Federal Deposit Insurance Corporation

FDIC Banking Review

1998
Vol. 11, No. 3

FDIC Banking Review

1998
Volume 11, No. 3

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, DC 20429.

Financial Deregulation in Japan

by Valentine V. Craig*

On November 11, 1996, Japanese Prime Minister Ryutaro Hashimoto unveiled a plan to reform Japanese financial institutions and markets by the year 2001. The plan, which consisted of dozens of proposals, was called "Big Bang," an analogy to the decade-earlier British effort to reform its securities industry and capital markets. The goal of Japanese Big Bang, as enunciated by the prime minister, was to create a "free, fair and global" financial system—free, in that it would operate according to market principles rather than regulatory prescriptions; fair, in that it would be transparent and reliable; and global, in that it would be sophisticated and internationally respected.

Japan is the largest creditor nation in the world. It is the world's second-largest economy (after the United States) and accounts for the world's second-largest insurance market. It has nine of the ten largest banks (in terms of loans outstanding) in the world. Its citizens enjoy the world's highest per capita income, and they contribute to one of the highest rates of savings in the world. However, the nation has been facing severe financial problems for much of the past decade. This article begins by examining these problems and describing the reforms proposed to address them. It then surveys the results of Britain's Big Bang, the model for Japanese financial deregulation. It ends by discussing the probable effects of Japanese Big Bang.

Japan's Financial Problems

Japan's financial industry and markets are suffering from a constellation of problems caused, to a large extent, by government protection and excessive regulation. These problems include inadequate investment choices and returns, inefficient and noncompetitive financial institutions, and underdeveloped financial markets that both fail to meet international standards for performance and are characterized by weak financial reporting and lack of transparency. Because of these problems, the country faces a potentially serious pension fund shortfall, a banking crisis, and a lack of respect for Japanese financial markets and currency.

Looming Pension Shortfalls: Inadequate Investment Choices and Returns

The government hopes to stave off a serious pension fund situation by expanding the number of investment vehicles available to the population and by increasing returns to savers.

The portion of the population approaching retirement age is much larger in Japan than in other industrialized nations. In 2007, an estimated 21 percent of the Japanese population will be over 65 compared with 15.5 percent now. It is projected that by 2025 there will be 61 Japanese pensioners for every 100 workers. The comparable projection for the United States is 49 retirees per 100 workers. According to a study by the Organization for Economic Cooperation and Development (the OECD), assuming the current Japanese retirement age and level of worker contributions and returns, government debt attributable to pensions will rise from approximately 25 percent of GNP in 2000 to

* Valentine V. Craig is a Chartered Financial Analyst in the FDIC's Division of Research and Statistics.

300 percent of GNP in 2030.[1] Japanese firms are not required to report pension liabilities on their balance sheets, but by some estimates, Japanese firms will have to spend 25 percent of profits on pension contributions by the year 2000.[2] These demographics explain Japan's resistance to international calls for tax cuts to spur its economy. The pending pension problem is severe, and returns to investors must improve dramatically for the country to avoid consuming a large portion of its economy with retirement payments.

This pension fund crisis appears paradoxical, as the amount of Japanese savings is huge. Japanese gross national savings represent approximately 30 percent of GDP, or approximately one-third of the world's savings.[3] However, most of this money has been funneled into low-yielding savings accounts. More than anywhere else in the developed world, Japanese investors have relied on savings accounts (offered by either Japanese domestic banks or the Japanese Postal System) as their primary investment vehicles. Approximately 60 percent of Japanese liquid assets are in bank accounts, compared with approximately 25 percent in the United States.[4] And unfortunately for Japanese savers, returns on bank or Postal System savings have historically been very low because of government policies that subordinated the needs of the banks and savers to the needs of Japanese industry. After the Second World War, Japanese industry needed cheap capital to restart itself, and this cheap capital was subsidized through government restrictions on where money could go and what yields it could earn.

Banking Crisis: Inefficient and Noncompetitive Financial Institutions

Government protection and excessive regulation have also resulted in inefficient and noncompetitive Japanese financial institutions, with the banks especially disadvantaged by government policy.[5] The post–World War II government policy referred to above, to promote Japanese industry at the expense of savers and intermediaries, kept bank profitability low in return for shifting risk from banks to the government. The banks funneled money cheaply to industrial firms that desperately needed funding to rebuild after the war—and in return for restricted or "appropriate" profits, the banks received protection from competition at home and abroad, and a tacit guarantee of a bailout should problems arise.

Japanese banks are currently saddled with bad loans and, having been protected for so long, have not been able to compete profitably in the new global arena. Japanese investment firms and insurance companies were also heavily regulated and protected from competition. Most securities firms have not made a profit in years; and the insurance companies, although not required to report the same kind of asset-quality information as the banks, are believed by many analysts to be much worse off financially than the banks.

Underdeveloped Financial Markets

The third major financial problem for Japan is that the nation's financial markets are relatively underdeveloped. Because of a variety of prohibitions, restrictions, and taxes, Japanese capital markets have not kept pace with other world markets and have, in fact, deteriorated greatly over the past decade. During the late 1980s, monthly trading volumes in Tokyo and New York were approximately equal; today Tokyo's volume is approximately 20 percent of New York's, with approximately 70 percent fewer shares traded now in Tokyo than during 1988. Not only has the volume of foreign shares traded on the Tokyo Exchange declined substantially, but the exchange's percentage of domestic shares traded has declined as well. Approximately 18 percent of total trade in Japanese equities is now done in London, a threefold increase in the past five years.[6] One-third of the Nikkei 225 stock futures business is conducted from Singapore.[7] Moreover, the number of foreign companies listed with Tokyo has dropped by approximately one-half over the past five years.

The underdevelopment of Japanese capital markets has both foreign and domestic consequences. Even though Japan is the world's largest creditor nation, its underdeveloped capital markets have dissuaded foreign investors from holding yen. Thus, the exchange-rate risk for Japanese businesses, particularly Japanese banks, has increased. The banks are particularly sensitive to the weakness in the yen because much of their foreign lending is done in dollars and accounted for in yen. As the dollar has strengthened relative to the yen, the yen-amount of loans outstanding has increased, forcing the banks to set aside more capital to meet the

[1] "A Suitable Case for Treatment," *The Economist* (June 28, 1997): 9.

[2] Ibid., 12.

[3] "A Giant Sucking Sound," *The Economist* (August 23, 1997): 53.

[4] "The Asian Tigers May Falter, but the Japanese Lion Is the Worry," *The New York Times* (November 13, 1997), D2.

[5] "A Time of Crisis," *FDIC Banking Review* 11, no. 2 (1998): 9–17.

[6] "A Big Bang in Slow Motion," *Financial Times* (December 10, 1996), 21.

[7] "Japanese Finance," *The Economist* (June 28, 1997): 1–18.

minimum reserve requirements of the Bank for International Settlements.

From a purely domestic point of view, the underdevelopment of the capital markets has made borrowers overdependent on banks. In the United States, bank loans account for less than 10 percent of corporate funding, but in Japan the figure is approximately 60 percent, according to estimates by Salomon Smith Barney.[8] Bank borrowers (for the most part Japanese corporations) certainly benefited handsomely from the low interest rates on bank borrowings, but at the same time they became overly dependent upon the banks for their capital needs, a potentially serious problem when the banks are in crisis, as they are today.

Weak and Opaque Financial Reporting

Westerners complain of a lack of transparency and materiality in the financial reporting of Japanese firms. Parent-only reporting has served to obscure the financial and legal position of Japanese parent firms. Even in the case where the parent is not legally responsible for its subsidiaries' debt, refusal to honor the subsidiaries' debt can result in a parent's failure. This was brought home recently in the case of Daido Concrete, which refused to honor its *shido nenshoes* (letters of awareness) for its subsidiaries' borrowings and was then brought down by the concerted action of its banks, which refused to roll over the parent's short-term borrowings. Extensive financial arrangements and obligations among firms in a *keiretsu*[9] are also common in Japan and may be very material to the health of a member firm, but are generally not reported.

Japan has neither the laws nor the infrastructure to deal with financial problems of the magnitude it faces today. For instance, Japanese firms often pledge the same collateral repeatedly for different loans, and when the borrower defaults, there is no legal procedure for settling the claims of the different lenders. Japanese law also makes it very difficult for banks to foreclose on bad loans. Nor does a professional infrastructure exist to promote Western ideas of transparency. With just over 12,000 accountants in Japan (the United States, whose economy is twice the size of Japan's, has 470,000 Certified Public Accountants), 710 bank examiners (the United States has approximately 7,000), and a very small judiciary, much financial reporting and enforcement of rules necessarily rests on the honor system.

Proposed Solution: Big Bang

The dozens of reform proposals presented by Prime Minister Hashimoto in late 1996 were the response to these pressing financial problems. The proposed reforms are discussed in this section according to the breakdown used by the Ministry of Finance:

- reforms to increase choice for investors and borrowers;
- reforms to encourage Japanese financial institutions to become more efficient and competitive;
- reforms to encourage better functioning of Japanese financial markets; and
- reforms to establish rules for fair and transparent financial operations and a reliable regulatory framework.

The initial plan called for these reforms to be implemented on a staggered basis over a five-year period. Most of the proposals have been passed by the Diet, and many have already been implemented.

Increasing Choice for Investors and Borrowers

To improve investor choice, Big Bang authorizes new financial instruments and new powers for Japanese financial institutions and removes controls on foreign exchange.

New Financial Instruments and Powers

Banks and securities firms are now permitted to deal in over-the-counter securities derivatives. Previously, there was uncertainty as to whether using them constituted gambling and was therefore banned by Japanese law. Beginning in July 1997, brokerages were allowed to sell options on individual stocks on the Tokyo and Osaka stock exchanges—previously this had been permitted only on indices. Banks are now authorized to engage in over-the-counter trading of derivatives related to securities and commodities, and asset-backed securities are being authorized to improve liquidity.

More choice was also given to investors and savers with the introduction of asset management accounts in October 1997; previously, postal or bank savings accounts were the main alternatives open to Japanese savers. Additionally, banks and insurance companies

[8] "Landmark Deals Indicate the Scale of Change," *Financial Times* (July 14, 1998), 3.

[9] A *keiretsu* is a grouping of businesses held together by cross shareholdings and a common economic purpose. *Keiretsu* groupings typically consist of a large commercial bank at the center, with trust banks, insurance companies, and trading, construction, finance and real-estate companies as other members.

have been authorized to enter the investment trust (mutual fund) sales business indirectly by renting space to investment companies, and they will be permitted to sell these trusts themselves in December 1998. It is expected that banks will eventually be authorized to sell long-term fire insurance and credit life insurance related to housing loans.

Removal of Controls on Foreign Exchange

Controls on foreign exchange have been largely removed. On April 1, 1998, the Foreign Exchange and Foreign Trade Control Act was amended, and among other changes, Japanese nonbank companies and individuals were allowed to open financial accounts in institutions in foreign countries and to deal directly with overseas banks and brokerages. Additionally, the monopoly that licensed banks and securities firms had on the foreign-exchange business was lifted. The foreign-exchange business was opened to nonbanks, and licensing requirements were removed.

Improving Efficiency and Competitiveness of Financial Institutions

The Big Bang reforms have created a different competitive structure for financial institutions by authorizing competition through financial holding companies. The reforms are also stripping away many of the protected powers enjoyed by the different kinds of financial firms and will allow for broad-based competition; in particular, foreign entities are being allowed to compete more freely with Japanese firms. All of these reforms designed to increase competition will necessarily increase investor choice as well.

Competition through Holding Companies

Initially, competition among the different sectors of the Japanese financial industry is being channeled through a holding company structure. Holding companies had been outlawed since the end of the war, but the Japanese Diet has repealed (subject to some restrictions) its general ban on them. The walls between banks and securities firms have been removed through the use of area-specific subsidiaries. It is planned that beginning in April 2000, insurance companies will be able to enter the banking, trust, and securities businesses through subsidiaries; in December 1998, securities companies will be able to enter the insurance business; and in April 2001, banks will be able to enter the insurance business. Head-to-head competition (not through a holding company structure) by the different financial sectors is to be decided on at a later date.

Removal of Monopoly Power and Other Industry Protections

A major thrust of Big Bang is to abolish the monopoly powers enjoyed by each of the three sectors of the financial industry in Japan: banks, securities firms, and insurance companies.

Reforms particularly relevant to banks. Some of the reforms particularly relevant to banks are mentioned above: the removal of the licensed bank and securities firms' monopoly on foreign exchange, and the opening up of the distribution of mutual funds to banks and insurance companies. In addition, bank securities affiliates have been allowed to trade convertible bonds, warrants, stock options, and futures, and will be allowed to broker cash equities.

Reforms particularly relevant to securities firms. Independent investment groups organized as investment advisors (Western-style fund managers), including foreign firms, will be allowed to compete more freely for Japan's $2 trillion pension fund business. Also, as already mentioned, since October 1997, securities firms have been allowed to offer asset management accounts—multi-purpose securities accounts which can be used to make payments and settlements. Fixed commissions on securities sales are being gradually abolished, first on transactions of more than 50 million yen; by the end of calendar year 1999, fixed stock commissions will be completely eliminated. Commission rates on securities transactions in Japan have been among the highest in the world. Requirements mandating the specialization of securities firms are also being abolished, so that the firms will be allowed to diversify; and a simplified registration system will replace the long process needed for licensing new brokerage firms. Finally, the securities transaction tax and the exchange tax will be reduced in December 1998 and may be totally abolished in 1999.

Reforms particularly relevant to insurance companies. Detailed restrictions on pension fund investments are being replaced with general requirements of prudence. According to the previous "5-3-3-2 Rule," 50 percent of pension fund assets had to be invested in assets that guaranteed a return of principal (bonds primarily, or cash); not more than 30 percent of assets could be in domestic equity; not more than 30 percent in foreign equity; and no more than 20 percent in property. In addition, insurance premiums will be deregulated.

Improving the Functioning of Financial Markets

A number of the Big Bang reforms are designed to make Japanese securities markets more like other global capital markets. Restrictions on off-exchange trading for listed securities will be abolished in December 1998, and the ban on broker trading of unlisted and unregistered stocks has already been lifted. Measures are being taken to improve the liquidity of the over-the-counter market (JASDAQ); and in cross-border capital transactions, requirements for permission and prior notification have been abolished for external settlements and capital transactions.

Improving Transparency and Accountability and Providing a Regulatory Framework

A number of the reforms improve the transparency and accountability of Japanese institutions and markets. Implementation of these reforms is necessary if the goals of the other reforms (better choice, more efficient institutions, and more respected financial markets) are to be achieved.

Japan has adopted a "prompt corrective action" system under which banks are required to classify loans into one of four credit categories (healthy loans, loans requiring close attention, potentially unrecoverable loans, and unrecoverable loans); to establish loss reserves; and to write off bad loans according to a set schedule. As part of this system, a new method for calculating capital adequacy ratios for banks, with specific corrective measures, was to have been adopted in April 1998. The corrective measures were postponed for a year, however, for banks engaged exclusively in domestic lending. The new standards require that internationally active banks with less than 8 percent capital prepare a management improvement plan (the threshold is 4 percent for banks engaged in domestic business only); internationally-active banks with capital below 4 percent are required to implement specific corrective measures (the threshold is 2 percent for banks engaged in domestic business only); and all banks with capital below 0 percent are required to suspend operations. Regulators will be empowered to shut down banks that do not meet capital reserve requirements.

Also, the classification of nonperforming loans was changed and strengthened in April 1998 to include those with interest arrears of more than three months (the previous requirement had been six months). Additionally, loans whose rates had been lowered and restructured are now considered bad loans. Outside auditors are empowered to examine the classifications and can force banks to adjust them if the auditors find them unrealistic.

In April 1999, the consolidated method of reporting will replace parent-only reporting. This change is intended to improve the reporting of corporate activities; it will also be needed, now that holding companies have been authorized. Additionally, in the year 2000 Japan plans to change its accounting standards to conform more closely to international accounting standards as set forth by the International Accounting Standards Committee (IASC). Mark-to-market of securities and derivatives investments will be reported at that time. And after the liberalization of foreign-exchange markets in April 1998, an ex post facto reporting system for capital flows was created.

Various measures are being undertaken to protect investors and to ensure a fair playing field. Fair-trading rules are being promulgated to cover new financial products. Penalties for insider trading abuses are being strengthened, and the existing civil dispute system is being improved. The Securities and Exchange Surveillance Commission is being strengthened to improve its systems for inspection, surveillance, and punishment. Measures to reduce settlement risk will be undertaken.

The government infrastructure is being enhanced to support increased surveillance and reporting. The Financial Supervisory Agency (FSA) opened in July 1998. Independent of the Ministry of Finance, it reports to the new Financial Revitalization Commission (which reports directly to the Prime Minister). The FSA is charged with supervising the financial sector, including banks, securities firms, insurance companies, and some nonbank lenders. It is also empowered to close insolvent lenders, issue and revoke financial licenses, arrange mergers, and direct the Japanese Deposit Insurance Corporation (DIC) to pay depositors of failed banks.

