Vol. 8 No. 2 - Article I - Published: June 1995 - Full Article

A Two-Window System for Banking Reform
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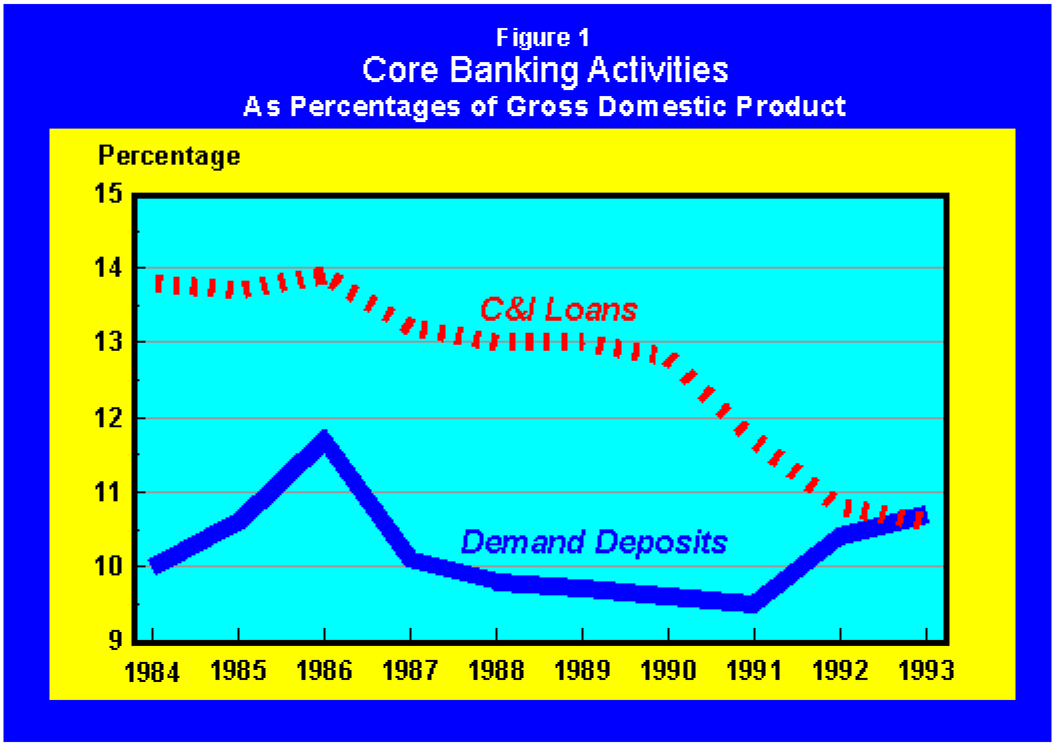
Bank specialness has eroded . . . If you went down the bank-asset balance sheet today, you would probably say that . . . only about $1.5 -- $2 trillion is special anymore (in the sense that deposit insurance protection is justified for the underlying activities). Why is the safety net still so big (protecting nearly $5 trillion of assets in insured depositories), and shouldn't we think about shrinking it? *Robert E. Litan* [1]

Despite strong earnings, improving asset quality, healthy growth and low failure rates in the banking industry of late, banking reform remains a popular topic among lawmakers, bankers, scholars and industry observers. This seems appropriate, given the record number of depository institution failures during the 1980s, record losses for the deposit insurance funds and the changing nature of banking due to innovation and increased competition. Traditional bank intermediation, the distinguishing feature of which is the conversion of liquid deposits into illiquid loans, or 'liquidity transformation,' is shrinking as a share of total economic activity (Figure 1 illustrates two components of this shrinkage). As banks seek new ways to remain profitable without repeating the results of the 1980s, it is useful to consider whether the structural design of the banking industry and the accompanying safety net are appropriate for the new environment. Such considerations underlie the continuing interest in banking reform, and this interest has generated a variety of reform proposals.

The common goals driving most reform proposals are to remove unnecessary restrictions on banking organizations that restrain competition for financial services and to eliminate undue risk to the deposit insurance funds (the Bank Insurance Fund (BIF), and the Savings Association Insurance Fund (SAIF)). The proposed reforms vary considerably, due in part to different diagnoses of the structural problems in the industry, different conceptions of banking's role in the economy, and different priorities regarding the policy objectives of federal deposit insurance.

This article discusses one version of a 'two-window' approach to banking reform. [2] The general approach is based upon principles set forth in the FDIC's 1987 study of reform issues, *Mandate for Change*, and it proceeds from the premise that the industry faces potential long-run problems due to restrictions on the product lines and ownership of banking organizations. [3] The proposed solution is 'two-window' banking, whereby customers could choose between a window offering insured deposits and a window offering various uninsured investments issued by nonbank affiliates. This approach is intended to allow banking organizations to engage in a wide array of 'nonbank' activities without benefit of insured-deposit funding, while strictly circumscribing the deposit insurance safety net to cover only traditional banking activities.



Structural Framework

Basic Elements

There are three primary features of the specific two-window structure discussed in this article: (1) Bank risk-taking is confined to traditional intermediation by restricting the activities that may be funded with insured deposits: illiquid loans and high-quality securities held for liquidity purposes are to be the primary assets of insured entities; (2) activities that are prohibited for insured banks are permitted for uninsured affiliates (perhaps subsidiaries) within the same banking organization, but the insured bank is insulated from nonbank risks through separate capitalization and a set of reinforcing 'firewalls' to maintain legal and financial separation; and (3) all ownership and product-line restrictions now applied to banking organizations are lifted so that new capital can be attracted from other industries and banking organizations can compete more directly with nonbank and foreign firms.

The 'two-window' approach occupies a unique middle ground between the major types of banking-reform proposals. So-called 'narrow-bank' proposals, which are discussed below, typically require that banks invest insured deposits entirely in liquid financial assets so that risk to the deposit insurance funds is minimal. This reflects a presumption that traditional bank lending can occur safely and sufficiently outside of the financial safety net. 4 The two-window proposal does not share this presumption. But unlike the group of modest reform proposals at the other end of the spectrum, there *is* a presumption underlying the two-window approach that banking reform must proceed beyond a mere 'turning of the dials' on existing policy instruments; for example, adjusting capital standards, accounting standards, or levels of depositor protection. In response to the shrinking role of traditional bank intermediation in today's economy, the two-window proposal offers a redesigned safety net that will shrink in a corresponding fashion.

Stated otherwise, the size and shape of the safety net would be adjusted as necessary under the two-window system to ensure that deposit insurance protects *only* the 'traditional' type of bank intermediation. 5 Perhaps more important than reducing risk for the deposit insurance funds, this measure is intended to rationalize the scope of safety-net coverage so that any risk exposure of the deposit insurance funds serves a legitimate economic purpose.

In response to the shrinkage of traditional intermediation, the two-window proposal also permits banking organizations to conduct nonbank activities of their choice within a structure that is designed to insulate insured institutions from nonbank risks. This provision likewise occupies a middle ground, between the *status quo* that features 'consolidated supervision' of the bank holding company and limited entry by holding-company affiliates into nonbank financial activities, and a system of 'universal banking' in which a wide variety of nonbank activities might be conducted within the legal banking entity itself, funded with insured deposits. 6

The two-window proposal confronts policymakers with some fundamental issues that often are neglected in discussions of banking reform. The remainder of this article examines one version of a two-window system and discusses the fundamental issues that arise in connection with these features. 7

Comparisons With the 'Narrow' Bank

The concept of two windows derives from the same philosophy that underlies the so-called 'core-bank' or 'narrow-bank' proposals for banking reform (these will hereafter be referred to as 'narrow-bank' proposals). 8 A common purpose is to reduce the risk exposure of the deposit insurance funds (hence, the taxpayer) to the minimum level that is consistent with adequate safety-net protection for deposits. The common approach is to restrict the permissible uses of insured deposits and to remove what are argued to be unnecessary restrictions on the activities of banking organizations. The major differences between the two-window system and various versions of the narrow-bank proposal relate to the proper means of achieving a largely common set of goals. The two-window approach departs from most narrow-bank proposals in the criteria used for determining acceptable uses of insured deposits, the restrictions imposed on nonbank-affiliate activities, and the structural design of the banking organization as a whole. These three major differences will be considered briefly in turn.

Activities Funded With Insured Deposits. Narrow-bank proposals tend to use risk measures alone for determining what are acceptable uses of insured funds 9. Only the safest activities are permitted in the insured entity, and thus the proposed 'bank' typically resembles a money-market mutual fund: its deposits are transactions accounts that are serviced through investments in Treasury secuities and high-grade commercial paper. In the two-window approach, the decision whether an activity should be funded with insured deposits involves more than risk measurement. Also important is whether there exists a legitimate economic rationale for extending the safety net to the activity in question.

For example, the traditional banking business of liquidity transformation arguably fulfills a unique and important economic purpose (the arguments are considered under *Risk to the Deposit Insurance Funds*, below). Accepting this premise for the moment, and recognizing that such intermediation is intrinsically susceptible to destabilizing bank runs that may impose significant social costs, there is a legitimate economic rationale for extending deposit insurance to this function. 10 It is much more difficult to provide a defensible rationale for extending the safety net to products or services that are traded in established markets with no inherent susceptibility to costly market failures (for example, foreign-exchange or government securities markets). 11

According to this logic, insured banks should be limited to activities that are consistent with the traditional business of banking: issuing deposits and other relatively liquid claims, clearing payments, and investing in short- and intermediate-term illiquid loans such as commercial loans and, perhaps, some consumer loans, as well as some high-quality investments for liquidity. 12 In the two-window system, all other activities would be conducted in separately capitalized subsidiaries or affiliates that are not funded with insured deposits. If there are important synergies between traditional banking functions and certain nontraditional activities, exceptions would be permitted.

