costs for the 651 closed thrifts totaled \$83.9 billion, 36 percent of their total liabilities at the time of resolution. If the insured deposits of all 651 institutions had been

paid out to depositors, the estimated resolution cost would have been \$87.0 billion. *RTC Review, August 1992.*

Separately, the RTC announced the successful sale of over 6,996 nonperforming loans, in 196 loan packages, with recoveries of \$247.9 million. Over 163 companies were registered to bid, and more than 40 purchased a variety of nonperforming loan packages ranging in size from \$21 thousand to \$22 million, stratified by collateral type, geography, and current book value.

The auction was conducted in Los Angeles as part of a major RTC effort to sell its nonperforming loans through auctions. Since June 1991, the RTC has auctioned in excess of \$700 million in nonperforming loans, and more than 15,000 real-estate properties. *News Release, RTC, 9/9/92.*

First Resolution Under Pilot Marketing Program

The RTC completed its first resolution under the agency's pilot Cooperative Institution Marketing Program with the sale of Investors Federal Savings Bank, Richmond, Virginia, to Central Fidelity Bank, Richmond. The resolution of Investors marked the first time that the RTC's primary asset-sales initiatives and tools—including portfolio sales, securitization, seller financing, and due diligence—have been employed in one transaction. Under the new marketing program, institutional investors and asset acquirers compete for the acquisition of assets at the time of resolution.

The CIM program provides for marketing an institution's deposit franchise along with all of its assets. By marketing savings institutions through the CIM program, the RTC is able to simultaneously solicit bids from prospective asset acquirers and from deposit-franchise investors. *News Release, RTC, 7/10/92.*

Restrictions on Sale of Assets

The RTC adopted a final regulation which puts restrictions on the sale of assets to persons who contributed

to the failure of a financial institution assigned to the RTC or FDIC. The regulation, effective August 20, 1992, implements provisions of the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Act of 1990. The regulation stipulates that the RTC will not sell any asset of an association to an individual or to an entity if that individual or entity's key official(s) participated in transactions resulting in a substantial loss to that association, was removed or barred by a federal agency from participating in the association's affairs, or misused the association's funds.

Additionally, the RTC will not sell the assets of a savings institution to any prospective purchaser who, as an officer or director of that savings association, participated in a material way in one or more transactions that resulted in an aggregate loss of more than \$50,000 to that association, or has been removed or prohibited from participating in the affairs of the savings association whose assets are being sold, or has demonstrated a pattern or practice of defaulting on obligations to the savings association whose assets are being sold. The regulation also makes RTC seller financing unavailable to persons or entities under certain circumstances.

The RTC also has strengthened its procedures for collecting on obligations due to institutions under its control. Effective on January 1, 1993, all prospective purchasers of RTC assets must certify that they have no existing defaults of \$500,000 or more on obligations to the RTC or institutions under its control. Prospective purchasers must certify also that they have no reason to believe that they are purchasing assets on behalf of, or for resale to, any party which would be unable to furnish the certification. *News Release, RTC, 7/21/92; FR, 7/21, p. 32392.*

Contracting with Firms Involved in Lawsuits with RTC/FDIC

The RTC adopted a policy statement, effective July 23, 1992, on contracting with firms that are being sued

by it, the FDIC or the Federal Savings and Loan Insurance Corporation (FSLIC). Generally, the RTC does not do business with firms that are being sued by it, the FDIC or FSLIC. However, the RTC may do business with such firms where the contractor can screen the persons and/or office(s) charged with wrongdoing from work on the RTC contract and the firm agrees that it will not use its retention by the RTC as a defense in the pending litigation. Where a contractor is subject to multiple lawsuits, or a single suit of major proportions, the revised policy recognizes that, even though individuals and offices can be screened from the RTC contracts, continuing to do business with the firm can no longer be justified on fitness and integrity grounds under 12 CFR, Part 1606. A determination under this standard will be based on the scope and breadth of pending lawsuits, total amount claimed, and other specified factors. *Press Release, RTC, 7/20/92; FR, 7/23, p. 32839.*

Minority and Women Outreach and Contracting Program

The RTC issued an interim final rule, pursuant to FIRREA, to identify, promote, and certify eligible firms for inclusion in its contracting activities, while ensuring that RTC utilizes the services of the private sector in a practicable and efficient manner. The interim final rule was effective August 10, 1992, and the comment period ran to October 9.

On August 15, 1991, the RTC published an interim final rule to govern the outreach portion of the program. That rule also provided standards for qualifying as a minority- or women-owned business (MWOB), or minority- or women-owned law firm, for purposes of the program. In November 1991, Congress passed the RTC Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRIA) which required, among other things, that in evaluating contract offers, the RTC shall provide technical preferences of at least ten percent and cost preferences of at least five percent to

MWOBs. Accordingly, this current interim final rule incorporates such measures. The RTCRRIA also gave the RTC authority to adjust the level of those preferences as necessary.

The RTC's outreach efforts to minorities and women include outreach to potential purchasers of assets from savings associations under the RTC's control, and to potential acquirers of such savings associations; however, the regulation addresses only the RTC's contracting program. (See this *Review*, Fall 1991, p. 43; Spring/Summer 1992, p. 43). *FR, 8/10/92, p. 35728.*

Affordable Housing Program

The RTC issued a final policy statement on multifamily properties marketed under the Affordable Housing Disposition Program. Under this policy, when more than one multifamily property is purchased from the RTC as part of the same negotiation, the RTC will require that not less than 15 percent of the dwelling units in each separate property purchased be made available to low- or very-low income individuals. *FR, 8/19/92, p. 37581.*

Court Rules Failed S&L Cannot Shield Assets from RTC

The U.S. Circuit Court of Appeals in Richmond, Virginia ruled that a failed savings and loan association could not prevent its subsidiaries from being taken under government control by placing them in bankruptcy protection. The Court removed a preliminary injunction issued by a federal bankruptcy court which blocked the RTC from taking control of certain resort properties (*Landmark Land Co. of Oklahoma v. RTC, 8/18/92*). *WSJ, 8/20/92, p. A2.*

Federal Reserve Board

Revising Risk-Based Capital Guidelines for Interest- Rate Risk

The FRB requested public comment on an inter-agency proposal for revising risk-based capital standards,

as prescribed by FDICIA, to incorporate interest-rate risk into the Board's risk-based capital guidelines. Also, comments are sought on methods to implement other requirements that risk-based capital standards be revised to take adequate account of concentration of credit risk, and the risks of nontraditional activities. The federal banking agencies are required by FDICIA to publish final regulations by June 19, 1993. *Press Release, FRB, 7/30/92.*

Corrective Action for Undercapitalized Banks

The FRB issued a final rule to carry out the "Prompt Corrective Action" provisions of FDICIA (Section 131). The rule applies to state member banks and becomes effective on December 19, 1992. The rules adopted by each of the federal banking agencies are substantially the same.

The regulation adopted by the FRB: a) defines capital measures and the capital thresholds for each of the five categories established in the law; b) establishes a uniform schedule for filing of capital restoration plans by undercapitalized institutions and agency review of those plans; c) clarifies aspects of the capital guarantees made as part of an acceptable capital plan by companies that control an undercapitalized institution; d) establishes procedures for providing institutions with advance notice of a proposed supervisory directive and an opportunity to contest the directive; e) establishes procedures for reclassifying an institution to a lower capital category based on supervisory factors other than capital; f) establishes procedures by which officers and directors who are dismissed as a result of an agency order may obtain review of the dismissal and possible reinstatement. *Press Release, FRB, 9/18/92.*

Interbank Liabilities

The FRB issued for comment a proposed new Regulation, F, to implement a provision of FDICIA, which requires the FRB to develop regulations

designed to limit the exposure of insured depository institutions to other depository institutions. The proposed rule would apply to banks, savings associations, and branches of foreign banks with deposits insured by the FDIC. Those institutions would be required to develop and implement internal procedures to evaluate and control exposure to the depository institutions with which they do business, referred to as "correspondents." These procedures would include limits on both credit and settlement exposure to each individual correspondent.

The proposed rule also would establish "benchmark" guidelines for daily overnight credit exposure to individual correspondents within which a bank ordinarily would be expected to remain. The benchmarks, which are based on a measure of credit exposure that excludes certain relatively low-risk transactions, generally would permit an institution to have credit exposure to an individual correspondent in an amount up to 25 percent of the exposed institution's total capital. For a correspondent that an institution can demonstrate is "adequately capitalized," the institution could have credit exposure equal to 50 percent of its total capital, but no more than 25 percent of that capital could be exposed through transactions that have a term-to-maturity of more than 30 days. No specific benchmark is provided for credit exposure to a correspondent that the exposed institution can demonstrate is "well-capitalized." In all cases, an institution would be expected to establish prudential credit limits internally, either within or in addition to the benchmark limits, and would be expected to place limits on settlement and other risks not addressed by the benchmarks. *FR, 8/20/92, p. 31974.*

Truth in Savings

The FRB adopted a new Regulation, DD, to implement the Truth in Savings Act. The Act and Regulation require depository institutions to disclose fees, interest rates and other terms concerning deposit accounts to con-

sumers before they open accounts. The Act requires depository institutions that provide periodic statements to consumers to include information about fees imposed, interest earned and the annual percentage yield earned. Substantive limitations are imposed on the methods by which institutions determine the balance on which interest is calculated. Rules dealing with advertisements for deposit accounts are also included.

The final rule is effective September 21, 1992; however, compliance is optional until March 21, 1993. *FR, 9/21/92, p. 43337.*

Revenue Limit on Securities Activities of BHC Subsidiaries

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. The current ten percent test was designed to prevent Section 20 subsidiaries from being "engaged principally" in underwriting and dealing in bank-ineligible securities in violation of Section 20 of the Glass-Steagall Act.

The FRB's view is that changes in the level and structure of interest rates since the revenue test was last considered in September 1989 can alter the measure of whether a Section 20 subsidiary is "engaged principally" in ineligible securities in ways that were not foreseen. One possible alternative test suggested was a revenue test that is indexed to interest-rate changes. The method of indexing proposed is 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.