The DIC, started in 1971 before Big Bang, reports to the FSA. It collects premiums on bank deposits and insures deposits of failed banks. It was recently strengthened in response to the banks' bad-loan problems. In 1996, it was granted authority to purchase the assets and deposits of failed institutions and to represent depositors in court proceedings. In 1998, in response to recent large failures, the Deposit Insurance Act was amended, providing 17 trillion-yen of government funds for bank assistance through the end of

March 2001. In October 1998, the Diet approved an additional 43 trillion-yen banking package to recapitalize and restructure the sector: 25 trillion-yen for capital injections into institutions, and 18 trillion-yen for the establishment of bridge banks and the purchase of financial institutions' assets. Earlier measures in this bill requiring the banks to provision against losses were dropped.

Two agencies were created to deal specifically with bad loans resulting from the failure of the *jusen* (real-estate lenders) and other Japanese financial institutions. In 1996, the Housing Loan Administration Corporation (HLAC) was created, and the Tokyo Kyodo Bank was restructured into the Resolution and Collection Bank, modeled after the U.S. Resolution Trust Corporation. Under new legislation, these two entities will be merged into the Resolution and Collection Organization. The new organization is charged with maximizing the recovery on nonperforming loans.

London's Big Bang: Changes Wrought

The model for the Japanese deregulation effort was London's Big Bang. British Big Bang officially took effect on October 26, 1986, but the chain of events that led to it began in 1979 when controls on foreign exchange ended. The removal of these controls resulted in a flight of British money out of the country as British businesses (in particular), seeking higher returns, invested in overseas securities. For these transactions they primarily used cheaper foreign securities firms. Because fixed-commission rates had been abolished in the United States four years earlier, the U.S. firms were cheaper competitors and the recipients of much of this new business. Furthermore, many U.S. firms, which had established London offices for their Eurobond business, branched out and began to trade securities of large-capitalization British firms on the London Exchange. In addition, some British financial institutions, rather than using the London Stock Exchange for their transactions, began to trade British securities on the New York Stock Exchange as American Depository Receipts (ADRs), again for reasons of price.

One of the first reforms of Big Bang was the removal of restrictions on London Stock Exchange membership. British law did not require separation among the securities business, investment banking, and commercial banking, but London Stock Exchange (LSE) membership restrictions effectively maintained such separation, protecting member firms from competition. The abolition of these restrictions in March 1986 allowed outsiders, including foreign banks and securities firms, to become members of the London Stock Exchange or to purchase members.

Also ended were fixed commissions on securities transactions. This reform allowed British brokers to compete with one another and with international competitors on price. Restrictions requiring separation of the two types of British securities firms—jobbers (firms that traded on their own account and made markets in securities) and brokers (firms that acted only as agents for a commission) were also abolished. Previously, a firm could be either a jobber or a broker, and brokers were required to use jobbers even if they could match both buy and sell orders.

The bond market was also opened up to all interested parties. Twenty-nine firms were immediately granted licenses (18 survived through the end of 1996), whereas until then, one firm had issued bonds and two others had dominated trading.[10]

Finally, an electronic quote-driven trading system replaced an order-driven trading system. Under the earlier system, brokers matched buy and sell orders provided by jobbers. Under the new system—the Stock Exchange Automated Quotations (SEAQ)—system, similar to the NASDAQ in the United States two-way firm-competing quotes caused marketmakers to risk their own capital.

Increased Efficiency, Improved Liquidity, and Lowered Cost

With the entry of new competition into the London securities market, efficiency and liquidity in these markets increased and the cost for institutional trades decreased. In 1991, five years after the introduction of Big Bang, capacity had increased by 500 percent, total costs had increased 200 percent, and fees were halved. By 1991, 25 marketmakers in equities and 18 in bonds had replaced the handful of jobbers that previously provided this function.[11] With improved liquidity, spreads were cut approximately in half; commissions almost disappeared in the wholesale markets.[12] The new market for gilts functioned effectively and provided a liquid market for investors, the government, and the Bank of England, with much of the growth in this market coming from foreign investors. Institutional in-

[10] "The Morning Ten Years After," *The Economist* (October 26, 1996): 91.

[11] "Five Years Since Big Bang," *The Economist* (October 26, 1991): 23.

[12] Norman S. Poser, *International Securities Regulation, London's "Big Bang" and the European Securities Market*, Little, Brown and Company, Boston, 1991, 68.

vestors were big winners. Commissions on large, heavily traded shares fell dramatically. Additionally, brokers on large transactions were often able to receive prices better than those offered on the SEAQ. By 1989, 45 percent of deals (by volume) were done at prices better than the best SEAQ quotes.[13]

London: A World Financial Center

Big Bang financial deregulation is generally credited with propelling London into its position as the major European financial center. Three years after Big Bang, there were 521 banks in London, and the city was the center of the Eurobond market, responsible for issuing 65 per cent of all Eurobonds.[14] Within five years of Big Bang's passage, roughly as much trading in foreign equities as in domestic equities was conducted in London. London had become Europe's leading stock market: approximately half of the transactions in large French and Italian shares and a quarter of the trades in German shares were done through London, as well as 90 percent of all global cross-border transactions. Also in 1991, more than 600,000 people worked in finance and business services in London, approximately 100,000 more than in New York.[15] In 1996, ten years after Big Bang, London surpassed Frankfurt and Paris as Europe's leading financial center. London is the world's largest swap trader, it arranges more international mergers than any other city in the world, and it is home to the largest foreign-exchange and international insurance markets in the world.[16]

Consolidation in the Financial Industry

Improvements in efficiency, liquidity and cost came about largely as a result of consolidation in the financial industry. Deregulation of fixed commissions resulted in much tighter margins and a decline in the profitability of securities firms. The decline in profitability, in turn, led to the demise of many small or medium-sized British securities firms. By February 1987, over half of the 200 LSE member firms had merged or been acquired.[17] Capital was in great demand, and for the most part foreign firms provided it. British merchant banks and brokers had insufficient capital to compete according to international standards and were unsophisticated in the use of capital. They were also technologically backward, and this deficiency hurt their competitiveness.

The previously deregulated U.S. firms, particularly the bond trading firms, proved to be formidable competitors. U.S. and other foreign institutions bought up British jobbers, brokers, and merchant banks. Attempting to stay competitive, British brokers merged with jobbers, merchant banks bought both jobbers and brokers in order to compete with investment banks, and commercial banks bought securities firms to provide capital to businesses.

Too-Hasty Entry into the Market

Afraid of missing out on the seemingly limitless opportunities, firms (many of them foreign) rushed into the London market, acquiring and merging with local firms. Not all of these acquisitions and mergers made good business sense. Many of them were not well thought out and were executed in great haste and at inflated cost. Many acquiring firms underestimated the difficulties of integrating different corporate cultures and overestimated the extent of the market. The result was severe overcapacity in professional personnel and capital. And the timing for an increased stock market presence could not have been worse. The worldwide stock market crash of October 1987 added to overcapacity, as existing markets shrank. In all, 7 of the 32 marketmakers that entered the equities market after Big Bang, and 9 of the 27 new marketmakers in bonds, had left by 1991. Moreover, at the same time that London was experiencing a general overcapacity in personnel and capital, clearing and settlement functions were deficient because of inadequate computerization and inexperienced back-office personnel. In the years immediately following Big Bang, settlement problems accounted for approximately half of all losses from dealing in British securities.[18]

Many of the mergers formed in the aftermath of Big Bang were later annulled at great cost. A notable failure at the time was Citibank's purchase of the British broker Scrimgeour Vickers, which Citibank subsequently sold at a substantial loss. In many cases, firms that remained independent had a comparative advantage. Not until 1990 did profitability return to London, brought back by increased volume, a good market, and more new issues.[19]

[13] "Five Years Since Big Bang," *The Economist* (October 26, 1991): 23.

[14] Poser, 75.

[15] Norman S. Poser, *International Securities Regulation, London's "Big Bank" and the European Securities Market*, 1992 Supplement, Little, Brown and Company, Boston, 1992, 3.

[16] "The Morning Ten Years After," *The Economist* (October 26, 1996): 91.

[17] Poser, *International Securities Regulation*, 1991, 32.

[18] "London's Certified Lunacy," *The Economist* (March 11, 1989).

[19] Poser, 1992 Supplement, 20.

Conflicts of Interest and Insider Trading

As barriers were removed, new conflicts of interest arose. The British Securities and Investment Board (SIB) reported that in the three years after Big Bang, unauthorized trading resulted in losses of at least 15 million British pounds.[20] No Chinese walls were in place to protect investors,[21] nor was there a strong regulatory apparatus, like the Securities and Exchange Commission in the United States. For the most part, securities regulation in Britain had consisted of self-regulation via the London Stock Exchange.[22] The post-reform conglomeration of banks, brokers, and jobbers made insider trading easier, and no infrastructure existed to police the industry effectively.

Japan's Big Bang Reforms: Likely Outcome

Outcomes similar to those that occurred in Britain, both the positive and the negative, can be expected to occur in Japan if Big Bang proceeds as planned. Improved returns and more vibrant institutions and markets, as well as the closure of domestic firms, initial overcapacity, and increased fraud are likely. However, there remain implementation and enforcement problems, and certain unaddressed problems, that stand in the way of the full attainment of the stated Big Bang goals.

Improved Returns, and More Vibrant Financial Institutions and Markets

Over the long run, the Big Bang reforms should result in greater competition, which should produce increased choice and returns and more vibrant financial institutions and markets. Japanese investors and savers should be able to earn global rates of return, with the result that looming Japanese pension shortfalls are lessened. In terms of helping to heal Japan's domestic banking crisis, the proposed reforms should enable the nation's banks (and securities firms and insurance companies) to become more efficient and competitive. In the short run, however, increased international competition will probably exacerbate their problems. Finally, given such a large economy and the problems afflicting other Asian financial centers, with decreased government intervention and increased transparency Japanese financial markets should once again become internationally significant.

Closure and Consolidation of Financial Institutions

As in Britain, the withdrawal of protections and the increase in competition will require consolidation in the Japanese financial industry, with all the attendant pain and dislocation. According to some analysts, if Big Bang succeeds, a third of Japanese financial institutions will disappear through mergers and closings.[23] Japanese banks, securities firms, and insurance companies are expected to fare differently under deregulation, with the banks and insurance companies likely to have a more difficult time during the adjustment period.

Prospect for Banks

Burdened with high costs, low demand, old debt, and new competition, the banks are particularly vulnerable as Big Bang reforms unfold. Morgan Stanley Dean Witter estimates the net capital of the 19 largest banks at August 1998 at an approximate negative $7.6 billion, after bad loans are written off.[24] There are simply too many banks, so that even with current competition and protection, many are unprofitable. Once more attractive investment alternatives are available and financial activities become more transparent, many Japanese investors are expected to reduce their dependency upon the banks and the Post Office and to invest in the Japanese stock market and overseas capital markets. This has already begun to happen. In 1993, Japanese households owned virtually no foreign securities; today, Japanese households own approximately $685 billion in offshore investments, much of it invested in U.S. savings bonds.[25] This capital outflow occurred despite onerous tax-reporting requirements for cross-border capital transactions and despite higher tax rates applied to nondomestic bank and postal savings accounts.

To deal with new competition, banks will need to restructure. Already some banks, particularly the larger ones, have begun to dispose of bad loans and are entering into arrangements to securitize and sell real-estate loans in international markets. They will also have to raise deposit interest rates to attract depositors.

[20] Ibid., 1.

[21] "Chinese wall" refers to the forced separation in a firm of investment banking and its trading and investment research functions to eliminate the use of insider information.

[22] Big Bang was followed ten days later by the Financial Services Act, which, for the first time in England, introduced a comprehensive system for regulating financial services.

[23] Jesper Koll of J. P. Morgan and Co. quoted in "Two Japans, The Gulf Between Corporate Winners and Losers Is Growing," *Business Week* (January 27, 1997): 24–28.

[24] "Japanese Bank Crisis Said to Be Worsening," *The Washington Post* (September 9, 1998).

[25] "Flight of Savings," *The London Daily Telegraph* (August 9, 1998), 4.

Loan demand from strong businesses will weaken, as these stronger borrowers are better able to access the capital markets for their funding needs. Weaker, smaller companies, used to subsidized lending rates, will remain as borrowers. To prosper in this environment, banks will need to price risk into the lending decision, and as businesses are forced to pay interest rates in line with their risk profiles, marginal businesses will fail.

The banks that remain in business will need to develop new financial products to replace lending. Again, this process has begun: Japanese banks and securities companies are beginning to compete for pension fund money management and mutual fund sales. Commercial banks have also been entering the bond business, gaining a market share of 60 percent in the year ending March 1997, up from 36 percent a year earlier.[26] On the whole, the larger banks are expected to weather the transition better than medium and small banks.

In Britain, foreigners rushed in to purchase British banks, but this is unlikely to occur in Japan, where the banks are saddled with huge debts and are still expensive. Instead, many foreign financial institutions that already have a presence in Japan are expected to expand internally. Others will form alliances, partnerships, and ventures with Japanese banks. Although U.S. banks have been cutting their exposure to Japan—it fell nearly 19 percent in the first quarter of 1998—foreign banks have done well overall, as Japanese consumers and corporations have flocked to these banks' relative safety. Citibank, for instance, currently reports more than half a million customers and more than one million accounts in Japan.[27]

Prospect for Securities Firms

Japanese small and medium-sized securities firms are also not expected to compete very well in the new deregulated environment. As the major beneficiaries of regulated commissions and other government protections, they are high-cost, low-tech producers and are weak in mutual funds, asset management, derivatives, and research. Commissions have accounted for at least half of the revenue of many smaller brokers. Almost all of the second-tier brokers suffered losses last year. Even the larger Japanese securities firms have not done well. Of the "Big Four" houses, Yamaichi was bankrupted last year, and the earnings of the remaining three—Nomura, Daiwa, and Nikko—plunged during the first quarter of 1998 as trading volumes and commissions were eroded by foreign competition.[28] The bigger firms are expected to do better, however, as they are not as dependent on commissions and have good research capabilities.

Foreign competition is much fiercer in the securities industry than in banking and insurance, where foreigners still account for only a small portion of Japanese business. Foreign securities firms have made great progress in developing their securities, fund management, and investment banking business. At the end of 1997, foreign securities firms accounted for a third of the turnover on Tokyo's stock exchange. The previous year they accounted for approximately a quarter of total business.[29] They have drawn their customers both from overseas and from Japan, with many Japanese investors having switched their business to foreign securities firms after scandals were exposed at the big four Japanese firms.

Mutual fund sales represent a potentially large market for foreign investment firms. Currently, mutual fund investments account for only 4 percent of Japan's household savings. In June 1998, the foreign share of this market increased from 2 percent to 7 percent.[30] The foreign firms have also excelled in pension fund management. Money managed by all investment advisory firms increased approximately one-third from 1996 to 1997; although from a very small base, the amount managed by foreign firms increased by 80 percent.[31] Two years after its entry into the investment trust business in Japan, Goldman Sachs was managing $6 billion; after a four-month presence, Merrill Lynch was managing $2.5 billion; and after 17 months in Japan, Alliance Capital had $5 billion under management.[32] However, foreign firms have achieved perhaps their greatest success in investment banking, where they have enjoyed great success in raising foreign capital for Japanese businesses, underwriting new issues, selling Japanese companies' cross-share holdings, and managing derivatives.

Although no Japanese securities firm has been purchased outright by a foreign firm, several major foreign firms have established relationships with them. For instance, Barclays established a joint venture with the

[26] "Japanese Securities Firms: Once There Were Four," *The Economist* (September 27, 1997): 80.

[27] "Japan's Down, Citibank's Up," *U.S. News and World Report* (September 7, 1998): 34–37.

[28] "Competition Hits Japan's Brokers," *Financial Times* (July 16, 1998), 41.

[29] "Rich Pickings for the Gaiijin," *The Economist* (May 16, 1998): 83.

[30] "Financial Big Boys of the West Go on a 'Dating Frenzy,'" *Financial Times* (August 12, 1998), 21.

[31] Ibid.

[32] "Finance Firms Hope to Strike Gold in Japan," *Star Tribune* (June 5, 1998), 1D.

third-largest Japanese securities firm, Nikko; and Travelers Group recently purchased a 25 percent stake in Nikko, effectively taking over its investment banking and international operations. Merrill Lynch acquired a national retail network with its purchase of 30 Yamaichi branches and its hiring of 2,000 of Yamaichi's laid-off staff. To ward off foreign competition, Japanese securities firms have also been undertaking cooperative arrangements with other Japanese financial entities.

Prospect for Insurance Companies

Prospects for the insurance industry will not be clear until more is known about which protections are waived for this industry. Many of these decisions have been postponed to the turn of the century. However, the life insurance industry in Japan is in serious trouble—according to some analysts, the industry as a whole is insolvent. Low interest rates, cancelled policies, and a bad stock market have hurt the industry badly. Additionally, insurance firms have been big lenders to brokerages and banks, so financial problems in those industries will be felt by the insurance companies as well.