Of course, there would be no avoiding some arbitrary judgments and operational difficulties in implementing this type of two-window system. How illiquid must a loan be to qualify for funding with insured deposits, and how should this be measured? Precisely how much investment for liquidity purposes should be permitted? There are no easy answers to these and a host of similarly practical questions. 13 In recognizing that the two-window system would inject some additional arbitrariness and complexity into banking regulation, however, it should be recognized that some would be removed as well. For example, there would be no artificial percentage limits on holding-company investments, and such investments would not be restricted to those activities 'closely related to banking.' Other examples will be discussed in what follows but, in the final analysis, the two-window alternative poses a trade-off of the existing set of arbitrary decisions for a different set. >BR>

Moreover, there are alternative versions of the two-window system that would pose fewer practical difficulties. There is nothing inherent in the basic concept of 'two windows' that requires a strict adherence to a liquidity-transformation test for determining insurable activities; thus, at least three different 'two-window' approaches to reform can be identified:

- **Passive Approach or Status Quo.** It might be determined to continue to permit all activities that currently are conducted by insured banks. New activities could be placed outside the insured bank and funded through an uninsured window if they are not closely related to the credit-granting process. The safety net still would shrink if traditional intermediation continues to shrink, and it could not grow arbitrarily.
- **Intermediate Approach.** Deposit-taking, lending and the holding of some marketable securities would be permitted for the insured bank, without making judgments about the degree of liquidity transformation that is accomplished. All other activities would be conducted in separately capitalized affiliates and funded through an uninsured window.
- **Activist Approach Based Upon Liquidity Transformation.** This option, emphasized throughout this article, requires a willingness to make judgments about the proper types of loans and deposits for insured banks, *i.e.*, about the degree of liquidity transformation that would justify deposit insurance protection, and a willingness to relocate current activities as needed to uninsured affiliates. Clearly, it poses more practical problems than the other options.

The third option is the primary focus of this paper because, in the author's judgment, it reflects the strongest economic rationale for safety-net protection of bank activities. However, operational and other factors also are important and, as will become evident, many advantages of the basic two-window structure are equally obtainable under the other two options.

Restrictions on Nonbank-Affiliate Activities. In most narrow-bank proposals, affiliates of the bank are restricted in their lines of business to some set of financial activities. 14 The operating principle embodied in the two-window approach is that insured banks should be free to affiliate with both financial and nonfinancial enterprises provided that: The bank is well-capitalized upon completion of any affiliation transaction; nonbank affiliates are separately capitalized; and supervisors are satisfied that the resulting entity will not operate in a manner that is abusive to the bank. Supervisors should have authority to preclude affiliation if there are concerns about the quality or character of management in either the bank or the prospective affiliate. Moreover, after an affiliation occurs, there should exist clear supervisory authority to audit both sides of any transaction between the bank and its affiliate and to require reporting as necessary from both parties to the transaction. 15

The general rule for bank supervision in a two-window system is that all advances of bank funds should be governed by an 'arm's-length' requirement. The two-window framework includes firewalls and regulatory safeguards to ensure legal and financial separation. 16. For the two-window structure to function safely and properly, financial flows from the bank to its affiliates must be strictly limited.

The Structure of the Banking Organization. So long as firewalls exist, capital flows are properly restricted, and proper supervisory measures are taken to ensure arm's-length dealings among insured banks and their nonbank affiliates, any corporate structure is permissible under two-window banking. Narrow-bank proposals typically impose a specific structure (usually resembling a holding company) along with a set of regulations and supervisory measures that apply to the banking organization as a whole. 17 The two-window structure is designed specifically to avoid this type of oversight and control: Consolidated supervision has the potential to impede cost efficiency and artificially reduce the value of the banking franchise, thus inhibiting the industry's ability to attract new capital. In order to enter banking under current law, nonbank firms typically must subject their entire organizations to federal supervision. As noted, the two-window system would remove this deterrent, replacing it with functional supervision of separate corporate units and a system of firewalls (discussed under *Supervisory Issues*, below).

Risk to the Deposit Insurance Funds Under 'Two Windows'

Again, the two-window system envisioned in this article would restrict the banking entity to traditional activities, except where important synergies with nontraditional activities have been demonstrated. The major risks posed to the deposit insurance funds thus would be the traditional types of banking risks, primarily related to credit quality, as well as the possibility that problems at the nonbank affiliates may adversely affect the insured entity. The effectiveness of firewalls will be discussed in a later section. At this point it is sufficient to note that the risk-reducing effects of a two-window approach are unclear.

However, risk reduction is not the sole aim of the two-window approach. Narrow-bank structures would achieve greater risk reduction for the insurance funds than would the two-window structure. The logic underlying the two-window approach suggests that this extra risk exposure is worthwhile because, as mentioned earlier, the traditional intermediation function of banks is considered to be essential for efficient credit allocation in the economy. More specifically, evidence suggests that an important component of the economy's production depends primarily upon banks for financing. 18 Such production is undertaken by firms that, for various reasons, tend to incur prohibitively high costs in attempting to convey information about their investment projects to potential investors. These firms are likely to find that they cannot successfully borrow by issuing their own securities, even when the projects to be financed are viable and productive.

Similarly, not all such firms with viable projects may be able to borrow from finance companies or other substitute lenders. While these lenders offer commercial loans just as banks do, they do not offer liquid claims to investors. This may limit their fundraising ability, so that it is unclear whether nonbank lenders could finance all of the viable projects that depend upon such lending in our economy.

At first glance, this last point appears counterintuitive. Why could not nonbank lenders attract sufficient funds from savers simply by offering higher rates of return on their claims? Perhaps they could, but there may be limits to the willingness of savers to sacrifice liquidity for return. Benston and Kaufman (1988) cite evidence from the money-market mutual fund experience indicating that those funds originally guaranteeing a return, instead of a share's nominal value, eventually were forced *via* competition to switch to nominal-value guarantees. The conclusion, as described by Phillips (1994), is that the 'public wishes to have a guaranteed nominal value, even at the expense of return.' If so, it is equally plausible that, at some point, individuals will opt for liquidity, even at the expense of return. Intermediation thus may be reduced if lenders are unable to issue liquid claims. 19

More fundamentally, there are no significant historical examples of strong economies in which illiquid lending has been financed primarily by private institutions issuing illiquid debt. Because such institutions have the distinct advantage over banks of reduced susceptibility to runs, it seems reasonable to believe that fundraising limits may explain their relative obscurity across time and across different economies. While today's information revolution undoubtedly has expanded the fundraising possibilities for such institutions, the foregoing discussion suggests that it is unclear whether they alone could finance all of an economy's viable projects requiring illiquid loans; 20 some liquidity transformation by banks may be necessary. As a result, the threat of bank runs may impose large social costs because it impairs this special banking function and precludes the funding of potentially productive projects.

Under this view of credit markets, there is a presumptive market failure to allocate credit appropriately in the absence of deposit insurance -- or some equivalent protection -- for traditional bank intermediation. [21] To remove safety-net protections from the traditional banking function could easily create more social costs than benefits if this view is correct.

Such a view is controversial, and a thorough treatment is beyond the scope of this article. [22] Most narrow-bank proponents do not share the presumption that the market failure cited above is sufficiently important to justify deposit insurance protection for traditional banking functions. Absent this presumption, it is highly unlikely that the two-window structure could be viewed as optimal, since narrow banks would expose the taxpayer to far less risk.

Regardless of which view is correct, this two-window approach serves as a reminder that there is likely to be no 'free lunch' with deposit insurance reform. Too often when changes in deposit insurance coverage are proposed, there appears to be an implicit assumption that the risk exposure of the insurance funds can be reduced costlessly. The two-window proposal reminds policymakers that real economic costs are likely to be associated with reforms that reduce the potential for bank intermediation. The relevant issue, of course, is whether these costs are likely to be smaller or larger than the benefits of the proposed reforms. Given the difficulty of estimating the benefit/cost ratio with any accuracy, opinions on this issue reflect a high degree of subjective judgment.

Profitability and Diversification of Risks

Expanded powers *per se* may change the risk exposure of the deposit insurance funds: They will create the opportunity for greater profits as well as greater losses within banking organizations. Expanded powers could reduce risks for banking organizations if appropriate diversification rules are followed, but no reliable prediction is possible for the banking industry as a whole. New investment opportunities will not be exploited identically at different institutions and similar investment choices may influence risk and return differently at different institutions, depending upon the characteristics of existing portfolios, the size of new investments relative to the existing portfolios, and managerial efficiency in capturing any economies of scope offered by new powers. [23]

Although the net effect of new powers *via* two-window banking is impossible to predict with any precision, it also may be largely irrelevant. The more relevant fact is that well-managed banking organizations currently face artificial obstacles to diversifying appropriately and maximizing returns for their shareholders; these institutions are likely to become safer and more competitive with expanded powers, potentially benefiting consumers as well as shareholders and taxpayers. [24] Poorly managed institutions, on the other hand, likely will suffer the consequences of a new set of poor choices if expanded powers become available, and many of these firms may fail.

