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The author examines how the European Union is dealing with forces of deregulation, globalization, financial innovation, and other changes.

Recent Developments Affecting Depository Institutions

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

European Union Financial Developments: The Single Market, the Single Currency, and Banking

by Neil B. Murphy*

In the past decade, the financial and banking structure of the 15-member European Union (EU) has changed substantially. In 1993 the single market in banking was inaugurated, transforming the legislative and regulatory environment for banking and financial markets. Then on January 4, 1999, 11 of the 15 member states embarked on a dramatic alteration of their monetary arrangements, initiating a single currency (the euro) and a single central bank (the European Central Bank [ECB]). Conversion to the single currency will be complete in the year 2002, at which time national banknotes and coins will be replaced by euro notes and coins. Clearly, implementation of the single currency will significantly affect the process of consolidation already under way in banking and financial markets. In addition, the EU's size and structure are expected to change. Many nations of Central and Eastern Europe that were formerly behind the Iron Curtain have been working to transform themselves from socialist, command-style economies into market economies. A number of them are preparing to join (accede to) the European Union and are therefore designing their new banking and monetary systems to be compatible with the EU's.

The single market in banking and the single currency are important in their own right, given the EU's size and financial depth, but combined with the EU's expansion eastward they will be even more important in the future. As the United States faces its own changes in the structure and regulation of financial institutions and markets, it is instructive to examine another system to learn how it is dealing with the same forces of deregulation, globalization, financial innovation, and technological change.

After surveying the size and composition of the European Union, the article discusses first the single market in banking and then the single currency. Topics under the single market in banking are the legislative framework, the approach taken, and the directives that address (a) barriers to cross-border banking, (b) capital adequacy, and (c) deposit protection. Topics under the single currency are the new currency, the criteria that must be met by nations wanting to join the single-currency area, and the single central bank system. Discussed next are the implications of all of these developments for banking, particularly with respect to the money and capital markets. The conclusion assesses the past and future of the single-market program in banking.

* Neil B. Murphy is Professor of Finance, Department of Finance, Insurance, and Real Estate, School of Business, Virginia Commonwealth University. The research for this article was undertaken while the author was a visiting scholar in the FDIC's Division of Research and Statistics.

I have benefited greatly from discussions with Edward P. M. Gardener, Philip Molyneux, and Jonathan Williams (all of the University of Wales, Bangor), Jean-Pierre Daloz (University of Southern Europe, Monaco), and Leonard Lapidus (formerly U.S. Treasury Department).

Size and Composition of the European Union

The starting point in discussing the EU, and in comparing its financial arrangements and issues with those of the United States, must be the EU's size and composition. In 1958 six nations—Belgium, France, Germany, Italy, Luxembourg, and the Netherlands—formed the European Common Market, and over the years those six nations were joined by nine other Western European nations. As a practical matter, it is useful now to think of the EU as all of Western Europe except Norway and Switzerland. (In the future, the EU will include member nations in Central and Eastern Europe as well.)

After passing through a selection process as outlined below, 11 of the 15 member nations embarked on the single currency. The four nonparticipants are Denmark, Greece, Sweden, and the United Kingdom. In the popular press, the nations in the single currency are sometimes referred to collectively as "Euroland."

Tables 1 and 2 list the population, gross domestic product (GDP), and financial depth (the ratio of financial assets to GDP) of the EU, Euroland, and the United States. The population of the EU is larger than that of the United States, while Euroland's population is approximately the same. In GDP and financial depth, the EU is similar to the United States. However, as discussed below, the EU and the United States are quite different in the composition of their financial assets and in the use of their currencies in international trade. The proportion of financial assets represented by bank deposits is much higher in the EU than in the United States, a difference reflecting the broad and deep money and capital markets in the United States. And the U.S. dollar is widely used in international trade and finance, whereas no single European currency is. (See Appendix for tables.)

In summary, the EU and Euroland are large, wealthy entities whose banking, financial, and monetary arrangements have changed dramatically in the past decade and will undoubtedly continue in change.

The Single Market in Banking

The stage was set for the single market in banking in 1958, and specific directives on barriers, capital standards, and deposit protection were issued in 1989, 1992, and 1994. In the interim, important decisions were made about the place of each member nation's legislative and supervisory framework and about the approach that would be taken to cross-border banking (what activities would be permitted, and would the host country or the home country control the status of foreign banks). The intent of all of this was to allow banks to be able to do business anywhere in the EU so that the benefits of competition would accrue to businesses and households—but, to ensure that competition would not result in banks taking excessive financial risks, identical standards of capital adequacy were imposed on all banks.

Setting the Stage

The goal of the original Common Market in 1958 was to establish an area with no internal barriers to the movement of goods, services, labor, and capital. Banking services were among those for which internal barriers were to be eliminated.

After many years of balancing this goal with the prerogatives of sovereign nations, the European Economic Community assessed the progress made. Its assessment was published in *Completing the Internal Market*, White Paper from the Commission to the European Council (1985), hereinafter referred to as the White Paper. The White Paper listed measures that would have to be adopted if the goal of free circulation of people, goods, services, and capital within the EU were to be achieved. The White Paper also contained 300 proposals for legislation that would have to be enacted if barriers were to be removed. Among the proposed measures and legislation were some that applied to banking services.

Another important document leading to change was the Price Waterhouse/Cecchini Report (1988), which dealt exclusively with banking. The report's basic findings were as follows:

- The nations of Europe had fragmented banking systems characterized by relatively small size, high concentration, excess capacity, and lack of competition.
- Gains could be achieved if the average size of banks was larger (economies of scale).
- Gains could be achieved if the products and services offered by banks in many countries were expanded (economies of scope).
- Beyond achieving economies of scale and scope, banks could also achieve gains in efficiency if there were incentives for banks to adopt "best practices."

- To ensure that all of these gains accrue to bank customers, barriers to competition would have to be removed.
- If economies of scale and scope, increased efficiency, and enhanced competition were achieved, the benefits to consumers would be substantial—an estimated .7 percent of GDP for the nations under study.

In summary, first the White Paper indicated that the process of achieving the internal market was not complete, and it made specific proposals to that end. Then the Price Waterhouse/Cecchini Report specified the nature of the costs of not having an integrated, competitive banking market in the European Union. The stage was set for the development of the single-market program in banking.[1]

Single-Market Legislative Framework

Three principles guide the EU's approach to the single market in banking. First, each nation retains its own banking supervisory and regulatory agencies. Second, there is to be minimal harmonization from a level above the national level. Most of these are related to safety and soundness. That is, individual countries may have their own regulatory and supervisory regimes, but all banks and nations within the EU must abide by certain minimal standards. Third, "directives" are to be issued at the EU level. That is, nations will be required to take legislative action, but the exact content of the legislation will not be dictated to them. There is normally a timetable that the nations must meet, and when they have enacted their legislation, it is submitted to the EU to ensure its consistency with the original directive.

Approach to Cross-Border Banking

In general, the activity of foreign banks doing business in another country is approached in one of two major ways, assuming such activity is permitted. The first approach is called *national treatment*: a host nation allows banks from foreign nations to conduct business on the same terms as banks that are domiciled in that host nation. This is the approach the United States takes. Foreign banks abide by the same rules and regulations as U.S. banks. Of course this approach implies that some banks will find they cannot do certain things in the host country that are permitted in their own nation. For example, the amount of investment banking activity conducted by banks in the United States has been limited. Thus, a foreign bank (say, German) may find that in the United States activities are forbidden that in Germany are quite legal. By the same token, U.S. banks in nations that have universal banking and national treatment will find they have far greater powers abroad than they do in the United States.

The second approach taken to the activity of foreign banks doing business in another country is called *mutual recognition*. This means that a host nation allows a foreign bank to do whatever is permitted in that bank's domestic environment; in other words, the host nation recognizes the primacy of home-country control. This approach implies that banks in the same market may have different powers. That is, a nation that simultaneously allows mutual recognition and has a restrictive regulatory environment may find that foreign banks coming from a more liberal home-country environment will have more powers than, and therefore a competitive advantage over, their domestic counterparts.

In developing the single market in banking, the EU took the mutual recognition approach internally. That is, the host nation recognized the primacy of the home nation's regulation of banks. Thus, the host nation would have to adapt its own regulatory environment or else stand by while foreign institutions might have advantages in the host nation's domestic market. This approach to the single market in banking allowed for a "market" in regulation, in that nations would strive to ensure that implementing EU requirements would not mean putting their own domestic banks at a competitive disadvantage. Of course, the danger is that such a situation may result in a competition in laxity whereby some nations seek to attract the business of banks by maintaining a lax set of rules and regulations. To forestall such a situation, the EU imposed some minimum standards for all banks in the EU.

Banking Directives

The minimum standards are contained in several banking directives. These address barriers, capital adequacy, and deposit protection.

Barriers and the Second Banking Directive. The cornerstone of the single market program is the

[1] Other documents and assessments of European banking were published at this time, some of them critical of the White Paper and Price Waterhouse/Cecchini. For a review, see Molyneux, Altunbas, and Gardener (1996), chapter 2. For an earlier analysis of European banking, see Gardener and Molyneux (1990). A thorough econometric analysis of economies of scale and scope as well as efficiency can be found in Molyneux, Altunbas, and Gardener (1996).

Second Banking Directive, which was adopted in 1989 to be implemented at the beginning of 1993.[2] Thus, by the end of 1992 all nations had to have in place laws and regulations consistent with this directive. It has three major components. First, it defined exactly what is meant by "banking." Across the EU, there were differences in the activities that could be undertaken by banks, but for purposes of the Second Banking Directive, banking activities were specified (see table 3). Taken together, these activities constitute "universal banking."