The opening up of the asset management business to other participants—previously the almost exclusive territory of the insurance companies and trust banks—will further affect this fragile industry. Life insurers currently manage approximately one-third of the assets of corporate Japanese pension funds. The returns on these pension funds have been very low, even by Japanese standards. New disclosure laws will require these investments to be reported at market value in April 1999, and it is expected that the movement of pension fund money away from the insurance companies will then accelerate. The competition is not just from foreign firms; Japanese securities companies and banks have also expressed an interest in developing their asset management business.

Some foreign interest has been expressed in Japanese insurers. GE Capital entered a joint venture with Toho Life to develop and distribute Western insurance products. Putnam, the fifth-largest U.S. mutual fund family, has entered into an agreement to manage approximately $700 million for Nippon Life, focusing on non-Japanese securities, and to develop products for Nippon Life's pension clients.

Overcapacity

Deregulation of the British securities markets resulted in an influx of foreign firms, resulting in initial overcapacity and lowered profitability. Many foreign entrants sustained substantial losses for a number of years, and many chose to leave the market. Similarly, over the past several years, foreign businesses have been rushing into Japan in what one observer has likened to "a financial dating frenzy."[33] Foreign financial firms would be wise to learn the lessons of British Big Bang and think twice before committing themselves to a large presence in Japan on the basis of unrealistic earnings expectations.

Increased Fraud

As the British experience also shows, another unwanted development likely to result from financial deregulation is increased fraud. And much like the British a decade ago, the Japanese do not appear to have the infrastructure necessary to support transparency and to discourage fraud. As mentioned previously, there are approximately 12,000 accountants in Japan, 710 financial examiners (the FSA is requesting an increase of approximately 15 percent in FY 1999), and a small judiciary; and the country is significantly more low-tech than most other developed countries. Additionally, the Japanese underworld, the *yakuza*, is reportedly deeply involved in the Japanese banks' bad-debt problem. A lesson from both the British experience and the U.S. savings-and-loan experience is that deregulation must be accompanied by supervision, but this will not be easy to do in Japan.

Implementation and Enforcement

Most of the Big Bang legislation has been passed, and many of the reforms have been implemented. Especially on the first three goals of Big Bang—increased choice, increased competition, and vibrant financial markets—a great deal has been accomplished. New financial instruments and powers have been introduced, controls on foreign exchange have been largely removed, many industry protections have been removed, and competition has been allowed through a holding company structure. Foreign businesses have been allowed to compete more freely. These reforms are not likely to be turned back.

In the area of increased financial industry transparency and accountability, however, less progress has been made in Japan. The new minimum capital ade-

[33] "Financial Big Boys of the West Go on a 'Dating Frenzy,'" *Financial Times* (August 12, 1998), 21.

quacy requirements have been postponed for most banks until 1999, and Japan's accounting standards are not slated to conform to international accounting standards until the year 2000. Even if and when these standards are brought into conformance, potentially serious deficiencies exist that could seriously undermine these reforms. As mentioned previously, no adequate infrastructure (or culture) currently exists in Japan to enforce increased financial reporting and to question the accuracy of reported financial results. For instance, one need not be a skeptic to question the validity of bank loan classifications based on self-assessment, the current reporting mechanism. And, the new minimum capital adequacy requirements will be mere window-dressing without realistic loan classifications. Auditing by respected external auditors is essential for investor confidence, and at this point in time, there is no such capability in Japan. Unfortunately, without investor faith in firms' reported financial positions, the other Big Bang goals—investor choice, competition, and financial market respect—are undermined.

The very dire situation of the banks and probably of the insurance companies, a deepening recession, and recent political upheaval also bring into question the ability and willingness of the government to stand aside and let market forces determine financial winners and losers. The government's commitment to full disclosure and accountability and to a reliance on unfettered market forces has been unclear in the light of some recent actions: the postponement of the new capital adequacy requirements for some banks; the adoption of accounting gimmicks for banks and insurance companies;[34] the pressure exerted by the government on an unwilling Sumitomo Bank to acquire the long-suffering Long Term Credit Bank; and calls during the summer by some leading politicians for short-term controls on capital flows. A bill was recently passed providing an additional 43 trillion-yen to recapitalize and restructure the banking sector. However, strict provisioning requirements were dropped from the bill, and it is not at all clear at this time whether the authorities will require the banks to restructure in a meaningful way or whether this capital infusion will represent only a temporary bailout and a continuation of "business as usual."

Deregulating the nation's financial institutions will be very difficult because deregulation will affect not only Japan's financial institutions and businesses (how they are financed and operated) but also basic Japanese values. In a deregulated, competitive environment, business practices in Japan will have to change. If capital is to earn global returns, there can be no more cheap money for well-connected marginal businesses—*keiretsu* loyalties and the concept of lifetime employment will need to be modified substantially, if not jettisoned. Changing such basic Japanese values will be difficult and painful.

Unaddressed Problems

There are also problems that have not been addressed by the Big Bang proposals but that cannot be ignored. The Big Bang proposals do not deal with the role of the world's biggest bank, the Japanese Post Office, which holds approximately $2 trillion in savings and over $800 billion dollars in life insurance policies. It pays no taxes or deposit insurance premiums; it is not required to hold reserves against losses; it is fully guaranteed; and its time deposits are more liquid than those of banks. The existence of this huge publicly financed, risk-free competitor to banks and insurance companies must be addressed to ensure a level playing field for financial participants.

Japanese tax policy, too, must be examined. The government is instituting consolidated reporting, which will provide an incentive for mergers between profitable and unprofitable firms, and it may totally abolish securities transaction taxes. However, preferential taxation on bank and postal savings accounts needs to be addressed. Bank and postal savings accounts are currently taxed at a flat 20 percent rate, whereas other investment income is subject to a maximum capital gains and interest tax of 65 percent. Furthermore, after foreign currency controls were removed, onerous tax reporting requirements were instituted for cross-border capital transactions. If the tax treatments for different investment alternatives remain substantially different, the effect of removing foreign-exchange restrictions and increasing the investment options for investors will be limited.

Additionally, many decisions about the deregulation and opening up of the insurance industry have been postponed for action until later. Government behavior toward the insurance industry will have a substantial effect on the outlook for Japanese deregulation.

Conclusion

Big Bang financial reform holds much promise as a way to alleviate the Japanese problems of inadequate

[34] New rules allow banks and insurance companies to inflate their balance sheets by booking some stocks at cost, and real estate at current value.

investment return and choice, underdeveloped financial markets that do not meet international standards for performance, and nontransparent financial reporting. Over the long run, these reforms should also make Japanese financial institutions more efficient and competitive. Over the short run, however, they will quite possibly exacerbate the problems of these institutions, in particular, the banks and insurance companies. As the history of British Big Bang shows, not all the results of deregulation are benign. Deregulation and increased competition can be expected to lead to the closure of marginal financial firms; and the three groups—banks, securities firms, and insurance companies—will vary in their capacity to weather the new competition. Recently, foreign financial firms in these markets have been doing well, but at some point the increased competition may lower returns for all participants. Also, if the British model holds, conflicts of interest will increase—an outcome for which the Japanese appear to be unprepared. Finally, although much of the legislation authorizing these reforms has been passed, and many have been implemented, in the area of transparency and accountability it is not clear that the government is willing or able to make great changes in the short run. A lack of an enforcement infrastructure, a banking crisis, a deepening recession, and political dissension may prevent or weaken the necessary implementation or enforcement of these reforms.

Assessing International Risk Exposures of U.S. Banks

by Timothy Curry, Christopher Richardson, and Robin Heider*

The debt crisis of the early 1980s was a critical period for the largest U.S. international banks. Several of these institutions verged on insolvency because of their international lending exposure and the potential for massive defaults by the less-developed countries (LDCs). Had one or more of these institutions failed, the stability of the entire U.S. financial system could have been jeopardized. Policies adopted by bank regulatory officials, along with assistance from international lending organizations, managed to prevent the failure of any large U.S. banks and to otherwise contain the crisis.[1] However, it took almost a decade for the international banks to clean up their balance sheets, rebuild capital levels, and resume international lending.

Loan losses incurred by banks in overseas lending during the 1980s and in other periods reflect the credit risks associated with such activity. Bank supervisors keep a close watch on this exposure by requiring the U.S. banking organizations that are engaged in international lending to file quarterly disclosure reports. In recent decades, with the integration of the regional and global economies, bank supervisors have also become concerned with indirect, or "secondary," risks. *Secondary risk* refers to increased probability of loan defaults because of trade-based economic linkages between nations. If the economies of two or more nations are linked by trading relationships, then adverse economic events in one nation may spill over to, and compound problems for, that nation's trading partner(s); and these secondary effects can, in turn, influence the ability of borrowers in these nations to repay loans to third parties like U.S. banks.

Foreign lending risk therefore has at least two components, direct and indirect, and to identify the true magnitude of the exposure, one cannot take a piecemeal approach. This article examines recent trends in both the direct and the indirect risks associated with the international lending activities of U.S. banks. The first section defines the components of foreign lending and surveys trends since 1982 in loan volume, risk exposure, and lending organizations; trends in foreign lending claims, by borrower and by maturity; and trends in the direction of foreign lending. The next section looks at secondary, or indirect risk, and the international trading relationships of the United States and of the countries to which U.S. banks have extended the largest dollar amounts of loans. The final part summarizes the data presented and draws conclusions about risks to U.S. foreign lenders in the near future.

* Timothy Curry and Christopher Richardson are financial economists and Robin Heider is a research assistant in the FDIC's Division of Research and Statistics. The authors would like to thank Jack Reidhill, John O'Keefe, Steven Seelig, Peter Elmer, Gary Fissel, Kathleen James, Louis Scalza, and Christopher Spoth for helpful comments and suggestions.

[1] U.S. bank regulators granted forbearance to the international banks with respect to the provisioning for future losses and other matters. Forbearance was the only practical solution at the time, for otherwise some of the large banks would have been insolvent. In addition, the international lending organizations like the World Bank and International Monetary Fund provided funds to developing nations to facilitate debt reduction. Part of these funds were used to repay bank creditors. For a discussion of these issues, see Seidman (1993) and Curry (1997).

Trends in Foreign Lending

Foreign lending has at least three components. First, "cross-border" lending is the dollar-denominated loans booked at the U.S. offices of American banks and extended outside the boundaries of the United States. These loans can be made to other commercial banks, private nonbank borrowers, or various governments and agencies. For example, Citibank, NY, might book a credit payable in U.S. dollars to a Mexican corporation headquartered in Mexico City. Cross-border lending entails considerable risks besides borrower default risk because lenders also have to consider the effects of local currency devaluations in terms of U.S. dollars. As the conversion rate of the local currency into dollars deteriorates, the weight of the debt service payments of the loans increases because foreign borrowers have to earn more units of the local currency to meet their dollar-denominated debt payments. Loan defaults caused by collapsing exchange rates have been associated with most international financial crises, including that of the early 1980s and the current Asian and Russian crises.

Second, international banks also engage in "local-currency" lending, which consists of loans that branches or subsidiaries of U.S. banks in a foreign country extend in the domestic currency. In contrast to cross-border lending, this type of activity does not involve direct exchange-rate risks for the borrower.[2] For example, when Citibank's branch in London extends loans in the local currency (pounds), they are considered local-currency loans rather than cross-border loans. The interest and principal payments on these loans are made in pounds and thus are not affected by fluctuations in the exchange rate.

Third, existing loan commitments to foreign borrowers are counted as foreign lending because commitments are contractual pledges by a financial institution to extend funds at some future date, even if the funds have yet to be disbursed.

In this article, "total foreign lending" refers to all three categories combined, and the degree of international lending risk is usually expressed as a function of a common measure, such as total capital or assets of the lending institutions.[3]

The rest of this section discusses trends in (a) loan volume, risk exposure, and lending organizations; (b) the nature of foreign lending claims; and (c) the direction of foreign lending.

Loan Volume, Risk Exposure, and Lending Organizations

Historically, cross-border lending followed international trading relationships, with large commercial banks pursuing opportunities generated by the expansion of multinational corporations. For decades this trend was reflected in the global expansion of U.S., Japanese, and European banks. More recently, there have been other incentives for international lending: world economic growth, the expansion of world trade, and the emergence of developing economies. Financial institutions with the necessary capital and technical skills have moved globally to take advantage of these opportunities, and large U.S. commercial banks have been at the forefront of such lending activities.

Foreign lending by U.S. banks declined during most of the 1980s and early 1990s in response to that period's LDC debt and other crises, all of which significantly eroded bank capital.[4] For example, between 1982 and 1992, such lending decreased from $520 billion to $398.7 billion (table 1). In 1993, as these banks recovered and recapitalized, they resumed lending; and over the next five years outstanding loans and commitments increased significantly, peaking in 1997 at $703.3 billion, for an annual compound rate of growth of 12 percent over this period. The Asian crisis, which broke out in mid-1997, chilled the fervor for new lending to the point that in the first quarter of 1998, loans and commitments remained unchanged. Furthermore, in response to the crisis, lending to certain nations (including, among others, Thailand, Indonesia, the Philippines, and Malaysia) has plummeted.

[2] The lender still faces exchange-rate risks, however, when converting the interest and principal payments on the loans back into U.S. dollars. To protect themselves against potential currency fluctuations, most lenders that are engaged in local-currency lending enter into foreign-exchange contracts to hedge potential losses.

[3] The analysis of foreign lending does not consider *all* risks associated with international lending by U.S. banks. For example, off-balance-sheet risks such as derivative contracts also represent potential drains on the capital of lending banks but are not considered here because data are lacking. Similarly, loans to investment funds that engage in international investments, or loans to domestic corporations that engage in international trade also represent risks to U.S. banks but are not considered in this analysis. Finally, third-party guarantees represent another potential source of risk.

[4] The collapse of commercial real-estate markets during the late 1980s and early 1990s significantly diminished bank capital by causing heavy loan losses and, in many cases, bank failures.

Table 1

Foreign Lending by U.S. Commercial Banks, Year-end 1982–1998

($Billions)

	1982	1987	1992	1997	1998[a]
All U.S. Banks (number)	**171**	**184**	**150**	**109**	**107**
Total Capital[b]	$ 70.6	$ 129.2	$ 182.0	$ 342.9	$ 356.2
Total Assets	1,261.0	1,633.0	1,767.5	3,257.8	3,389.6
Cross-Border Loans	353.3	267.3	197.1	333.9	325.4
Total Commitments	87.3	76.3	72.8	105.3	101.6
Total Cross-Border Lending	**440.6**	**343.7**	**269.9**	**439.2**	**426.9**
Percent of Capital	**624%**	**266%**	**148%**	**128%**	**120%**
Percent of Assets	**35%**	**21%**	**15%**	**13%**	**13%**
Local-Currency Loans and Other Claims[c]	79.4	136.4	128.8	264.1	277.0
Total Foreign Lending	**520.0**	**480.1**	**398.7**	**703.3**	**703.9**
Percent of Capital	**737%**	**372%**	**219%**	**205%**	**198%**
Percent of Assets	**41%**	**29%**	**23%**	**22%**	**21%**
Money-Center Banks (number)[d]	**9**	**9**	**8**	**6**	**6**
Total Capital[b]	$ 29.0	$ 51.5	$ 74.9	$ 122.5	$ 123.9
Total Assets	588.0	626.0	667.2	1,298.8	1,337.3
Cross-Border Loans	205.3	162.9	123.6	234.0	237.2
Total Commitments	69.1	60.2	60.8	79.7	75.0
Total Cross-Border Lending	**274.4**	**223.1**	**184.4**	**313.7**	**312.2**
Percent of Capital	**946%**	**433%**	**246%**	**256%**	**252%**
Percent of Assets	**47%**	**36%**	**28%**	**24%**	**23%**
All Other Large Banks (number)[e]	**15**	**13**	**11**	**7**	**7**
Total Capital[b]	$ 13.5	$ 23.9	$ 29.4	$ 70.0	$ 72.5
Total Assets	253.0	284.0	278.8	677.5	704.5
Cross-Border Loans	67.3	44.7	34.5	65.9	59.2
Total Commitments	10.5	10.5	7.4	11.1	12.1
Total Cross-Border Lending	**77.8**	**55.2**	**41.9**	**77.0**	**71.4**
Percent of Capital	**577%**	**231%**	**142%**	**110%**	**98%**
Percent of Assets	**31%**	**19%**	**15%**	**11%**	**10%**
All Other Reporting Banks (number)	**147**	**162**	**131**	**96**	**94**
Total Capital[b]	$ 28.1	$ 53.8	$ 77.6	$ 150.3	$ 159.7
Total Assets	420.0	723.0	821.4	1,281.5	1,347.8
Cross-Border Loans	80.6	59.7	38.9	34.0	28.9
Total Commitments	7.7	5.6	4.7	14.5	14.4
Total Cross-Border Lending	**88.4**	**65.3**	**43.7**	**48.5**	**43.3**
Percent of Capital	**314%**	**121%**	**56%**	**32%**	**27%**
Percent of Assets	**21%**	**9%**	**5%**	**4%**	**3%**

Source: FFIEC, *Country Exposure Reports.*

[a]March 31, 1998.