The deposit insurance funds may benefit under a two-window system to the extent that nonbank risks would be removed from the insured entity and to the extent that scope economies, synergies or innovations resulting from new powers would salvage some banking franchises that now are endangered. Capital also would be free to move to nonbank uses within the organization when banking returns are low, thus stabilizing earnings. More-stable earnings may allow organizations to provide better support for their banking units during difficult times, should the owners wish to do so. [25] Meanwhile, any new risks posed by expanded powers would be borne outside the safety net, if the firewalls and regulatory safeguards embedded in the two-window structure are effective. [26] If effective, this structure dispenses with any need for concern about the effects of new powers. Effectiveness is considered in the following section.

Supervisory Issues Under Two Windows

The supervisory issues that arise under the two-window structure may be grouped into two categories. The first category consists of familiar concerns that apply to any proposed expansion of banking powers.

Foremost among these concerns are the possibility of anticompetitive effects, including undue concentrations of power, and the potential problems associated with conflicts of interest, including abusive 'tie-in' sales and improper uses of inside information. Such concerns have been debated extensively and, thus, are relegated here to an *Appendix* that provides a brief summary. The second category of issues deals with the effectiveness of firewalls in maintaining the safety and soundness of insured banks. Because the two-window proposal relies so heavily upon firewalls to protect the insured bank without impairing the ability of the larger organization to capture economies of scope and other synergies, this category is particularly important for evaluating the relative merits of two-window banking. The remainder of this section focuses on firewalls.

Firewalls for Safety and Soundness. For purposes of deciding the merits of a two-window structure, determining whether insured financial institutions can be effectively insulated from risks posed by their nonbank affiliates is more critical than selecting a particular set of permissible activities for those nonbanks. If corporate separation can be achieved within a banking organization and safety-net protections can be confined to the insured bank as required under the two-window framework, then the selection of activities to be conducted by nonbank affiliates is of second-order importance.

Economic theory and formal empirical evidence are ambiguous regarding the prospects for effective separation. 27 Similarly, the abundant anecdotal evidence on both sides of the question offers no firm conclusions. 28 The following discussion contrasts opposing perspectives on the feasibility of corporate separation under a two-window system.

Affiliations may carry two types of risks for an insured bank and, ultimately, the insurance funds: (1) the bank may endanger its own financial health by directly or indirectly assisting a troubled affiliate, and (2) public confidence may be shaken by problems plaguing a nonbank affiliate, with negative repercussions for the bank (such as higher funding costs, bank runs, *etc.*). For convenience, these risks may be termed 'financial' and 'market' risks, respectively. 29

As noted earlier, financial separation implies separate funding, no commingling of assets, and an arm's-length requirement for all advances of bank funds to affiliates. It follows that loans or services obtained by an affiliate from an insured bank should be on terms comparable to those available for nonaffiliates. Financial separation also requires that a bank does not unduly transfer assets to, or purchase bad assets from, an ailing affiliate. 'Firewalls' refer to the behavioral rules and restrictions that promote the fulfillment of these requirements for financial separation among affiliates.

Banks currently are subject to lending limits, statutory restrictions on transfers of funds, dividend restrictions, and restrictions on amounts and terms for insider loans. 30 Nonetheless, abuse of an insured financial institution by individual owners to benefit outside activities has resulted in a number of bank failures. While this may occur under the strongest of firewall systems, it is relevant to note that state laws governing corporate separation are uneven. The two-window system would potentially close state law loopholes that facilitate such abuse by requiring a minimal set of uniform firewalls for all insured institutions affiliated in any manner with nonbank firms. Despite this, it is reasonable to expect that the incidence of such abuse will rise if there are expanded opportunities for affiliation.

There is no doubt that strong incentives exist to manage the various components of an organization as an integrated whole. For example, funding costs can be lowered for any given affiliate if creditors believe that the strength of the entire organization stands behind the affiliate's obligations. To the extent that stockholders' returns can be elevated or risks can be better controlled by managing the various affiliates as an integrated entity, there will be strong incentives for management to do so. However, experience confirms that regulators also can create strong incentives that affect the bottom line for shareholders. The firewalls separating holding-company affiliates (Sections 23A and 23B of the Bank Holding Company Act) have insulated many banks effectively against repercussions from the demise of nonbank affiliates, and such firewalls always can be strengthened if necessary with stiffer penalties for noncompliance.

A fair assessment of the anecdotal evidence would suggest that existing firewalls work well in the usual course of business but occasionally fail when there are serious problems in one or more parts of the organization. As Flannery (1986, p. 223) has noted: 'The policy question is therefore whether the possibility of . . . relatively extreme behavior should have an important weight in making regulatory decisions.'

A complicating factor is that the anecdotal evidence comes from a regulatory regime that differs from the one envisioned under a two-window system. Firewalls have, to date, operated within the context of consolidated supervision for bank holding companies by the Federal Reserve Board (see note 6). Because the two-window framework does away with consolidated supervision, it is unclear whether firewalls would be equally effective in that environment.

A counterpoint is that consolidated supervision has served as a signal to the market that regulators expect affiliates to be managed as integrated entities. This could account for those past instances in which insured banks have been punished by the market for problems arising in their nonbank affiliates. Thus, it is unclear whether the market reaction would be similar in an environment where regulators demand corporate separation and show a willingness to strengthen firewalls as necessary to enforce it.

As this discussion indicates, complete financial separation is impossible without 'market' separation. Economic theory and empirical evidence suggest that some amount of market risk is probably unavoidable for banking units within financial holding companies, even if firewalls work well. 31 For example, to the extent that customers seek a complete set of financial products and services from an organization, a nonbank affiliate's performance in delivering one element of the set will also affect the demand for the bank's products and services. 32 Similarly, because empirical evidence indicates that the market uses new information regarding one firm's performance to infer changes in the stock values of unrelated firms in the same industry, it is reasonable to expect that the performance of affiliates in businesses closely related to banking will influence also the market's valuation of a bank. 33

Even if affiliates conduct activities that are unrelated to banking, the market is unlikely to ignore signs of poor management anywhere in the organization. If the parent selects management of questionable quality for a nonbank affiliate, the quality of bank management may also come under suspicion. This will be expressed through higher funding costs for the bank, with or without the presence of effective firewalls. Moreover, entities within any conglomerates are likely to be chosen such that their risk-return characteristics are complementary. 34 While firewalls may prevent direct interrelationships among affiliates, they cannot prevent the indirect connections established through the judicious use of financial theory and statistical evidence in exploiting covariance or other properties of asset returns. The market is likely to recognize these indirect connections and understand their implications for the bank's performance. Correspondingly, a bank's portfolio choices are likely to be influenced by the risk-return characteristics of its affiliates, even in the presence of firewalls.

In short, it seems clear that some exposure to market risk will be unavoidable for banks under a two-window system. Such exposure already exists for holding-company banks, but the two-window framework places no restrictions on the types of affiliates that banks may choose. As a result, the mix of affiliates within a two-window organization could have diverse and complex consequences for a bank's exposure to market risk. More generally, the net effect on the banking industry's safety and soundness is impossible to predict with confidence.

Given this ambiguity, some argue that a reliance upon firewalls to protect the insured bank would be too risky. 35 They note that perfect insulation is not possible, and that attempts to strengthen firewalls may merely negate any economic advantages resulting from expanded powers. It is not certain that firewalls can be simultaneously strong enough to maintain an acceptable level of risk for the deposit insurance funds and flexible enough to allow banking firms to exploit new opportunities or economies of scope associated with expanded powers. It is argued that these uncertainties signal a continuing need for consolidated supervision of banking firms in order to catch any problems that may slip through cracks in the firewalls. Quite apart from the substantive merits of consolidated supervision, such skeptics note that this concept is firmly embraced in the revised Basle Concordat; hence, an important international agreement could be threatened by any reforms that suggest a weakened U.S. commitment to consolidated supervision. [36]

The case for two-window banking does not rest upon a denial of these complications and uncertainties. It rests upon a belief that there are crucial flaws in the structural design of the banking industry, including the financial safety net, with potential consequences that justify the risks associated with two-window reforms. More concretely, it appears that the safety net is now and, in the absence of reforms, increasingly will be extended to activities for which it is not essential. This creates artificial incentives in the marketplace and raises questions concerning the future ability of the deposit insurance system to support the safety net. The list of nontraditional activities conducted by insured banks (foreign-exchange operations, bond underwriting, off-balance-sheet activities) continues to grow virtually without regard to the design and purpose of federal deposit insurance. No legitimate economic rationale exists for extending safety-net protections in this manner. This argument, and the corollary concern over undue risk to the insurance funds, motivate the redesign of the safety net to protect only traditional intermediation in the two-window system.

An additional 'two-window' argument for structural reform is that restrictions on bank ownership and affiliations currently restrain competition in the financial marketplace. Consolidated supervision appears as an integral part of this problem. It potentially deters entry into banking by nonbank firms and narrowly restricts activities that may be conducted in nonbank units of a holding company; thus, it reduces the flexibility of banking organizations to adapt to a rapidly changing environment and otherwise meet the diverse needs of borrowers and savers.

Conclusions

The two-window proposal, like the recent versions of the narrow-bank proposal, was motivated by the experience of the 1980s. Enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) has changed the landscape significantly.