The second component of the directive is the principle of home-country control, or mutual recognition. That is, banks will be regulated by, and will conform to, the regulation and legislation of their home country. If a bank does business in another EU nation, the regulatory authorities of the host nation recognize the primacy of the home nation.

The third component of the Second Banking Directive is the concept of a "single passport." That is, a bank licensed to do business in any EU nation is allowed to do business in any other EU nation on whatever basis it considers most advantageous. A bank may establish a branch or subsidiary, or may acquire another bank, in any other nation. The host nation is not allowed to impose any barriers to such action. Previously, cross-border activities had been permitted, but nations had routinely required separate capital for branches located in their borders. A combination of capital requirements, called *endowment capital*, and the need to seek and obtain permission made it somewhat difficult for banks to conduct cross-border activities. The Second Banking Directive removed all such barriers.

As a result of mutual recognition and the single passport, a bank located in a nation with permissive laws about activities would be able to enter a nation with a restricted set of activities and conduct business that would not be permitted to domestic banks. Thus each EU nation, in passing the legislation required by the Second Banking Directive, has an incentive to consider all specified banking activities (table 3) as permissible activities for its domestic banks, since to do otherwise would put domestic banks at a competitive disadvantage. Hence, the principle of mutual recognition is used to create incentives for nations to enact legislation that makes universal banking the norm in the entire EU.[3]

Capital Adequacy. The amount of capital a bank holds has an effect on its competitiveness, its financial strength, its profitability, and its incentives to take risk. It also represents a cushion against losses elsewhere in the bank, standing between those losses and potential losses to depositors and/or (in nations with deposit insurance programs) the taxpayer.[4]

Because of the crucial role of capital in banking, the EU promulgated a series of directives intended to ensure that all banks in the EU had the same capital standards. The first two directives (the Own Funds Directive and the Solvency Ratio Directive) defined what is meant by bank capital and what is considered to be adequate. In these directives, the EU adopted the definitions, approach, and standards of the Basel (Bank for International Settlements) Committee of the Group of Ten.

In the absence of capital standards, a low capital ratio allows a bank to price loans aggressively and still meet a return-on-capital target. But, if all banks face the same capital standards, there are no capital-related incentives to price loans overly aggressively. A high capital ratio implies financial strength and, in the absence of deposit insurance, can result in an enhanced ability to attract deposit funds easily and cheaply. Of course, if a credible deposit protection program covers any potential losses, the incentive for depositors to monitor and assess the financial strength of banks is removed. But the deposit guarantor has the same incentive as the now-protected depositor would have had to monitor financial strength, and can be expected to favor strong capital standards.

The third capital-related directive was the one on Monitoring and Controlling Large Exposures of Credit Institutions. It requires that the maximum lending exposure to a single client cannot exceed 25 percent of a bank's capital, and a bank must report to its supervisor any exposure greater than 10 percent of capital. This requirement is designed to avoid concentration of risk in a single client whose financial difficulties could substantially affect an individual bank.

[2] There was a First Banking Directive that made some progress toward integration. Under it, however, banks needed authorization from host-country supervisors; host-country legislation determined permissible activities; banks had to earmark endowment capital for new branches as though they were new banks; and capital controls restricted cross-border financial activities.

[3] Of course, EU nations' adoption of universal banking has implications for the transition economies of Central and Eastern Europe, which are designing their banking systems. To be compatible with the EU, such nations have an incentive to adopt the universal banking model.

[4] The EU requires that all member nations have a deposit protection program, as discussed below.

Effects of Second Banking Directive and Capital Standards. The approach taken by the directives discussed above may be set against the objectives mentioned by the White Paper and the concerns expressed in the Price Waterhouse/Cecchini Report. Freedom of movement, as advocated by the White Paper and Price Waterhouse/Cecchini, implies that banks may conduct business in any part of the EU. The Second Banking Directive imposes no apparent regulatory restrictions that would keep a bank from realizing economies of scale by expanding via branching and/or merger and acquisition, throughout the EU. In addition, because of home-country control with a single passport, all EU nations have adopted a broad array of banking powers, allowing banks to realize economies of scope. All nations' banking markets have become *contestable*, a development implying that either existing banks in a market will change their conduct to forestall external entry or foreign banks could indeed enter a market. Thus, the Second Banking Directive sets the stage for cross-border activity, deconcentration of markets, and the ability of larger banks to produce efficiently by realizing economies of scale and scope and having incentives to adopt "best practices" in conducting their banking activities.

But although the pro-competitive aspects of the Second Banking Directive should lead to lower loan rates, higher returns to depositors, and higher-quality services, the combined effect of the capital directives is in the opposite direction. Higher capital standards should result in higher loan rates and lower returns to depositors. That is, the net interest margin should be higher than would be the case if capital ratios were lower and the bank was still trying to meet a return-on-capital target.[5]

The fact that the Second Banking Directive and the capital directives have opposing effects may seem contradictory, but it is not. The combination is designed to achieve for consumers the maximum benefits from competition that is constrained by safety-and-soundness standards, as these are manifested in capital requirements.

Deposit Protection. The EU issued a Deposit Guarantee Scheme Directive to be effective on July 1, 1995. This directive indicated that all member nations had to have a deposit protection scheme (analogous to deposit insurance in the Unites States): deposit protection was to be mandatory for all member nations and for all banks within member nations. The directive put a floor on coverage, €20,000 per depositor, but contained no requirements for funding the scheme, nor did it say whether the deposit insurance agency should be public or private or, if public, whether it should be an independent agency, part of a bank supervisory agency, part of the central bank, or part of the ministry of finance. The scheme could be funded either in anticipation of any problems (so that the deposit insurance agency would have the resources to deal with problem situations) or after the fact (so that other members of the scheme would be assessed to deal with problems). The directive also indicated that depositors should be paid quickly (no more than three months after a deposit became "unavailable").

Those drafting the directive recognized that the principles of mutual recognition and the single passport could cause difficulties for deposit protection schemes. If the deposit protection provided by a home country were much less than that of a host country, a branch within the host country might be at a competitive disadvantage. That is, the deposit products and services that it offered to the public would have a deposit guarantee that was smaller, or might have a requirement for co-payment in which the depositor shared in losses up to some specified amount. This competitive disadvantage seemed inconsistent with the spirit of the single market in which banks can enter markets and compete for the business of the public. For that reason, the directive allowed a bank with a low-coverage home-country scheme to enter a high-coverage market and join the host-country scheme for the difference. Doing this is referred to as "topping up." Thus, the host-country scheme provides deposit protection coverage in excess of what the home-country provides.[6]

In contrast, branches of banks with high home-country coverage do not have symmetrical treatment. That is, these branches cannot "export" their higher coverage to low-coverage countries and acquire a competitive advantage.

[5] For an assessment of the likely consequences of the single-market program, see Dermine (1993).

[6] Massachusetts illustrated a similar arrangement: a state-sponsored deposit insurance fund for savings banks provides 100 percent coverage. For Massachusetts savings banks that are also insured by the Federal Deposit Insurance Corporation, the Massachusetts deposit insurance agency provides a guarantee for deposits in excess of the FDIC's maximum, $100,000.

As a result of this directive, a number of different deposit protection schemes operate side by side in the single market, as table 4 indicates. Coverage varies greatly, ranging from €20,000 to €114,000. This variation implies a large difference in the amount of safety that can be provided from one country to the next. To be sure, the combination of topping up and no export implies that within a country, banks are offering the same guarantee. Yet as electronic banking and the single currency evolve, consumers will be able to access banking services originating anywhere in the EU, and the competitive implications of deposit protection may change. Another important competitive factor is the cost of delivering deposit services, including the guarantee. Even if the coverage for the deposit protection schemes of two countries is identical, banks may face different costs depending upon the method of funding the deposit protection scheme.[7]

In any event, the EU nations are relatively new at providing deposit protection schemes. Most of the schemes were set up either in anticipation of the Deposit Guarantee Scheme Directive or in reaction to a banking crisis. How this system of differently structured schemes can coexist in the context of a single market and single currency will have to be carefully evaluated, especially in a technological environment in which physical location of customer and bank matters less and less.

Summary of Single-Market Initiatives in Banking

The pieces for the single-market program in banking are now in place. All countries have enacted the legislation required by the directives; all EU countries now have the universal banking model;[8] all banks are permitted to enter into other nations' markets by branching, acquisition, and/or solicitation of business across borders by remote means; all consumers can deal with banks in their nations knowing that their deposits are protected; and all banks have the same capital rules, both as to how capital is measured and as to how much is sufficient.

However, until early 1999 all transactions across borders within the EU involved currency risk and transactions costs. Each nation had its own currency, and, for example, a bank that made a loan in a currency other than its own had to consider not only the normal credit risk but also the risk that the value of the other currency would change in relation to its own currency. Banks had to consider the risk involved in setting the price of the loan or had to engage in costly hedging activities to reduce these risks. In addition, the process of exchanging currency involved in these transactions entailed transactions costs. Finally, the quotation of prices and rates in many differing currencies reduced transparency and made it more difficult for consumers, businesses, and banks to make the comparisons necessary for markets to become more integrated.

On January 4, 1999, however, all of this changed, as the European Union launched its single currency for 11 of its 15 member nations.

The Single Currency: Background, Convergence Criteria, and Central Bank

The single currency began with the signing of the Maastricht Treaty (Treaty on European Union) by all EU heads of state in 1992. Appended to it was the Statute of the European System of Central Banks and of the European Central Bank.

The Maastrict Treaty set the stage for an historical change: sovereign nations agreed to go without their own monetary policy, give up the possibility of an exchange-rate policy, and accept limited flexibility in fiscal policy. For the nations participating in the single currency, there would be a single monetary policy. And because they would no longer have their own currency, it would no longer be possible for them to change the exchange rate to accomplish some national objectives. For example, a nation whose product prices were not competitive in world markets would not be able to effectively reduce those prices by lowering the value of its currency. Finally, the conditions for being considered for participation in the single currency required many EU nations to adopt restrictive fiscal policies regardless of the phase of their business cycle.