[b]Total capital includes equity, subordinated debentures, and reserves for loan losses.

[c]Data on local-currency loans were not available for the individual groupings but only for the aggregate. Thus, the combined data for the individual groupings contain only the total cross-border lending and commitments and do not add up to the "total foreign lending" panel for all banks.

[d]For year-end 1997 and March 1998, the "money-center banks" category includes Bank of America, Bankers Trust, Chase Manhattan, Citicorp, First Chicago, and J. P. Morgan.

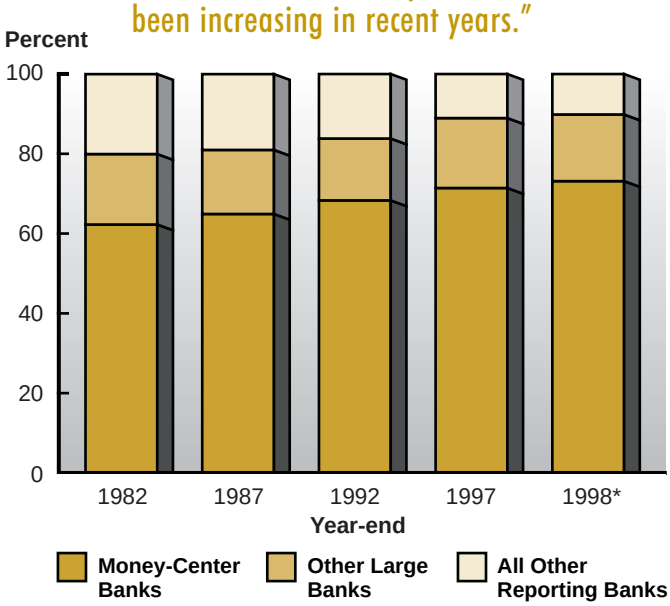
[e]For year-end 1997 and March 1998, the "other large banks" category includes BankBoston Corp, Bank of New York Co., Corestates Financial Corp, First Union Corp, NationsBank Corp, Republic NY Corp, and State Street Corp.

U.S. banks' overall risk exposure to foreign lending also declined for most of the 1980s through 1992. At year-end 1982, at the outbreak of the LDC debt crisis, the concentration of foreign loans and commitments on the balance sheets of U.S. banks represented over seven times capital and 41 percent of total assets. This ratio fell during the next decade as new commitments declined and delinquent loans were written off.[5] By year-end 1992, the total of loans to capital was only approximately 30 percent of what it had been in 1982. This downward trend continued, slowly, over the next five years, as U.S. banks were recapitalized. By March 31, 1998, the total capital at risk was still relatively modest in comparison with what it had been at the start of the 1980s (table 1).

Foreign lending is dominated by large money-center banks, and this domination has increased over time. As of March 31, 1998, money-center banks accounted for $312.2 billion of the $426.9 billion in cross-border loans and commitments by U.S. banks (table 1). This market share has been steadily increasing in recent years, going from 62 percent of total foreign lending in 1982 to 73 percent as of March 31, 1998 (figure 1). The money-center banks have also had substantially more capital and assets at risk than all other foreign lending banks, leveraging almost 2.5 dollars of loans for each dollar of capital and holding 23 percent of total assets in foreign loans as of the same date. But while the money-center banks' risk exposure has been increasing since 1992, the levels are modest in comparison with what they were at the outbreak of the debt crisis in 1982, when foreign lending represented 946 percent of capital and 47 percent of total assets for these banks.

Figure 1

"The market shares of the money-center banks have been increasing in recent years."



Source: Federal Financial Institutions Examination Council (FFIEC), *Country Exposure Reports.*

* March 31, 1998.

Unlike the money-center banks, the "other large banks" (super-regionals) and "all other reporting banks" have cut back foreign lending both in terms of the absolute volume of loans on their books and as a percentage of capital and assets devoted to such lending. For example, the super-regionals' foreign loans outstanding declined slightly from $77.8 billion at year-end 1982 to $71.4 billion at the end of the first quarter of 1998. Furthermore, their foreign lending declined from 577 percent of capital and 31 percent of assets at year-end 1982 to 98 percent of capital and only 10 percent of assets as of March 31, 1998 (table 1). The "other reporting banks" that have been involved in foreign lending have also cut back from the business but much more dramatically. As of March 31, 1998, these banks carried almost 50 percent fewer foreign loans on their books than in the early 1980s, and the group's international lending amounted to only 27 percent of its capital and 3 percent of its assets.

Nature of Foreign Lending Claims

Characteristics of foreign loans granted by U.S. banks over the 1982–1998 period:

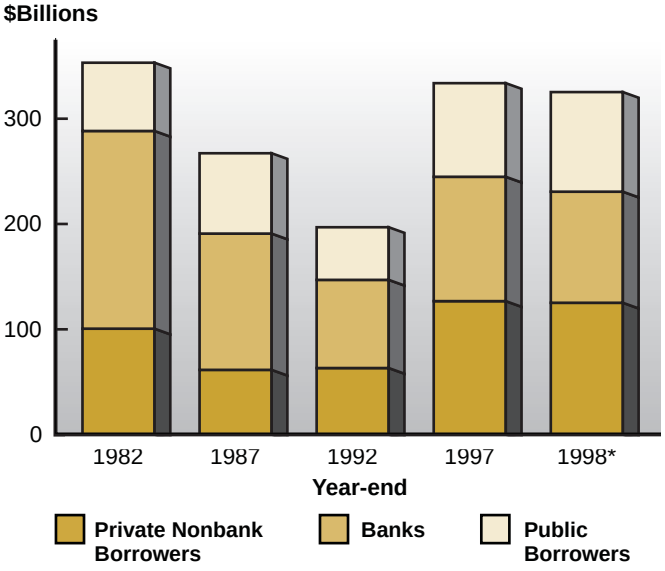
■ *Borrower*

The data show that over the 1982–1998 period, U.S bank foreign lending to other bank intermediaries (interbank market) declined relative to lending to other groups. U.S. bank loans to the banking sector have been trending downward since the early 1980s, with the market share for this type of loan declining from 53 percent of total cross-border lending in 1982 to 32 percent in 1998 (figures 2 and 3). The cross-border interbank market consists of loans to various parties, including local financial institutions, correspondent banks, and, in some instances, branches or subsidiaries of the parent bank. These loans are typically unsecured, although secured lending also occurs through

[5] Citicorp was the first U.S. bank to take a loss on its foreign lending portfolio. It wrote off approximately $3.3 billion of international loans in 1987, and shortly thereafter most other major U.S. banks that engaged in international lending followed suit. *See* Curry (1997), 208.

Figure 2

"U.S. bank cross-border lending has been increasing to the private nonbank sector and declining to the banking sector in recent years."

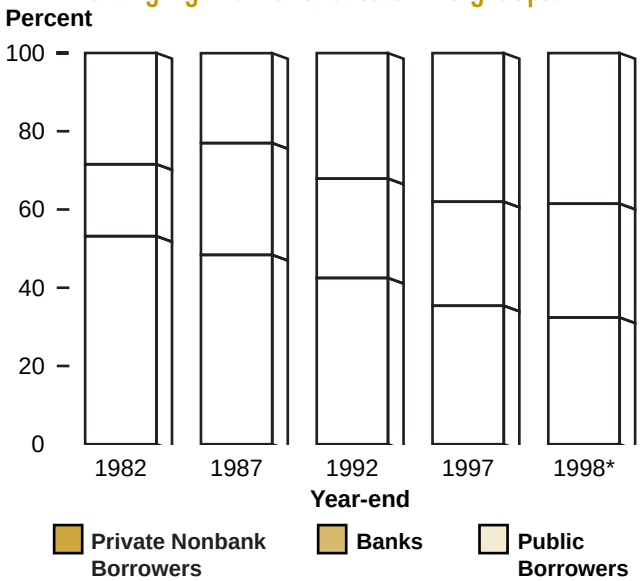


Source: FFIEC, *Country Exposure Reports.*

* March 31, 1998.

Figure 3

"Increased U.S. bank lending to the different foreign sector borrowers is reflected in the changing market shares of the groups."



Source: FFIEC, *Country Exposure Reports.*

* March 31, 1998.

the "repo" or repurchase market (overnight or term loans collateralized by pledged securities). The recent shift away from the interbank market is explained primarily by the declining risk/reward trade-offs, as reflected in the narrowing spreads on interbank loans relative to other types of lending.

As lending to the interbank market has declined, direct loans to private nonbank borrowers have captured an increasing share of cross-border lending, growing from 29 percent in 1982 to 39 percent in 1998 (figure 3). Increases in the flow of bank funds to the private nonbank sector are linked, in part, to (a) active privatization programs in several nations and regions, including (among others) Mexico, Argentina, Brazil, and Eastern Europe; (b) continued economic expansion and capital investment in Asia through the mid-1990s; and (c) accelerating economic reforms in China and elsewhere. Increases in private-sector loans may have also resulted from greater direct access to private-sector borrowers, as U.S. banks have maintained a substantial international presence in various countries over time with branch offices and subsidiaries.[6]

Loans to public institutions, or "sovereign" debt, includes obligations of the federal, state, and local governments and governmental agencies. This type of lending, too, has been growing in recent years. For example, the market share accounted for by lending to public institutions has increased from 18 percent of total U.S. cross-border lending in 1982 to 29 percent in 1998. In addition, in sharp contrast to the absolute decline in U.S. bank lending to the private sector during the first quarter of 1998 as the Asian financial crisis deepened, lending to public institutions increased more than 6 percent. This growth in sovereign debt reflects the increasing concern over default risk from private-sector loans, a concern that has prompted many lenders to shift new credits to institutions backed by the government or international organizations.

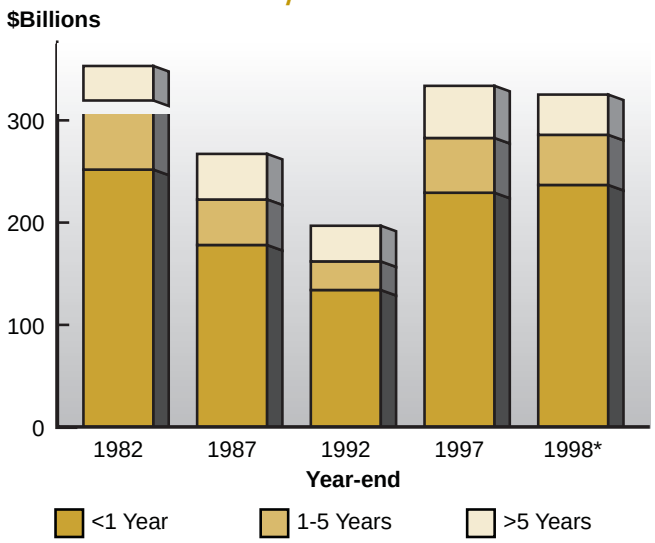
Maturity

Figures 4 and 5 display trends in the maturity distribution of outstanding foreign loans by U.S. banks. Short-term credits, or those with maturities of less than one year, still dominate U.S. international lending. Most of these credits are trade-related transactions associated with the financing of imports or with third-party export credits. The proportion of total lending accounted for by short-term loans remained fairly constant over the 1987–1997 period at approxi-

[6] For example, as of year-end 1997, the six money-center banks operated 580 foreign branch offices, excluding foreign subsidiaries, and all U.S. banks engaged in international lending operated 907 branch offices.

Figure 4

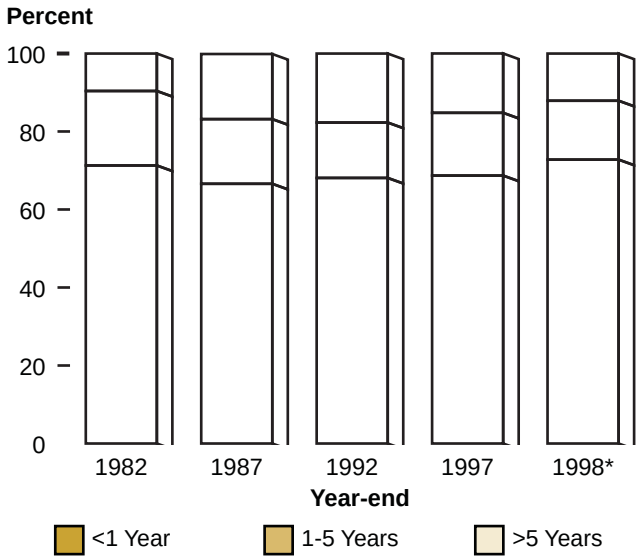
"International lending by U.S. banks has been dominated by short-term loans."



Source: FFIEC, *Country Exposure Reports.*
* March 31, 1998.

Figure 5

"Market shares of foreign loans by U.S. banks with maturities of less than one year have been resonably stabile over time but increased during the first quarter of 1998."



Source: FFIEC, *Country Exposure Reports.*
* March 31, 1998.

mately 69 percent but increased during the first quarter of 1998 by approximately 4 percentage points (figure 5). This change represented a natural response to the problems in Asia and elsewhere, as lenders sought to lessen default risk by restricting longer-term loans.

The high proportion of international lending accounted for by short-term credits is explained by commercial bank preferences for international trade-related finance, concerns over default risk, and a number of structural factors related to regional trends and changes in the underlying status of developing-country debt positions. In general, most international banks have preferred to extend short-term trade credit, especially to developing countries, as opposed to medium- or long-term credit. This is especially true for lending to Latin America, where creditor banks took severe losses in the wake of the 1980s debt crisis. Other reasons for the high level of outstanding short-term loans include: (a) the bunching of residual maturities of long-term loans falling due, (b) debt sales or write-offs of loans with maturities greater than one year, or (c) debt conversions. The shift is also due to the entry into the capital markets of nations from Eastern Europe and Central Asia, many of which could contract funds only for short durations.[7]

In the past, when emerging nations wanted to raise long-term funds, they relied more on syndicated bank loans than on bond issues. Bond issuance was minimal because investors generally lacked information about developing-country borrowers, and few emerging countries had high-enough credit ratings to enable institutional investors to purchase their bonds. In contrast, many commercial banks had long-established relationships with developing-country borrowers, having provided them with short-term financing over the years. These relationships, coupled with knowledge of local economic conditions, often enabled the banks to extend their loans to unrated or speculatively rated borrowers. Moreover, syndicated bank financing is easily tailored to the requirements of the borrower.[8]

The typical foreign term loan consists of an intermediate- to long-term syndicated credit with a floating-rate contract. The interest rate is usually tied to the London Interbank Offering Rate (LIBOR) and reprices approximately every three to six months. Syndicated lending can be highly profitable to the banks that originate the loans because, in addition to a variable interest rate that offers some protection when interest rates go up, these loans carry fees for the

[7] Bank for International Settlements (1998).

[8] While syndicated loans have been the primary source of funds for emerging nations, an increasing number of developing countries have been gaining access to the bond and equity markets in recent years. This access has reduced the share of total emerging-nation borrowings that originate with commercial banks.

banks that manage and participate in the loans. Typically, the managers of the loan receive a fee representing ⅜ to 1¼ percent of the total loan amount. This is divided among the loan managers, with the largest share going to the lead bank—the bank that won the syndication rights for the loan. Banks party to the offering also receive a participation fee, which generally ranges from ¼ to 1⅛ percent of the total loan value.[9] This fee is usually split among all the banks participating in the loan, with largest shares going to the banks that assumed the greatest risk or largest participations. Because the managing banks generally have the largest shares in a loan, they usually receive the largest percentage of the participation fee, in addition to the management fee.[10]

Figures 4 and 5 show that intermediate-term lending in the one- to five-year range is accounting for a slightly decreasing portion of longer-terms credits, declining from 19 percent in 1982 to 16 percent in 1997. Longer-term syndicated credits with maturities greater than five years captured some market share from the intermediate ranges, increasing from approximately 10 percent in 1982 to 15 percent at the end of 1997. But with the current crises in various parts of the world, the amount of longer-term loans on the books of the U.S. banks decreased during the first quarter of 1998, with the market share of total lending accounted for by this category declining to 12 percent, the lowest level since 1982.

Direction of Foreign Lending

The direction of bank lending has changed considerably during the past several decades. The geographic regions with the largest share of cross-border lending by U.S. banks are listed in table 2. As of March 31, 1998, the greatest exposure of the large banks was in Western Europe, which accounted for $177.7 billion, or 42 percent of total cross-border lending. Latin America and the Caribbean nations (excluding Mexico) rank second with $91.4 billion, or 21 percent. East Asia is the third-largest destination for U.S. loans with $63.9 billion, or 15 percent, followed by Canada and Mexico with $40.7 billion, or approximately 10 percent. U.S. bank loans to Eastern European nations (including Russia) increased significantly during the 1990s in response to those countries' economic reforms and now account for $22.9 billion, or 5.4 percent. Miscellaneous other regions account for the balance.