Under the proposed indexing method, current revenue would be adjusted by a series of factors supplied by the FRB that vary according to the average duration of the securities portfolio. For each duration the factor represents the ratio of interest rates in

September 1989 on Treasury securities to the average interest rates in the most recent quarter. These adjustment factors would then be applied to current interest and dividend revenue. A sample table of adjustments is provided with the proposal. *Press Release, FRB, 7/23/92; FR, 8/31, p. 33961; 7/29, p. 33507.*

Investment Advisory Activities of Bank Holding Companies

The FRB amended its interpretive rule, effective August 10, 1992, to expressly provide that a bank holding company and its nonbank subsidiaries may act as an agent for customers in the brokerage of shares of an investment company advised by the holding company or any of its subsidiaries. A bank holding company and its nonbank subsidiaries may provide investment advice to customers regarding the purchase and sale of shares of an investment company advised by a holding company affiliate.

Bank holding companies engaged in these activities are required to make appropriate disclosures to customers to address potential conflicts of interest or adverse effects. *Press Release, FRB, 7/6/92; FR, 7/9, p. 30387.*

Permissible Nonbanking Activities Expanded

The FRB added full-service securities brokerage and financial advisory services to the regulatory list of permissible nonbanking activities for bank holding companies, effective September 10, 1992. The final rule generally simplifies the conditions previously imposed by the FRB on the conduct of full-service securities brokerage activities and on financial advisory activities. Bank holding companies seeking to conduct these activities or acquire companies engaged in these activities will be able to take advantage of a number of streamlined procedures relating to listed nonbanking activities. These procedures substitute a notice period in lieu of an application procedure for companies seeking to engage *de novo* in these activities and permit Reserve Banks to review proposals

to conduct these activities under expedited procedures. *Press Release, FRB, 8/31/92; FR, 9/10, p. 41381.*

Transactions with Affiliates

The FRB issued a rule, effective September 11, 1992, to exclude from Section 23A of the Federal Reserve Act transactions between affiliated insured depository institutions that are subject to review under the Bank Merger Act. The exclusion is intended to reduce unnecessary regulatory burden by eliminating the need for duplicative federal applications. *Press Release, FRB, 9/4/92; FR 9/11, p. 41643.*

Loans to Member Banks' Officials and Principal Shareholders

The FRB adopted revisions to its Regulations O and Y, effective May 18, 1992, to conform to Section 306 of FDICIA (see this *Review*, Spring/Summer 1992, p. 45). The amendments establish a limit on the total amount a bank may lend to its executive officers, directors, and principal shareholders, and their related interests. In general, this limit is equal to the bank's unimpaired capital and unimpaired surplus. For a one-year study period, a higher limit will apply to banks with deposits of less than \$100 million. Among other changes, loans to directors and their related interests will be subject to the same lending limit that now applies to executive officers and principal shareholders.

Currently, Regulation O: a) requires a bank's board of directors to approve any extension of credit to an insider or a related interest in excess of a threshold amount (generally the higher of \$25,000 or five percent of the bank's capital and unimpaired surplus, up to \$500,000); b) prohibits any extension of credit on preferential terms; c) limits the amount a bank may lend to each of its executive officers and principal shareholders and their related interests; and d) prohibits the payment by a bank of an overdraft of an executive officer or director on an account at the bank.

The amendments also implement a reporting requirement relating to credit extended to executive officers and principal shareholders of certain banks and bank holding companies. *Press Release, FRB, 5/7/92; 5/22; FR, 5/19, p. 21199; 5/28, p. 22417.*

Changes in Procedural Requirements to Reduce Regulatory Burden

The FRB adopted several amendments, effective June 29, 1992, to reduce unnecessary regulatory burden. One revision increases the size of non-bank companies that can be acquired by bank holding companies under 15-day expedited notice procedures. Bank holding companies (subject to other criteria) will be permitted to acquire nonbank companies where neither the book value of the assets to be acquired nor the gross consideration paid for the assets exceeds the lesser of \$100 million or five percent of the applicant's consolidated assets.

The relative size of nonbank assets that can be acquired by bank holding companies in the ordinary course of business without prior FRB approval is increased. A bank holding company may, under certain circumstances, acquire nonbank assets in the ordinary course of business without filing an application if the assets to be acquired relate to activities that the bank holding company has previously received approval to conduct. Currently under the FRB's interpretation, the book value of the assets to be acquired cannot exceed 20 percent of the book value of the assets of the applicant in the same line of activity. The revision expands the relative size criteria to 50 percent.

The amendments waive certain requirements applying to an acquisition by a bank holding company if the transaction involves primarily the merger of a bank into an existing operating subsidiary bank of the acquiring bank holding company in a transaction that is reviewed by a federal banking supervisor under the Bank Merger Act. To qualify for this waiver, several criteria are specified. *Press Release, FRB, 7/2/92; FR, 6/29, p. 28777.*

The FRB approved several changes in applications procedures, which include procedures to limit extension of the pre-acceptance period for applications; offering prospective applicants the opportunity to submit a pre-filing notice of intent to file an application; and other changes. The FRB also invited comment on any other ways in which the burden on applicants may be reduced, consistent with the FRB's statutory responsibilities. *Press Release, FRB, 8/25/92; FR, 9/1, p. 39641.*

Subordinated Debt Approval Procedure Revised

The FRB eliminated the requirement, effective September 4, 1992, that state member banks obtain the FRB's prior approval before issuing subordinated debt in order to treat that debt as capital rather than as a deposit. The FRB issued an interpretation of the capital adequacy appendices to Regulations H and Y which provides general guidance on the criteria that subordinated debt and mandatory convertible debt issued by state member banks and bank holding companies must meet to be included in capital. *Press Release, FRB, 8/28/92.*

Home-Equity Lending Disclosure Rules

The FRB decided not to change the rules in Regulation Z that set forth the way creditors disclose discounted initial rates and certain payment examples for home-equity lines.

The Home Equity Loan Consumer Protection Act of 1988 requires creditors to provide consumers with information for open-end credit plans secured by the consumer's dwelling. While Regulation Z does not require the stating of the discounted rate in the preprinted early disclosures, it requires disclosure of related aspects of "teaser rates," including that the initial rate is discounted and the time period the rate would be in effect. The second issue involves the statutory requirement for disclosure of three types of home-equity loan payments, and the disclosure of representative examples of the various payment options under Regulation Z. The approach adopted

by the FRB for disclosure of the discounted initial rate and certain payment examples was examined by the U.S. Court of Appeals for the District of Columbia Circuit in recent litigation, and remanded to the FRB for further consideration. *FR*, 8/6/92, p. 34676; 12/30/91, p. 67233.

FRB Allows Thrift Acquisition with Interstate Branching

The FRB granted approval for BankAmerica Corporation (BAC), San Francisco, to acquire the shares of HonFed, a Federal Savings Bank, Honolulu, which would be merged with BAC's wholly owned subsidiary federal savings association in Portland, Oregon. As a result of this transaction, BAC will operate branch offices in Oregon and Hawaii through its subsidiary. While the FRB previously has permitted bank holding companies to acquire and operate several savings associations that each operate in a different state, it is the FRB's first approval of an acquisition that would result in a savings association operating branches interstate. *Press Release, FRB*, 7/13/92, with *FRB's Order Approving Acquisition of a Savings Association*; *BBR*, 7/20, p. 93.

Availability of Funds and Collection of Checks

The FRB adopted in final form, with minor modifications, its interim rule amending Regulation CC to conform to recent amendments to the Expedited Funds Availability Act incorporated into FDICIA. The amendments allow banks to extend holds, on an exception basis, to "next-day" and "second-day" availability checks and allow one-time notices of exception holds in certain cases. The amendments should benefit and reduce costs for all banks that choose to take advantage of the rule changes. The effective date is September 14, 1992.

Regulation CC implements the Act and, among other things, establishes availability schedules to limit the holds banks (including commercial banks, savings institutions, and credit unions) can place on deposits in transaction accounts and requires banks to dis-

close their funds availability policies to their customers. The Act and the Regulation provide for certain safeguard exceptions to the availability schedules, wherein the depository bank may extend the hold on a deposit for a reasonable period of time. The exception holds apply to deposits to new accounts, daily aggregate check deposits in excess of \$5,000, checks deposited into an account that has been repeatedly overdrawn, and certain other categories of deposits. Prior to FDICIA, most of the exception holds did not apply to checks that must be accorded next-day or second-day availability under the Act and the Regulation, such as government, cashier's, certified, and teller's checks. *Press Release, FRB*, 8/7/92; *FR*, 8/14, p. 36593.

Withdrawals from Priced Services

The FRB requested comment on a proposal by the Federal Reserve Banks to withdraw from the priced definitive securities safekeeping service by year-end 1993. This proposal would eliminate the safekeeping of definitive securities pledged to state and local governments, but would not affect the safekeeping of collateral pledged to the discount window, to the Treasury Department, or to U.S. 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 no longer be included under this service line after 1993. *FR*, 7/14/92, p. 31201.

The FRB requested comment on proposed factors that would be used for evaluating Reserve Banks' requests to withdraw from a priced Federal Reserve service line. These factors are intended to provide a consistent methodology for reviewing withdrawal proposals. Among these factors are: a) it is likely that other service providers would supply an adequate level of the same service (*i.e.*, 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; and 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. *FR*, 7/14/92, p. 31203.

Court Rules on Examiner Report Confidentiality

The U.S. Court of Appeals for the District of Columbia reversed a lower-court decision that gave access to examiner reports to stockholders suing Fleet/Norstar Financial Group, Inc., now known as Fleet Financial Group, Inc., in Providence, Rhode Island, on the grounds that the reports had been made available by regulators to the bank holding company. The suit involves a claim that Fleet/Norstar had failed to maintain adequate reserves.