[7] In the United States, there has been much debate among savings institutions, commercial banks, and credit unions over the cost of delivering virtually identical deposit guarantees to the public.

[8] Of course, having the power to conduct particular types of business does not imply that all banks will do all things. Indeed, it is likely, for example, that a relatively small number of banks will be involved in investment banking activities.

Before the Maastricht Treaty, the EU had adopted a policy in which the central banks of the member nations would maintain the value of their currencies to each other within an agreed range. This was known as the Exchange Rate Mechanism (ERM). However, the policy did not work, partly because different nations were in different phases of their business cycles and, for some, maintaining the currency value resulted in a degree of monetary restrictiveness that was inappropriate for their domestic economy. The Exchange Rate Mechanism broke down in 1992.

With that experience in mind, those who wrote the Maastricht Treaty had two guiding principles: first, no nation is required to participate, and second, in order to participate, each nation has to satisfy *convergence criteria*. The convergence criteria were designed to ensure that all nations were starting from similar positions regarding inflation, public debt, interest rates, and exchange rates. The convergence criteria are as follows:

- **High degree of price stability.** Each country must attain an average rate of inflation that does not exceed the average inflation rate of the three best-performing member countries by more that 1.5 percentage points.
- **Sustainable government financial position**. The ratio of government deficit to gross domestic product (GDP) cannot exceed 3 percent, and the ratio of government debt to GDP cannot exceed 60 percent.
- **Long-term interest rates**. In the year preceding admission, a country's average nominal long-term interest rate may not exceed the average of the three best-performing member countries by more than 2 percentage points.
- **Participation in the narrow bands of the Exchange Rate Mechanism (ERM)**. In the two years preceding admission to the single currency, the currency of each member country must have remained within the normal bands of the ERM without experiencing severe tension.

In 1994 the EU established the European Monetary Institute (EMI) as a sort of "shadow central bank" and as a forum for coordinating the monetary and fiscal policies of the member nations in preparation for the single currency. Time passed, and some nations decided not to participate. In May of 1998, the participating nations were chosen (as listed in table 5).

On January 4, 1999, the transformation took place. On that date, for the participating nations, all government debt was denominated in euro, all stock market transactions and prices were in euro, and all monetary policy operations were in euro. Bank deposits and credit-card transactions were in either euro or the legacy currencies. At the outset there were no euro banknotes so coin and currency would still be denominated in the legacy currencies. The domestic legacy currency of each participating nation now had a fixed relationship to the euro. An analogy is the relationship of a U.S. ten cent piece (a dime) to a U.S. dollar: there are always ten dimes to a dollar. Similarly, there are always 6.55957 French francs to the euro, and so on for each nation. (The relationship of each legacy currency to the euro is shown in table 6.) The effort required was monumental, since all banks, all central banks and their large-value payment systems, all governments, and all financial institutions, stock exchanges, and business firms had to reprogram their computer systems extensively to accommodate the new currency. In addition, a new large-value payment system for euro, the Trans-European Automated Real-Time Gross Settlement Express Transfer system (TARGET), was implemented.

The monetary policy of the new single currency is conducted by the European System of Central Banks. This system includes the National Central Bank (NCB) of each country in the EU as well as the European Central Bank (ECB), located in Frankfurt, Germany. The ECB has two major parts, the Executive Board and the Governing Council. The six-member Executive Board (a president, vice president, and four directors) is appointed by the European Council, a body comprising the heads of state of the member countries. The Governing Council consists of the Executive Board and the heads of the member-country National Central Banks, who are appointed by their national governments.

The ECB's primary objective is to maintain price stability. To pave the way for it to do this, the treaty and appended statute give it considerable independence from the national governments and from the Community institutions.

This article leaves it to others to discuss the conduct of the EU's monetary policy, the political reality of the ECB's degree of independence, the difficulties that arise when countries have cyclical problems different from those of Euroland as a whole (asymmetric

shocks), the exchange value of the euro, the euro's role in the international monetary system, and other macroeconomic considerations. The focus here is on the implications of the single currency for the EU banking system.

Implications for Banking: Development of Money and Capital Markets

The European Union has now developed a regulatory framework for a single banking market and has implemented a single currency. All banks are subject to the same capital rules, and all member nations have installed deposit protection schemes. To the extent that the general conclusions of Price Waterhouse/Cecchini are valid, banking and financial markets in the European Union can be expected to change greatly. That is, consolidation should lead to economies of scale; with universal banking a choice for all banks in all nations, some banks can realize economies of scope; and greater competition should encourage all banks to become more efficient. As noted above, the extensive empirical tests conducted by Molyneux, Altunbas, and Gardener (1996) and Economic Research Europe, Ltd. (1997) support the general conclusion that these changes should take place.

Much discussion of the single market and single currency has focused on their implications for banking markets, that is, for bank consolidation, cross-border mergers, the pricing of bank services, and so forth. Not often looked at, however, is one very important outcome of the single currency: the movement toward more *direct* finance within the EU, as money and capital markets develop.

Table 2 shows that the ratio of bank assets to GDP is much higher for the EU than for the United States but that the United States has a much more highly developed market for bonds and equities and much more highly developed nonbank institutional investors, such as pension funds and mutual funds. One of the two main reasons for this observed difference is that the development of money and capital markets is enhanced by the existence of a single currency, and the United States has had a single currency for several hundred years. This longevity has allowed U.S. money and capital markets to develop breadth, depth, and resilience. For the EU, in contrast, developing such markets was more difficult because assets could not be easily accumulated in any one currency, and currency risks were added to the normal credit and market risks. The single currency and the large-value payment system, TARGET, should allow the trend toward direct finance to accelerate.

The second main reason for the observed difference in development of money and capital markets is that in the United States, although a single currency existed, banking markets were fragmented by the historical prohibitions on interstate banking and the separation of commercial and investment banking (Glass-Steagall). Thus, banks could not develop nationwide, and entities other than banks were supporting the development and operation of the money and capital markets.

Several observers (Davis [1999], McCauley and White [1997], and Prati and Schinasi [1997]) have noted that one implication of the single currency is the development of broad, deep, and resilient money and capital markets in the European Union.

To understand how this development might affect banks, one may review the role of banks in dealing with information asymmetries (the theory of financial intermediation places a great deal of emphasis on this role [Diamond 1984]). Information asymmetry means that those who seek funds have more information about the prospective risks and returns than the potential investor does. The potential investor must then expend real resources to obtain the necessary information, and this expenditure lowers the return on any investment. Moreover, once an investment is made, the use of the funds must be monitored. Banks are thought to specialize in resolving the informational asymmetries more efficiently than individual investors and in monitoring the use of the funds once committed.

However, technological change helps make accurate financial information available to many investors. That is, information is available in many forms, some of which involve the Internet, and many analysts follow the prospects of firms whose ownership is publicly traded. Under these circumstances it becomes progressively easier and cheaper for individual investors and nonbank institutional investors to make their assessments. Of course, this statement assumes that financial information is provided in a timely and accurate manner (transparency).

Banks are generally compensated for resolving informational asymmetries and for performing delegated monitoring by a difference between the interest

rates they pay to suppliers of funds (primarily depositors) and the interest rates they charge to borrowers. This difference (net interest margin) can be viewed as the cost of intermediation. To the extent that borrowers and suppliers of funds can effectively deal with each other directly, the net interest margin that would occur with financial intermediation is available to be divided between them. For very large transactions, the costs per unit of currency (in this case, either dollar or euro) are relatively low; hence such transactions will probably be the best candidates for direct finance.

Thus, the development of money and capital markets in the EU implies that many of the banks' best customers will borrow long term in the bond markets and short term in the commercial paper markets. It also implies that many of the banks' largest depositors will invest directly in the money and capital markets. The result is likely to be a substantial change in the size and structure of bank balance sheets over time. The very best borrowers will move off the banks' balance sheets. What is left will be those borrowers for whom the bank can make a real contribution to financial intermediation—that is, borrowers whose financial information is not easily and cheaply transparent to potential suppliers of funds. Fund suppliers who can assess the prospects of potential investments in the money and capital markets will supply funds directly, leaving those depositors who do not have the resources to resolve information asymmetries. This development will be favorable to the overall level, cost, and efficiency of financial activity in the EU, but because banks' share of total finance will decline over time, the adjustment will impose costs on banks. Although for European banking the prospect of losing business over time hardly seems grounds for optimism, there are three offsetting factors. First, large corporations with very high credit ratings are paying the lowest rates for any of their borrowing. Large corporations with substantial pools of funds available for short-term investment will demand the highest rates on deposits. Hence, the movement of such activity off the balance sheet should result in higher net interest margins. In the United States, where banks have a smaller share of total finance, net interest margins are higher than those in the EU.

Second, because banks in the United States are more profitable than banks in the EU, it seems reasonable to maintain that a smaller share of total finance can be consistent with strong profitability.

Third, because of universal banking in the EU, many transactions that flow to the money and capital markets will be handled in the investment banking departments of the bank rather than in the credit or deposit departments. Bonds and shares need to be underwritten, and commercial paper may be guaranteed. All such activity must eventually result in placement of securities with investors. The result should be fee income.

Conclusion: Assessments of the Single-Market Program in Banking, Past and Future

Although the single-market program in banking has been in place since 1993, it was the single currency that marked a dramatic change in the EU's financial environment. The single currency, of course, has existed for only a short time, so one cannot yet assess its affect, but one can review the single-market experience up to and including 1996. One may also make reasonable assumptions about the future on the basis of an analysis of the EU's experience with the single market and on the prospects now that the single currency is in place.