Table 2 also lists outstanding loans and commitments to individual nations. The majority of credits is highly concentrated among the developed nations, with the five largest recipients (United Kingdom, Germany, Mexico, Brazil, and France) accounting for $142.7 billion, or almost 33.4 percent of total lending as of March 31, 1998. The next five largest (Japan, Canada, Cayman Islands, the Netherlands, and Argentina) account for an additional $81.5 billion, or 19.1 percent of the total. The next five (Italy, Korea, Russia, Hong Kong, and Switzerland) account for an additional $49.7 billion, or 11.6 percent.

Figure 6 shows the direction of international lending by U.S banks since 1982 by region. After the debt crisis erupted in Mexico in August 1982, U.S. banks started to cut back international lending to almost all nations. As international lending resumed in the early 1990s, the flow of funds moved rapidly toward Western Europe during the next five years. Furthermore, this flow continued increasing to Western Europe in the first quarter of 1998, as the Asian crisis caused a "flight to quality" in lending. Starting in 1992, funds flowed again to Mexico and the Latin America/Caribbean area as they recovered from a decade of slow growth. Loans to East Asian nations, whose economies were growing, increased rapidly during the early to mid-1990s; after peaking in 1996, loans to the region dropped precipitously with the outbreak of the financial and economic crisis there.

Secondary Lending Risk: Trade Relationships

In addition to the direct risk of foreign lending, U.S. banks are subject to secondary risk. Secondary risk arises from the spread of adverse economic conditions between countries. Economic theory suggests that adverse economic conditions may be spread between countries by international trade. The spread of adverse conditions may be between the United States and its own trading partners, or it may be between the countries for which U.S. banks have relatively high lending exposure and their partners, but in either case, loans by U.S. banks may be at risk.

[9] Madrid (1990), 51.

[10] Ultimately, the interest-rate spread determines the profitability of a loan. However, fees can be lucrative when loan amounts are in the hundreds of millions of dollars.

Table 2

Foreign Lending by Region and Nation, March 31, 1998

($Millions)

	Total Amount Owed by Borrowing Region/Nation	Total Commitments for New Lending	Total U.S. Cross-Border Exposure	Risk Exposure as a Percent of U.S. Foreign Lending[a]
Region				
Western Europe	$ 129,866	$ 47,813	$ 177,679	41.6%
Latin America/Caribbean	73,665	17,721	91,386	21.4
East Asia	50,247	13,673	63,920	15.0
Canada and Mexico	29,204	11,455	40,659	9.5
Eastern Europe	19,873	3,116	22,989	5.4
All Other	22,523	7,776	30,299	7.1
Total	**$325,378**	**$101,554**	**$426,932**	**100.0%**
Nation				
1 United Kingdom	35,019	19,009	54,028	12.7%
2 Germany	20,400	4,527	24,927	5.8
3 Mexico	17,378	4,101	21,479	5.0
4 Brazil	19,344	1,975	21,319	5.0
5 France	15,750	5,193	20,943	4.9
6 Japan	15,119	5,663	20,782	4.9
7 Canada	11,826	7,354	19,180	4.5
8 Cayman Islands	13,213	1,491	14,704	3.4
9 Netherlands	9,930	3,655	13,585	3.2
10 Argentina	10,609	2,660	13,269	3.1
11 Italy	10,479	1,165	11,644	2.7
12 Korea	9,194	1,336	10,530	2.5
13 Russia	8,820	743	9,563	2.2
14 Hong Kong	7,681	1,574	9,255	2.2
15 Switzerland	5,653	3,045	8,698	2.0
16 Bermuda	2,504	5,966	8,470	2.0
17 Belgium	6,737	736	7,473	1.8
18 Spain	6,395	977	7,372	1.7
19 Sweden	3,753	3,280	7,033	1.6
20 Australia	4,875	1,386	6,261	1.5
21 Indonesia	4,108	1,146	5,254	1.2
22 Chile	4,764	444	5,208	1.2
23 Singapore	4,025	981	5,006	1.2
24 Norway	3,313	1,572	4,885	1.1
25 Venezuela	3,927	753	4,680	1.1

Source: FFIEC, *Country Exposure Reports*.

[a]Excluding local-currency loans.

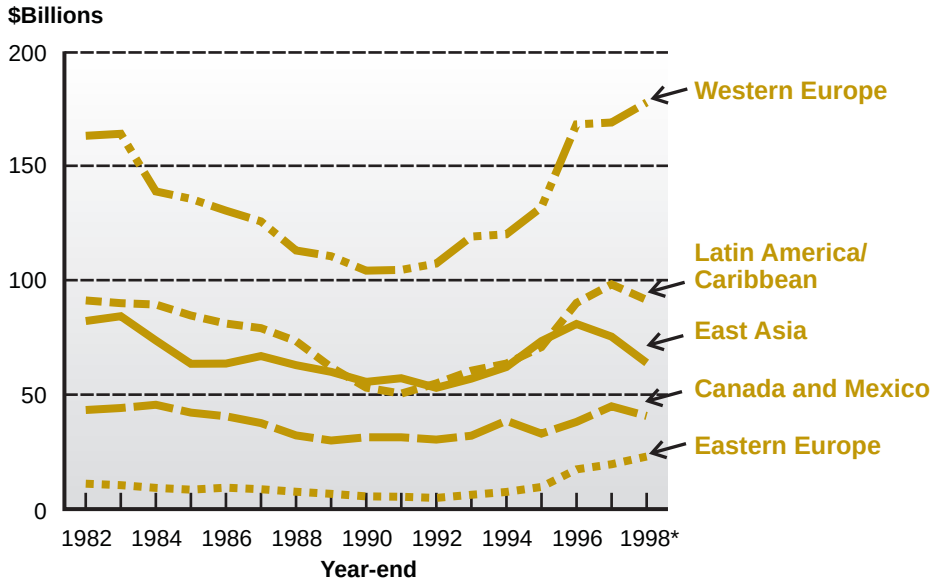
Trade flows (exports and imports) are a key mechanism in the transmission of risk among countries because countries closely linked by direct trade are more likely to transmit economic disturbances—positive or negative—to each other. Trade relationships tend to be regional, and evidence suggests that financial market disturbances (for example, currency crises) are more likely to spread among countries in close geographic proximity that have strong trade relationships.[11] Identifying trade relationships can thus be helpful in identifying possible sources of international lending risk.

For example, if the U.S. economy is highly dependent upon a country (or group of countries) for export

[11] Glick and Rose (1998) and Eichengreen and Rose (1998) provide recent evidence that trade relationships are important to the spread of currency crises. Backus, Kehoe, and Kydland (1993), Stockman and Tesar (1995), and Fernald, Edison, and Loungani (1998) also find high correlations of economic variables among major industrialized countries that happen to have significant intercountry trade flows.

Figure 6

"U.S. bank foreign lending to Western Europe has been growing rapidly in recent years."



Source: FFIEC, *Country Exposure Reports.*

* March 31, 1998.

earnings, adverse economic events in those countries (such as a recession) may have negative consequences for the United States in the form of decreased foreign demand for U.S. goods. These negative consequences may, in turn, make it more difficult for businesses exporting from the United States to meet their debt obligations. Conversely, if a foreign country is highly dependent upon the United States as an export market, adverse economic events in the United States may decrease U.S. demand for the foreign country's goods, and to the extent that the decrease in demand makes it harder for foreign businesses to meet their debt obligations, the performance of their loans from the U.S. banks may be impaired.

Of particular importance to the effect of trade fluctuations on foreign lending is the relationship between where a country *lends* and where it *trades*. If a country lends heavily to and trades heavily with the same partner, the risk associated with foreign lending may increase, because in this case the risk component of foreign lending that is due to fluctuations in trade with other countries is not as easily offset by domestic loans. The scenario is akin to, for example, lending money to a chef to cook meals that you will buy back from the chef, with the understanding that you will be the chef's biggest customer and the chef can sell a limited number of meals to other people as well. If you later decide you don't like the chef's cooking anymore or you can't afford to continue buying the meals, the chef will lose sales and may not be able to pay you back, and both of you lose. However, if you make a loan to the chef but are only a small portion of the chef's market, the chef's ability to repay the loan is less likely to be affected if you decide to stop buying the meals or are unable to afford them.

Another significant aspect of trade relationships and the transmission of risk from one country to another is that the more trade-dependent a country's economy, the more sensitive its economic condition and foreign loan performance are to fluctuations in trade flows and the terms of trade. Thus, because the United States is less dependent on trade than most other industrialized nations (see table 3), the United States is also less susceptible to fluctuations in trade flows or to the events that cause such fluctuations (for example, changes in the terms of trade, fluctuations in exchange rates, and import tariffs). For many other countries, however, exports and imports account for a substantial portion of GDP, and for these countries, fluctuations in trade flows can cause significant fluctuations in economic

growth. As table 3 shows, many European and Asian economies are heavily dependent on international trade. For example, exports of goods totaled nearly 60 percent of GDP in 1996 for Belgium and Luxembourg[12] and more than 25 percent for Korea. All other things being equal, therefore, fluctuations in foreign trade are more likely to affect economic growth in these countries than in countries such as the United States and Japan.

U.S. Trade Relationships

Even though the United States is less trade-dependent than other industrialized countries, it has grown more dependent in recent decades. Figure 7 shows that in 1970 both exports and imports of goods and services totaled less than 6 percent of U.S. GDP, with exports actually greater than imports. Since 1970, however, U.S. trade dependence has increased, with exports and imports at approximately 13 and 11.5 percent of GDP, respectively, as of year-end 1996. This trend suggests that currently international trade has a potentially greater effect on the performance of U.S. international loans than it did in 1970.

One can examine international trade at both the regional and the country levels. At the regional level, U.S. trade is concentrated in North America (Canada and Mexico) and East Asia. As of year-end 1996, North America accounted for 30.3 percent of U.S. exports and 28.4 percent of U.S. imports (table 4). East Asia accounted for 29.1 percent of exports and 37.3 percent of imports. Western Europe is less significant as a trading partner to the United States, making up 21.9 percent of exports and 19.4 percent of imports in 1996. At the country level, the largest U.S. trading relationships involve Canada, Japan, and Mexico, which together accounted for more than 41 percent of total U.S. exports and 43 percent of U.S. imports as of year-end 1996. The next three largest markets for U.S. exports are the United Kingdom, Korea, and Germany, followed by Singapore, the Netherlands, France, and Hong Kong (table 5). The ordering of the largest markets for U.S. imports, however, deviates from the ordering of exports after the first three countries: China, Germany, and the United Kingdom are the next three largest markets for U.S. imports (after Canada, Japan, and Mexico), followed by Korea, Singapore, France, and Italy (table 5).

[12] Export and import data were available only for Belgium and Luxembourg combined.

Table 3

Exports of Goods as a Percent of GDP for Major Borrowers of U.S. Banks and for Selected East Asian Countries

(Year-end 1996)

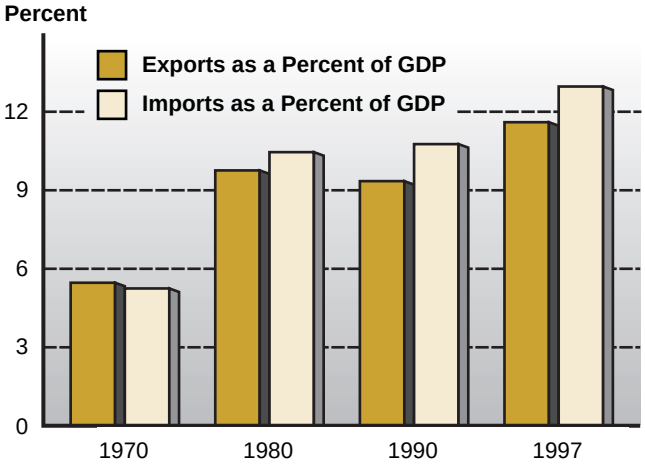
Major Borrowers from U.S. Banks	Exports as a Percent of GDP
Belgium–Luxembourg[a]	59.7%
Netherlands	50.3
Canada	33.5
Korea	26.8
Switzerland	25.9
Argentina	24.7
United Kingdom	22.5
Germany	22.2
Italy	20.7
France	18.8
Mexico	17.7
Spain	17.6
Australia	15.5
Japan	8.9
United States	8.2
East Asia	
Malaysia	78.9
Thailand	30.3
Philippines	24.4
Indonesia	21.9

Source: International Monetary Fund.

[a] Export data are not available for Belgium and Luxembourg separately.

Figure 7

"U.S. exports and imports of goods and services as a percent of GDP have increased since 1970."



Source: Haver Analytics.

Table 4

U.S. Trade Relationships by Region

(Year-end 1996)

Region	Total U.S. ($Millions)	Percent of Total U.S.	As a Percent of U.S. GDP
		Exports[a]	
North America (Canada and Mexico)	$ 189,345	30.3%	2.5%
East Asia	182,044	29.1	2.4
Western Europe	136,895	21.9	1.8
Latin America/Caribbean	35,312	5.6	0.5
All Other	81,477	13.0	1.1
Total Exports	**$625,073**	**100.0%**	**8.2%**
		Imports[b]	
East Asia	$ 306,812	37.3%	4.0%
North America (Canada and Mexico)	233,857	28.4	3.1
Western Europe	159,271	19.4	2.1
Latin America/Caribbean	52,080	6.3	0.7
All Other	70,005	8.5	0.9
Total Imports	**$822,025**	**100.0%**	**10.8%**

Source: International Monetary Fund.

[a]Exports of goods only.

[b]Imports of goods only.

Table 5

U.S. Trade Relationships by Country

(Year-end 1996)

Nation	Total U.S. ($Millions)	Percent of Total U.S.	As a Percent of U.S. GDP
		Exports[a]	
1 Canada	$ 132,584	21.2%	1.7%
2 Japan	67,536	10.8	0.9
3 Mexico	56,761	9.1	0.7
4 United Kingdom	30,916	4.9	0.4
5 Korea	26,583	4.3	0.3
6 Germany	23,474	3.8	0.3
7 Singapore	16,686	2.7	0.2
8 Netherlands	16,614	2.7	0.2
9 France	14,431	2.3	0.2
10 Hong Kong	13,956	2.2	0.2
Total Exports	**$399,541**	**63.9%**	**5.2%**
		Imports[b]	
1 Canada	$ 159,746	19.4%	2.1%
2 Japan	117,963	14.4	1.5
3 Mexico	74,111	9.0	1.0
4 China	54,409	6.6	0.7
5 Germany	39,989	4.9	0.5
6 United Kingdom	29,700	3.6	0.4
7 Korea	23,297	2.8	0.3
8 Singapore	20,648	2.5	0.3
9 France	19,196	2.3	0.3
10 Italy	19,001	2.3	0.2
Total Imports	**$558,060**	**67.9%**	**7.3%**

Source: International Monetary Fund.

[a]Exports of goods only.

[b]Imports of goods only.

Trade Relationships of Countries with High Totals of U.S. Loans

Economic instability in a foreign economy may pose additional risk to U.S. foreign loans if that country's adverse economic conditions spread to countries the United States lends heavily to. Suppose, for example, that the economies of the United States and Indonesia are linked to one another through trade and bank lending and that Indonesia and Japan are similarly linked. In this case, economic fluctuations in Japan represent secondary risk to U.S. lending to Indonesia because economic fluctuations in Japan may affect the profitability of Indonesian businesses and, in turn, the performance of U.S. loans to Indonesia. Thus, a viable means of identifying secondary risks to U.S. lending is to examine the international trade relationships of countries to which the United States has large lending exposure.

Table 6 shows trade relationships for the 15 nations with the largest amount of indebtedness to U.S. commercial banks as of December 31, 1997. Columns (1) and (2) identify the nations and specify each one's fraction of total U.S. foreign lending. Column (3) ranks the five most important trading partners of each of the nations in column (1), and column (4) specifies the percentage of exports (goods only) going to each of the five trading partners. As indicated by table 6, most of the top 15 nations are highly dependent on exports to the United States. Six of the top 15 nations have the United States as their largest export market; of those 6 nations, 2 (Mexico and Canada) send over 80 percent of their total exports of goods to the United States, while another (Japan) ships almost 27.5 percent of its total exports to the United States. For another 2 (Switzerland and Argentina), the United States is the second-largest export market. For the remaining 7 nations, the United States is one of the top 5 export markets.

Table 6 also reveals that, excluding the United States, the export markets of major U.S. borrowers are largely regional. The biggest U.S. borrower as of year-end 1997, the United Kingdom, exports mainly to Germany, France, the Netherlands, and Belgium-Luxembourg, with almost 33 percent of the U.K.'s exports going to these four countries. A similar regional pattern is evident in other European countries: Germany, France, Italy, Belgium–Luxembourg, and Switzerland all export a considerable percentage of goods to other Western European nations. To a somewhat lesser degree, the regional pattern is also present in Asia: while exporting heavily to the United States (27.5 percent), Japan—which represented 9.2 percent of U.S. foreign lending exposure at year-end 1997—exports mainly to Asian nations, with Korea, Hong Kong, China, and Singapore as its four next-largest export markets.