The FDIC's loss exposure has been reduced by the least-cost failure-resolution requirement of FDICIA and, perhaps, by the incentives created through prompt corrective action for undercapitalized institutions (PCA). As well, the Budget Act of 1993 amended FDICIA by providing that domestic-office depositors of federally insured U.S. financial institutions would occupy a preferred position in the failure-resolution process with respect to foreign-office depositors and general creditors. Taken together, these provisions may reduce significantly the maximum potential failure-resolution costs of the FDIC.

Moreover, FDICIA may have greatly reduced the potential magnitude of the deposit insurance subsidy by addressing the 'too-big-to-fail' problem. This aspect of FDICIA has been little noticed and apparently underappreciated. The least-cost resolution requirement generally prohibits the FDIC from extending protection to any failed-bank creditors other than insured depositors, unless such action reduces FDIC costs. An explicit process is created for systemic-risk exceptions, requiring agreement among the FDIC, Federal Reserve, and the Secretary of the Treasury in consultation with the President, and FDICIA provides for a special assessment on the industry to pay for any losses exceeding the least-cost amount. Thus, it can be argued that the process for determining whether large banks get special treatment is similar to, but more systematic than, the process that might be used for other large firms. [37] It would now be difficult to argue that the deposit insurance system *per se* is responsible for any perception in the marketplace that some banks are 'too big to fail.'

On balance, then, FDICIA appears to weaken substantially the case for those reforms aimed primarily at reducing risk to the deposit insurance fund and eliminating the 'too-big-to-fail' doctrine.

Despite this, and despite the strong performance of the banking industry recently, it can be argued that structural reform is necessary because of an overextension of the safety net and unnecessary restrictions on bank ownership and affiliations. On these bases, the two-window proposal merits serious consideration.

In particular, a two-window system avoids potential problems posed by reforms that rely upon 'narrow banks' and/or consolidated supervision of banking organizations. Narrow-bank proposals ignore social costs that may be associated with removing safety-net protections for traditional bank intermediation and do not address concerns that consolidated supervision deters entry into banking and restricts the flexibility of banking organizations to meet the needs of customers.

There are legitimate concerns regarding the effectiveness of firewalls in a two-window system. Given expanded opportunities for bank affiliation with nonbanks, it is reasonable to expect new temptations that could lead to abuse of insured banks. The effectiveness of firewalls in preventing such abuse has not been tested in an environment of functional supervision. On the other hand, to the extent that FDICIA successfully limits the costs associated with bank failures, reliance on firewalls may pose less risk to the deposit insurance funds and the taxpayers. Moreover, it should be considered that such a risk may be worth taking in order to rationalize the financial safety net, bring it under control, and reduce barriers to entry in the financial-services industry.

APPENDIX

Competition, Concentration of Power, and Conflicts of Interest With Expanded Powers

Decreased Competition and Conflicts of Interest. A longstanding fear associated with expanded product powers and nationwide branching is that a comparatively small number of large organizations may ultimately dominate the financial marketplace. This raises the specter of localized monopolies, destabilization of the financial system in the event of a single bank failure, and disproportionate control over the nation's financial resources on the part of a few large institutions.

Such concerns are real but difficult to assess. While banking organizations may be larger and fewer under a two-window system, they also may be better diversified. Thus, while any given bank failure under this system may be more costly and destabilizing, there may be fewer failures. Similarly, a decline in the number of banks need not mean that fewer banks will be competing in any given market. Technological advances in information processing and communications are constantly reducing the costs associated with entry into new markets. This suggests that if inadequate competition creates excess profits in a given market, new entrants are likely to be attracted until above-normal profits are competed away. To the extent that expanded powers would increase either actual or potential competition, this would provide a safeguard against the costly excesses typically associated with concentrations of power. 38

For these reasons, it appears unlikely that concentrations of power would produce any serious economic problems. Under a two-window system, however, other legitimate concerns may arise in connection with this issue, including potential effects of financial concentration on the political process. Before committing to any structure that allows for large-scale consolidation in financial services, lawmakers may wish to consider whether remedies would be available to offset any untoward implications of concentration. 39

Another longstanding fear associated with expanded powers is that conflicts of interest will multiply unmanageably as product lines grow, leading to widespread abuses. The primary concern for bank supervisors is that insured institutions may be jeopardized by attempts to combat financial problems elsewhere in the organization. For example, banks may be called upon to make unsound loans, capital injections or asset purchases for the benefit of a nonbank affiliate. This concern is addressed with firewalls and other regulatory safeguards in the two-window system, as discussed in the text. The remainder of this *Appendix* examines two conflicts that may harm consumers: 'tie-in' sales and improper uses of inside information.

Tie-ins occur when a business entity attempts to condition the sale of a particular product or service upon the purchase of another of the entity's products or services. Typically, problems with tie-ins can be traced to inadequate information or weak competition. For example, extensions of credit to bank customers may be conditioned upon the customers obtaining additional services from a bank, its parent company, or one of its affiliates. In such cases, customers may enter into undesirable tie-in arrangements if uninformed of the consequences of their actions or if unaware of their alternatives. If no viable alternatives exist, customers may feel compelled to purchase products or services they do not want. The fear is that expanded powers will create more opportunities and stronger incentives for tie-in sales, so that problems of this type will become more widespread.

Implicit in the two-window approach is the view that tie-in problems resulting from inadequate information are best controlled by requiring full disclosure of costs, alternatives, and other pertinent facts. Likewise, tie-in arrangements arising from inadequate competition are best addressed through policies that will strengthen competition in the financial marketplace. Under the two-window system, there would be no geographic or product-line restrictions to protect firms that saddle their customers with undesirable tie-in arrangements. The potential competition created by these new ground rules would act as a deterrent to tie-in abuses.

A related concern is that violations of a bank's fiduciary responsibilities might increase along with the number of products and services offered by affiliates. As banking organizations obtain new powers, bankers are likely to gain access to new types of confidential information. Skeptics argue that such information is likely to be misused, because there is a conflict of interest whenever one entity acts as both a promoter of services or products and a disinterested financial advisor.

Such arguments historically have centered on bank involvement in securities underwriting and, in part, served as the basis for passage of the Glass-Steagall Act. Recent evidence indicates, however, that, far from harming investors, issues underwritten by bank affiliates prior to 1933 were, on average, of higher quality and better performing than those underwritten by independent investment banks (Krozner and Rajan, 1994).

More generally, potential conflicts of this type within banking typically have been neutralized successfully in the past. Because banks generally have succeeded in creating an effective 'Chinese Wall' between their commercial lending and trust departments, for example, it would seem that similar steps could be taken if banking organizations are permitted to engage in activities that grant them access to other types of confidential information. Should the level of abuse prove unacceptable under the two-window system, however, lawmakers could enact additional safeguards and stiffer penalties. Given the changing dynamics of competition in the market for financial services, product-line restrictions should probably be viewed as a last resort.

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Recent Developments Affecting Depository Institutions

by Benjamin B. Christopher

REGULATORY AGENCY ACTIONS

Inter-Agency Actions

The federal bank and thrift regulatory agencies are engaging in joint or coordinated efforts in a number of regulatory areas that are mentioned specifically in this issue of the *Review* , among which are: Community Reinvestment Act compliance evaluation; risk-based capital requirements; capital-requirements accounting; appraisal guidelines; and examinations of bank-affiliate sellers of mutual funds. For full information on the inter-agency actions included in this issue, reference is necessary to the pages devoted to each of the agencies and the Federal Financial Institutions Examination Council.

Federal Deposit Insurance Corporation

Assessments

The FDIC proposed changes in its risk-related insurance premium system, including a significant reduction in rates paid by well-capitalized and well-managed banks. No change is proposed at this time in the insurance rates paid by savings associations. Under the proposal, premiums paid by about 90 percent of BIF-insured institutions would fall to four cents per $100 of domestic deposits, from their current rate of 23 cents per $100. The 31-cent rate currently paid by the lowest-rated BIF-institutions would continue.

Present law requires the BIF to have an average assessment rate of 23 cents per $100 of deposits until the Fund amounts to $1.25 per $100 of insured deposits. As of the third quarter of 1994, the Fund balance of $19.4 billion represented $1.03 per $100 of insured deposits. The FDIC projects that the 1.25 ratio will be reached between May 1 and July 31, 1995. Premiums can be reduced 'because of the efforts of the banking industry to make their individual institutions stronger' and to make their insurance fund stronger, said Chairman Ricki Helfer. The proposed new assessment rate would not be implemented until it can be verified that the BIF has been recapitalized.

The FDIC also is considering a process for adjusting BIF rates quickly in response to changing conditions. As proposed, the entire assessment rate schedule could be raised or lowered twice a year, within a range of five cents per $100 without first seeking public comment.