The European Union has undertaken a number of studies of the effects of the single-market program in many areas, such as manufacturing, services, trade, and so forth. All of these studies are part of a series known as the *Single Market Review*. Volume 3 of that series, entitled *Credit Institutions and Banking* (1997) was prepared by a team of distinguished scholars under the auspices of Economic Research Europe, Ltd., and contains an exhaustive analysis of the single market's effect on banking. The analysis is based on econometric analysis, surveys of bankers, and detailed case studies in EU countries. The findings may be summarized as follows:

- The Single Market Program (SMP) has had a positive effect on competition and strategy in many product lines and in a number of countries. However, barriers to achieving the goals of the SMP remain.
- It is difficult to disentangle the effects of the SMP from other factors, such as technology and globalization, on the one hand, and the capital regulations implemented at the same time, on

the other hand. That is, technology and globalization would enhance the move to greater competition, reducing the spread between rates charged to borrowers and rates paid to depositors, while at the same time higher capital regulations would push in the other direction.

- Although progress in eliminating regulatory barriers has been impressive, it is not complete. One sector where obstacles remain is mortgage credit. This sector involves a number of issues, including access to capital markets, national subsidies to housing and mortgage credit, and tax law.
- Differences in taxation and fiscal policy affect competition for financial services. For example, in some countries the deductibility of mortgage interest for income tax purposes depends on the borrower's dealing with a domestic lender. Another example: tax-favored investments (analogous to IRAs, 401[k] plans, *etc.*) may be tied to domestic institutions. Such incentives influence consumer choice of financial services in such a way as to constitute a barrier to competition.
- Restrictive labor laws and regulations make it difficult for banks to realize benefits from a more competitive environment. The consolidation that occurs when economies of scope and scale and increases in efficiency are possible implies that labor will probably be displaced. In many countries, displacing labor is difficult to do.
- In some cases, large public-sector involvement in banking involves implicit or explicit guarantees by the state. These give such institutions a competitive advantage not related to the efficiency and effectiveness of their delivery of financial services. In addition, national governments are reluctant to close banks, especially large ones, and this reluctance gives banks perceived as "too big to fail" an advantage.

Notwithstanding these restrictions, there is ample evidence of pro-competitive behavior by banks:

- Prices on particular services are converging to a lower average value, especially in countries that were highly protected before the SMP.
- Case studies and postal surveys show that banks have taken strategic steps to control costs, to increase market share and scale by merging, and to focus on enhancing shareholder value rather than engaging in regulatory capture activities and other noncompetitive behaviors.
- Merger activity, both within countries and cross-border, has increased.
- Measured productive inefficiencies have been reduced, and the reduction has moved banks closer to the "best practices" frontier.

What are the prospects for the banking industry in the EU? A number of commentators have discussed this, but the focus here is on two recent contributions, one by White (1998) and the other by the European Central Bank (1999). First, though, it should be noted that banking in the EU is not homogeneous, even though most of the discussion below focuses on the entire area. Marked differences exist between, on the one hand, the banking system of the United Kingdom, the Netherlands, and Ireland and, on the other hand, those of the remainder of Western Europe. The banking tradition of the United Kingdom was similar to that of the United States, and the tradition is generally referred to as the "Anglo-Saxon" model, with limited banking and limited state involvement in the management of individual banks. The Netherlands and Ireland are small, open economies with relatively free financial systems. The rest of Western Europe is characterized by a tradition of universal banking and of state involvement in the ownership and management of financial institutions. Moreover, these nations tend to have more restrictive labor laws. For that reason, White focuses on the potential changes in Continental Europe, and the title of his contribution is "The Coming Transformation of Continental European Banking?"

White concludes as follows: (1) Most of the concerns of the Price Waterhouse/Cecchini report still apply to banking in Continental Europe: too many banks (effects on scale), too many branches (effects on scale), too many employees (effects on efficiency). (2) There is too much state intervention in these banking systems: state-owned banks account for large percentages of banking assets in Italy, Germany, and France, the three largest continental economies. (3) Notwithstanding these difficulties, increased attention is being paid to cutting costs and to reorienting management's focus on activities that increase shareholder wealth rather than increasing market share. Moreover, banks have increased the level of risk in their portfolios in part because of the lack of availability of low-risk government securities as a consequence

of the fiscal policies of the Economic and Monetary Union. (4) Merger and acquisition activity has increased substantially but is focused first on within-country mergers (cost cutting) and mergers of banks with nonbank providers of financial services (economies of scope). Cross-border merger activity is expected to increase.

The European Central Bank's report includes substantial data comparing EU countries with the United States and Japan on many aspects of banking activities and structure. The report was supported by staff of all of the EU members' national central banks and independent banking supervisors. They agree with many of the conclusions reached by White (1998) and Economic Research Europe, Ltd. (1997). Their own conclusions are the following:

- Eliminating commissions and fees from foreign-exchange trading within the single market will substantially affect bank profitability in the short run.
- Money and capital market developments spurred by the single currency will force banks to face disintermediation. They will need to focus on activities to support that shift and will need to gain fee income from underwriting and placement.
- Banks will expand both within country and cross-border not only to achieve economies of scale and scope but also to diversify credit risk across a wider geographic area. With currency risk eliminated inside Euroland, banks can focus on wider geographic patterns of lending and therefore on greater diversification.
- Although concentration ratios for individual countries within the EU are quite high, if all of the single-market area, or the single-currency area, is considered the relevant market, concentration ratios are quite low. Thus, there is room for consolidation without too much worry about anticompetitive consequences.
- Merger patterns show that cross-border activities are preceded by a phase of in-country defensive moves to mop up excess capacity and achieve critical scale levels. There is some evidence that nationalistic sentiments on the part of some governments have a dampening effect on the free movement of banks across national borders.
- Since markets are contestable and EU banks have excess capacity and low profit rates, there is no alternative to a restructuring of the banking sector in the medium and long terms.
- Two related issues must be considered. First, the need to increase revenue and profits may tempt some banks to take excessive risks. Second, building large pan-European banks with home offices in small countries raises the question of the costs of resolving failures and the deposit insurers' temptation to consider some banks "too big to fail." Well-known moral hazard issues are involved.

In summary, there is substantial agreement that the EU financial environment will change dramatically over time. The effects of globalization and technology that all banks in all countries are facing will be reinforced by several major initiatives that the EU has put in place. Increased competition from money and capital markets will change the nature of banking and financial intermediation in Europe. Excess capacity, uneconomic size and structures of banks, and inefficiency will all be eliminated over time. Deregulation, globalization, technological change, and macroeconomic policy are all exerting pressure in the same direction.

In summary, the implications of the single market in banking and the single currency for the EU's financial system and banking structure are significant. Inevitably, money and capital markets will develop for the single-currency area, and their existence will remove business from both sides of their balance sheets. Fortunately, the banks will be able to offer the investment banking services to support money and capital market development.

Although it is generally agreed that banking in the EU has serious problems of excess capacity and uneconomic scale and that adjustment to a more competitive environment will be hampered by restrictive labor laws, nonetheless the signals are fairly clear. To survive and prosper, banking in Europe will need to adapt to the changes in the environment. And with 11 more nations applying for membership in the European Union and working to meet the standards for joining,[9] the banking and financial context described here may eventually encompass a population of 400 million people.

[9] The 11 nations are Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

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APPENDIX

A SELECT CHRONOLOGY OF EVENTS RELATED TO THE EUROPEAN UNION

- September 1946—Winston Churchill calls for a United States of Europe.
- April 1951—Belgium, France, Germany, Italy, Luxembourg, and the Netherlands (the Six) sign the Treaty of Paris establishing the European Coal and Steel Community.
- March 1957—The Six sign treaties establishing the European Economic Community (EEC) and the European Atomic Energy Community (Euroatom) in Rome ("Treaties of Rome").
- January 1958—The Treaties of Rome enter into force.
- January 1973—Denmark, Ireland, and the United Kingdom join the European Community.
- January 1981—Greece joins the European Community.
- June 1985—European Commission sends European Council a White Paper on Completion of Internal Market by 1992. Later that month the White Paper is approved by the European Council.
- January 1986—Spain and Portugal join the European Community.
- February 1987—Jacques Delors presents European Commission's program for 1987 to the European Parliament, accompanied by the communication "The Single Act: A New Frontier for Europe."
- February 1992—Treaty on European Union signed in Maastricht by foreign and finance ministers of Member States ("Maastricht Treaty").
- January 1993—The Single European Market enters into force.
- January 1995—Austria, Finland, and Sweden become members of the European Union.
- May 1998—Eleven Member States satisfy conditions for adoption of the single currency. The Governments of the Member States adopting the single currency appoint the president, vice president and the other members of the Executive Board of the European Central Bank.
- January 1999—Eleven Member States adopt the euro as their official currency.

Source: European Union, *Yearly Chronology of the European Union*.

Table 1

POPULATION AND GROSS DOMESTIC PRODUCT (GDP) EUROPEAN UNION, EUROLAND, AND THE UNITED STATES, 1998

Entity	Population	GDP (€ Billion)
European Union	374,566,000	€ 7,472.5
Euroland	290,832,000	5,776.1
United States	266,490,000	7,269.4

Source: Eurostat (Statistical Office of the European Communities), 2000. All data are expressed in terms of ECU (European Currency Unit) because the euro did not exist in 1998. However, upon adoption of the single currency, 1 ECU = €1.

Table 2

FINANCIAL STRUCTURE OF EUROPEAN UNION, EUROLAND, AND THE UNITED STATES, 1996

	Equities/ GDP (Percent)	Government Bonds/ GDP (Percent)	Private Bonds/ GDP (Percent)	Bank Assets/ GDP (Percent)	Total/ GDP (Percent)	Institution Assets/ GDP (Percent)
European Union	55%	56%	36%	207%	354%	74%
Euroland	35	55	34	206	330	59
United States	117	96	60	73	346	145

Source: Davis (1999).