The appeals court said that five factors must be considered in deciding whether the reports must be released, including: a) the relevance of the documents, b) the availability of other evidence, c) the seriousness of the litigation, d) the government's role in the litigation, and e) the effect of releasing confidential information on future communication between government officials and banks. Whether these factors require that the documents be released will now be determined by a lower court. *WSJ*, 6/30/92, p. B7.

Office of the Comptroller of the Currency

Prompt Corrective Action Directives

The OCC proposed amendments implementing Section 131 of FDICIA that requires or permits the federal banking agencies to take certain supervisory actions when federally insured institutions fall within one of five specifically enumerated capital categories. It also restricts or prohibits certain activities and requires submission of a

capital restoration plan when insured institutions become undercapitalized.

The proposed amendments are necessary to establish the capital levels at which insured national banks and insured federal branches will be deemed to come within the five capital categories. The proposals also establish procedures for issuing and contesting prompt corrective action directives, including directives requiring the dismissal of directors and senior executive officers. *FR*, 7/7/92, p. 29808.

Real-Estate Lending Standards

The OCC and OTS requested comments on the costs and benefits that are likely to accrue as a result of implementing proposed amendments to their real-estate lending standards. The two agencies specifically asked for any available data on the costs and benefits of the proposed rule on the economy at large. For example, comments were requested on the impact on real-estate lending operations at depository institutions, including the possible reduction in losses on real-estate lending; the deposit insurance funds; the availability of credit for economically sound projects; and on loan documentation, monitoring and processing time. *FR*, 8/17/92, p. 36911.

Risk-Based Capital: Residential Construction Loans

The OCC issued a final rule, implementing a provision of RTCRRIA, and amending the risk-based capital guidelines to include in the 50 percent risk-weight category certain loans to builders to finance the construction of presold 1-4 family residential properties. These loans were formerly weighted 100 percent. The change is effective October 5, 1992. *FR*, 9/3/92, p. 40302.

Branch Closings

The OCC proposed a guidance to national banks regarding branch closings by those banks and insured federal branches. A provision of FDICIA requires an insured depository institution to give 90 days' written notice of

a branch closing to its federal regulator and to branch customers, to post notice at the branch site at least 30 days prior to closing, and to develop a policy with respect to branch closings. The notice to the regulator must include a detailed statement of the reasons for the decision to close the branch and information in support of those reasons. The FRB, FDIC, and OTS have developed substantially similar positions to those contained in the OCC's proposal. There may be some procedural differences between the agencies' policies. *FR*, 9/2/92, p. 40249.

Courts Rule on Insurance Law

The U.S. Court of Appeals for the Second Circuit said that a 1916 law still exists that permits banks in towns not exceeding 5,000 in population to sell insurance. The New York court's decision conflicts with a ruling last month of the U.S. Court of Appeals for the District of Columbia that Congress had inadvertently repealed the small-town exemption in 1918. In the case of *American Land Title Association v. Comptroller Robert L. Clarke*, the Second Circuit court also ruled that national banks located in towns of more than 5,000 persons cannot offer title insurance. Given this portion of the decision, analysts believe that other bank insurance activities approved as "incidental to banking," including the sale of annuities and credit life insurance, could be in danger. *ABA Bankers Weekly*, 6/23/92, p. 3; *AB*, 6/17, p. 3.

The U.S. District Court in Kentucky ruled that the provision of the National Bank Act permitting national banks in towns of 5,000 or less in population to sell insurance continues to exist, and directed the state Insurance Commissioner to take applications from banks in Kentucky that qualify. *ABA Bankers Weekly*, 8/11/92, p. 1.

Closing of Still-Solvent Bank Ruled Not a Taking

The U.S. Claims Court said that the closing by the OCC of a still-solvent bank was not "a taking" under the Fifth Amendment to the U.S. Constitution.

Following the closure in 1985 of Golden Pacific Bank, a suit against the OCC was brought by the holding company, Golden Pacific Corp., and a major stockholder, under the Federal Tort Claims Act and the Fifth Amendment. Claimants argued that they were entitled to compensation because the bank was solvent when it was closed. The Claims Court disagreed, stating that "... plaintiffs voluntarily chose to invest in the Bank... they were on reasonable notice as to what the 'rules of the game' were, or reasonably could be, in the highly regulated banking industry... at those times when the government could legally inspect the Bank or place it into receivership, plaintiffs were unable to exclude the government from their property... without the right to exclude others, plaintiffs do not have the historically rooted expectation of compensation necessary to establish a Fifth Amendment taking." *BBR*, 5/11/92, p. 838.

Court Rules Loan Participations Are Not Securities

The U.S. Court of Appeals for the Second Circuit, in a two-to-one decision that affirmed a lower-court decision, ruled that loan participations sold by banks are not securities, since purchasers are individually in a position to watch and protect their investments. The loans thus should not be subject to the disclosure standards of stocks, bonds, and other securities.

Security Pacific National Bank, now a unit of BankAmerica Corp., was sued by several financial institutions after a borrower defaulted on short-term loans sold by the bank and in which they participated. The plaintiffs argued that Security Pacific should have informed them more fully on the borrower's financial condition, and also that the speed and sophistication of the bank's loan participation program made the notes more like commercial securities. *AB*, 6/29/92, p. 2.

Court Limits Accountants' Liability

The New York Appeals Court, reversing a lower-court decision, said

an accounting firm was not liable in a lawsuit because of insufficient evidence that the firm knew its audit was to be used by a bank in making a credit decision. In the case, Security Pacific Business Credit sued Peat Marwick Main & Co. for negligence in issuing an unqualified audit opinion and financial statement on a company which subsequently filed for bankruptcy. The bank said it depended on the audit opinion and financial statement in extending a line of credit to the company. The Court said a phone call from the bank informing the auditor of its use of the report was not sufficient, and also, the audit was not performed solely to assist the company in obtaining a line of credit. *ABA Bankers Weekly*, 7/28/92, p. 5.

Office of Thrift Supervision

Risk-Based Capital

Interest-Rate Risk Component. The OTS seeks comment on how to incorporate an interest-rate risk component into the risk-based capital rule. The amendment is intended to ensure that savings associations maintain levels of capital commensurate with the degree of interest-rate risk to which they are exposed. Under the proposal, a savings association's risk-based capital requirement would be comprised of two components: a credit risk component and an interest-rate risk component. The agency proposes to measure a savings association's interest-rate risk exposure in terms of the sensitivity of the market value of the portfolio equity of an association to changes in interest rates. The market value of portfolio equity is defined as the net present value of an association's assets, liabilities, and off-balance-sheet contracts. Associations with a greater than "normal" level of interest-rate risk exposure will be subject to an "add-on" to their risk-based capital requirement.

OTS also will be instituting a substantially revised data collection form that will be used to calculate the interest-rate risk component. Small, highly-capitalized institutions would be given the option of filing an abbreviated reporting form. *NEWS, OTS, 9/2/92; FR, 9/3, p. 40524.*

Multifamily Housing Loans. RTCRRRIA provides that first liens of multifamily residential properties meeting certain prudential criteria and securities collateralized by such loans qualify for the 50 percent risk-weight category. OTS proposes to amend the definition of "qualifying multifamily mortgage loan" to incorporate the criteria set forth in the statute. These criteria include the ratio of the property's annual net operating income to required debt service, the loan's maximum amortization and minimum maturity, demonstrated timely payment performance on the loan, and other prudent underwriting standards. The OTS's proposed rule parallels the proposal of the other banking agencies.

The proposed rule also would expand the category of privately-issued mortgage-backed securities (MBSs) that qualify for inclusion in the 50 percent risk-weight category to include MBSs that at the time of origination are collateralized by qualifying multifamily mortgage loans. *NEWS, OTS, 9/2/92; FR, 9/2, p. 40143.*

Treatment of Equity Investments. OTS proposed that equity investments that are permissible for both savings associations and national banks would no longer be deducted from savings associations' calculations of total capital over a five-year transition period. They would instead be placed in the 100 percent risk-weight category, the same as prescribed by the OCC for national banks. Only those equity investments held by savings associations that are not permissible for national banks would continue to be required to be deducted from assets and thus total capital.

The proposed revisions would not increase or in any way affect a savings association's underlying authority to make such investments. It is noted that some equity investments permissible for national banks, such as investments in foreign banking corporations, are not permissible for savings associations. The equity investments currently held by thrifts that would be most affected by this change are loans with equity participations

that are considered equity investments under Generally Accepted Accounting Principles (GAAP). *NEWS, OTS, 9/2/92; FR, 9/2, p. 40147.*

General Valuation Allowances

The OTS requested comments on proposed revisions to its guidance to savings associations and its examination staff regarding the appropriate levels of general valuation allowances (GVAs) savings associations should maintain. Associations are required to maintain GVAs that are sufficient to absorb probable losses not yet identified in their portfolios.

Examiners must ensure that associations have thoroughly documented their process for determining the level of the allowances, including analysis of all significant factors. The proposed policy directs examiners to rely on management's estimates of adequate GVAs if the association's process for determining adequate allowances is sound. To guide examiners in evaluating the reasonableness of an association's allowance levels and in reviewing associations that do not maintain adequate policies, the proposed guidelines set forth quantitative benchmarks as a starting point for the determination of appropriate levels of GVAs. The guidelines also set forth additional quantitative and qualitative factors for analysis in determining the appropriate adjustments to the benchmark amounts for the specific association. *FR, 9/1/92, p. 39736.*

Qualified Thrift Lender Test

The OTS proposed to revise its qualified thrift lender (QTL) regulations to implement provisions of FDICIA. Among the statutory changes, effective in December 1991, were lowering the required QTL percentage of housing-related investments from 70 percent to 65 percent of a thrift's portfolio assets, changing the computation period, increasing the amount of regulatory liquidity excludable from portfolio assets, and authorizing certain shares of the stock of certain government-sponsored enterprises to be included in the computation of qualified thrift

investments. *Transmittal#59, OTS, 9/11/92; FR, 9/2, p. 40140.*

Qualified Thrift Lender Guidelines

The OTS implemented the QTL provisions of FIRREA in new regulations to provide additional supervisory guidance on investments in "starter homes" and "credit-needy" areas. In addition, further guidance is provided on acquisition, construction and development loans and loans on mixed-use properties.