The FDIC proposed retaining the existing assessment rate schedule for the Savings Association Insurance Fund (SAIF). Under the existing SAIF assessment rate schedule, which averages 24 cents per $100, the Fund is projected to be capitalized in the year 2002. As of the third quarter of 1994, the SAIF had an estimated balance of under $2.0 billion, this representing a ratio of 26 cents per $100 of insured deposits. The SAIF also will assume from the Resolution Trust Corporation the responsibility for resolving failed thrifts, starting July 1, 1995. Comments were requested additionally on the proposal to keep SAIF assessment rates unchanged, and on the potential impact of a substantial premium differential between BIF-insured and SAIF-insured institutions. *PR-6-95, FDIC, 1/31/95.*

The FDIC is seeking comments on whether the deposit insurance assessment base should be redefined and, if so, how. Broadly stated, the assessment base is defined as an institution's total domestic deposits as of the end of a quarter. The definition of the assessment base has remained substantially the same since 1935. Until recently, the FDIC did not have statutory authority to change the definition. However, the FDIC Improvement Act of 1991 (FDICIA) gave the agency the ability to determine the assessment base, starting January 1, 1994. Among the key questions on which the agency is seeking guidance is whether it should begin charging insurance premiums for deposits that U.S. banks have in their foreign offices and for certain nondeposit liabilities and 'off-balance-sheet' items. Comments also are sought on whether assessments should be based on an average level of deposits held by the institution rather than quarter-end figures. The latter question is intended in part to address situations where institutions temporarily shift funds out of the assessment base at the end of a quarter solely to reduce their insurance payments. If the FDIC Board finds revisions to be warranted, it will propose specific amendments and invite public comment. *PR-64-94, FDIC, 9/27/94; FR, 10/5, p. 50710.*

The FDIC is taking steps to modernize the way deposit insurance premiums are collected to make the process more efficient and less burdensome. Institutions currently mail a check to the FDIC twice a year after determining how much they owe for deposit insurance, based on their assigned risk-related assessment rate and their deposit base. Under a new rule scheduled to take effect April 1, 1995:

> (a) The FDIC will compute the assessment owed, thereby improving the accuracy and relieving each institution of the burden of performing the calculation;
> (b) The agency will arrange for each institution's payment electronically through the Automated Clearing House (ACH) Network;
> (c) Each semiannual insurance assessment will be paid in quarterly installments, based on an invoice prepared by the FDIC showing the insurance calculation and information on any adjustments from previous quarters.

The revisions delete from the assessment regulation the existing references to experience factors, which are not available for use after 1994.

The new rule also changes the way insurance premiums are collected from insured institutions that acquire deposits through mergers or other transactions in the latter half of a semiannual assessment period. When such a transaction occurs, the surviving institution's payments will be adjusted to account for the increased insurance risk the deposits may pose. *PR-83-94, FDIC, 12/20/94; FR, 12/29, p. 67153.*

Required New Disclosures of 'Pass Through' Coverage
The FDIC adopted new rules requiring insured institutions to provide timely disclosures to depositors in certain retirement accounts and employee benefit plans about whether their funds qualify for ' pass through' insurance coverage. In general, ' pass through' insurance means that the share of each participant in the account, rather than the total account balance, is insured up to $100,000. A 1991 law and FDIC regulations that went into effect in 1992 provide for pass through deposit insurance for employee benefit plan accounts if the insured institution satisfies certain capital standards.

At issue are deposits in accounts such as 401(k) retirement accounts, Keogh plan accounts, and corporate pension plan and profit-sharing plan accounts. Among the new required disclosures are the institution's 'prompt corrective action' (PCA) category, and whether the deposits are believed to be eligible for ' pass through' insurance (must be disclosed in writing when an affected account is opened, and upon request of the account manager); and notification if new, rolled-over or renewed deposits will not be eligible for 'pass through' insurance (must be disclosed in writing within ten days of when an existing account is believed to be no longer eligible for 'pass through' insurance coverage).

The new rules become effective July 1, 1995; however, holders of employee benefit plan deposits made between December 19, 1992 and July 1, 1995, will receive specified disclosures if at the time of deposit the account was not eligible for pass through insurance coverage. *PR-7-95, FDIC, 1/31/95; FR, 2/9, p. 770.*

Brochure on Insurance Coverage
In an effort to reduce continuing customer confusion, the FDIC is now offering a free brochure, 'Insured or Not Insured - A Guide to What Is and Is *Not* Protected by FDIC Insurance.' The brochure explains the term mutual funds, advises purchasers to obtain definitive information, states clearly that 'mutual funds' are not deposits and therefore are not insured by the FDIC or any federal agency, and explains the difference between FDIC coverage of deposits and insurance from other sources that may be available

on certain other bank products. The brochure also includes a discussion of the insurance aspects of Treasury securities, safe deposit boxes and robberies. Institutions that sell nondeposit products either directly or through a third party are strongly urged to provide this brochure to anyone who inquires about, or purchases, such products. *FIL-53-94, FDIC, 7/20/94.*

BIF Rises to $19.4 Billion in Third Quarter; Agency Staff Reduced
The Bank Insurance Fund (BIF) increased to $19.4 billion as of September 30, 1994, up 48 percent from the 1993 year-end level of $13.1 billion. The Fund balance amounted to 1.03 percent of insured deposits on September 30. As a result of the improving financial health of the banking industry, the estimated liability for the cost of anticipated bank failures declined to $1.46 billion, from $3.00 billion at the end of 1993. BIF revenue for the nine-month period totaled $5.00 billion, of which $4.22 billion was assessments earned. Expenses and losses were a negative $1.23 billion, this amount representing mainly provision for insurance losses of minus $1.66 billion.

The FDIC reported that its current staff of 12,116 is 421 less than the initial projected 1995 year-end staff level, and 1,200 below the year-end authorized level. Staff levels decreased by 820 during the third quarter, and 2,103 (14.8 percent) for the year-to-date. Most of these reductions were related to office closings in Houston, Denver, Orlando, Encino, and San Antonio. *Financial Management Report, 3rd Quarter 1994, FDIC.*

Thirteen Banks Failed Last Year
In 1994, there were 13 failures of BIF-insured banks, which had assets of just under $1.6 billion, down from 41 failed banks, with assets of $3.5 billion, the year before. The number of closures in 1994 was the lowest since the year 1981.

The FDIC's 'problem' list at the end of the third quarter consisted of 293 commercial banks, with assets of $36 billion, and 84 savings institutions, with $59 billion in assets. From year-end 1993, the total number of 'problem' institutions declined by 195, and their assets were down by $239 billion. *FDIC Quarterly Banking Profile, Third Quarter 1994; FDIC Office of Corporate Communications.*

Supervisory Guidance on Mortgage Derivative Products
The FDIC has updated and distributed to FDIC-supervised banks its supervisory guidance to examiners on mortgage derivative products. The new guidance incorporates the provisions of the Federal Financial Institutions Examination Council's (FFIEC) interim revision to its Supervisory Policy Statement on Securities Activities, which addressed the application of Statement No. 115 of the Financial Accounting Standards Board (FASB) to mortgage derivative products.

The FDIC's guidance states that a mortgage derivative product that was non-high-risk at purchase and designated as held-to-maturity later becomes high-risk, the security will not be subject to redesignation as available-for-sale or trading if the institution can continue to demonstrate a positive intent and ability to hold the security to maturity. However, examiners will continue to consider any unrealized net depreciation in held-to-maturity, high-risk mortgage derivative products in the evaluation of an institution's capital adequacy. Mortgage derivative products that expose an institution to risk of loss of principal or book value may be classified in accordance with the provisions in attached exhibits. The entire amount of unrealized losses (not just any amounts scheduled as loss) on available-for-sale debt securities *that are adversely classified* must be deducted from Tier 1 capital before calculating regulatory capital ratios. No such adjustment to regulatory capital calculations is necessary for adversely classified trading securities, as unrealized gains and losses on trading securities are included in an institution's earnings. *FIL-82-94, FDIC, 12/13/94.*

Supervisory Guidance For Structured Notes
The FDIC issued a supervisory guidance to the agency's examiners and to FDIC-supervised banks on the characteristics, risks and examination treatment of structured notes. Since 1990, U.S. Government-sponsored enterprises, private corporations, and multilateral development banks have issued structured

notes, with the Federal Home Loan Banks the most predominant issuers. Banks have increased their investment in structured notes. These securities typically contain embedded options such as caps, calls, and floors and have cash flows that are linked to indices such as interest rates, foreign-exchange rates, commodities prices, prepayment rates, and other financial variables. The cash-flow uncertainty of structured notes, caused by movements in interest rates, foreign-exchange rates, and other indices, may expose banks to greater market risk, liquidity risk, operating risk, or interconnection risk than traditional medium-term notes. As a result, bank investments in structured notes warrant increased supervisory attention to ensure that bank management understands the nature of the risks in the securities and has the ability to measure, monitor, and manage these risks. Specific examination guidance regarding the characteristics and risks in structured notes is provided. *FIL-61-94, FDIC, 8/31/94.*

Management of Interest-Rate Risk
The FDIC issued a guidance to its examiners and to FDIC-supervised banks on the assessment and management of interest-rate risk in financial institutions. The guidance considers such factors as the size of the institution, capital adequacy, earnings and the complexity of the institution's business. The management of interest-rate risk may range from the formation of formal management committees and the use of complex measurement systems to informal management oversight and the use of simple measurement tools in smaller, more basic, bank operations.