Table 3

BANKING ACTIVITIES PERMITTED IN THE EUROPEAN UNION

- Deposit taking and other forms of borrowing
- Lending (including consumer credit, mortgage credit factoring, invoice discounting, and trade finance)
- Financial leasing
- Money transmission services
- Payments services (including credit cards, electronic funds transfer, point of sale, travelers checks, and bank drafts)
- Providing guarantees and commitments
- Trading on their own account or for customers in money-market instruments, foreign exchange, financial futures and options, exchange and interest-rate instruments, and securities
- Participating in share issues and providing services related to such issues (for shares, bonds, and other securities), including corporate advice and arranging mergers and acquisitions
- Money brokering
- Portfolio management and advice
- Safekeeping of securities
- Offering credit reference services
- Safe-custody services

Table 4

SUMMARY OF DEPOSIT PROTECTION SCHEMES IN EUROPEAN UNION

Country	Funded	Coverage	Premium	Location of Deposit Insurance Agency
Austria	No	€ 22,000	ex post, pro rata	Private
Belgium	Yes	€ 20,000	.02% insured liabilities	Bank supervisory agency
Denmark	Yes	€ 20,000	.2% insured deposits (max.)	Bank supervisory agency within central bank
Finland	Yes	€ 27,000	.05% to .3% (risk-based) on insured deposits	Supervised by bank supervisor and ministry of finance
France	No	€ 60,000	on demand, but limited	Responsibility of bank supervisor, part of central bank
Germany	Yes	90% of capital for savings banks, 90% of deposit up to € 20,000 for commercial banks	.03% of insured deposits	Private
Greece	Yes	€ 20,000	.025% to 1.25% of deposits	Private
Ireland	Yes	90% coinsurance to € 22,222	.2% of insured deposits	Private
Italy	No	€ 114,000	ex-post risk adjusted .4% to .8%	Part of central bank
Luxembourg	No	90% coinsurance to € 22,222	ex-post	Private
Netherlands	No	€ 20,000	ex-post	Private
Portugal	Yes	€ 20,000, coinsurance to € 45,000	risk-based .08% to .12% of insured deposits	Private
Spain	Yes	€ 20,000	max. of .2% of insured deposits	Private
Sweden	Yes	€ 20,000	max. of .2% of insured deposits	Part of ministry of finance
United Kingdom	Yes, small (mostly ex post)	coinsurance to € 22,222	on demand	Separate legal entity staffed by bank supervisor

Source: Garcia, (1999).

Table 5

NATIONS IN EUROPEAN UNION AND IN SINGLE-CURRENCY AREA

European Union	Single-Currency Area (Euroland)
Austria	Austria
Belgium	Belgium
Denmark	
Finland	Finland
France	France
Germany	Germany
Greece	
Ireland	Ireland
Italy	Italy
Luxembourg	Luxembourg
Netherlands	Netherlands
Portugal	Portugal
Spain	Spain
Sweden	
United Kingdom	

Table 6

LEGACY CURRENCY VALUES IN RELATION TO THE VALUE OF ONE EURO

Nation and Currency	Number of Units per Euro
Austria—Schilling	13.760300
Belgium—Belgian Franc	40.339900
Germany—Mark	1.955830
Spain—Peseta	166.386000
Finland—Markka	5.945730
France—French Franc	6.559570
Ireland—Punt	.787564
Italy—Lira	1,936.270000
Luxembourg—Belgian Franc	40.339900
Netherlands—Guilder	2.203710
Portugal—Escudero	200.482000

Recent Developments Affecting Depository Institutions

by Lynne Montgomery*

REGULATORY AGENCY ACTIONS

Interagency Actions

Gramm-Leach-Bliley Financial Services Modernization Act

On November 12, 1999, President Clinton signed into law a bill allowing banking, insurance, and securities firms to affiliate, and creating rules aimed at protecting consumers and low-income communities. The Gramm-Leach-Bliley Act is the result of approximately two decades of effort to repeal the anti-affiliation provisions of the 1933 Glass-Steagall Act and the 1956 Bank Holding Company Act. In general, the Gramm-Leach-Bliley Act: lifts restrictions on affiliations among banks, securities firms, and insurance companies; expands the financial activities permissible for financial holding companies and insured depository institutions; and provides for a greater degree of functional regulation of securities and insurance activities conducted by banking organizations. The Act will also expand the reach of the Community Reinvestment Act (CRA) by requiring banks to have at least "satisfactory" CRA ratings to take advantage of the new law's expanded powers. In addition, the Act takes significant steps to protect consumers' financial privacy, such as requiring financial institutions to disclose their privacy policies and allowing consumers to block their financial institutions from sharing personal financial information with third parties. The Act also directs the Treasury Department to study the financial-services industry's privacy practices and recommend further legislative steps. The Act becomes effective on March 11, 2000. *BBR, 11/15/99, p. 765–766*.

Independent Audits for Small Banks and Thrifts

On September 28, 1999, the Federal Financial Institutions Examination Council (FFIEC) issued an interagency policy statement on external auditing programs of banks and savings associations. The policy statement recommends, but does not require, that banks and thrifts with assets under $500 million undergo external audits annually. The FFIEC noted that approximately 65 percent of smaller institutions already undergo external audits. The policy statement is aimed at smaller institutions because larger institutions are already required to undergo annual audits by independent certified public accountants. The policy statement is effective for fiscal years beginning on or after January 1, 2000.

The FFIEC is made up of representatives of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC). The National Credit Union Administration is also a member of the group, but does not plan to adopt the policy at this time. *BBR, 10/4/99, p. 518–519*.

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

Reference sources: *American Banker* (AB) and *BNA's Banking Report* (BBR).

Extended Exam Cycle for Foreign Banks

On October 22, 1999, the Federal Reserve Board, the OCC, and the FDIC adopted a final rule to expand the examination frequency cycle for certain U.S. branches and agencies of foreign banks. The rule finalizes an interim rule, which was effective August 28, 1998, that made healthy, smaller U.S. branches and agencies of foreign banks eligible for exams every 18 months, instead of every 12 months. U.S. banks were given the opportunity to have exams every 18 months in a 1991 law, but foreign banks were not afforded the same treatment at that time. The extended exam cycle applies to U.S. branches or agencies of a foreign bank that have total assets of $250 million or less and have received a supervisory ROCA rating of 1 or 2. (ROCA stands for risk management, operational controls, compliance, and asset quality.) In addition, the foreign bank branch or agency must meet certain specified capital requirements and must not be subject to any formal enforcement action by U.S. regulators. *PR-FRB, 10/21/99; BBR, 10/25/99, p. 649*.

Web Site Privacy Survey

On November 9, 1999, the Federal Reserve Board, the OCC, the FDIC, and the OTS released a report on the results of a survey of Internet privacy policies of banking and thrift institutions. The survey examined 314 randomly selected Web sites of financial institutions, plus the Web sites of the 50 largest banks and thrifts. The agencies conducted the survey between May and July 1999, examining the Web sites' collection of consumer information, interactive capabilities, and privacy disclosures. The purpose of the survey was to provide an indication of the state of the industry with respect to data collection and on-line privacy disclosures. The survey results were published in the *Interagency Financial Institution Web Site Privacy Survey Report*.

Overall, 48 percent of the 364 Web sites surveyed posted a privacy disclosure, in the form of either a privacy policy or an information practice statement. Sites that collected personal information were three times as likely to post a privacy policy than sites that did not collect personal information. The survey also found that 96 percent of the nation's 50 largest banks and thrifts that are on-line provided a privacy policy or information practice statement. The agencies define a privacy policy as "a comprehensive statement regarding the collection and use of consumer information," and an information practice statement is "a statement describing a particular information handling practice, such as data security." *PR-66-99, FDIC, 11/9/99; BBR, 11/15/99, p. 774*.

Guidance on Asset Securitization Activities

The four federal banking agencies released guidance on December 13, 1999, reminding financial institutions of basic risk-management practices that should be in place at institutions engaging in securitization activities. The agencies said that recent examinations have shown "significant weaknesses" in the asset securitization activities at certain financial institutions, and they noted that such weaknesses raise concerns about the basic level of understanding and controls at financial institutions that engage in securitization activities. The guidance highlights the risks associated with retained interests in securitizations, and points out that reported values for retained interests should be reasonable, conservative and supported by objective and verifiable documentation. The guidance states that institutions should ensure that sufficient capital is held to support the risks associated with securitization activities, and the institutions are expected to place concentration limits on retained interests relative to equity capital. In addition, the guidance states that institutions should establish and implement an adequate and independent audit function to oversee securitization activities effectively. The guidance, which was issued by the FDIC, the Federal Reserve Board, the OCC, and the OTS, is part of the agencies' ongoing review of securitization activities at insured depository institutions. *PR-80-99, FDIC, 12/13/99; BBR, 12/20/99, p. 983*.

Federal Deposit Insurance Corporation

Chairman Tanoue Renominated

On January 31, 2000, President Clinton renominated FDIC Chairman Donna Tanoue to a new six-year term. Ms. Tanoue, who joined the FDIC as Chairman on May 26, 1998, is currently finishing the term of former FDIC Chairman Ricki Helfer. Her term was set to expire on October 3, 2000. *BBR, 2/7/00, p. 243*.