The statute and regulations provide that savings associations may, subject to certain conditions, include 200 percent of the dollar amount of loans and investments to purchase, construct, or develop starter homes or starter home developments in qualified thrift investments (QTI). To be classified as a starter home loan for QTL purposes, a loan must: a) be secured by a 1-4 family home, condominium, or cooperative; or by a development where 75 percent or more of the value of the development consists of such homes; b) be located in the association's Community Reinvestment Act (CRA) community; and c) be valued at an appraised value of 60 percent or less than the median value of newly-constructed 1-4 family homes in the savings association's CRA community.

The statute and regulations also authorize savings associations to include in QTI 200 percent of the dollar amount of loans to assist small businesses or to construct, develop, or improve domestic residential housing or community service facilities within credit-needy areas. *Thrift Bulletin 20-2, OTS, 6/15/92.*

Accounting, Reporting Requirements Adopted

The OTS adopted new accounting and reporting rules, effective October 2, 1992, that will require savings institutions to tell their customers how well they meet capital requirements. The final regulation makes the accounting and reporting rules for thrifts comparable in approach and terminol-

ogy to those for national banks. The regulation implements federal laws specifying that OTS' accounting rules for savings associations: a) must, as a minimum requirement, follow GAAP where GAAP is employed by the other federal banking agencies; b) may be more stringent than GAAP if the OTS Director determines that stricter rules are necessary for safety and soundness reasons; and c) must be at least as stringent as the accounting standards imposed on national banks by the OCC.

As in the past, each savings institution must publish an annual statement of condition in a local newspaper and make it or an audited financial statement conspicuously available at the association's home and branch offices. The new regulation specifies that the statement of condition clearly disclose the institution's regulatory capital requirement and its actual regulatory capital and explain how the public can obtain the institution's audited financial statement. Institutions are given three months—up from the current 30 days—to file their statement of condition with OTS and make it available to the public.

Among other measures in the new regulation, associations will be required to maintain a register of all financial futures and options contracts that is adequate to identify and control these activities. Documentation of the objectives and results of financial options and hedging strategies must also be maintained under the rule. Mandatory records retention for futures and options activities are increased from two to ten years. *NEWS, OTS, 9/2/92; FR, 9/2, p. 40085.*

Regulatory Review

The OTS proposed to modify or delete a number of its regulations, consistent with the President's program calling for a review of all federal regulations and policies for the purpose of eliminating over-burdensome regulations, and as a result of the agency's review process.

Among the many changes and deletions proposed are the following:

a) Delete the regulation that governs the liability growth of savings associations, which is tied to a capital standard based on liabilities that were removed in 1989. OTS has in place asset-growth restrictions based on an association's financial health that more adequately address safety and soundness concerns;

b) The agency's recently revised "appraisals" regulation sufficiently covers the requirements for appraisals on all real-estate-related transactions, thus savings associations should need only to obtain evaluations, not more costly appraisals, on real-estate loans of \$100,000 or less, regardless of location;

c) Delete the 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. Capital rules and interest-rate risk management policies adequately address safety and soundness concerns in this area;

d) Delete the regulation limiting the amount of secured debt that can be incurred by service corporations of savings associations. These limitations are unnecessary because of the consolidated capital requirements imposed under FIRREA;

e) Regarding fixed-rate and adjustable-rate mortgage loan disclosures, delete the requirement for disclosure of additional information dealing with due-on-sale clauses, late charges and prepayment penalties, escrow payments, and the notice of maturity for non- or partially-amortizing loans. Home loan contracts typically contain provisions regarding these matters, and some of them are referenced in Truth in Lending disclosures. Also, the deletion will make OTS' regulations consistent with those of the other agencies. *NEWS, OTS, 9/3/92; FR, 9/3, p. 40350.*

Thrift Merger and Conversion Procedures

The OTS proposed to significantly streamline the process of mergers and charter conversions involving federal thrifts and banks. Current OTS

regulations would be amended, implementing sections of FDICIA, to allow federally chartered savings associations to convert directly to state and national banks. The change also would permit any insured depository institution that qualifies for membership in one of the 12 Federal Home Loan Banks and that meets the requirements for a federal thrift charter to convert to a federal savings association. Under the proposal, all insured depository institutions could merge, assume each other's deposits, and transfer assets to each other in exchange for assuming deposit liabilities.

All such actions would be subject to new OTS notice or application procedures. Approval would be required by the appropriate federal banking agency, generally the agency with primary jurisdiction over the surviving institution. In addition, the resulting institution would continue to pay proportionate premiums to both BIF and SAIF. *NEWS, OTS, 8/18/92; FR, 8/18, p. 37112.*

Applications for Interstate Branching Approved

The OTS gave its first approval under a rule permitting federally chartered thrifts to branch interstate, allowing the \$4 billion-asset TCF Bank Savings fsb, Minneapolis, to open branches in suburban Des Moines, and Milwaukee. Prior to the rule, which became effective May 11, 1992, thrifts were permitted to branch interstate only by acquiring and converting a failed institution, and only if permitted by state law. Under the new rule, thrifts must be well-capitalized and present viable proposals, including market analysis, before their applications for interstate branches may be approved. *BBR, 7/20/92, p. 108.*

The OTS approved an application from the \$692 million-asset Investors Savings Bank fsb, Minneapolis, to convert its agency office in Oakbrook, Illinois to a branch. Officials said they do not plan to operate the office as a full-service branch. *BBR, 8/24/92, p. 257.*

Purchase Approved with Qualified Stock Issuance

The OTS granted approval for a holding company of American

Savings Bank, Stockton, California, to purchase \$1 million of stock from Family Savings Bank, FSB, a Los Angeles-based minority-owned and operated thrift. The purchase, conducted through a qualified stock issuance (QSI), is the first action of its kind authorized by FIRREA.

The Act permits a savings association that fails to meet minimum, regulatory capital requirements to sell stock to a savings and loan holding company to raise capital. The buyer may purchase up to 15 percent of the institution's stock and not be deemed to be in control of the institution. Family Savings' QSI was conducted in accordance with its approved capital plan. An OTS official said the innovative use of the QSI enabled a minority-owned and operated institution to access capital so that it can continue to serve the business and family banking needs of customers within its community.

The \$135.5 million-asset Family Savings Bank has two branch offices located in Los Angeles and Pasadena. American Savings Bank, with \$16.9 billion in assets, has branch offices throughout California. *NEWS, OTS, 4/10/92.*

Outreach Program for Minorities, Women and the Disabled

The OTS will actively seek contracts for goods and services from businesses owned and controlled by minorities, women and disabled individuals. The policy, as mandated by FIRREA, would ensure to the maximum extent possible that businesses owned and controlled by members of minority groups, women, and the disabled participate in the OTS contracting programs. These businesses whether large, small or publicly-owned should be at least 51 percent owned and controlled by members of one or more of the designated groups, who must either be citizens or permanent residents of the U.S. A program chairperson has been appointed. *NEWS, OTS, 9/17/92; FR, 9/17, p. 42906.*

Court Says S&L Rule Change Was Contract Abrogation

A U.S. Claims Court judge ruled that FIRREA abrogated a contract between the government and Glendale Federal Bank, a unit of Glenfed, Inc. The agreement with regulators had allowed the bank to take up to 40 years to write off \$734 million in losses of a thrift it acquired in 1981, and to report that amount as capital. The 1989 law abrogated the right of thrifts to count "supervisory goodwill" as capital, affecting as much as \$30 billion in industry capital. The Court said that the government is liable for damages or restitution for the monetary losses and loss of business suffered by Glendale.

In the decision, the judge also ruled in favor of two other S&Ls, which are now closed, in similar cases. The government is allowed to appeal the three combined cases before the amounts of the damages are determined. A total of 18 S&Ls have filed such cases in the Claims Court. *WSJ, 7/27/92, p. A3.*

OTS, FDIC to Conduct Joint Examinations

The OTS and FDIC agreed to new ground rules designed to prevent conflicting orders from being issued to the nation's savings institutions. The agreement establishes procedures for the two agencies to jointly conduct examinations and resolve inter-agency disagreements on exam findings and appropriate corrective action. OTS Director Timothy Ryan said "we need to streamline the regulatory process and eliminate redundancy and unnecessary burdens, particularly concerning examinations. Better coordination between the two agencies will enable the industry to understand exactly what is expected by federal regulators in carrying out their responsibilities. This will benefit the institutions, the examiners and, foremost, the depositors."

Most FDIC savings association examinations will be performed jointly with OTS. Teams from both agencies will work together conducting the

examinations, reaching conclusions regarding the overall condition of the institutions and determining what corrective actions, if any, are required. Any inter-agency differences that cannot be worked out between the OTS and FDIC examiners-in-charge at the exam site will be forwarded to OTS and FDIC regional officers, and if necessary to the agencies' Washington headquarters.

Institutions will receive a single report of the examination findings unless the two agencies are unable to reach agreement and the FDIC intends to exercise its backup enforcement authority. By using these procedures, the agencies expect to resolve any differences before exam findings are presented to the management and directors of a thrift institution. The two agencies also agreed that OTS regulations, policies and directives will be used in reaching examination conclusions. Findings in the examination report will be based on GAAP.

The program is scheduled for all examinations commencing after June 1, 1992. *NEWS, OTS, 5/19/92; Memorandum to Regional Directors, FDIC and OTS, 5/18.*

Federal Financial Institutions Examination Council

Required CRA Documentation Clarified

The FRB, FDIC, OCC, and OTS, in an effort to simplify and streamline compliance supervisory processes and reduce regulatory burden, issued a guidance that clarifies the agencies' expectations regarding the documentation that financial institutions should maintain to support their performance under CRA. It emphasizes that the agencies base their evaluation of CRA performance primarily on how well an institution helps meet the credit needs of its community or communities, not on the amount of documentation it maintains. Also, a lack of documentation is not sufficient basis on which to grant a poor rating if an institution's performance

can otherwise be determined to be satisfactory or better.