Interest-rate-risk management can be defined as the management of the potential impact of interest-rate movements on an institution's net interest income and market value. Applicable to all banks in various degrees, interest-rate risk management in larger institutions can be segmented into several parts which are discussed in the guidance: (a) the establishment of an interest-rate-risk management committee that is approved by and reports to the board of directors or assumption of such responsibility by the full board; (b) written policies and procedures, including risk limits; (c) a written interest-rate-risk management strategy or strategies; (d) an appropriate measurement and monitoring system(s) to quantify interest-rate-risk exposure; (e) the evaluation of interest-rate-risk exposure. *FIL-60-94, FDIC, 8/26/94.*

Rapid-Growth Rule Rescinded
Effective November 7, 1994, the FDIC rescinded a section of its regulations on notification of rapid growth. Currently, all insured banks, except insured bankers' banks, are required to give the FDIC prior notice of planned rapid growth as a result of any 'special funding plan or arrangement.' For purposes of this requirement, such a funding plan is any effort to increase the assets of a bank through the solicitation and acceptance of fully insured deposits obtained from or through the mediation of brokers or affiliates (which would include insured brokered deposits); the solicitation of fully insured deposits outside a bank's normal trade area; or secured borrowings, including repurchase agreements. The recission will lessen the regulatory burden on banks which are currently also required to comply with the FDIC's brokered deposit regulation and the prompt corrective action rule, both of which were designed in part to address the same risks resulting from rapid growth. *FR, 10/6/94, p. 50826.*

Task Force on Risks From Capital Market Instruments
FDIC Chairman Ricki Helfer announced the creation of a special task force to analyze and make recommendations regarding the potential risks posed to the federal deposit insurance funds by capital market instruments, including derivatives. The recommended actions will include those necessary to enhance the agency's ability to respond appropriately to the possibility that failed banks could be involved in these capital market activities and to situations in which these activities could pose a systemic risk that threatens the deposit insurance funds or the financial system. The FDIC noted the unprecedented growth in capital market instruments and the advances in technology that enable practitioners, including insured depository institutions, to condition their income streams on increasingly complex financial relationships. To the extent that these complexities including the global nature of the inter-linkages between market participants are not well-understood or are mismanaged, capital market instruments can result in losses that may take management and regulators by surprise. The agency said there is no reason to believe that the capital market activities of any insured financial institution pose a significant risk at this time to the deposit insurance funds. *PR-72-94, FDIC, 11/7/94.*

Early-Warning System on Loan Underwriting Standards
The FDIC plans to establish a system designed to identify any relaxation in the underwriting standards for bank lending before problems occur. The new program will commence with pilot projects in all eight of the agency's supervisory regions, and will involve periodic surveys of bank examiners to identify changes in underwriting standards as they occur. Chairman Ricki Helfer said 'this effort will allow the FDIC to analyze systematically the findings of our field personnel who observe lending practices on a day-to-day basis, and then to work with banking institutions to correct any problems before they are serious.'

FDIC personnel at selected, regularly-scheduled bank examinations during the first quarter of 1995 will be asked to report on the prevalence of specific lending and investment practices that have led to difficulties in the past, such as commercial real-estate loans based on unrealistic cash-flow projections, and to identify new practices that could have implications for the safety and soundness of the banking system. *PR-79-94, FDIC, 12/13/94.*

Revised Proposal on CRA Compliance Evaluation
The FDIC, the Office of the Comptroller of the Currency (OCC), the Federal Reserbe Board (FRB) and the Office of Thrift Supervision (OTS) modified a proposal that the agencies published in December 1993, (see this *Review* , Spring/Summer 1994, p. 40) to change the way institutions are evaluated under the Community Reinvestment Act (CRA). The revised proposal retains the structure and principles of the December plan; for example, both would replace the 12 factors now used to evaluate an institution's CRA performance with a more objective, performance-based system. However, the revised plan would make the performance tests more flexible, simplify data reporting requirements and increase the importance of community development lending, such as loans for affordable housing and economic development in low- and moderate-income areas. The revised proposal gives greater recognition to the importance of all types of lending to low- and moderate-income individuals and neighborhoods, treats community development lending as a principal component of lending performance, and clarifies that an institution's loans outside its service area to low- and moderate-income individuals and to small businesses and small farms could be considered as part of its CRA performance.

As in the December proposal, large financial institutions (generally those with $250 million or more in assets) would be evaluated for their CRA performance under three 'tests' -- a lending test, an investment test and a service test. However, under the revised proposal, the tests would be less rigid and would allow the examiner more flexibility to take into account the characteristics and needs of a community and the capacity and limits of an institution. Large institutions also would be required to file new data about their lending and investments, but less than what was proposed in December. A new reporting requirement is data on an institution's loans to small businesses and small farms that would include information on the race and gender of the borrowers. Small banks and thrifts would be evaluated under a streamlined method that would not subject them to additional reports of loan data. The revised proposal would not require, as initially proposed, a small institution to have at least a 60 percent loan-to-deposit ratio in its community in order to be given a 'satisfactory' CRA rating. The agencies instead propose to consider each institution's financial condition and the credit needs of the community in evaluating lending performance under CRA. *PR-135-93, FDIC, 12/9/93; FIL-67-94, 10/12/94; FR, 10/7, p. 51232.*

Self-Testing Guide on Fair Lending
The FDIC issued a 56-page booklet on self-testing for fair lending practices. The guide is designed to help lenders compare the treatment of loan applicants and identify differences that may be discriminatory, and offers suggestions on how to correct discriminatory practices and improve lending performance.

> Among the topics included are:
> (a) How to plan and manage a pre-application testing program. The focus here is the point where an applicant inquires about a loan, gathers information and receives counseling or an invitation to apply. Financial institutions are encouraged to take whatever steps are necessary, including some form of pre-application testing, to inspect the treatment of potential applicants, as a means of helping to prevent illegal discrimination, improving customer service and attaining lending goals.

(b) Treatment of applicants after submission of an application through a comparative analysis of loan files. Examples are provided of how loan product features, underwriting standards, or instances of lender assistance to borrowers can be compared to identify unequal treatment that may constitute discrimination. The use of comparative file analysis is discussed with reference to applications where disparate treatment may occur regarding applicants who are neither clearly qualified nor clearly unqualified for a loan.
(c) How to identify and correct specific forms of discrimination, that may occur as overt or subtle discrimination, disparate treatment, disparate impact, an individual instance of discrimination or a pattern or practice of discrimination.
(d) Criteria used by the regulatory agencies in taking enforcement actions and seeking remedial measures.
(e) The importance of providing training on multicultural awareness, and on race, gender, and handicap sensitivity, to all levels of an institution's staff. *Side By Side: A Guide to Fair Lending, FDIC, August 1994.*

Audit Reports
Under an FDIC proposal that could affect approximately 70 institutions, annual audit reports on a separate, bank-only basis would be eliminated for institutions with over $9 billion in assets, if they are rated '1' or '2' on the CAMEL system and are subsidiaries of multibank holding companies. Instead, these institutions could be included in the holding company's annual report.

Another proposal relating to procedures for determining compliance with certain laws and regulations, that would affect about 1,000 banks, includes new formatting and modifications of certain procedures so that they are more efficient and less burdensome. *PR-9-95, FDIC, 2/2/95.*

FDIC Will Test Consumer Disclosures in Bank Sales of Mutual Funds
The FDIC announced that it has hired a market research firm to study whether institutions are doing a good job explaining to consumers the distinctions between FDIC-insured deposits and uninsured products being offered by banks and thrifts, such as mutual funds. The agency's action is in response to concerns from lawmakers, bank customers and other regulators that confusion still exists despite various educational efforts by the industry and regulators about insured and uninsured bank products. To implement the study, trained representatives of the research firm, in person and by telephone, will pose as consumers asking typical questions about mutual funds, annuities and other nondeposit investment products, in the process of surveying a random, nationwide sample of several thousand locations of FDIC-insured banks and thrifts that sell these products. While the study is not intended to be used as an enforcement tool, if significant problems are found at an FDIC-supervised institution, the agency will seek appropriate corrective measures, and will refer problems found at other institutions to their primary regulator for follow-up. Results of the study are expected to be publicly available by mid-1995. *PR-80-94, FDIC, 12/13/94.*

Mutual-to-Stock Conversions The FDIC issued a final rule, to become effective January 1, 1995, that addresses the conversion by mutual savings banks to stock form of ownership. The rule, applicable to the approximately 600 state-chartered mutual savings banks supervised by the FDIC, combines elements of an interim rule adopted in February 1994 and a rule proposed in June. A proposed policy statement issued in February, and a separate request for comment issued in May on certain fundamentals of the conversion process have been withdrawn.

Among the requirements, which, under the final rule, a bank that proposes to convert must meet are: provide 60 days' advance notice to the FDIC of plans to convert, and if the FDIC finds any features to be unfair or unsafe it can object to and prevent the transaction; submit a full, independent appraisal report on the institution's value; and obtain a favorable vote on the conversion by depositors. Proxies are not permitted that are obtained from depositors in advance when they open an account. Eligible depositors must be given a priority over other buyers, including employee stock ownership plans, in purchasing stock when it is first offered, and bank management is permitted, but not required, to give preference to eligible local depositors. A bank generally is not permitted to buy back its stock within the first year after conversion. After one year, stock repurchases are subject to case-by-case review by the FDIC. The bank must submit a business plan detailing the use of capital to be acquired in the conversion and expected earnings.