Houseworth Nominated to Board of Directors

President Clinton nominated Richard H. Houseworth to the FDIC Board of Directors on January 31, 2000. Mr. Houseworth is the Superintendent of Banks for the State of Arizona. He has served as the U.S. Alternate Executive Director of the Inter-American Development Bank and as both a consultant to the Assistant Secretary of the Treasury for International Affairs and as the Director of the Export-Import Bank of the United States. *Bloomberg News, 1/31/00.*

Assessment Rates Maintained

The FDIC Board of Directors voted on November 8, 1999, to maintain the existing insurance assessment rate schedules for both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) through June 2000. Since the FDIC applies a risk-based assessment system for insurance coverage, the healthiest institutions currently pay nothing for insurance and the weakest institutions pay up to 27 cents per $100 of insured deposits. Federal law requires the FDIC to maintain a minimum reserve ratio of 1.25 percent, or $1.25 for every $100 of insured deposits, in the BIF and the SAIF to cover the costs of bank and thrift failures. As of June 30, 1999, the BIF reserve ratio was 1.40 percent and the SAIF ratio was 1.29 percent. *BBR, 11/15/99, p. 771–772.*

Municipal Securities Rule Rescinded

Effective December 19, 1999, the FDIC rescinded an agency regulation that requires insured state nonmember banks that are municipal securities dealers to file with the FDIC certain information about potential municipal securities principals. The FDIC says the regulation is unnecessary and duplicative, and the number of entities covered by the regulation is declining. The OCC and the Federal Reserve Board have already rescinded their regulations on this subject; thus, the FDIC's rescission maintains uniformity among the banking agencies. *BBR, 11/22/99, p. 822–823*.

Report on Underwriting Practices

The October 1999 issue of the *Report on Underwriting Practices* reported no significant change in overall loan underwriting practices at FDIC-supervised banks during the six months ending September 30, 1999, compared to the previous six-month period ending March 31, 1999. However, the FDIC examiners reported increased concerns about the level of "carryover debt" at FDIC-supervised banks actively making agricultural loans. Carryover debt refers to loans that are not paid off at the end of the growing season and are subsequently carried over into the next growing season. The survey of loan 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. The October report includes surveys from 1,227 FDIC-supervised banks that were examined during the six months ending September 30, 1999. *Report on Underwriting Practices*, *FDIC, October 1999*.

Real-Estate Survey—October 1999

The October 1999 issue of the *Survey of Real Estate Trends* reported that the nation's commercial and residential real-estate markets continued to show improvement in the late summer and early fall, but at a slower pace than before. The quarterly survey polled 297 senior examiners and asset managers from the FDIC, the Federal Reserve System, the OCC, and the OTS. Reports about residential real-estate-market activity were notably less positive than in recent surveys; however, assessments of improvements in residential markets continued to outweigh reports of worsening market activity. Specifically, 31 percent of the survey respondents described the general direction of their local housing market as better in October than three months earlier, compared to 45 percent in July. Reports of weaker housing markets increased from 3 percent in July to 10 percent in October. As for commercial market trends, 33 percent of the respondents in October noted better conditions in local markets, down slightly from 35 percent in July.

The national composite index used by the FDIC to summarize results for both residential and commercial real-estate markets was 62, down from 69 in July. Index scores above 50 indicate improving conditions, while index scores below 50 indicate declining conditions. Beginning in 2000, the FDIC will conduct a substantially revised and expanded semi-annual survey, covering the periods January to June and July to December. As a result, the next FDIC

published real-estate report is expected to be available in August 2000. *Survey of Real Estate Trends, FDIC, October 1999*.

Financial Results for Third-Quarter 1999

The FDIC reported that the Savings Association Insurance Fund (SAIF) earned income of approximately $365 million for the first nine months of 1999; however, the Bank Insurance Fund (BIF) experienced a comprehensive loss (net loss plus unrealized loss on available-for-sale securities) of $113 million for the first nine months of 1999. At September 30, 1999, the BIF balance was approximately $29.5 billion, down from $29.6 billion at year-end 1998. The decrease in the fund balance was primarily attributable to recognizing estimated losses of $917 million for the resolution of bank failures in 1999 and the prior year. The BIF revenues totaled $1.4 billion for the first nine months of 1999, including $1.3 billion in interest on investments in U.S. Treasury obligations and $25 million in deposit insurance assessments. The SAIF closed the quarter with an unrestricted fund balance of $9.2 billion and $978 million in the restricted SAIF Special Reserve. The Special Reserve was established on January 1, 1999, and contains the amount by which the SAIF exceeds the Designated Reserve Ratio of 1.25 percent. However, the Gramm-Leach-Bliley Act of 1999 eliminated the SAIF Special Reserve upon enactment on November 12, 1999, so the SAIF's total fund balance is now unrestricted. The SAIF earned $442 million in revenue during the first nine months of 1999, consisting of $432 million in interest on investments in U.S. Treasury obligations and $10 million in deposit insurance assessments.

The FSLIC Resolution Fund (FRF) returned $3.7 billion in appropriated funds to the U.S. Treasury in the third quarter, pursuant to the RTC Completion Act. The Act required the FDIC to return any funds that were transferred to the Resolution Trust Corporation (RTC) pursuant to the Act but not needed to satisfy obligations of the RTC. FRF assets in liquidation were reduced to $592 million on September 30, 1999. The FRF was established in 1989 to assume the remaining assets and obligations of the former Federal Savings and Loan Insurance Corporation (FSLIC). On January 1, 1996, the former Resolution Trust Corporation's financial operations were merged into the FRF. *PR-81-99, FDIC, 12/14/99*.

Bank Failures

On November 19, 1999, the California Superintendent of Banks closed Pacific Thrift and Loan Company, Woodland Hills, California, and the FDIC was named receiver. Pacific Thrift and Loan had total assets of approximately $118 million and total deposits of $108 million in roughly 2,600 accounts. Affinity Bank, Ventura, California, paid a premium of $350,000 to assume the failed institution's $106 million of insured deposits and to purchase approximately $13 million of the assets. The FDIC will retain the remaining assets for later disposition. The FDIC estimates that this transaction will cost the Bank Insurance Fund (BIF) approximately $50 million. Pacific Thrift and Loan was the sixth failure of a BIF-insured institution in 1999.

On December 10, 1999, the New York Superintendent of Banks closed Golden City Commercial Bank, New York, New York, and the FDIC was named receiver. Golden City was a state-chartered bank with total assets of approximately $89 million and total deposits of $82 million. Cathay Bank, Los Angeles, California, paid the FDIC a premium of $2.7 million to assume all the deposits and purchase approximately $85 million of the failed bank's assets. This was the seventh failure of a BIF-insured institution in 1999; however, the FDIC anticipates that this will be a no-cost transaction for the BIF.

The Iowa Superintendent of Banking closed Hartford-Carlisle Savings Bank, Carlisle, Iowa, on January 14, 2000, and the FDIC was named receiver. Hartford-Carlisle had approximately $114 million in assets and total deposits of $69 million in approximately 7,700 accounts. The FDIC approved the assumption of the insured deposits of Hartford-Carlisle by Citizens Bank, Carlisle, Iowa. Citizens Bank, a newly chartered subsidiary of Spectrum Bancorp, Omaha, Nebraska, paid a premium of $5.5 million to assume the insured deposits and to purchase approximately $4 million of the failed institution's assets. The FDIC will retain the remaining assets for later disposition. The FDIC has identified apparent fraud at the failed bank and estimates that the losses at the bank will range between $18 million and $25 million. Hartford-Carlisle is the first failure of a BIF-insured bank in 2000. *PR-71-99, FDIC, 11/22/99; PR-79-99, FDIC, 12/10/99; PR-4-2000, FDIC, 1/14/00.*

Federal Reserve Board

Greenspan Confirmed for Fourth Term

On February 3, 2000, the U.S. Senate voted to confirm Alan Greenspan to serve a fourth, four-year term as chairman of the Federal Reserve Board. Mr. Greenspan's current term was due to expire on June 20, 2000. He was first appointed by President Reagan and took office as chairman on August 11, 1987. President Bush named Mr. Greenspan to a second term in 1991, and President Clinton tapped him for his third term in February 1996. *BBR, 1/13/00, p. 59; BBR, 2/7/00, p. 243–244*.

Senate Confirms Vice Chairman

On September 30, 1999, the Senate confirmed the nomination of Roger W. Ferguson as vice chairman of the Board of Governors of the Federal Reserve System. Mr. Ferguson has been a member of the Board of Governors since November 1997. In August 1999, President Clinton nominated Mr. Ferguson to fill the vice-chairman seat, which is a four-year appointment. Mr. Ferguson replaces Alice Rivlin, who left the Federal Reserve Board in mid-summer 1999. *BBR, 10/4/99, p. 517*.

Interest Rates

On November 16, 1999, the Federal Open Market Committee (FOMC) voted to raise the targeted federal funds rate by 25 basis points, increasing the rate from 5.25 percent to 5.50 percent. In a related action, the Board of Governors approved a 25-basis-point increase in the discount rate, raising the rate from 4.75 percent to 5.0 percent. The FOMC raised the federal funds rate an additional 25 basis points on February 2, 2000, increasing the rate to 5.75 percent. The Board of Governors also approved a 25-basis-point increase in the discount rate, raising the rate to 5.25 percent. The federal funds rate is the fee that banks charge each other for overnight loans, and the discount rate is the fee charged to financial institutions for borrowing from their district Federal Reserve Banks. *PR-FRB, 11/16/99; PR-FRB, 2/2/00*.

New Communications Procedures for Federal Open Market Committee

The Federal Open Market Committee announced on January 19, 2000, that it approved modifications to its disclosure procedures in an effort to enhance communication to the public. The FOMC determined that a statement would be issued to the public immediately after every FOMC meeting. The previous procedure was to release a statement only in the event of a policy action or a major shift in the Committee's view about prospective developments. The FOMC also changed its language describing its assessment of future developments. The prior procedure was to describe the FOMC's view about the period ahead in terms of the relative chances of an increase or decrease in the intended federal funds rate. Under the new procedures, an announcement will indicate how the Committee assesses the risks of heightened inflation pressures or economic weakness in the foreseeable future. The modifications take effect as of the February 2000 FOMC meeting. *PR-FRB, 1/19/00*.