The agencies expect depository institutions to have a well-managed program in place to address their responsibilities under the law. The documentation expected is primarily that which is useful to the institution's own management needs. The regulatory agencies can use this documentation in their assessment of the institution's CRA performance. In so doing, the agencies recognize that CRA-related documentation will generally be less formal and less extensive in small and rural institutions than in larger, urban institutions. *Press Release, FFIEC, 6/17/92.*

Study of Regulatory Burden

The FFIEC invited public comment, and planned a series of public meetings, in connection with a study of the regulatory burden imposed on insured depository institutions. Section 221 of FDICIA requires the Council to submit to the Congress no later than December 19, 1992, a report describing any suggested revisions to regulatory policies, procedures, recordkeeping and documentation requirements that could reduce unnecessary regulatory burden on insured depository institutions.

In addition to comments generally on the nature and scope of regulatory burden imposed on depository institutions, the Council in particular is seeking: a) specific suggestions on how to comply with particular statutory mandates while, at the same time, easing the regulatory burden imposed on depository institutions; b) alternative forms, reports, procedures, etc., that would simplify institutions' reporting and recordkeeping without diminishing compliance with applicable laws, or endangering the ability of the agencies to monitor an institution's condition to ensure safety and soundness; c) information regarding the burden of regulatory compliance relative to the size of the depository institution, as well as any appropriate ameliorative measures to ease any undue burden in that regard; and d) any studies

of regulatory burden concerning depository institutions; particularly, studies containing quantitative data relating to the costs and time attributable to regulatory compliance for depository institutions, and specifying, to the extent possible, those costs/burdens attributable to statutory requirements, and those attributable to agency discretion. *Press Release, FFIEC, 5/14/92; FR, 5/20, p. 21408.*

Changes in Reporting Requirements

Under the auspices of the FFIEC, the four federal banking agencies are establishing a uniform policy concerning the frequency and timing of changes to their regulatory reports. These regulatory reports are the Consolidated Report of Condition and Income (Call Report) filed by insured commercial banks and FDIC-supervised savings banks, the Thrift Financial Report filed by savings associations, the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks filed by these branches and agencies, and the Foreign Branch Report of Condition filed by U.S. bank branches located in a foreign country, Puerto Rico, or a U.S. territory or possession.

Effective immediately, the agencies will announce prior to the end of each year all reporting changes that will take effect in the following year. The only exceptions to this policy are deletions of items from the regulatory reports and reporting changes required by statute or regulation, necessitated by new standards issued by accounting standards setting bodies, or determined by majority vote of the members of the FFIEC to be necessary for safety and soundness, insurance assessment, or other regulatory reasons.

This new formal policy supersedes an informal FFIEC policy that, in general, had sought to limit changes to the bank Call Report forms to once a year as of the March 31 report date. Under that informal policy, the agencies had only committed themselves to give at least two months' advance notice of

these reporting changes. The agencies now believe it is appropriate to provide for a longer advance notification period for changes to the Call Report and similar regulatory reports.

This advance notification policy applies not only to the addition of new line items to the report forms, but also to certain revisions to the instructions for the preparation of these regulatory reports. *Press Release, FFIEC, 5/22/92.*

Registry of Licensed Appraisers

The Appraisal Subcommittee (ASC) of the FFIEC has established a "national registry of state certified and licensed appraisers," in accordance with the Privacy Act of 1974. Each state appraiser regulatory agency was notified to submit registry data to the ASC, beginning on January 1, 1992. The system consists of a centralized, computerized data base of files and records concerning individual state licensed and state certified appraisers. Those files and records are compiled by each state agency during the licensing or certification process and also are used by the state agencies in monitoring their universe of appraisals and state regulatory standards and requirements pertaining to those appraisers. *FR, 4/1/92, p. 11084.*

National Credit Union Administration

Proposal to Expand Business Loans

The NCUA proposed amendments to permit waivers of the LTV requirements for certain loans subject to its business loan regulation. The agency said the action complies with the President's request for federal agencies to take certain steps to reduce unnecessary regulatory burden and foster economic growth, because it encourages economic growth by allowing certain credit unions to make loans they would otherwise be unable to make.

Currently, business loans are subject to a LTV ratio of up to 70 percent for second liens and up to 80 percent

for first liens. The limit on a first lien is 95 percent if the value in excess of 80 percent is covered by either a private mortgage or equivalent acceptable insurance. The NCUA believes an exemption is warranted if: a) the credit union has a proven, successful track record in its specific field of business lending; b) the credit union or its members depend upon this type of business lending, meaning that if such lending is prohibited it could jeopardize the safety and soundness of the credit union or seriously impact on the ability of the credit union's members to obtain such credit; and c) the credit union limits its aggregate exposure to this type of lending.

The exemption would only be available to credit unions that had an existing business loan program prior to January 1, 1992. If the exemption is granted, the NCUA Regional Director may require that the credit union submit special monitoring reports of this lending activity. *FR, 5/15/92, p. 20798; ABA Bankers Weekly, 5/26, p. 7.*

Reserves for Loan Losses

The NCUA proposed amending its regulations to modify the valuation of the allowance for loan losses to better conform with GAAP. This proposed change would 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. *FR, 6/30/92, p. 29050.*

Definition of "Risk Assets"

The NCUA proposed changes to its regulation defining "risk assets" as used to determine federal and federally insured state credit union reserve requirements. Currently, all assets that have a remaining maturity of three years or less and are insured by, fully guaranteed as to principal and interest by, or due from the U.S. government, its agencies, the Federal National Mortgage Corporation, the Government National Mortgage Association, or Federal Home Loan

Mortgage Corporation are exempt from the definition of risk assets. The proposed change would include in this exemption certain assets with maturities greater than three years which reset or reprice within one year from the date that the calculation of risk assets is made, subject to certain restrictions. The proposal also clarifies that risk assets include loans as well as investments, but does not expand beyond certain items in the current regulation. *FR, 5/1/92, p. 18836; 6/9, p. 24395.*

Policy Statement on Securities Activities

With certain modifications, the NCUA adopted for federal credit unions the FFIEC supervisory policy statement on securities activities, which updates and revises a previous statement. The policy addresses the selection of securities dealers, requires depository institutions to establish prudent policies and strategies for securities transactions, and defines securities trading or sales practices that are viewed by the agencies as being unsuitable when conducted in the investment portfolio. The statement indicates characteristics of loans held for sale or trading, and establishes a framework for identifying when certain mortgage derivative products are high-risk mortgage securities which must be held in either a trading or held-for-sale account. *FR, 5/27/92, p. 22157.*

Additional Quarterly Call Reports Proposed

The NCUA proposed an amendment to its regulations to require quarterly reporting, phased in over a three-year period, by federally insured credit unions with over \$20 million in assets. Credit unions whose assets exceed \$100 million as of March 31, 1992, \$50 million as of March 31, 1993, and \$20 million as of March 31, 1994, would have to file with NCUA a quarterly Financial and Statistical Report ("Call Report"). An agency order issued in January 1992, already has required credit unions whose assets exceed \$100 million as of March 31, 1992 to report quarterly.

Credit unions not affected by the schedule will continue to be subject to the current requirement of filing a semiannual Call Report. *FR*, 8/3/92, p. 34091.

State Legislation and Regulation

Court Limits Auditors' Liability

California: The state's Supreme Court ruled that non-clients of accounting firms cannot sue for alleged professional negligence in the course of a financial audit, unless they can allege fraud or deceit. Non-clients may also recover damages resulting from violations of federal securities laws. *WSJ*, 8/28/92, p. B1.

Disclosure of Loan Data

California: A new law is designed to encourage banks to make emergency funds available to South Central Los Angeles, following the rioting there. Among the several provisions of the statute, effective immediately, the state for the first time will collect and publicly disclose race and gender data on business loan borrowers, and will disclose also the business location and type of business loans granted or denied. *BBR*, 6/1/92, p. 952.

Fees on Out-of-State Credit Cards

Delaware: A U.S. court of appeals, reversing a district court, ruled that a Delaware bank can charge late fees to card customers in Massachusetts.

The case involved Greenwood Trust Co., a Delaware subsidiary of Sears Roebuck Co., which issues the Discover card. Greenwood's agreement with its credit-card customers specifies that it is governed by the state of Delaware and applicable federal laws, under which it imposed a \$10 charge for late payments. Massachusetts' law prohibits late payment charges on open-end credit-card accounts. The appeals court held that Section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) preempts the state law. *BBR*, 8/24/92, p. 270; 11/4/91, p. 735.

New York: Shortly before the Delaware decision (above), a district court in Minnesota ruled that a bank in New York can impose late fees on credit cards of customers in Minnesota. *BBR*, 8/24/92, p. 270.

Failed-Bank Records Disclosures

Florida: An amendment to the state's banking statutes passed by the legislature provides for opening records of failed institutions to the public within one year after declaration of insolvency. *BBR*, 6/29/92, p. 1138.

Loan Program for the Disabled

Illinois: Illinois became the first state to start a loan program for disabled persons and businesses that are complying under the Americans With Disabilities Act (ADA), which became effective on July 26. The state Treasurer will place deposits with participating banks, who will pay 3.75 percent for the funds which they can lend with a three-percent spread. Several institutions are offering the low-rate loans. *Bank Letter*, 8/3/92, p. 4.

Low-Cost Checking Account

New Jersey: The Department of Banking issued a proposal for a basic, low-cost checking account that depository institutions are required to offer under a state law enacted in 1991. The current proposal modifies a proposal issued in September 1991. Among the features of the basic account as proposed are: a) no minimum balance to maintain the account, b) eight free checks per period (about 30 days), and a maximum charge of 50 cents for each additional check, c) an unlimited number of deposits without charge, and d) a \$3 limit on service charges per period.

Holders of the account may be charged for check printing, automated teller machine usage, and other banking services at rates no higher than those charged on regular checking accounts. *BBR*, 5/11/92, p. 826.