Significant U.S. trade relationships are not limited to countries with strong lending ties to the United States; many countries that do not borrow heavily from the United States nevertheless depend greatly on the United States as a major export market. Of particular current interest in this regard are the economies in East Asia. Most of the developing Asian nations stricken by the "Asian flu" of devalued currencies, massive outflows of capital, stock market fluctuations, and banking sector instability are only moderately indebted to U.S. banks but are still highly dependent upon the United States as a major export market. As table 7 shows, the United States is the number-one export market for Singapore, Thailand, and the Philippines, and the number-two market for Indonesia and Malaysia. As the world's economic superpower, the United States influences foreign economies—through trade or financial flows—throughout the world.

The patterns of U.S. trade flows and bank-loan flows suggest that a major threat to U.S. lending to foreign countries is, ironically, a U.S. recession. A U.S. recession would decrease this country's demand for exports from countries that borrow heavily from it, thus making it harder for these countries to pay back their loans to the United States.

Similarly, a major threat to economic stability in Europe is a recession in Germany. Germany has the third-largest economy in the world, behind the United States and Japan. Germany is also much more dependent on international trade than are the United States and Japan, as its ratio of exports to GDP is 22 percent. Moreover, Germany is a major export market for most Western European nations, including the United Kingdom, France, the Netherlands, Switzerland, Italy, and Belgium–Luxembourg (table 6). Germany's trade statistics strongly suggest that the German economy to a large extent "drives" Europe. Hence, an economic downturn in Germany would likely cause economic problems for many of the countries of the continent

Table 6

Secondary Risk Exposures of U.S. Banks, All Countries

(Year-end 1996)

(1) Largest U.S. Bank Exposures (Country A)	(2) Percent of U.S. Foreign Lending[a]		(3) Largest Export Markets of Country A	(4) Exports of Country A as a Percent of Its Total Exports
1 United Kingdom	10.2%	1	United States	12.1%
		2	Germany	11.3
		3	France	9.3
		4	Netherlands	7.3
		5	Belgium–Luxembourg	4.7
2 Japan	9.2	1	United States	27.5
		2	Korea	7.1
		3	Hong Kong	6.2
		4	China	5.3
		5	Singapore	5.1
3 Germany	7.4	1	France	10.7
		2	United Kingdom	7.9
		3	United States	7.7
		4	Netherlands	7.3
		5	Italy	7.3
4 France	6.1	1	Germany	16.8
		2	United Kingdom	9.2
		3	Italy	9.0
		4	Belgium–Luxembourg	8.2
		5	United States	6.0
5 Canada	5.6	1	United States	81.7
		2	Japan	3.7
		3	United Kingdom	1.4
		4	Germany	1.1
		5	China	1.0
6 Brazil	4.2	1	United States	19.5
		2	Argentina	10.9
		3	Netherlands	7.4
		4	Japan	6.4
		5	Germany	4.4
7 Korea	3.8	1	United States	16.8
		2	China	8.9
		3	Hong Kong	8.6
		4	Singapore	5.0
		5	Germany	3.6
8 Netherlands	3.6	1	Germany	25.1
		2	Belgium–Luxembourg	11.6
		3	France	9.7
		4	United Kingdom	8.4
		5	Italy	5.2

(continued)

Table 6 (continued)

Secondary Risk Exposures of U.S. Banks, All Countries

(Year-end 1996)

(1) Largest U.S. Bank Exposures (Country A)	(2) Percent of U.S. Foreign Lending[a]		(3) Largest Export Markets of Country A	(4) Exports of Country A as a Percent of Its Total Exports
9 Mexico[b]	3.4	1	United States	83.4%
		2	Canada	2.2
		3	Japan	1.4
		4	Spain	1.0
		5	Italy	0.1
10 Switzerland	3.3	1	Germany	23.6
		2	United States	9.8
		3	Italy	7.8
		4	United Kingdom	6.8
		5	Japan	4.3
11 Italy	3.2	1	Germany	17.4
		2	France	12.5
		3	United States	7.4
		4	United Kingdom	6.5
		5	Spain	5.0
12 Spain	3.1	1	France	20.1
		2	Germany	14.5
		3	Italy	8.8
		4	Portugal	8.6
		5	United Kingdom	8.5
13 Belgium–Luxembourg[c]	2.7	1	Germany	20.4
		2	France	17.8
		3	Netherlands	13.3
		4	United Kingdom	9.0
		5	United States	4.1
14 Australia	2.5	1	Japan	19.9
		2	Korea	9.5
		3	New Zealand	7.2
		4	United States	6.4
		5	Indonesia	4.0
15 Argentina	2.3	1	Brazil	27.8
		2	United States	8.3
		3	Chile	7.4
		4	Netherlands	5.1
		5	Uruguay	3.1

Sources: FFIEC, *Country Exposure Reports*; International Monetary Fund.

[a] Excluding local-currency loans.

[b] Total exports for Mexico uses the DOTS world total. All other total exports data use the IFS world total.

[c] Commercial bank lending data for Belgium only; exports data for both Belgium and Luxembourg.

Table 7

Secondary Risk Exposures of U.S. Banks, East Asian Countries

(Year-end 1997)

(1) Largest U.S. Bank Exposures (Country A)	(2) Percent of U.S. Foreign Lending[a]		(3) Largest Export Markets of Country A	(4) Exports of Country A as a Percent of Its Total Exports[b]
Indonesia	1.3%	1	Japan	25.9%
		2	United States	13.6
		3	Singapore	9.2
		4	Korea	6.6
		5	China	4.1
Singapore	1.1	1	United States	18.4
		2	Malaysia	18.0
		3	Hong Kong	8.9
		4	Japan	8.2
		5	Thailand	5.7
Thailand	1.1	1	United States	18.0
		2	Japan	16.8
		3	Singapore	12.1
		4	Hong Kong	5.8
		5	Malaysia	3.6
Malaysia	0.6	1	Singapore	20.4
		2	United States	18.2
		3	Japan	13.4
		4	Hong Kong	5.9
		5	Thailand	4.1
Philippines	0.6	1	United States	34.1
		2	Japan	18.0
		3	Singapore	6.0
		4	Netherlands	5.5
		5	United Kingdom	4.6

Sources: FFIEC, *Country Exposure Reports*; International Monetary Fund.

[a]Excludes local-currency loans.

[b]Exports of goods only.

and, as a result, would limit the profitability of U.S. loans not only to Germany but to the entire continent.

Similarly in East Asia, the trade flow data suggest that the greatest threat to the economic stability and well-being of the region is a prolonged recession in Japan. The current Japanese recession highlights the debilitating effect of Japan's economy on the rest of East Asia. As table 7 shows, Japan is the leading export market for Indonesia (26 percent of exports as of year-end 1997), the second-largest export market (after the United States) for the Philippines (18 percent) and Thailand (17 percent), and the third-largest (after Singapore and the United States) for Malaysia (13 percent). The East Asian corridor has suffered not only because of trade relations with Japan but also because systemic structural problems in the Japanese banking system have all but eliminated the ability of Japanese banks to provide the credit necessary to spur investment and economic growth in the region—and Japan has lent heavily to developing East Asian countries.[13]

[13]"Available, but incomplete, balance-sheet data compiled by the Bank for International Settlements (BIS) indicate that as of mid-1997, banking system exposures to Asian emerging market countries amounted to approximately $260 billion in the European Union (3¼ percent of GDP), $210 billion in Japan (5 percent of GDP), and $40 billion in the United States (½ of 1 percent of GDP)" (International Monetary Fund [1998], 25.

Summary and Conclusions

Trends in both the primary and secondary risks associated with the international lending activities of U.S. banks over the 1982–1998 period indicate that U.S. banks recovered from the heavy losses they incurred on foreign loans during the 1980s debt crisis; and in the 1990s they resumed international lending. But while foreign lending grew significantly during the 1990s, substantial amounts of new capital also came into the industry. Thus, the amount of risk exposure as reflected in the ratio of foreign loans to total capital is lower than it was during the early 1980s, when some of the largest U.S. banks faced the possibility of insolvency because of delinquent cross-border loans. Another way in which foreign lending by U.S. banks is different in the 1990s is that the money-center banks have expanded their domination of these markets.

This expansion of the role of money-center banks has come about for several reasons: the money-center banks pursue highly competitive pricing strategies, they have numerous foreign branch offices, they have the technical expertise to originate such loans, and at the same time many of the super-regional and other U.S. banks have cut back their origination of and participation in foreign lending, after incurring heavy loan losses on developing-country debt during the 1980s.

Some of the characteristics of foreign loans made by U.S. banks have also changed. An increasing percentage of these loans is being made to the private nonbank sector and away from the interbank market. The shift has occurred because active privatization programs under way in many nations, as well as other developments, have increased the demands for private-sector loans and made them more profitable, especially with the recent narrowing of interest-rate spreads on loans in the interbank market. Maturity, however, has not changed: the maturity of most foreign loans continues to be short term—over 70 percent of total foreign loans are in this category. But the direction of foreign lending has shifted somewhat: during the 1990s loans to Western Europe have accounted for an increasing share of total lending. Lending to the Latin American/Caribbean region resumed after a decade of retrenchment, and loans to East Asia increased significantly during the 1980s and early 1990s but declined in the late 1990s, in response to changing circumstances in Asia. These changing lending patterns—the heavy concentration of lending to Western Europe and away from East Asia—may have reduced overall U.S. bank lending risk during the 1990s, but the increasing levels of lending to Mexico, Brazil and other Latin American/Caribbean region may partially offset the reduction.

In addition to the primary risks of international lending, bank supervisors have also become concerned about the secondary risks of such lending, risks that arise when economies are linked by trading relationships. Adverse economic disturbances are transmitted between countries by international trade. The greater the trading interdependence among countries, the more likely it is that economic disturbances will be transmitted, and the higher the probability that one country's economic problems will affect other countries. Economic problems transmitted through the trade mechanism affect not only the private nonbank sector of an economy but also the banking sector, as trade-related problems such as currency devaluations and falling exports can increase the incidence of credit risk and loan defaults.

An example of the direct risk is evident in Asia. The recession in Japan has reduced its import demand for products from other Asian countries. This in turn has jeopardized the loans of Japanese banks to exporters in these countries. Although U.S. banks may be sheltered from this direct risk they nevertheless may be exposed. Because most Asian nations depend somewhat upon the Japanese market for export earnings, indirect risk appears to have increased. Thus, a prolonged recession in Japan is likely to increase the total risk to banks in the United States. Similarly, because most European nations depend upon the German market for export earnings, a recession in Germany would also increase the total risk to banks in the United States. In today's increasingly international banking environment, when bankers and their supervisors assess the risks associated with the international lending activities of U.S. banks, they should be particularly aware of the linkages between economies.

The largest indirect risk to U.S. international lending, however, is a recession in the United States itself. The United States is a major export market for most of the world, and particularly for nations that the

United States lends heavily to. If the U.S. economy were to fall into a sustained recession, exports to the United States would probably fall. This would make it harder for many countries around the world to pay back their loans to the United States. Thus, as international trade and financial linkages grow, weakness in the largest economies increases the risk associated with international lending.

References

Backus, David K., Patrick J. Kehoe, and Finn E. Kydland. 1993. International Business Cycles: Theory vs. Evidence. *Federal Reserve Bank of Minneapolis Quarterly Review* 17, no. 4: 14–30.

Bank for International Settlements. Various issues. *International Banking and Financial Market Developments*. Basle, Switzerland.

Curry, Timothy J. 1997. The LDC Debt Crisis. In *History of the Eighties—Lessons for the Future*. Vol. 1. Federal Deposit Insurance Corporation.

Eichengreen, Barry, and Andrew K. Rose. 1998. Contagious Currency Crises: Channels of Conveyance. In *Changes in Exchange Rates in Rapidly Developing Countries*, edited by T. Ito and A. Krueger. Forthcoming.

Fernald, John, Hali Edison, and Prakash Loungani. 1998. Was China the First Domino? Assessing Links between China and the Rest of Emerging Asia. International Finance Discussion Paper. Board of Governors of the Federal Reserve.

Fissel, Gary. The Anatomy of the LDC Debt Crisis. *FDIC Banking Review* 91, no. 1: 1–17.

Glick, Reuven, and Andrew K. Rose. 1998. Contagion and Trade: Why Are Currency Crises Regional? Working Paper. University of California, Berkeley.

International Monetary Fund. 1998. *World Economic Outlook*. International Monetary Fund.

Madrid, Paul L. 1990. *Overexposed*. Investor Responsibility Research Center. Washington, DC.

Seidman, L. William. 1993. *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*. Random House.

Stockman, Alan C., and Linda L. Tesar. 1995. Tastes and Technology in a Two-Country Model of the Business Cycle: Explaining International Comovements. *American Economic Review* 85, no. 1: 168–85.

Recent Developments Affecting Depository Institutions

by Lynne Montgomery*

REGULATORY AGENCY ACTIONS

Interagency Actions

FFIEC Issues Year 2000 Guidance

On April 10, 1998, the Federal Financial Institutions Examination Council issued guidance to help financial institutions prepare testing procedures to address computer-related problems linked to the century date change. The Exam Council declared that testing is the most important phase in Year 2000 preparations. In addition to the institution's own systems, banks and thrifts are required to look at services and products provided by vendors. The Exam Council outlined the general internal and external systems that should be examined and also set several deadlines for institutions to meet in the Y2K testing process. The Exam Council explained that noncompliance with the Y2K guidance and deadlines could threaten the safety and soundness of the institution. *BBR, 4/20/98, p. 634.*

New Approach to Evaluating Investment Risks

The Federal Financial Institutions Examination Council issued a policy statement on investment securities and end-user derivative activities, which requires depository institutions to focus on how combinations of risk affect the institution's overall financial health. The policy statement was published in the *Federal Register* on April 23, 1998. The new approach eliminates three tests that bank regulators have used since 1992 to measure investment risks. The banking agencies were concerned that the 1992 policy placed too much emphasis on the type of instrument involved, rather than the investment's risk characteristics and how they affected the institution's total risk profile. The new policy statement emphasizes that senior managers and directors should understand how the risks of an institution's investment portfolio affect the entire organization. The policy statement advises that determining whether a security or mortgage derivative product is an appropriate investment depends on a variety of factors, including the institution's capital level, the security's effect on the aggregate risk of the portfolio, and the management's ability to measure and manage the risks. *BBR, 4/27/98, p. 668; FIL-45-98, FDIC, 4/28/98.*

Regulators Approve Uniform Application

On May 6, 1998, the Conference of State Bank Supervisors announced that state and federal banking regulators approved a Uniform Interstate Application/Notice Form. State-chartered banks operating in more than one state will be permitted to file a single application with federal and state regulators to set up, relocate, or discontinue a branch, an automated teller machine, or other place of business.

*Lynne Montgomery is a financial analyst in the FDIC's Division of Research and Statistics.