Regulation CC

The Federal Reserve Board adopted a final rule amending Regulation CC, Availability of Funds and Collection of Checks, in order to give banks the option to experiment with nontraditional ways to return unpaid checks, such as by electronic means. However, using an electronic image for check presentment will be optional and by agreement for those institutions that want to participate. Institutions will not be required to enter into such an agreement involving electronic check processing. The final rule was effective December 15, 1999. *PR-FRB, 10/28/99; BBR, 11/8/99, p. 727*.

HMDA Reporting Exemption Threshold Increased

The Federal Reserve Board announced on December 15, 1999, that the exemption threshold for depository institutions that are required to report data under the Home Mortgage Disclosure Act (HMDA) was increased from $29 million to $30 million. Beginning December 31, 1999, depository institutions with assets of $30 million or less will be exempt from reporting data on their housing-related lending activities in 2000. The final rule amends Regulation C, which implements the Home Mortgage Disclosure Act. The asset level that releases institutions from reporting data under HMDA is adjusted each year on the basis of changes in inflation as measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers. *PR-FRB, 12/15/99; BBR, 1/3/00, p. 10*.

Interim Rule for Bank Holding Companies and Foreign Banks with U.S. Offices

On January 19, 2000, the Federal Reserve Board approved an interim rule setting forth procedures for bank holding companies and foreign banks with U.S. offices to elect to be treated as financial holding companies. Financial holding companies may engage in a broad range of securities, insurance, and other financial activities under Title I of the Gramm-Leach-Bliley Act. The rule becomes effective on March 11, 2000, which is also the effective date of the Gramm-Leach-Bliley Act. *PR-FRB, 1/19/00*.

Office of the Comptroller of the Currency

Hawke Confirmed by Senate

On October 7, 1999, the Senate confirmed John D. Hawke, Jr. for a five-year term as Comptroller of the Currency. Mr. Hawke has held this office since December 8, 1998, after being appointed by President Clinton during a Congressional recess. *NR 99-92, OCC, 10/8/99*.

1999 Survey of Credit Underwriting Practices

In its 1999 Survey of Credit Underwriting Practices, which was released in September 1999, the OCC reported that national banks tightened their underwriting standards for commercial loans in 1999 for the first time in the past five years. The survey covered the period between March 31, 1998, and March 31, 1999. The OCC looked at the 67 largest domestic banks with assets of over $2 billion. The aggregate loan portfolio of the banks in the survey was $1.8 trillion as of December 31, 1998, which represents 90 percent of all outstanding loans at U.S. banks. Examiners at 25 percent of the banks surveyed reported tightened underwriting standards for commercial loans in 1999, compared with 4 percent in 1998. At the same time, examiners at 13 percent of the surveyed banks reported an easing of underwriting standards in 1999, compared to 44 percent in 1998. Additionally, the survey found that international loans, syndicated and national loans, and agricultural loans experienced the most pronounced tightening in underwriting standards, while commercial real-estate and middle market credits experienced the most easing of underwriting standards. Despite the reported tightening of standards, examiners reported that the level of inherent portfolio credit risk continued to increase for all of the surveyed commercial and retail products. This embedded risk is the result of banks taking on higher levels of risk in previous years, which will take time to work its way through the loan portfolios. *BBR, 10/4/99, p. 513–514*.

New Handbook on Internet Banking

The OCC issued a new handbook on October 14, 1999, outlining procedures for examining Internet banking activities at national banks. The handbook, which is part of the Comptroller's Handbook for National Bank Examiners, is the most comprehensive document on Internet banking issued by the OCC to date. The handbook outlines risks unique to Internet banking. For example, the handbook notes that Internet loan customers can be anywhere in the world which creates special challenges in authenticating identities, an important element in making sound credit decisions. In addition, Internet banking customers react quickly to changing market conditions and could create deposit volatility for banks. The handbook emphasizes that interest-rate and liquidity risk can exist with Internet customers, which might require increased monitoring of liquidity. Additional issues addressed in the handbook are: customer privacy, the anonymity of banking over the Internet, and the threat from intruders into bank systems. *NR 99-94, OCC, 10/14/99*.

Final Rules Reduce Regulatory Burden on Community Banks

On November 4, 1999, the OCC adopted final rules that will reduce the regulatory burden on community banks. One change to Part 7 of the OCC's regulations allows banks to buy back their own stock more easily and to pay cash for the acquired shares. This increased flexibility will make it easier for community banks to meet Subchapter S status, which permits smaller corporations (those with fewer than 75 shareholders) to avoid paying corporate taxes. Another Part 7 rule change increases the number of ways bank directors can hold required stock interests, called "qualifying shares," in the bank they serve. Directors may now acquire qualifying shares under an agreement that would give the seller the right to repurchase the shares if the director ceases to serve on the board or seeks to transfer ownership to another. This change is designed to improve the ability of

national banks to attract qualified directors. The final rules also state that, because automated teller machines and other remote service units are excluded from the definition of a branch under federal law, they are not subject to state geographic restrictions, operational restrictions, or licensing laws. Further, the rules clarify that a facility that combines non-branch functions of a loan production office, deposit production office, and remote service unit is not a branch. The final rules also clarify the scope of the OCC's "visitorial" powers over national banks. This authority applies in the case of an examination of a bank, inspections of a bank's books or records, regulation and supervision of activities permitted under federal banking law, and enforcement of compliance with any applicable federal or state laws on such activities. *NR 99-99, OCC, 11/3/99; BBR, 11/8/99, p. 726.*

Information-Sharing Accord

The OCC and insurance regulators in Illinois, Iowa, Mississippi, and Washington, D.C., have reached agreements to share information when consumers complain about bank insurance sales. The agreements are part of an ongoing effort to improve relations between the OCC and state insurance regulators. The agreements call for the OCC and the insurance departments to send copies of complaints to each other and also to communicate on other matters, including regulatory and policy initiatives. The OCC now has agreements with 23 state insurance regulators. The agreements enhance consumer protection and ensure compliance with appropriate insurance sales standards. *BBR, 1/3/00, p. 9*.

Office of Thrift Supervision

New Guidance on Directors' Responsibilities

On October 21, 1999, the OTS unveiled a new agency document that is aimed at providing more guidance to directors of thrifts. The new guide, "Directors' Responsibilities Guide," covers such topics as selecting and retaining competent management, establishing a thrift's objectives and strategies, establishing policies and procedures to achieve those objectives, identifying and understanding associated risks, monitoring and assessing the progress of operations, and ensuring the institution's compliance with laws and regulations. The new guide, which is more comprehensive than the first guide issued by the OTS in 1989, was prompted by the high turnover among thrift directors because of mergers, new institutions, and retirements.

The OTS issued a second document, "Directors' Guide to Management Reports," which explains various management reports commonly used by thrifts. This guide is also intended to help directors in exercising their oversight duties and responsibilities. *OTS 99-71, 10/21/99; BBR, 10/25/99, p. 660*.

New Compliance Guide and Handbook

In December 1999, the OTS issued an updated guide that is designed to help institutions identify and understand the primary regulatory requirements and evaluate the effectiveness of their compliance programs. "Compliance: A Self-Assessment Guide" was first published in 1988 and revised once before this current revision. The guide emphasizes that a successful compliance operation requires the commitment of the institution's directors and active involvement of senior management. Accompanying that commitment must be effective and comprehensive policies and procedures, including suitable internal review mechanisms. The guide serves as an internal reference source for managers, compliance officers and others whose duties include compliance matters. *OTS 99-92, 12/20/99*.

In January 2000, the OTS also issued an updated compliance handbook that includes new interagency fair lending examination procedures which were developed by the Federal Financial Institutions Examination Council and implemented by the OTS. The fair lending procedures in the handbook provide extensive and detailed guidance for evaluating fair lending and compliance using a risk-focused approach. The handbook, entitled the *Compliance Activities Handbook*, also contains a section on electronic banking, providing additional guidance on agency guidelines and policies regarding the use of electronic technologies and innovative product delivery systems while maintaining compliance with consumer protection obligations. *BBR, 1/24/00, p. 156*.

Federal Housing Finance Board

Expanded Authority for Mortgage Asset Programs

On October 4, 1999, the Federal Housing Finance Board approved a resolution allowing the 12 Federal

Home Loan Banks to offer single-family Member Mortgage Asset programs, such as the Mortgage Partnership Finance program, which allow for risk-splitting between the FHLBank and the member bank originating the mortgage loan. The Mortgage Partnership Finance program (MPF), which started as a pilot program at the Chicago FHLBank in July 1997, allows FHLBank members to sell mortgage loans they originate to a FHLBank rather than to Fannie Mae or Freddie Mac, thus avoiding the guarantee fees paid to Fannie Mae and Freddie Mac. The FHLBank can then sell participation interests in the program to other FHLBanks. The new resolution allows for an additional risk-sharing structure for the existing MPF program. The resolution also allows for a new program, the Mortgage Partnership Purchase program (MPP), which was recently proposed by the FHLBanks of Cincinnati, Indianapolis, and Seattle. Under the MPP program, the FHLBanks can purchase fixed-rate, single-family mortgages from member financial institutions, subject to the establishment of a credit risk-sharing account to transfer some of the credit risk. Through the process, the member would provide further credit enhancements for the mortgage loans by providing supplemental mortgage insurance. Thrift industry groups have raised competition-related concerns over these mortgage asset programs. Several groups sued the Finance Board in 1997, claiming the Board had exceeded its authority in allowing the MPF program and that the Chicago FHLBank was going into direct mortgage lending by starting up the program. However, the U.S. Court of Appeals for the Fifth Circuit rejected the legal challenge on January 20, 2000. *BBR, 10/11/99, p. 576–577; BBR, 1/24/00, p. 159–160.*