ATM Security

New York: New York City approved automated teller machine (ATM)

security requirements, including: a) surveillance cameras at each location, b) better lighting, c) large windows in at least one wall at ATM locations, and d) mirrors to prevent blind spots. Following an 18-month study, banks may be required to take other specified security measures. *New York State Banker*, 8/28/92, p. 3.

Banks' Selling of Annuities

New York: The state's Supreme Court, in deciding against the state Banking Department, said that banks chartered in New York may not sell annuities. The Court is second in the state's legal hierarchy to the Court of Appeals.

Texas: A federal district court upheld a rule of the OCC allowing a subsidiary of a national bank to offer fixed- and variable-rate annuities. The court found the OCC's decision to be reasonable under the "incidental powers" granted by banking law. *AB*, 7/15/92, p. 2; *ABA Bankers Weekly*, 7/21, p. 5.

Controls on Charter Applicants

New York: The Governor signed the Financial Frauds Prevention Act, creating a Criminal Investigations Bureau within the state Banking Department, and requiring the fingerprinting of applicants for bank licenses and charters, those seeking to incorporate a banking company, and applicants for acquiring control of a banking organization. The state Banking Superintendent is given discretion—based on reasonable suspicion—that an applicant has engaged in unlawful conduct—on the use of the prints to check on whether the applicant has a criminal history. *BBR*, 8/3/92, p. 173.

Interstate Banking

New York: The Governor signed a bill that permits state-chartered banks in other states to branch into New York on a reciprocal basis. It is the first state law specifically authorizing out-of-state bank entry by branching. Under the new law, banks branching into New York are subject to the same branching limits within the state that

apply to New York banks, and may exercise the same powers. The state's Superintendent of Banking is empowered to deny entry to banks that do not have an acceptable CRA record, and may examine a branch of an out-of-state bank on the same basis as the state's banks, and may issue regulations as appropriate. *ABA Bankers Weekly*, 6/30/92, p. 10; *BBR*, 7/6, p. 18.

Kansas: A new interstate, reciprocal banking statute allows the purchase of Kansas banks by banks from Missouri, Oklahoma, Nebraska, Colorado, Arkansas, and Iowa, effective July 1, 1992. Currently, all of these states, except Iowa, have laws permitting entry of Kansas banks. Out-of-state banks and bank holding companies applying to buy banks in the state must demonstrate safe, sound, and prudent operations, and must provide a record of adequate and appropriate community service. *BBR*, 7/20/92, p. 106.

Revised CRA Rules Proposed

New York: The Banking Department proposed major changes in the methods for enforcement of CRA that would apply to New York's 168 state-chartered banks. Coordination with federal regulators would be needed. The proposed changes include: a) numerical targets correlating a bank's CRA investments with its level of insured deposits; b) enhanced CRA credit for banks that make equity investments in minority-owned banks or maintain branches or ATMs in low-income areas; c) increased tie-ins between regulatory applications and CRA reviews; and d) exemption from application-tied CRA reviews for banks that achieve top ratings in three consecutive exams. *AB*, 9/10/92, p. 2.

New Savings Bank Charter

Wisconsin: A new state law permits thrifts in the state to convert to a new state savings bank charter. To be eligible to convert, an institution must have a capital-to-assets ratio of more than six percent. Under the new charter, thrifts would be regulated by the state Savings and Loan Commissioner and the FDIC, eliminating the

OTS as a regulator of these institutions. *BBR*, 5/4/92, p. 779.

Bank and Thrift Performance

Banks' Earnings Continue Uptrend, Asset Growth Is Slow

Earnings of insured commercial banks rose to a record \$7.9 billion in the second quarter of 1992 (preliminary), up from \$7.6 billion in the first quarter, and \$4.6 billion in the second quarter of 1991. The two primary factors in the improved performance were favorable interest-rate conditions, with wider net interest margins for the fifth consecutive quarter, and a continued decline in loan-loss provisions. Net interest income totaled nearly \$33 billion in the quarter, an 8.8 percent increase from the second quarter of 1991. Loan-loss provisions were \$6.3 billion in the second quarter, down from nearly \$8.3 billion in the same 1991 period. The average return on assets in the second quarter was 0.94 percent, the highest level since banks began reporting quarterly income in 1983. Banks limited the decline in gross interest income by increasing their holdings of residential mortgages and longer-term (over one year) fixed-rate securities, and reducing their short-term investments, including federal funds sold. Lower interest expense reflected the sharp declines in short-term rates over the prior twelve months, increased equity funding, and larger depositor balances held in noninterest-bearing accounts.

Commercial banks' troubled assets—mainly non-current loans and foreclosed real estate owned—declined by \$3.3 billion during the second quarter, falling to 2.90 percent of assets from 3.19 percent on June 30, 1991. The average ratio declined for banks of all sizes and in all regions. Asset-quality improvements were strongest at banks in the Northeast and Southwest Regions, while those in the West had the smallest decline in troubled assets.

Assets of commercial banks grew by only \$2.7 billion in the second quarter of 1992, down from an increase of \$5.2 billion in the first quarter. Totalling \$3,438 billion as of mid-1992, bank assets were only 1.8 percent above the level of a year earlier. Loans in the aggregate have been shrinking for six consecutive quarters, much of this decline being in commercial and industrial loans. Among the categories that increased in the second quarter were adjustable-rate home mortgage loans, agricultural production loans, and non-construction commercial real-estate loans. Overall, the strongest-growing asset continued to be investment securities, which were \$18.6 billion higher during the quarter, most of this increase being in U.S. Treasury securities and collateralized mortgage obligations.

Commercial banks' equity capital rose by \$9.3 billion in the second quarter, of which retained earnings contributed \$4.8 billion. Equity capital now stands at 7.23 percent of assets for the industry. By bank asset size, the average ratio was 9.39 percent for small banks (assets less than \$100 million), falling to 6.00 percent for banks with assets of more than \$10 billion. By region, banks in the Midwest had the highest ratio (8.55 percent), while those in the Northeast had the lowest (6.43 percent). *FDIC Quarterly Banking Profile*, Second Quarter, 1992.

Thrifts' Earnings Down in Second Quarter

Savings associations in the private sector earned \$1.27 billion in the second quarter of 1992, down by 18 percent from the first three months. For the first six months, profits were a record \$2.81 billion. Ninety-three percent of private-sector thrifts were profitable in the second quarter, the industry's sixth consecutive profitable quarter.

A key factor in the industry's recovery has been the ongoing cleanup of nonviable thrift institutions and consolidation through mergers, charter conversions and acquisitions. In addition,

the growth in earnings is due to the unusually large spread between thrifts' cost of funds and their lending rates. Gross interest income was down by about 20 percent in the second quarter compared to the second quarter of 1991, while interest expense declined by nearly 32 percent, producing a 13 percent rise in net interest income. Thrifts made provision for loan losses of \$1.25 billion in the second quarter, \$344 million less than in the same period in 1991.

The thrift industry continues to shrink, as the number of private-sector savings associations declined in the 12 months ending June 30, 1992 by 203 to a total of 2,013 in operation, and their assets fell by \$80.8 billion to \$839.7 billion. The associations' tangible capital increased in the period by \$4.76 billion to \$46.3 billion. As a percentage of tangible assets, the increase was from 4.51 percent to 5.49 percent. The OTS, in describing a "smaller but healthier" thrift industry, noted that the number of thrifts declined by 35 percent from June 1988 to June 1992, and their assets were down by the same percentage. In the period, total tangible capital of the associations increased from 0.33 percent of assets to 5.70 percent, while the number of insolvent associations dropped from 632 to 11. Earnings for the six months prior to midyear 1988 and 1992 improved from minus \$8.01 billion (-1.26 percent of assets—annualized) to a positive \$2.81 billion (0.66 percent of assets).

As of mid-1992, OTS classified 982 thrifts (49 percent of total) in its supervisory Group I (well-capitalized and profitable), 657 (32 percent) in Group II (meet or expected to meet capital requirements), 337 (17 percent) in Group III (troubled with poor earnings and low capital), and 37 (two percent) in Group IV (expected to require government assistance). *NEWS, OTS, 9/16/92; 2nd Quarter 1992 Financial Developments for Private Sector Savings Associations, OTS, September 1992.*

Banks Sell Securities at Record Level

Banks sold \$11.4 billion in domestic stocks and bonds in the third

quarter, narrowly surpassing the previous record of \$11.3 billion in the preceding quarter. Common stock sales were down, falling to \$420 million from \$3.1 billion in the first six months. Total debt and equity offerings in the first three quarters of 1992 amounted to \$34.7 billion, up from \$26.8 billion for all of 1991.

Banks added \$6.1 billion to their capital, including \$2.5 billion of Tier 1 capital, in the third quarter. *AB, 10/2/92, p. 1.*

Market-Value Accounting

J.P. Morgan & Co. and Bankers Trust New York Corp. said they are adopting market-value accounting for most of their investment portfolios. Traditionally, banks have accounted for most investment securities at amortized cost. Banks that go to MV accounting before it is required are showing signs of strength, analysts said. An argument against a requirement for this accounting is that it could cause earnings to fluctuate widely from quarter to quarter. *AB, 8/20/92, p. 2.*

Offshore Loans Boost Foreign Banks' Share of U.S. Market

Offshore bank loans to U.S. businesses in the 1980s grew rapidly as foreign banks were able to avoid a cost of U.S. regulation, which is the reserve cost of booking loans in the U.S. The largely foreign ownership of the banks responsible for the offshore lending means that the foreign bank share of the U.S. commercial lending market is higher than the frequently cited 30 percent, which is based on loans booked in the U.S. Foreign banks have gained a market share closer to 45 percent, putting commercial lending ahead of chemicals and automaking in the foreign share of the U.S. market.

U.S. banks reported \$428 billion of corporate loans at the end of 1991, while foreign banks had \$348 billion. Offshore loans to U.S. commercial and industrial borrowers—by foreign banks in places such as the Cayman Islands—had risen to \$152 billion by

the end of the year, up from \$20 billion in 1983. During the same period, onshore lending, or loans booked through U.S. offices of foreign banks, increased to \$196 billion from \$66 billion. Onshore and offshore lending by U.S. banks rose at a far slower rate, to \$428 billion from \$381 billion in 1983.