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

The uniform application will ease the regulatory burden for state-chartered banks. The application was developed by the State Federal Working Group, which consists of senior regulators representing the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Conference of State Bank Supervisors. *BBR, 5/11/98, p. 756.*

Revised Policy on Civil Money Penalties

Effective June 3, 1998, the Federal Financial Institutions Examination Council issued a revised interagency policy on the criteria agencies should use when assessing fines on depository institutions for violations of laws, regulations, and other misconduct. The revised joint policy replaces an existing civil money penalty policy statement, which was adopted in 1980. The updated policy statement eliminates unnecessary references to interagency coordination of civil money penalty proceedings and specifies that the amount of a fine should be sufficient to deter future misconduct. The revised policy also requires federal regulators to consider five statutory factors when deciding whether to impose fines, including: the financial resources of the institution; good faith; the seriousness of the violation; history of previous offenses; and other factors that may require corrective action. Further, the revised policy lists the type of violations that may warrant civil money penalties. *BBR, 6/8/98, p. 921.*

New Capital Limits for Servicing Assets

The Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the FDIC, and the Office of Thrift Supervision (OTS) issued a final rule on August 4, 1998, which amends capital adequacy standards for banks, bank holding companies, and savings associations. The final rule increases the maximum amount of mortgage servicing assets and purchased credit-card relationships (PCCRs) that depository institutions may include in regulatory capital calculations. The final rule increases the Tier 1 capital limit for mortgage servicing assets and PCCRs from 50 percent to 100 percent of Tier 1 capital. The rule is effective as of October 1, 1998. *BBR, 7/13/98, p. 55–56; FRB-PR, 8/4/98.*

New Risk-Based Capital Standards

The Federal Reserve Board, the OCC, the FDIC, and the OTS amended their risk-based capital standards for banks, bank holding companies and thrifts regarding the capital treatment of unrealized holding gains on certain equity securities. These gains have been reported as a component of equity capital under U.S. generally accepted accounting principles (GAAP), but have not been included in regulatory capital under the banking agencies' capital standards. The final rule, which is effective October 1, 1998, permits institutions to include up to 45 percent of the pre-tax net unrealized holding gains on certain available-for-sale equity securities in supplementary capital (Tier 2). The final rule will make the capital treatment of these unrealized gains consistent with the international standards of the Basle Accord. *FRB-PR, 8/26/98.*

Federal Deposit Insurance Corporation

Tanoue Sworn in as Chairman

Donna A. Tanoue was sworn in as the 17th Chairman of the FDIC on May 26, 1998. Before her appointment to the FDIC, Ms. Tanoue was an attorney with the law firm of Goodsill Anderson Quinn & Stifel in Honolulu. She also served as Hawaii's financial institutions commissioner during the banking crisis in the mid-1980s, where she engineered a rescue package for Hawaii's underfunded thrift insurance corporation. Ms. Tanoue replaces FDIC Acting Chairman, Andrew C. Hove, Jr., who will resume his position as the agency's Vice-Chairman. *PR-35-98, FDIC, 5/26/98.*

Semiannual Agenda of Regulations

On April 27, 1998, the FDIC published its semiannual agenda of regulations in the *Federal Register* to inform the public of projected new rulemakings, as well as existing regulations under review and completed rulemakings. Many of the actions are the result of the FDIC Board's ongoing efforts to reduce the regulatory burden on banks, simplify rules, improve efficiency and comply with the Riegle Community Development and Regulatory Improvement Act of 1994. The agenda contains 26 regulatory actions. Six actions have been completed and the others are in various stages of the rulemaking process. *PR-29-98, FDIC, 4/29/98.*

Assessment Rates

The FDIC Board of Directors voted to maintain the current deposit insurance assessment rates for the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) through year-end 1998. Insurance premiums for the BIF and the SAIF

range between zero and 27 basis points, depending on the institution's supervisory rating. The healthiest banks and thrifts pay nothing for deposit insurance. Currently, approximately 95 percent of all federally insured banks and 91 percent of all federally insured savings associations pay no deposit insurance premiums. Federal law requires the FDIC to maintain a minimum reserve ratio of 1.25 percent (reserves as a percent of insured deposits) for both the BIF and the SAIF. The FDIC estimates that the BIF reserve ratio will be 1.43 percent and the SAIF ratio will be 1.45 percent by December 31, 1998. *BBR, 5/4/98, p. 705; FIL-66-98, FDIC, 6/19/98.*

Bank Failures

The Michigan Commissioner of the Financial Institutions Bureau closed Omnibank in River Rouge, Michigan, on April 9, 1998, and the FDIC was named receiver. The deposits of Omnibank were assumed by ShoreBank, Detroit, in Detroit, Michigan, which is a newly chartered bank subsidiary of Shorebank Detroit Corporation. ShoreBank paid the FDIC a premium of $154,000 to receive the failed bank's deposits and to purchase $41.8 million in assets. In addition, ShoreBank will participate in a five-year loss-sharing arrangement on approximately $23.8 million of the assets that it purchased from the receivership. The FDIC estimates that this transaction will cost the BIF approximately $3.1 million. Omnibank is the first FDIC-insured failure since November 1997. *PR-24-98, FDIC, 4/9/98.*

On July 23, 1998, the Colorado State Bank Commissioner closed BestBank in Boulder, Colorado, and the FDIC was named receiver. The FDIC approved the assumption of the insured deposits of BestBank by The Pueblo Bank and Trust Company in Pueblo, Colorado. The Pueblo Bank also purchased $47.2 million of the failed bank's assets. The former office of BestBank was reopened on July 27, 1998, as a branch of Pueblo Bank and Trust. This was the first bank failure in Colorado since 1993. *PR-50-98, FDIC, 7/25/98.*

Montana's Commissioner of Financial Institutions closed Q Bank of Fort Benton, Montana, on August 7, 1998, and the FDIC was named receiver. The FDIC approved the assumption of the insured deposits of Q Bank by Heritage State Bank in Fort Benton, Montana, which is a newly chartered banking subsidiary of United Financial Corporation in Great Falls, Montana. Heritage State Bank paid a premium of $445,000 for the right to receive the insured deposits and will purchase $2.5 million of the failed bank's assets. The FDIC estimates the cost of the transaction to the BIF will be approximately $1.3 billion. Q Bank is the third failure of an FDIC-insured bank this year and the first in Montana since March 1992. *PR-54-98, FDIC, 8/7/98.*

Simplified Deposit Insurance Rules

On April 28, 1998, the FDIC Board of Directors approved final revisions clarifying certain aspects of the deposit insurance regulations. The revised deposit insurance regulations, which are effective July 1, 1998, make three significant revisions to the insurance rules. The revised regulations give the FDIC more flexibility to insure deposits made by third-party agents on behalf of account owners. The regulations also clarify the insurance coverage of living trust accounts and provide a six-month grace period following the death of a depositor for beneficiaries to restructure inherited accounts in order to maximize deposit insurance coverage. *BBR, 5/4/98, p. 704–705; PR-26-98, FDIC, 4/28/98.*

Interstate Banking Interest Charges

The FDIC published a legal opinion in the *Federal Register* on May 18, 1998, clarifying how interest charges are applied when a state-chartered bank operates across state lines. The FDIC opinion gives state banks the same flexibility that national banks have under Section 85 of the National Bank Act, which permits a bank to charge interest allowed by its home state to out-of-state borrowers. The opinion addresses three main issues, including: where interstate state banks are located for purposes of federal law; which state's interest provisions should govern the interest charged on the loan; and the need for disclosures to customers regarding which state's law will cover the loan. *PR-33-98, FDIC, 5/13/98; BBR, 5/25/98, p. 851–852.*

Midyear 1998 Financial Results (Unaudited)

The Bank Insurance Fund (BIF) reported $637 million in net income for the first half of 1998, and the Savings Association Insurance Fund (SAIF) earned $242 million for the same period. Both funds closed the second quarter of 1998 with record balances, the BIF with $28.9 billion and the SAIF with $9.6 billion. The strong results are attributed to the continuing low numbers of bank and thrift failures. Revenue for the BIF totaled $858 million for the first six months ending June 30, 1998, including $827 mil-

lion in interest on investments in U.S. Treasury securities and $8 million in deposit insurance assessments. The SAIF earned $282 million in revenue, consisting of $278 million in interest on investments in U.S. Treasury securities and $4 million in deposit insurance assessments.

The FSLIC Resolution Fund (FRF) assets in liquidation were reduced by 24 percent, to $1.8 billion. Federal Financing Bank borrowings for the FRF were reduced by $492 million, to $357 million, during the six-month period. *PR-58-98, FDIC, 8/25/98.*

Real-Estate Survey—April 1998

The April 1998 issue of the *Survey of Real Estate Trends* continued to report favorable conditions for residential and commercial real-estate markets. The survey polled 302 senior examiners and asset managers from the federal bank and thrift regulatory agencies about developments in their local markets in the preceding three months. Sixty-three percent of those surveyed in late April described local housing markets as improving, up from 49 percent in the January survey. More than half of the respondents (56 percent) cited better conditions for commercial markets in the last three months compared to 49 percent in the January survey.

The national composite index was 79 in April, up from 72 in January and 71 in April 1997. Index scores above 50 reflect improving conditions, while index scores below 50 indicate declining conditions. Every region showed an increase in the index between January and April. *Survey of Real Estate Trends, FDIC, April 1998.*

Real-Estate Survey—July 1998

The July 1998 issue of the *Survey of Real Estate Trends* also reported favorable conditions for residential and commercial real-estate markets. The July survey polled 299 examiners and asset managers. Sixty-one percent observed that local housing markets had improved during the preceding three months, compared with 63 percent in the April survey and up from 51 percent in July 1997. Assessments of commercial market conditions remained positive in July, although the frequency of favorable reports was slightly less than three months earlier. Fifty-two percent reported improvements, compared with 56 percent in the April survey.

The national composite index was 77 in July, a slight decrease from the April index of 79, but improved from the July 1997 index of 74. *Survey of Real Estate Trends, FDIC, July 1998.*

Report on Underwriting Practices

The April 1998 issue of the *Report on Underwriting Practices* reported that banks' underwriting practices have weakened during the last year. The weakened standards are most evident in commercial real-estate and construction lending; however, the FDIC examiners noted early signs of adverse trends for all major types of loans. Implemented in early 1995, the survey of underwriting practices is aimed at providing early warnings of potential problems in underwriting practices at FDIC-supervised, state-chartered nonmember banks. The focus of the survey is threefold: material changes in underwriting standards for new loans, degree of risk in current practices, and specific aspects of the underwriting standards for new loans. *Report on Underwriting Practices, FDIC, April 1998.*

Expedited Application Procedures

The FDIC Board of Directors voted on July 7, 1998, to expedite the processing of applications filed by well-managed, well-capitalized institutions and to simplify and streamline its application rules. The revised Part 303 of the FDIC's rules applies expedited processing procedures to applications for deposit insurance, mergers, branches, trust powers, stock buy-backs, and certain international banking activities. The revised rule, which is effective October 1, 1998, reduces regulatory burden for well-managed institutions and permits the FDIC to focus resources on applications that present a significant issue or risk. *PR-45-98, FDIC, 7/7/98.*

Federal Reserve Board

Phillips Resigns

Federal Reserve Governor Susan Phillips resigned from her post on the Board of Governors as of June 30, 1998. Ms. Phillips accepted the post of dean in the School of Business and Public Management at The George Washington University. Ms. Phillips had served on the Board of Governors since 1991. *BBR, 5/11/98, p. 757.*

Interest Rates

The Federal Reserve Open Market Committee again voted to leave short-term interest rates unchanged on August 18, 1998. The Federal Reserve Board has kept the interest rates constant since March 1997. *BBR, 8/24/98, p. 292.*

Loan Quality Assessment Project

In a supervisory letter released on June 30, 1998, the Federal Reserve Board reported that banks have eased lending standards for commercial loans significantly since 1995 in response to intense competition for loan customers. However, the Board notes that the overall quality of banks' business loans has not deteriorated greatly, because of strong economic conditions. The Board's report on lending standards is based on the results of a recent study, the Loan Quality Assessment Project, which compared several hundred commercial and industrial loans made in late 1995 with loans made in late 1997. The Loan Quality Assessment Project found that banks have relaxed the terms of commercial loans to attract customers by cutting interest-rate spreads, extending loan maturities, easing collateral requirements, or waiving financial covenants. *FRB-PR, 6/30/98; BBR, 7/6/98, p. 5.*

Guidance for Assessing IT-Related Risks

The Federal Reserve Board announced that bank examiners would be required to consider the risks associated with an institution's use of information technology when developing safety-and-soundness assessments under the risk-focused supervisory process. In an April 20, 1998 letter to all Federal Reserve–supervised institutions, the Federal Reserve Board outlined a framework for examiners to use in evaluating how banks manage their information technology risks, and reiterated its commitment to continuing examiner training in the information technology area. The Federal Reserve Board's information technology framework includes five elements: the institution's management processes, system design and structure, security, and the integrity and availability of the information delivered to end-users. *BBR, 5/4/98, p. 712.*

Relaxed Limits on Insurance Sales

As of May 1998, the Federal Reserve Board granted bank holding companies greater flexibility to sell life insurance and annuity products through their securities dealer subsidiaries on behalf of affiliated insurance agencies. The insurance activities may be conducted only in states that permit insurance sales under the Bank Holding Company Act, and the insurance activities must be conducted according to the federal banking agencies' joint policy on the retail sales of nondeposit investment products. Additionally, the bank holding companies must separate the insurance activities from areas in which insured deposits are accepted. *BBR, 7/6/98, p. 20.*

Regulation Y

The Federal Reserve Board revised its leverage capital rules for bank holding companies (Regulation Y), effective June 30, 1998. The revisions allow the most highly rated bank holding companies to maintain a minimum Tier 1 leverage ratio of 3 percent, while requiring all other bank holding companies to maintain a Tier 1 leverage ratio of 4 percent. The Tier 1 leverage ratio is defined as the proportion of core capital to total assets. Before the revisions, all but the highest-rated bank holding companies were required to maintain a minimum level of core capital equal to 3 percent of total assets, plus an additional 100 to 200 basis points. The revised final rule also provides that higher capital ratios would be required for bank holding companies that have significant financial, operational, or managerial weaknesses that make them more risky. *BBR, 6/8/98, p. 920–921.*

Regulations H and P

On July 7, 1998, the Federal Reserve Board announced final revisions to Regulation H, updating and clarifying its procedures for state-chartered banks to join the Federal Reserve System. The new Regulation H is intended to reduce the regulatory burden for state banks and replaces the entire existing regulation, except for the appendices to the rule, which remain unchanged. Under the new Regulation H, well-capitalized and well-managed institutions could qualify for faster consideration of Federal Reserve membership and branch applications. As part of the process of revising Regulation H, the Federal Reserve Board rescinded Regulation P. Regulation P, which was folded into the new Regulation H, implemented the Bank Protection Act of 1968 and required federal banking regulators to establish minimum standards for banks' security systems. The new Regulation H is effective beginning on October 1, 1998. *FRB-PR, 7/7/98; BBR, 7/13/98, p. 49–50.*

Regulation DD

On July 27, 1998, the Federal Reserve Board made final an interim rule amending Regulation DD, Truth in Savings, regarding the disclosure of the annual percentage yield (APY). The rule permits institutions to disclose an APY equal to the contract interest rate for certain time accounts. The rule

applies only to time accounts with maturities greater than one year. *FRB-PR, 7/27/98.*

Office of the Comptroller of the Currency

Comptroller Nomination

The White House announced on July 16, 1998, that President Clinton intends to nominate Treasury Undersecretary for Domestic Finance John D. Hawke, Jr. to be the next Comptroller of the Currency. If confirmed by the Senate, Mr. Hawke would succeed Eugene A. Ludwig, who departed after his five-year term expired in April 1998. Former OCC Chief Counsel, Julie L. Williams, has been serving as acting comptroller since April. Mr. Hawke has served as Treasury Undersecretary for Domestic Finance since 1995. *BBR, 7/20/98, p. 96.*

Loan Underwriting Survey

On July 13, 1998, the OCC announced that banks' commercial lending standards have slipped for the fourth year in a row, as heavy competition and pressure to increase loan volume are causing banks to grant more generous concessions to business borrowers. The findings are based on the results of the OCC's fourth annual survey of national banks' loan underwriting standards. As a result, the OCC is implementing a series of new supervisory initiatives intended to reverse the trend of sliding commercial and consumer credit practices. The new initiatives build on existing programs that have already been implemented to help national banks deal with an increase in problem loans that could result from an economic downturn. *NR 98-70, OCC, 7/13/98; BBR, 7/20/98, p. 95.*

Bank Municipal Securities Dealers

Effective June 29, 1998, the OCC adopted final revisions to its municipal securities dealers' regulation. The final rule clarifies that national bank subsidiaries, which conduct municipal securities activities, are subject to the Municipal Securities Rulemaking Board and must register with the National Association of Securities Dealers. As a result, these national bank subsidiaries are exempt from the OCC's municipal securities dealers' regulation. *BBR, 6/1/98, p. 883.*

Bank Can Take Fee for Insurance Referrals

On February 27, 1998, the Chief Counsel for the Office of the Comptroller of the Currency ruled that a national bank would be permitted to collect a finder's fee for referring bank customers to a group of independent insurance agencies. The ruling is significant because it allows national banks to collect fee revenue in addition to their existing authority to sell insurance as agent. *BBR, 4/20/98, p. 651.*

New Supervision Handbooks

A new version of the OCC's Large Bank Supervision handbook was issued on July 22, 1998, in order to help examiners develop more detailed and meaningful risk profiles of the nation's largest national banks. The manual, which is aimed at the 80 national banks with assets of more than $1 billion, applies supervision by risk to all aspects of the supervisory process so that risks are properly assessed and evaluated across the entire organization, regardless of its size, complexity or geographic reach. *NR-98-75, OCC, 7/22/98.*

On August 24, 1998, the OCC issued another new manual that is designed to help examiners evaluate the internal control systems that national banks use to guard against fraud and financial mismanagement. *NR-98-87, OCC, 8/24/98.*

Credit-Card Suspension Agreements

In an interpretive letter made available on June 23, 1998, the OCC gave a national bank permission to enter into credit-card debt suspension agreements. A suspension agreement states that, in exchange for a monthly fee paid by the cardholder, the bank will agree to freeze the cardholder's account for a specified period if certain temporary hardship circumstances occur. During the freeze, the cardholder is not charged interest, fees, or penalties. *BBR, 6/29/98, p. 1066.*

Office of Thrift Supervision

Simplified Rule on ARMs Disclosure

On July 17, 1998, the OTS finalized a rule giving thrifts two options when disclosing potential interest payments to borrowers of adjustable-rate mortgage loans. The OTS's new rule requires thrifts to follow the provisions of the Federal Reserve Board's Regulation Z. Regulation Z requires institutions to either: (1) provide a borrower with a 15-year historical example showing how interest-rate changes would affect loan payments and loan balances on a $10,000 loan, or (2) disclose the maximum interest rate and payment possible for a $10,000 loan. *OTS 98-50, 7/16/98.*