The final regulation does not prohibit conversions through a merger with an existing institution or an acquisition by a holding company; however, because of the abuses that have been associated with such conversions, the FDIC will scrutinize closely these proposed transactions. *PR-77-94, FDIC, 11/22/94; FR, 11/30, p. 61233.*

Capital Rule For Unrealized Gains and Losses on Securities
The FDIC adopted a final rule, effective January 27, 1995, that clarifies the regulatory capital treatment for unrealized gains and losses on securities that are 'available for sale.' Statement No. 115 of the Financial Accounting Standards Board requires institutions to recognize as a separate component of stockholders' equity any holding gains and losses on securities that are deemed available-for-sale. In general, this refers to securities that a bank does not have a positive intent and ability to hold to maturity but also does not intend to actively trade. Banks already are required by the banking regulators to follow FASB 115 for the quarterly Reports of Condition and Income (Call Report), under instructions issued in 1993 by the FFIEC. At issue, however, has been the application of FASB 115 to regulatory capital standards.

The FDIC and the other banking regulators previously proposed to require that net unrealized gains or losses on all available-for-sale securities (debt as well as equity securities) be included in determining Tier 1 capital (see this *Review* , Winter 1995, p. 35). The FDIC has joined with the FRB and OCC in rejecting that earlier proposal. Instead, the FDIC is adopting only technical changes to conform the wording in its leverage and risk-based capital rules with the terminology used in FASB 115. A similar rule is expected to be issued by the OTS for the institutions it regulates. FDIC Chairman Ricki Helfer said: We believe bank regulatory capital levels would be unnecessarily volatile, without appreciable benefits to the safety and soundness of the banking system, if institutions were required to include all unrealized securities losses in their regulatory capital calculations.

The new rule closely tracks an interim guidance jointly issued by the three bank regulatory agencies in December 1993, and the capital treatment recommended by an inter-agency task force of the FFIEC in November 1994. Under the final rule, net unrealized holding losses on available-for-sale equity securities (but not debt securities) with readily determinable fair values will be deducted from the elements that determine Tier 1 capital. All other unrealized holding gains or losses on available-for-sale securities will be excluded from the definition of Tier 1 capital. However, the extent of any unrealized appreciation or depreciation on securities will continue to be a factor that FDIC examiners consider in their overall assessment of an institution's capital adequacy. The amortized cost rather than the fair value of available-for-sale debt securities generally will continue to be used when calculating leverage and risk-based capital ratios. Banks also should continue to use the amortized cost of available-for-sale debt securities when reporting average total assets and risk-based capital data in the Call Report. *PR-85-94, FDIC, 12/20/94; FR, 11/25, p. 60552; 12/28, p. 66662.*

Proposed New Appeals Process
The FDIC proposed guidelines for a new process that institutions could use to appeal supervisory decisions involving examination ratings, adverse classifications of significant assets, and the adequacy of loan-loss reserves. An 'independent' appeals process for 'material supervisory determinations' is required by Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994 for the FDIC as well as the other federal regulators of banks, thrifts and credit unions. The law defines an independent appeals process as one where the review is by an agency official who does not directly or indirectly report to the person who made the supervisory determination being questioned.

The new program would replace a less formal appeals process adopted by the FDIC in February 1992. Under the proposed guidelines, an institution first would be encouraged to attempt to resolve the disputed matter with the regional office of the agency's division that made the supervisory determination. However, the institution could file an appeal with the Washington-based director of the appropriate division within 60 days after receiving written notification of the initial FDIC decision. That division director either would grant the change requested by the institution or promptly refer the matter to a special committee consisting of the FDIC's Vice Chairman, General Counsel, an internal ombudsman and supervisory division directors. This committee would decide the appeal and notify the institution of its decision. From the time the FDIC receives an appeal, it would reach a final decision and notify the institution within 60 days.

Certain types of determinations would not be subject to this appeals process, including decisions to appoint a conservator or receiver for a failing institution; 'prompt corrective action' taken when an institution's capital falls below specified levels; formal enforcement actions; and risk classifications for deposit insurance premiums (review of these determinations is covered by other FDIC procedures). The proposed guidelines also contain safeguards against possible retaliation by FDIC examiners. *PR-84-94, FDIC, 12/20/94; FR, 12/28, p. 66965.*

The OCC has issued a similar request for comments. *FR, 12/22/94, p. 66067.*

Applications For Merger Transactions
The FDIC amended its requirements to provide that in emergency cases necessitating prompt action, an applicant for a transaction under the Bank Merger Act will be required to publish only twice during the statutory ten-day period, with the second publication on the tenth day or the newspaper's publication date closest to ten days after the first publication, instead of daily for ten days as presently required. In non-emergency cases, publication will be required only three times at approximately two-week intervals. The regulation brings the FDIC's notice requirements into greater conformance with those of the other federal banking agencies, gives applicants more flexibility, and lessens regulatory burden. *12/28/94, p. 66653.*

Remote Service Facilities
The FDIC is revising its requirements, effective immediately, for the establishment and relocation of remote service facilities (RSFs) in order to lessen the regulatory burden on state nonmember banks and state-licensed branches of foreign banks. Prior to the revisions, banks desiring to establish an initial RSF were required to comply with all the application and publication requirements applicable to the establishment of a 'brick and mortar' branch office. Successive RSFs could be established or relocated without a formal application under somewhat less involved requirements. The amended regulation provides that a state nonmember bank or an insured state-licensed branch of a foreign bank whose recent CRA rating is Satisfactory or better may establish and operate or relocate an RSF by filing a letter with the appropriate FDIC regional director. The letter must state the location of the RSF and information indicating compliance with the National Historic Preservation Act. Unless the institution is notified otherwise by the FDIC within seven days of receipt of the letter, the institution may establish or relocate the RSF. The public notice requirements are being dispensed with in this case. *8/23/94, p. 43281; FIL-59-94, FDIC, 8/24.*

Loans to Executive Officers
The FDIC amended its regulations to except loans which are fully secured by certain types of collateral from the general limit on 'other purpose' loans to executive officers of insured nonmember banks. The FDIC's rules place limits on loans that a bank can make to its executive officers for purposes other than an education or a home, such as commercial loans, farm loans and other types of consumer loans. When secured by any of the specified types of collateral, which in part include a perfected security interest in a segregated deposit account in the lending bank, a loan may be made in any amount and will not be subject to the limit for other purpose loans set forth elsewhere in the regulation. The amendment parallels recent changes by the FRB to that agency's regulations on insider loans. *FR, 8/16/94, p. 41990; 12/28, p. 66666; FIL-5-95, FDIC, 1/5/95.*

Foreign Banks
The FDIC is amending its regulations, effective January 1, 1995, concerning applications procedures and plans for divestiture or cessation of activities by state-licensed insured branches of foreign banks. FDICIA

provides that after December 19, 1992, such a branch may not engage in any activity that is not permissible for a federal branch of a foreign bank without the approval of the FRB and the FDIC. In the event that an application to begin or to continue to engage in an activity is denied by the FRB or FDIC, or the foreign bank elects not to continue the activity, a plan of divestiture or cessation must be submitted and the transaction completed within one year, or sooner if the FDIC so directs. *11/28/94, p. 60703.*

Courts Again Decide For Gross Negligence Standard
The U.S. Court of Appeals for the Sixth Circuit, in the case of *FDIC v. Bates* , ruled that the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires regulators to meet a gross negligence standard in suits against officers and regulators. It was the third federal appeals court decision upholding the gross negligence standard, which generally makes it more difficult for regulators to prove negligence than would a simple negligence standard.*AB, 12/29/94, p. 2.*

Agency Uses Self-Appointment Authority
The FDIC appointed itself receiver of the $3.2 million-deposit The Meriden Trust and Safe Deposit Company, Meriden, Connecticut, and on July 7, 1994, took possession of and closed the bank. This was the first exercise of the agency's self-appointment authority which it received in 1991. The announcement said the bank would reopen the following day as a 'bridge bank,' New Meriden Trust and Safe Deposit Company, National Association. Meriden Trust's closing was the direct result of the 1991 failure of an affiliated institution, Central Bank of Meriden. The FDIC used its 'cross guaranty' authority to assess Central Bank's affiliated insured depository institution for potential losses to the deposit insurance fund, resulting in Meriden Trust's insolvency. *PR-41-94, FDIC, 7/7/94.*

Real-Estate Recovery Less Widespread Than Earlier
While reports of improvement in real-estate conditions continued overall to substantially exceed reports of decline, the margin of difference diminished in the FDIC's quarterly survey for the third consecutive time.

The national composite index of survey results fell to 62 in January from 67 in October and 72 in July 1994. Values of the index above 50 indicate more respondents believed conditions were improving than declining, compared to the previous quarter, while values below 50 indicate the opposite. The surveys, which began in April 1991, are based on interviews across the country with senior examiners and asset managers of federal bank and thrift regulatory agencies. The 407 participants in the latest survey were polled in late January.

In residential markets, the index declined to 58 in January from 64 in October. Over half of the January respondents reported local housing conditions unchanged, while 32 percent saw continuing improvement down from 41 percent in October and 17 percent reported a decline. The recovery continued to be somewhat more widespread in commercial real-estate markets, as 38 percent of the respondents in January reported gains in that sector, while only 4 percent saw worsening conditions. These results were, however, somewhat less favorable than in October, when the percentages were 44 and less than one, respectively.

As another indicator of the recovery in real estate, where the results were better than in the previous surveys, 28 percent of the respondents assessing local housing markets, and slightly over one-half for commercial real estate, reported an excess supply in the markets.