Another conclusion is that more corporate funding was supplied by banks, including foreign banks, and less by the securities markets than is generally thought. The common perception of banks' loss of corporate business to the securities markets in the 1980s overstates the case. *Quarterly Review, Federal Reserve Bank of New York, Spring 1992, pp. 52-65; AB, 6/15, p. 1.*

Banks' Holdings of U.S. Government Securities Exceed Loans

Banks held \$607.3 billion in U.S. government securities on June 30, 1992, according to Federal Reserve data, and \$598.5 billion in commercial and industrial loans, marking the first time since January 1965 that U.S. securities surpassed business loans in banks' portfolios. Critics say that a tightening of banks' lending policies has been the principal cause for the decline in loans. Banks generally attribute the trend more to a lack of loan demand related to weakness in the overall economy. *AB, 7/27/92, p. 1.*

Bank Employment Shrinkage Smaller Than Expected

The number of employees of federally insured commercial banks fell by about 60,000, or 4 percent, in the past five years to just under 1.5 million at the end of 1991, according to FDIC data. The decline has been well below the 15 to 20 percent reduction that some analysts have said is necessary to the future competitiveness of the industry.

The employment figures as released are somewhat distorted by the effects of commercial banks' acquisitions of savings institutions which previously did not report to the FDIC. Also, while some mergers and acquisitions of banking institutions have led

to substantial job restructuring, banks' retention of employees in different job capacities, and the hiring of laid-off technical and other bank employees by other banking organizations apparently has been somewhat more prevalent than expected. Observers say a better test of this development will be shown in year-end 1992 employment data after the effects of some large recent mergers/acquisitions are further worked out. *AB*, 7/1/92, p. 3.

Less Mortgage Credit from Deposits in Minority Communities

A study by the Association of Community Organizations for Reform Now (ACORN) found that between 1989 and 1990, for every dollar that banks had on deposit in predominantly minority neighborhoods, they loaned about four cents for mortgages in those same neighborhoods, while the corresponding amount in white neighborhoods was nearly eight cents. The results were not significantly different when comparing neighborhoods of comparable income but with dissimilar racial compositions. Middle income, predominantly minority localities received only two cents in loans for every dollar of deposits, while in white localities the figure was seven cents.

Of the 14 major U.S. cities in the study, New Orleans showed the highest racial discrepancy, but the comparative data were favorable to white neighborhoods in every city except Philadelphia.

A spokeswoman for ACORN said the study provides new evidence that "investment strategies in the banking industry are contributing to urban decay and decline." *BBR*, 6/8/92, p. 988.

Credit Life Insurance Criticized

A study by the Consumer Federation of America and the National Insurance Consumer Organization concluded that consumers in most states are being substantially overcharged for credit life insurance, and disclosures that lenders make to borrowers are inadequate. Nationally,

credit life policies pay out only 42 percent of premiums in claims, well below the 70 percent the groups said is reasonable. Only the District of Columbia, New York, and Maine, places where the product is highly regulated, have payout ratios of 60 percent or more. Arizona, California, Maryland, New Jersey, Oregon, Pennsylvania, and Vermont have payouts exceeding 50 percent. Also, credit unions nationally have payout ratios of more than 50 percent.

An industry spokesperson responded that credit insurance does not require a medical examination, and is considered to be reasonably priced in most cases, noting that the typical borrower pays only about \$2.50 per month for coverage.

The two consumer groups that sponsored the study urged states to tighten regulations and consumers to exercise firmer resistance to offers of the insurance. *AB*, 5/21/92, p. 8.

Electronic Payments Grow

Consumers have increased their usage of electronic payments over the last five years by over 100 percent, according to the National Automated Clearing House Association. In 1990, the number of payments exceeded 1.5 billion with a value of \$6 trillion.

The number of participants in automatic bill paying for one or more recurring expenses such as utilities and life insurance premiums has more than doubled. Over 25 percent of employed persons, or about 27 million people, now receive their pay *via* direct deposit. *Northwestern Financial Review*, 4/18/92, p. 7.

Regional Banks to Link ATM Systems

Banc One Corp., CoreStates Financial Corp., PNC Financial Corp., and Society Corp. will combine their automated teller machines and point-of-sale terminals, subject to approval by the Federal Reserve. Anchored by CoreStates' Mac system, the joint network, with more than 12,000 ATMs, would be the largest in the country by some key measures. The move is

intended to reduce operating costs, encourage product development and reverse the flow of consumer payment processing to nonbank companies. *AB*, 7/23/92, p. 1.

Recent Articles and Studies

ABA Study of Regulatory Burden

The nation's banks paid over \$10.7 billion in 1991 "to keep pace with industry rules and regulations," according to a survey by the American Bankers Association. Regulatory costs represented about ten percent of the industry's total operating expenses, and nearly 59 percent of bank profits for the year. An official said that banks could lend an additional \$20 to \$30 billion each year if 25 percent of their compliance costs could be added to earnings and capital.

The survey, distributed in February to the ABA's member banks, was concerned largely with the time and resources that banks devote to compliance. Of the 974 which responded, 714 had assets of less than \$100 million, 211 were in the \$100 million- to \$999 million-asset range, and 21 had assets of \$1 billion or more. Asset size was not available in 28 responses. By region, the number of respondents ranged from 58 in the Northeast to 367 in the Midwest. The survey and a recent ABA public statement were used to prepare this article.

The survey found that CEOs of small banks devote eight to nine hours per week to regulatory issues, and large banks five hours, with an industry average of about eight hours. Typically, compliance issues are discussed at every meeting of banks' boards of directors, and consume 16 percent of a board's time. This figure did not vary much between banks in different size groups. Small banks pay a higher percentage of their operating costs and profits on regulatory compliance. Their compliance costs as a percentage of operating expenses were over 20 percent, declining to ten percent or less for large banks. It is noted that nearly 2,000 banks in the U.S. have

ten or fewer employees, and nearly half of all banks have 25 or fewer employees.

Seventy percent of respondents—many of them community bankers—cited CRA as their greatest regulatory concern. CRA compliance was first among regulatory compliance issues causing CEOs the “most headaches,” and also the most time-consuming. Banks complained of regulatory overkill in the area of CRA. There is a perception that the agencies are putting as much or more emphasis on documentation as actual CRA performance. Large banks also say that an outstanding rating does not protect them from CRA protest against a merger or acquisition application.

The second most serious complaint in the survey from bank CEOs is the need for written policies for many bank activities. Thirty percent of CEOs cited written policies as the most time-consuming compliance burden. For front-line bank staff, filling out currency transactions reports is the most time-consuming. Banks fill out over seven million CTRs annually at a cost of almost \$130 million. It is particularly costly, for example, for large urban banks that process large numbers of commercial deposits.

Bankers feel that the regulatory agencies do not appreciate the extent of the burden a rule imposes on their institutions. For example, the Paperwork Reduction Act requires the agencies to measure and report the burden created by required paperwork, but their estimates of the time required to comply with individual regulations are said to be much too low.

The regulatory burden is preventing some banks from offering certain products; for example, many survey respondents do not offer adjustable-rate mortgages because of the difficulty and expense involved in providing the proper disclosures, and stiff penalties that can result from inadvertent errors. The same comments apply to home-equity lines of credit, other types of real-estate-based loans, and variable-rate consumer loans. In respect to not offering certain products

because of the regulatory burdens, small banks in particular mention Truth in Lending and the Real Estate Settlement Practices Act, and in the future the Truth in Savings legislation when that is implemented.

The effects of the regulatory burden would exist even if banks had no nonbank competitors; however, other financial and nonfinancial firms are free to compete for bank customers without the same regulatory impediments and costs.

Among a comprehensive set of regulatory and legislative changes the ABA has recommended are: a) CRA relief for community banks, together with a safe harbor for all banks earning outstanding or satisfactory ratings, and relief from the requirement for geo-coding of loan applications; b) a recognition that small banks do not need a multitude of formal written policies; c) the growth of required Call Report information must be restricted; instructions should be simplified; where entire sections do not have relevance to an institution, separate schedules should be utilized which need not be completed unless certain specified conditions exist; d) under the Paperwork Act and other legislation, the agencies should publish realistic estimates of the impact of a rule proposal, and seek public comment on that estimate; and e) the agencies should adopt uniform applications for mergers and acquisitions, as well as other purposes. *Survey of Regulatory Burden, American Bankers Association, June 1992; Statement of Alan R. Tubbs on behalf of the ABA, FFIEC, 6/18.*

Community-Bank Charter Proposed

Developments in the thrift and banking industries have made the “dual banking system” of state and federal chartering less important, Gary M. Welsh says, while another dual system, “community banks” and “commercial banks” is “driving competition and politics” within the banking industry. “Community banks” are defined here as the smaller, insured depository institutions—thrifts as well

as banks—that serve primarily customers in local areas. The larger institutions that compete in statewide, regional or larger market areas are “commercial banks.” He states that community banks presently are subject to excessive costs for compliance, deposit insurance, and liability, while commercial banks are being denied the interstate banking and product reform which they need to compete with nonbank firms and foreign banks. The proposal is to create a new federal charter for community banks (states could also issue such charters). The expected benefits would be to reduce regulatory burden, and also gain support across the industry for bank powers reform.

Community banks must have sufficient powers to provide the loans needed by consumers, small businesses, local governments, community organizations, and other local-area customers. With limited geographic diversification under the proposal, they should have lower lending limits than the current national bank limits. Insider-lending limits would be eased to encourage local participation and director service in the institutions.

Community banks would be prohibited from speculative trading but could engage in activities necessary for effective liability management. They could accept all types of deposits, but could not accept brokered deposits or solicit deposits outside their communities. Community banks would be permitted to engage in “agency” activities, but only in joint-ventures with local securities, insurance, or real-estate firms, and under arrangements that would strictly limit a bank’s liability.