New Rule Gives FHLBanks More Authority

On December 14, 1999, the Federal Housing Finance Board voted to adopt and issue for comment an interim final rule that implements provisions to transfer corporate governance responsibilities from the Finance Board to the boards of the Federal Home Loan Banks. Under the new rule, banks will have final approval over: employee selection and compensation; budgets, bylaws, and dividend payments; and forms relating to advances, conditional advances, and transfers of advances and advance participations. Further, the rule sets limits that the law imposes on the compensation of FHLBank directors. Under the budget requirement in the rule, FHLBanks no longer have to submit to the Finance Board budget and financial reports. FHLBanks can also engage in construction transactions without the approval of the Finance Board. *BBR, 12/20/99, p. 1000.*

National Credit Union Administration

Operating Level on Insurance Fund

The Board of Directors of the National Credit Union Administration (NCUA) approved a final rule on October 6, 1999, setting the normal operating level for the National Credit Union Share Insurance Fund (NCUSIF) between 1.2 and 1.5 percent equity level. Credit unions are required to maintain a deposit in the NCUSIF equal to 1 percent of their insured shares at the close of the preceding reporting period. However, the NCUA has the authority to set a normal operating level for the fund, and the agency is required to declare a dividend to credit unions when the available asset ratio exceeds 1 percent and the NCUSIF exceeds the normal operating level. The NCUA Board determined that no insurance premium assessment was necessary for 2000, since projections indicate that the NCUSIF's investment earnings will continue to be adequate to cover all insurance and operating costs while maintaining at least a 1.3 percent equity level. The Board also agreed to return $88.4 million in dividends to federally insured credit unions, which is the fifth consecutive cash dividend issued by the NCUSIF. *NCUA-PR, 10/6/99; BBR, 10/11/99, p. 578–579*.

STATE LEGISLATION AND REGULATION

California

On November 2, 1999, San Francisco and Santa Monica voters approved a local ordinance that prohibits banks from charging noncustomers extra fees for using automated teller machines. Proposition F prohibits financial institutions from imposing surcharges of any kind on a customer for accessing an ATM located within San Francisco. Supporters of the bill accuse banks of "double dipping" by charging noncustomers fees when their home bank already assesses those customers. However, the California Bankers Association filed suit on

November 3, 1999, to block the Proposition, arguing that the ordinance will only affect state-chartered banks. The bankers argued that the National Bank Act, which sets no cap on fees by national banks, overrides local restrictions so that the ordinance is ineffective with respect to national banks. On November 15, 1999, the U.S. District Court for the Northern District of California granted a preliminary injunction preventing San Francisco and Santa Monica from enforcing Proposition F. In addition, the District Court issued another ruling on November 24, 1999, which prevents individual consumers in Santa Monica from using the new ordinance as a basis for a lawsuit against banks that charge the extra fees. *BBR, 11/8/99, p. 752; BBR, 11/15/99, p. 800; BBR, 11/22/99, p. 842; BBR, 12/6/99, p. 926*.

Michigan

On January 5, 2000, Michigan Governor John Engler signed legislation that will overhaul and modernize the Michigan Banking Code. The new Banking Code of 1999 modernizes Michigan's existing banking statute by removing obsolete and conflicting provisions. In addition, the legislation eliminates barriers to the use of technology in bank operations and reduces bureaucracy for both the banks and the state regulator. The law also extends the period between examinations of healthy banks to 18 months, which will reduce the burden on banks and make it easier for the Michigan Financial Institutions Bureau to coordinate supervision with federal agencies. The new law becomes effective on March 1, 2000. *BBR, 1/17/00, p. 101*.

BANK AND THRIFT PERFORMANCE

Third-Quarter 1999 Results for Commercial Banks and Savings Institutions

FDIC-insured commercial banks earned $19.4 billion during the three months from July through September 1999, which represents the highest quarterly earnings ever reported by the industry. The surge in commercial banks' earnings reflected continued strength in noninterest revenues, especially fee income, as well as a moderation in noninterest expenses. Noninterest income rose to $36.9 billion, from $34.5 billion in the second quarter of 1999, and $29.6 billion one year earlier. Banks' annualized return on assets (ROA) was 1.42 percent in the third quarter, up from 1.25 percent in the second quarter and 1.15 percent a year earlier. The number of problem banks rose from 62 in the second quarter of 1999 to 69 in the third quarter, and there were three bank failures during the quarter.

FDIC BIF-insured mutual savings institutions reported net income of $2.8 billion in the third quarter of 1999, which is $13 million less than in the second quarter. The slight decline in industry earnings was caused by lower gains on sales of securities, which fell to $276 million in the third quarter from $445 million in the second quarter. The industry's ROA for the third quarter was 1.00 percent, down from 1.03 percent in the second quarter and 1.14 percent in the third quarter of 1998. The number of problem thrifts declined to 11 thrifts with $3.9 billion in assets, down from 14 thrifts in the second quarter with $4.2 billion in assets. There was one thrift failure during the third quarter of 1999, which is the first failure of a thrift institution in almost three years. *The FDIC Quarterly Banking Profile, Third Quarter 1999*.

RECENT ARTICLES AND STUDIES

An article in the October-December 1999 issue of the Atlanta Federal Reserve Bank's Financial Update reports that insurance sales by banks should not have a major effect on the safety and soundness of well-run institutions. Senior economic analyst Michael Padhi argues that, as banks prepare to expand into the insurance market with the recent enactment of the financial modernization law, recent data suggest that insurance sales do not pose a big threat to well-managed bank holding companies. The study focused on insurance agency subsidiaries of bank holding companies in the Atlanta Federal Reserve District. *BBR, 12/6/99, p. 916–917*.

Timothy J. Yeager, an economist with the Federal Reserve Bank of St. Louis, reports that community banks will continue to play an important role in the marketplace, despite the new challenges and pressures community banks are facing because of the changing U.S. financial marketplace. Community

banks—those banks with less than $300 million in assets—will play a role in the future banking environment because they provide personal customer service and cater to small businesses. Mr. Yeager's article, "Down, But Not Out: The Future of Community Banks," appears in the October 1999 issue of the St. Louis Federal Reserve Bank's quarterly publication *The Regional Economist*. *BBR, 12/13/99, p. 955.*

INTERNATIONAL DEVELOPMENTS

Information-Sharing Framework

The OCC, the Board of Governors of the Federal Reserve System, and the European Commission signed a statement of cooperation on September 17, 1999, and agreed upon a common framework to enhance information sharing among international bank supervisors. The framework provides a basis for bilateral cooperative arrangements between U.S. and European Union (EU) supervisors for overseeing banking organizations that have material operations in each other's jurisdiction. The framework addresses three specific areas: sharing of supervisory information and consultation on common supervisory issues; on-site inspections; and confidentiality of shared supervisory information. The framework provides sufficient discretion and flexibility to take into account any factors that are particular to the supervisory authorities and banking organizations involved. Although the statement of cooperation is not a legal document, it provides a basis for subsequent, more detailed bilateral arrangements between U.S. supervisors and the bank supervisors in the EU member states. The statement of cooperation and framework for information sharing do not affect existing bilateral arrangements between the United States and EU member states. *NR 99-88, OCC, 10/1/99*.

China

The United States and China entered into an agreement on November 15, 1999, which would provide foreign financial institutions wider access to China's markets. The deal constitutes a precondition for allowing China to apply for membership in the World Trade Organization (WTO). Foreign banks would be allowed to engage in local-currency transactions with Chinese companies within two years after China joins the WTO, and they would be permitted to handle retail-banking transactions with Chinese consumers within five years. U.S. and other foreign banks would also be allowed to engage in all transactions that Chinese banks currently handle. In addition, all restrictions or limitations on geographic expansion by U.S. and other foreign bank branches in China would be lifted within five years. Foreign financial institutions would also be able to acquire 33 percent minority stakes in Chinese fund management companies, with an option to increase those positions to 49 percent. The pact also calls for the beginning of talks to allow foreign investment banks to acquire 33 percent stakes in ventures to underwrite domestic securities issues, including debt, equity, and foreign-currency-denominated securities. *AB, 11/17/99.*

Japan

On February 9, 2000, the Japanese government announced the sale of Long-Term Credit Bank of Japan Ltd. (LTCB) to a U.S. investor group led by Ripplewood Holdings. The transaction marks the first-ever sale of a Japanese bank to foreign ownership. To effect the transfer of LTCB to the investor group, the New LTCB Partners, the Japanese government will spend an estimated $34 billion in taxpayer money for the cleanup of LTCB's delinquent assets. *BBR, 2/14/00, p. 330*.

Mexico

On September 22, 1999, Mexican officials published new rules that would gradually strengthen requirements for bank capitalization and credit classification. The new rules should help bring Mexico's banking regulations in line with international standards. Among the most important changes in the new reforms is the gradual reduction of deferred taxes as basic capital on banks' balance sheets to a maximum of 20 percent of the value of the tax credit. Currently, banks can treat 100 percent of deferred taxes as basic capital on their balance sheets. In addition, the new rules require banks to deduct from basic capital their investments in non-financial companies that are not publicly traded. Those investments in companies that are publicly traded must also be deducted from banks' basic capital, when the investments exceed 15 percent of the capital. The new rules for classification of credit risk would permit financial authorities to evaluate risk for mortgages,

credit cards, and business loans, with additional reserve requirements determined according to risk. Officials of the National Banking and Securities Commission (Comision Nacional Bancaria y de Valores) will later announce the new methodologies for classifications of credit risk, as well as new accounting criteria, bases for fixed-asset valuation, and the evaluation of deferred tax levels in banks where deferred taxes form a significant part of their basic capital. *BBR, 9/27/99, p. 498–499.*