Limits on Repurchase Transactions

The OTS approved a final rule on August 12, 1998, that prohibits reverse repurchase agreements between savings associations and their nonbank affiliates. In a reverse repurchase agreement, a depository institution buys securities from another party and agrees to sell them back later at a higher price. The final rule clarifies that the OTS will treat reverse repurchase agreements as loans or other extensions of credit for the purposes of the Home Owners' Loan Act. Therefore, thrifts will be barred from entering into these agreements with nonbank affiliates because reverse repurchase agreements are extensions of credit. Exemptions from the ban are possible if several conditions are met. The final rule takes effect on October 1, 1998. *BBR, 8/24/98, p. 301.*

One-Member, One-Vote Rule Adopted

Under a final rule announced by the OTS on August 27, 1998, mutual depository institutions with a one-member, one-vote provision in their current charters will be able to retain that authority when converting to a federal savings association. In addition, any existing federal mutual savings association will be able to adopt a one-vote-per-member provision if it desires. The new rule applies to all mutual-type institutions, including credit unions that wish to become thrifts. The rule expands the range of votes a federal mutual savings association may allow a member to cast on issues requiring membership action from the current 50 to 1,000 votes to 1 to 1,000 votes per member. *OTS 98-64, 8/27/98.*

National Credit Union Administration

Credit Union Membership Access Act

The Credit Union Membership Access Act was signed by President Clinton on August 7, 1998. The Act permits federal credit unions to offer membership to multiple groups of less than 3,000 persons, and grandfathers all existing members and groups as of the date of enactment of the bill. Other provisions impose statutory limits on member business lending and prompt corrective action requirements on the NCUA. H.R. 1151 was introduced in 1997 after a federal appeals court ruled against the National Credit Union Administration's multiple-group membership policy. The Federal Credit Union Act requires members of federal employment-based credit unions to share a common bond. The NCUA interpreted that requirement to allow multiple fields of membership, each with its own common bond; however, the U.S. Court of Appeals for the District of Columbia Circuit ruled in 1996 that each federal occupational credit union must share just one common bond. The NCUA appealed to the Supreme Court, but the Supreme Court also ruled against the NCUA in February 1998. After the ruling, Congress quickly initiated the Credit Union Membership Access Act to give the NCUA relief from the "one common bond" ruling. *NCUA PR, 8/4/98 and 8/7/98; BBR, 8/3/98.*

Federal Housing Finance Board

Amended Rule for FHLBank System Membership

On April 9, 1998, the Federal Housing Finance Board approved a rule that will make it easier for banks with assets of less than $500 million to qualify for membership in the Federal Home Loan Bank System. Previous regulations required FHLBank System members to have at least 10 percent of their loans in home mortgage loans. A home mortgage loan for certain combination properties is defined as a mortgage loan where the appraised value of the residence on the property equals at least 50 percent of the appraisal value of the entire property. As a result of this 50 percent test, many institutions found it difficult to make enough home mortgage loans to qualify for membership in the FHLBank System. The new rule allows institutions with assets of $500 million or less to ignore the 50 percent test for combination properties. The new rule states that combination property loans will be considered as residential property loans, as long as there is a permanent residential structure that is an integral part of the property. *BBR, 4/13/98, p. 612.*

New Financial Disclosure Requirements

On June 24, 1998, the Federal Housing Finance Board approved a final policy statement expanding financial disclosures by the Federal Home Loan Bank System. The final policy statement, *Disclosures in the Combined Annual and Quarterly Reports of the Federal Home Loan Bank System*, requires that the reports be prepared in a manner that is consistent with the disclosure requirements of the Securities and Exchange Commission. The Finance Board also adopted a final rule requiring that the financial statements of the individual FHLBanks are consistent with the combined annual and quarterly reports presented by the Finance Board and are provided to the Finance Board in a timely manner. *BBR, 6/29/98, p. 1064.*

STATE LEGISLATION AND REGULATION

Illinois

On July 30, 1998, Illinois Governor James Edgar signed the so-called banking industry omnibus bill, Senate Bill 1528. The legislation will permit state-chartered banks in Illinois to compete more efficiently with national banks and insured savings associations through expanded "wild card" provisions. The legislation also establishes standards for information sharing between bank affiliate organizations, creates a safe harbor from liability in certain electronic transactions, and streamlines motor vehicle repossession rules. All aspects of the bill became effective on July 30, except for the auto repossession provision which becomes effective January 1, 1999. *BBR, 8/24/98, p. 289.*

Kansas

The Kansas legislature approved a bill on May 8, 1998, that requires all banks located in the state that have nonbank affiliates to file consolidated tax returns. Both state- and federally chartered banks must file consolidated state tax returns or combined reports with any subsidiaries that own, hold, or manage any portion of their securities portfolios. In order to keep the Kansas State tax burden in line with that of other states, the bill also includes a provision to reduce the base tax rate on net income of banks and savings-and-loan associations. *BBR, 5/18/98, p. 814.*

Massachusetts

On May 22, 1998, Massachusetts Acting Governor Paul Celluci signed legislation that permits state-chartered banks to sell insurance and annuity products beginning on September 1, 1998. Massachusetts is one of the last states to offer this authority to banks. *BBR, 6/1/98, p. 883-884.*

Mississippi

Effective July 1, 1998, a new state law permits Mississippi-chartered trust operations to branch into other states. The law requires the trust operations to notify the state banking commissioner before setting up branches across state lines. Out-of-state trust operations will be permitted to enter Mississippi after getting approval from banking regulators in their home state. *American Banker, 6/17/98.*

New York

The New York State Banking Board approved final regulations on June 4, 1998, that allow state-chartered banks and trust companies located in places with populations of 5,000 or less to sell insurance directly to customers. The regulations require that all credit and insurance transactions be completed separately. In addition, all insurance sold by banks and trusts will be subject to state Insurance Department regulations. *BBR, 6/15/98, p. 967.*

On June 19, 1998, the New York legislature approved a bill to extend the state's "wild card" banking law for two more years and expand the scope of the law to cover thrifts. The state's original wild card banking law, which was enacted last year, allows the New York State Banking Board to grant state-chartered banks the same powers as federally chartered institutions. It also establishes safeguards to prevent banks from tying banking and insurance products together. The latest bill extends the expiration date of the wild card law until September 10, 2000. The new bill also authorizes the New York State Banking Board to adopt regulations granting state-chartered thrifts any insurance powers that have been granted to state-chartered commercial banks under the wild card law. *BBR, 6/29/98, p. 1052.*

An additional regulation was published in the *Federal Register* on June 24, 1998, which permits New York State banking institutions to create banking development districts in areas that have traditionally been underserved by banks. The districts can be established through a joint application by a local government and a commercial bank, trust company, or national bank. *BBR, 7/6/98, p. 19.*

Oklahoma

On June 5, 1998, a bill was signed that amends Oklahoma's Consumer Credit Code and allows banks and other companies to issue credit cards and impose a variety of fees on the credit-card holders. The new law, which becomes effective November 1, 1998, removes legislative limits on credit-card charges and allows Oklahoma-based companies to charge fees for membership, transactions, cash advances, documents, and for stopping payments on checks by the users of the credit cards. The new law gives

Oklahoma businesses an advantage when competing with out-of-state lenders. *BBR, 6/15/98, p. 971.*

Texas

In May 1998, the Texas Banking Commissioner announced that state banks would be allowed to branch and merge interstate. The announcement was made in response to a court decision allowing NationsBank Corporation to fold its Texas operations into its North Carolina headquarters. *American Banker, 5/15/98.*

West Virginia

On April 1, 1998, Governor Cecil Underwood signed a law that permits mobile branch banking in West Virginia. The law limits mobile banks to a radius of 30 miles from the bank's permanent main office or a fixed branch office, and it does not allow any mobile bank within 2,000 feet of another bank's main office or branch office. The law became effective on June 12, 1998. *BBR, 4/13/98, p. 604.*

BANK AND THRIFT PERFORMANCE

First-Quarter 1998 Results for Commercial Banks and Savings Institutions

Insured commercial banks continued to produce record profits in the first quarter of 1998, earning net income of $15.9 billion, which was $621 million higher than the previous record set in the fourth quarter of 1997. The FDIC attributed much of the increase in banks' first-quarter earnings to the continued strong growth in noninterest income, especially from trust activities and other sources of fees. Revenues also received a one-time gain from sales of securities and other assets. Banks' annualized return on assets (ROA) was 1.26 percent in the first quarter, up from 1.24 percent in the fourth quarter of 1997 and 1.25 percent in the first quarter of 1997. The number of problem banks decreased from 71 in the fourth quarter of 1997 to 67 in the first quarter of 1998. Problem banks had assets of $4.8 billion. There were no failures of insured commercial banks in the first quarter.

FDIC BIF-insured mutual savings institutions earned $2.6 billion in the first quarter of 1998, up by $178 million from one year earlier. The savings industry reported an average annualized ROA of 1.03 percent in the first quarter, which matches the ROA in the first quarter of 1997. The number of problem thrifts declined to 16 in the first quarter from 21 at the end of 1997. However, assets of problem thrifts rose to $2.3 billion from $1.7 billion at year-end 1997. *FDIC Quarterly Banking Profile, First Quarter 1998.*

First-Quarter 1998 Results for Thrifts

The nation's thrift industry earned $1.87 billion in the first quarter of 1998, which was up from $1.66 billion in the fourth quarter of 1997 and $1.73 billion in the first quarter of last year. Profitability and capital levels also increased in the first quarter, while troubled assets and delinquent loans decreased. The equity capital to assets ratio rose to 8.40 percent at the end of the first quarter, compared with the previous quarter's record of 8.32 percent. All but one of the OTS-supervised thrifts met or exceeded minimum capital requirements, and 98 percent of the thrifts were in the highest capital category (well-capitalized) at the end of March 1998.

The thrift industry's ROA was 0.97 percent in the first quarter, up from 0.87 in the fourth quarter of 1997. The number of problem thrifts fell to 14 in the first quarter, down from 18 in the fourth quarter and 30 one year ago. The OTS attributed the strong financial performance of the thrift industry to an increased demand for single-family mortgage loans because of the robust economy and low, stable interest rates. *OTS 98-45, 6/3/98.*

RECENT ARTICLES AND STUDIES

A working paper, entitled *Capitalization of the Bank Insurance Fund*, concludes that the current funding arrangement of the Bank Insurance Fund (BIF) is sufficient to maintain FDIC solvency, assuming that the prior history of losses is a good indicator of future losses. The study simulates the BIF's future reserve levels and examines the implications of different assessment rates and required reserve ratios. The working paper was written by Kevin Sheehan, a financial economist in the Division of Research and Statistics at the FDIC. *Working Paper Series, 98-1, FDIC.*

A working paper published in June 1998 by the Swiss-based Bank for International Settlements (BIS) concludes that the separation of commercial banking and securities activities cannot be justified either on bank safety-and-soundness or conflict-of-

interest grounds. The paper, entitled *Commercial Banks in the Securities Business: A Review*, was written for the BIS by former Federal Reserve Bank of Cleveland official Joao Santos. The working paper notes that the advantages of allowing "universal banking," both banking and securities services offered under one roof, include improved information on companies they underwrite and economies of scope that allow consumers to save time and money by purchasing an array of financial services from a single provider. *BBR, 7/6/98, p. 37.*

The Federal Reserve Bank of Chicago released a report on April 28, 1998, entitled *1996 CRA Small Business Lending Profile*. The report revealed that low- and moderate-income neighborhoods in the Midwest are receiving a smaller share of small-business loans than their broader metropolitan areas. The report analyzes data collected under the Community Reinvestment Act and evaluates five metropolitan areas, including Chicago, Des Moines, Detroit, Indianapolis, and Milwaukee. *BBR, 5/4/98, p. 714.*

The Federal Reserve Board released a study on May 29, 1998, which declared that banks' internal credit risk models will not completely replace international risk-based capital standards any time soon, but may enhance current supervisory and regulatory policies. The final report, entitled *Credit Risk Models at Major U.S. Banking Institutions: Current State of the Art and Implications for Assessments of Capital Adequacy*, concluded that the internal models used to measure risk and to allocate capital have significant shortcomings that make them unreliable substitutes for existing risk-based capital rules. The study states that difficulties regarding model construction, data availability, and model validation procedures limit the use of banks' internal models in the regulatory process. *FRB PR 5/29/98; BBR, 6/8/98, p. 920.*

A paper, entitled *The Evolution of Bank Lending to Small Business*, concludes that the recent wave of bank mergers may actually increase the amount of credit available to small businesses. The paper reports that mergers among community banks produce larger institutions, which means they may make larger loans and still remain within government-set limits on loans to any single borrower. Joe Peek of Boston College and Eric S. Rosengren of the Federal Reserve Bank of Boston performed the study. *American Banker, 5/8/98.*

Deposit Insurance Reform in the FDIC Improvement Act: The Experience to Date reports that a 1991 law meant to restore the industry's health and avoid banking crises appears to be working. The Federal Deposit Insurance Corporation Improvement Act appears to be preventing banks from taking excessive risks and encouraging regulators to sanction financially troubled institutions. Two economists authored the paper, George Benston of Emory University and George Kaufman of Loyola University. *American Banker, 8/28/98.*

INTERNATIONAL DEVELOPMENTS

International Deposit Insurance Conference

The FDIC sponsored an International Deposit Insurance Conference in September 1998, in order to discuss the role of deposit insurance in sustaining public confidence in the world's banking systems. The Conference brought together top government officials from 63 countries, including the leaders of deposit insurance agencies in more than 20 nations. *PR-61-98, FDIC, 9/1/98.*

Deposit Insurance for Russian Banks

In an effort to restore confidence in Russia's banking system, the Central Bank announced plans to insure deposits held by individuals at commercial banks. On August 20, 1998, Central Bank Chairman Sergei Dubinin announced the proposed insurance plan and stated that it would cover all bank deposits established before August 1, 1998. The insurance would work through Russia's largest commercial bank, Sberbank, in which the government holds a controlling stake. *BBR, 8/24/98, p. 308.*

Basle Committee

The Basle Committee on Banking Supervision announced on April 7, 1998, that they amended their rules regarding the capital that banks must keep on hand to cover risk resulting from loans to securities firms. The changes affect the Committee's 1988 Basle Capital Accord, which is an international agreement that sets minimum capital requirements for banks. The amendment reduces the risk weight on a bank's credit exposure for claims on regulated securities firms to 20 percent from 100 percent. The

amendment applies only to claims on regulated securities firms and not holding companies that may own the securities firms. The Basle Committee on Banking Supervision is a group of senior supervisors and central bank officials from nine western European countries and the United States, Canada, and Japan. *PR-23-98, FDIC, 4/8/98; BBR, 4/13/98, p. 620.*

European Union

On April 30, 1998, the European Parliament approved changes to European Union legislation involving capital adequacy and solvency requirements for banks, credit institutions, and investment firms. The changes will be effective upon publication of three new directives. Governments will have up to 24 months to confirm that their national laws comply with the new European Union requirements. The first directive introduces changes to Directive 89/647/EEC, which establishes a solvency ratio for credit institutions. The second proposal includes amendments to the 1989 solvency directive, as well as Directive 77/780/EEC, which sets rules for establishing and operating credit institutions, and Directive 93/6/EEC on capital adequacy of investment firms and credit institutions. The amendments to these directives involve updated capital requirements, including requirements for credit risks inherent in derivatives, as well as extending the exchange of information between European Union bank supervisors and nonbanking supervisory authorities in third countries. The third directive updates the 1993 capital adequacy directive regarding commodities and commodity directives. *BBR, 5/18/98, p. 828.*

Eleven Countries Establish Economic and Monetary Union

On May 3, 1998, eleven European Union countries received confirmation that they qualified for the Economic and Monetary Union. The eleven countries—Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain—will convert to a single currency, the Euro, on January 1, 1999. Once the 11 countries convert to the Euro, the legacy currencies will become denominations of the Euro. Belgium, France, and Germany will redenominate their existing government debt into Euros. On January 1, 2002, Euro notes will be issued, and the legacy currencies will be withdrawn from circulation. *BBR, 5/11/98, p. 781; BBR, 6/8/98, p. 949.*

Indonesia

On April 4, 1998, the new Indonesian Bank Restructuring Agency made its first moves to rebuild the country's battered banking system by closing seven small banks and taking control of seven large banks. The Indonesian Bank Restructuring Agency was created in January 1998 to repair the country's banking system. *The Wall Street Journal, 4/6/98.*

Statement of Cooperation

In April 1998, the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Superintendencia de Bancos de Chile entered into a Statement of Cooperation that will facilitate the supervision of financial institutions operating in each other's country. The Statement of Cooperation provides for the sharing of supervisory information to facilitate the performance of each agency's duties and to promote the safe and sound functioning of financial institutions in their respective countries. The arrangement provides for cooperation during the authorization process as well as in the supervision of ongoing activities of financial institutions operating in each other's country. The statement supercedes an earlier one established between the Superintendencia and the Federal Reserve in March 1997. *NR-98-40, OCC, 4/16/98.*