Supervisory examinations of community banks normally would need to be conducted less often and in a shorter time than under the current system. The banks would not be subject to CRA requirements, but would have to comply with all anti-discrimination laws. They would be permitted to form community bank holding companies, which could acquire only community banks, including those across state

lines, and could engage in nonbank activities closely related to community banking. CBHCs could not be acquired by commercial bank holding companies or foreign banks. Commercial banking firms would not be allowed to establish *de novo* banks or *de novo* branches in any rural community under 10,000 in population already served by a community bank.

Michael K. Gutttau, in responding to the new charter proposal, sees serious disadvantages that result primarily from the restrictions in the charter. These negatives are outlined as: a) size disincentives, b) strict limitations on activities, c) competitive disadvantages, and d) reduction in the value of community bank franchises. He proposes, as another way to reduce regulatory burden on community banks, a "regulatory basket" approach, which he says would avoid many of the rigidities and complexities involved in separate charters. The two proposals are similar in some respects.

All regulations would be reviewed to determine which should be applied to a bank engaging only in community bank activities. Those institutions would be subject to the basic basket of regulations, while other banks would be subject to specific additional regulations appropriate to their expanded activities. For example, the basic regulations might apply to a bank that: a) serves only a local area, b) does not engage in underwriting or "risky" activities, and c) its failure would not pose a threat to the economy or the deposit insurance fund. The basket of regulations that might apply in this case could include: a) streamlined safety and soundness regulation, b) very limited CRA and HMDA rules, c) limited financial disclosure and accounting requirements, and d) holding company would be regulated by the same regulator as the bank. For each specific area where a bank does not meet the criteria for the basic regulations, a specific additional set of regulations would apply. For example, if the bank's services are not limited to the local area (more than in the basic basket), more CRA/HMDA rules

might apply. If the institution or an affiliate engages in the underwriting or "risky" activities, another basket of safety and soundness regulations could be called for, including firewalls, separate subsidiaries, regulation of the umbrella holding company, and functional regulation of nonbanking activities. *AB*, 1/17/92, p. 4; *ABA Bankers Weekly*, 5/26, p. 3.

Mixing Banking and Commerce

A recommendation by the Treasury Department that commercial firms be allowed to own banks failed to be enacted as part of FDICIA, and the writer, Loretta J. Mester, notes that almost 70 percent of senior bank executives recently surveyed were against commercial firms owning banks. This article presents evidence on both sides of the issue.

One argument is that expanding the field of owners to include commercial firms would bring new capital to the banking industry. The writer questions whether the industry as a whole is undercapitalized. She suggests that further consolidation within the industry should enable many individual banks in need of capital to meet their requirements. Also, the commercial firms most interested in banking probably would be more likely to expand their own bank-like operations rather than buy existing full-service banks if permitted to do so.

Also in favor of ownership of banks by commercial firms, but not supported by the evidence, is the claim that the combination might lower the cost of providing services through scale or scope economies. Most studies, however, of scale economies in banking suggest that they are exhausted in banks of relatively small size (around \$100 million of deposits), and if they occur at all in larger banks, are small. As to scope, in a recent empirical study, Ms. Mester found diseconomies between traditional commercial bank activities and certain potential synergy-yielding, bank-nontraditional activities. There may be synergies through cross-marketing of bank products and

commercial firm products that might yield enhanced revenues. While some of this does occur, the performance of nonbank banks, which can provide both commercial and financial products, does not indicate that they have a significant advantage over commercial banks from revenue or cost synergies.

Diversification of firms into financial services and commercial production could lower their risks, if profits in the commercial activities could be used to offset losses from financial services. Based on limited studies of the correlation of the earnings of banks and nonbanking industries, there appears to be some potential for reducing banks' risk through such diversification.

The claim that allowing commercial firms to own banks would cause the industry to become overconcentrated is not supported by the evidence. The results of scale and scope studies, and experience from nonbank banks suggesting that tie-ins would not be a problem, are cited.

If commercial firms had access to bank deposits by affiliates' transactions, regulators would have to tighten firewalls or closely monitor the risky activities of the holding company, at least until the new provisions of FDICIA take effect calling for risk-based assessments. If firewalls, however, are strengthened too much, potential synergies and benefits from diversification would be cancelled out. Regarding affiliates' riskiness spreading to the bank, management studies suggest that the management of a parent and its subsidiaries is usually centralized. In several cases banks have acted to prop up ailing affiliates even when under no legal obligation.

The article concludes that in many cases the net benefits of commercial firms' ownership of banks depend on the ability of regulators to control possible abuses of the financial system by its participants. Without necessary changes to the current system, the potential costs of allowing banking and commerce to mix outweigh the potential benefits. However, as the

reforms contained in FDICIA, such as risk-based deposit insurance premiums and limits on too-big-to-fail, are implemented, the prohibitions against commercial firms' owning banks and *vice versa* will need to be reconsidered. *Business Review, Federal Reserve Bank of Philadelphia, May/June 1992, pp. 17-29.*

"Transferable Puts" for Loans at Failed Banks

This article by Eric S. Rosengren and Katerina Simons discusses a proposal by Richard F. Syron, President of the Federal Reserve Bank of Boston, for a mechanism to help relieve current credit availability problems by making existing FDIC guarantees of loans transferable throughout the private financial system.

One of the distinctive features of the current problems has been the rapid growth in "performing nonperforming loans," which are loans current on payments of principal and interest whose collateral value has dropped below the value of the loan. Many of these loans are in the portfolios of failed banks whose assets are controlled by the FDIC. When a bank fails, the FDIC normally tries to find a bank to buy the deposits and good assets of the failed banks, and normally allows the acquiring banks to return substandard loans, including performing nonperforming loans, to the FDIC for full face value during the first year after the acquisition. This "put" to the FDIC is at a discount to the full face value after the first year and normally does not exceed three years. Once assets have been put back to the FDIC, they are normally transferred into a "bad asset" pool. The FDIC usually contracts to have these assets managed by collecting agencies, which are instructed to maximize the cash flow to the FDIC, after appropriately discounting for the time value of money for cash received in the future. These management contracts provide neither the incentive nor the ability to work out loans in the way that might have been done, had the borrower had a relationship with a well-capitalized bank. As a result, too many loans are foreclosed.

Under Mr. Syron's proposal, when performing nonperforming loans are placed in the equivalent of "bad banks" by the FDIC, the borrower could transfer the loan to any willing financial institution, with the same government guarantee on the loan that is currently extended to acquirers of failed banks — in effect, making the put transferable. The resulting competition for "puttable" failed-bank assets would provide a market for performing nonperforming loans that would reduce the number of liquidated loans and potentially reduce costs to the FDIC.

How extensively banks would lend to borrowers with transferable puts would depend, at least in part, on the regulatory treatment of these loans under the risk-based capital standards. If the puts were treated as government securities, they would receive a risk-weighting of zero; however, if they were treated as agency securities they would receive a risk-weighting of 20 percent. Given the shortage of capital at many New England institutions, a risk-weighting of 20 percent could discourage some lenders. In addition, many institutions are shrinking and may not want to acquire loans that require substantial monitoring. Nonetheless, for borrowers with transferable puts able to find a willing lender, their risk of liquidation may be significantly reduced. *New England Economic Review, Federal Reserve Bank of Boston, March/April 1992, pp. 4-11.*

Would a Reconstruction Finance Corporation Work Today?

Some would contend, writes William R. Keeton, that a program of government investment could avoid the unnecessary closure of weak, but viable banks, thus benefitting the taxpayer and the economy as a whole. The successes of the Reconstruction Finance Corporation (RFC) in the Great Depression are cited as evidence that this approach could also work today. By purchasing preferred stock in thousands of banks, the RFC is claimed to have spurred a strong recovery in banking. This article

reviews the current debate over government investment, examines the record of the RFC in the 1930s, and considers the implications of the RFC experience for the current debate in the light of key differences between the 1930s and today.

Proponents of government investment argue that some weak banks should be left open because they are viable. Such banks may have valuable intangible assets, such as long-term relationships with depositors and borrowers, that would be lost if the bank were closed, even if later it was resold to a healthier bank. Further, under "prompt corrective action," weak but viable banks would be forced to close because they would not be able to raise enough capital to meet the minimum requirements. In that connection, because regulators examine banks on a regular basis it is contended that the government is usually in a better position than private investors to determine which troubled banks are truly viable. Critics of government investment in weak banks say it would lead to excessive ownership and control of the banking industry, and, contrary to the above argument, the government would in fact prop up many nonviable banks.

In its program for purchasing the preferred stock (and subordinated debt) of undercapitalized banks, the RFC spent a total of \$1.2 billion, peaking in 1935 at \$892 million of bank capital held, consisting of \$869 million in commercial banks and the rest in mutual savings banks. The investment in commercial banks accounted for 14 percent of the industry's total book capital and involved 5,685 banks — 40 percent of all insured banks. (In addition to this type of assistance, the RFC made direct loans to businesses, financed emergency relief and public works projects, and helped fund mobilization for World War II.)

Banks with high RFC capital failed at a higher rate than other banks, suggesting that a greater fraction of RFC banks were nonviable or took excessive risk than in the industry as a whole. However, the failure rate of

RFC banks was not very high in numbers, further suggesting that the fraction of nonviable banks or risk-prone banks was also not very high. Thus, while the RFC may have assisted some nonviable banks that later failed, it may have rescued an even greater number of viable banks that later recovered. If so, the preferred-stock program was a better way to deal with weak banks than prompt corrective action, though not necessarily superior to forbearance.

The favorable record of the RFC suggests that government investment can sometimes work better than either prompt corrective action or forbearance. In particular, government investment can help viable banks recover without nationalizing the banking industry, propping up large numbers of nonviable banks, or encouraging excessive risk-taking. However, the many differences between the 1930s and today also sug-

gest that government investment should be used with caution. Among other conditions, government investment should always be provided in a form that reduces banks' incentive to gamble by forcing them to give up a share of their future profits. *Economic Review, Federal Reserve Bank of Kansas City, 1st Quarter 1992, pp. 33-54.*