Regionally, respondents in January reported small differences in the overall indexes, as the index for the West mirrored the national average. The evaluations for the South and Northeast were slightly more positive than for the nation as a whole, but were below the average in the Midwest, where the 22 percent of responses indicating improvement in local housing markets was down from 40 percent in the October survey. More than three-fourths of reports in California indicated commercial property sales were below average for that area. *Survey of Real Estate Trends, FDIC, January 1995.*

Agency Will Sell Mortgage-Backed Securities

The FDIC will issue approximately $761.4 million of securities backed by commercial mortgage loans. The issue is the FDIC's first entry into the mortgage-backed securities market. The certificates will evidence beneficial ownership interests in real-estate loans that were originated by failed depository institutions nationwide that were insured by the Bank Insurance Fund (BIF). The issue consists of $264.0 million of floating-rate Class I certificates and $497.4 million of fixed-rate Class II certificates. The certificates include a limited FDIC guaranty provided solely by the BIF against credit losses and other shortfalls due to credit defaults. The guaranty will be limited to a maximum of 32.5 percent of the principal amount of the collateral outstanding; any additional losses will be borne by the holders of the certificates. Except under the limited guaranty, the certificates are not guaranteed by the FDIC or any other government agency. The offering of the securities will be made only by means of a prospectus. *PR-51-94, FDIC, 8/9/94.*

Standards of Ethical Conduct For FDIC Employees

The FDIC, with the concurrence of the Office of Government Ethics (OGE), proposes to issue regulations for the employees of the Corporation that would supplement the Standards of Ethical Conduct for Employees of the Executive Branch issued by the OGE. The proposed rule would establish prohibitions on borrowing and extensions of credit; prohibitions on the ownership of certain financial interests; prohibitions on the purchase of property controlled by the Corporation or the Resolution Trust Corporation; limitations on official dealings with former employers and clients; disqualification requirements relating to employment of family members outside the Corporation; and limitations on outside employment activities. *FR, 7/12/94, p. 35480.*

Treasury Reduces BSA Information Requirements

The Treasury Department issued a final rule, effective immediately, rescinding a requirement adopted pursuant to the Bank Secrecy Act for financial institutions to maintain a chronological log, and reducing substantially the amount of information required to be recorded. The BSA prohibits financial institutions from issuing or selling bank checks or drafts, cashier's checks, money orders or traveler's checks for $3,000 or more in currency unless the financial institution verifies and records the identity of the purchaser. Treasury also withdrew a proposal that would have required banks with deposits over $100 million, and certain nonbank financial institutions, regardless of asset size, to maintain specific systems to aggregate currency transactions, and would have required financial institutions that file more than 1,000 Currency Transaction Reports per year to file by magnetic media. *FR, 10/17/94, pp. 52250, 52275.*

Resolution Trust Corporation

Audit Report by the General Accounting Office (GAO)

A GAO report of its audit of the RTC's statements of financial position as of December 31, 1993 and 1992, found that: (a) the Corporation's financial statements were reliable in all material respects; (b) internal controls as of December 31, 1993, were effective in safeguarding assets against unauthorized acquisition, use, or disposition; (c) there was no material noncompliance with laws and regulations that were tested; and (d) the Corporation adequately addressed the material weakness and reportable conditions that were identified in the GAO's 1992 audit. The report noted that although the Corporation used the best available information to estimate securitization credit losses and future losses arising from representations and warranties, significant uncertainties exist. The limited claims experience raises the risk that the amount of future losses may significantly increase or decrease. These future losses will be affected by the behavior of the economy, interest rates, and real-estate markets as well as the performance of the collateral underlying the transactions. The Chairman of the Thrift Depositor Protection Oversight Board announced a management reform agenda in March 1993, which included requirements that the Corporation strengthen its internal controls in several areas. Among the steps the Corporation has taken to enhance its internal controls is the oversight of contractors that perform services for receiverships. However, audits of some contractors are continuing to identify contractor performance problems, such as poor asset management and disposition practices and questionable billings, which could result in increased expenses or reduced recoveries on assets.

The report contains estimates of unused loss funds after completion of the RTC's resolution activities. Based on total loss funding made available of $105 billion, and estimated loss funding needs of $92 billion, the estimated unused loss funds would total $13 billion. However, if actual asset recoveries are less than estimated or future resolution costs are greater than anticipated, the RTC will need to use additional loss funds. Loss funds not used by the Corporation are available for losses incurred by the Savings Association Insurance Fund (SAIF), subject to the conditions set forth in the RTC Completion Act. Funds in excess of the amounts needed by both the RTC and SAIF will be returned to the general fund of the Treasury. Under the RTC Completion Act, the Corporation will terminate on or before December 31, 1995. All remaining assets and liabilities will be transferred to the FSLIC Resolution Fund, which is managed by the FDIC. *Annual Management Report, RTC, submitted to Congress on June 30, 1994, containing Opinion Letter from the U.S. General Accounting Office.*

Operations Update
The resolution, in December 1994, of one institution under the Accelerated Resolution Program brought the total number of resolutions to 774 since the inception of the RTC in 1989. As of December 31, the RTC had one institution to be resolved.

As of November 30, 1994, the assets under RTC management had decreased to $31 billion, consisting of $4 billion in cash and securities, $5 billion in performing 1-4 family mortgages, $5 billion in other performing loans, $7 billion in delinquent loans, $2 billion in real estate, $5 billion in investments in subsidiaries, and $3 billion in other assets. The conservatorship program held $3 billion in gross assets on November 30. Assets in receiverships remaining from the institutions closed by the RTC amounted to $28 billion. Because many of the relatively marketable assets have been sold before an institution enters a receivership, most of the assets retained by the RTC in receivership consisted of lower-quality, less-marketable assets. Thus, real estate and delinquent loans represented 32 percent of receivership assets.

From inception through November, the RTC collected $156 billion from securities, $103 billion from 1-4 family mortgages, $54 billion from other mortgages, $30 billion from non-mortgage loans, $16 billion from real estate, and $21 billion from other assets. The recoveries, which have amounted to 88 percent of book value reductions, included 98 percent from securities, 96 percent from 1-4 family mortgages, 77 percent from other mortgages, 90 percent from non-mortgage loans, 55 percent from real estate, and 65 percent from other assets. Through the end of November the RTC also had collected $19.3 billion in receivership income. The thrifts closed through November held $240 billion in assets at the time of closure. Estimated resolution costs for these closures totaled $88.2 billion. *RTC Review , January 1995.*

Marketing Real Property on an Individual Basis
In September 1994, the RTC adopted an interim rule, implementing the marketing provisions contained in the FHLBank Act and the RTC Completion Act, to provide policies and procedures for the marketing of real-estate-owned (REO) assets on an individual basis, and for the disposition of REO assets with a book value of more than $400,000 and nonperforming real-estate loans with a book value of more than $1 million. The agency subsequently adopted the interim rule without change as a final rule to be effective December 23, 1994. *FR, 9/19/94, p. 47790; 11/23, p. 60304.*

Affordable Housing Disposition Program
The RTC is amending its regulations to implement provisions of the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act of 1991 and other statutes enacted in 1992 and 1993 that changed the manner in which the RTC is to identify, market and sell certain affordable housing properties. The regulations as amended will enhance the availability and affordability of residential real property for very-low-income, lower-income and moderate-income families and individuals. An interim final rule became effective October 19, 1994, and this rule was adopted in October without change as a final rule to be effective January 12, 1995. *FR, 10/19/94, p. 52669; 12/13, p. 64111.*

Affordable Housing Unification Plan
The RTC reported that in the four-month period beginning in June 1994, RTC-FDIC joint sales of single-family and multifamily affordable housing properties totalled over $6.8 million. In April 1994, the FDIC

Board approved the unification plan of the affordable housing programs of the two agencies, which would implement the merger approved in March by the newly-formed Affordable Housing Advisory Board, in accordance with the RTC Completion Act of 1993. The FDIC will assume full control of both affordable housing programs by October 1, 1995.

Among the key elements of the unification plan are: (a) FDIC will use RTC seller financing to underwrite its single-family and condominium sales through the transition period 1994-1995; (b) the agencies will consolidate their clearing house notices of available single-family and condominium properties; (c) the agencies will hold joint sales events, including at least two auctions in 1994 and two in 1995; (d) the agencies will use the same purchaser eligibility certification forms, and will develop a standard system of purchaser incentives for single-family sales, such as direct discounts and buyer counseling. *The Silver Lining, RTC, Spring 1994, Summer 1994.*

Minority Thrift Sales
As of June 14, 1994, the RTC had sold 14 savings-and-loan associations to minority bidders during the year. The RTC Completion Act, enacted in December 1993, requires the RTC to provide minorities a distinct preference to purchase failed savings-and-loan institutions. By April 1994, the agency had finalized new assistance terms for minority acquirers purchasing thrifts or branches that serve minority neighborhoods. Under these assistance provisions, minority acquirers can obtain financing for up to two-thirds of the required regulatory capital and any premium, provided that the total amount financed does not exceed the tangible book value of the institution. Minority acquirers can obtain performing assets to offset deposit liabilities, giving them an option to acquire assets of up to 100 percent of net deposits. The RTC will make owned branch facilities located in minority neighborhoods available on a rent-free basis to minority acquirers for up to five years.

The RTC permits the highest minority bidder to match the highest non-minority bidder's offer if, after a competitive bid process, the minority bidder's offer is within ten percent of the highest non-minority bid. If the minority bidder matches the high bid, it will be considered the winning bid. In order to acquire branches in minority neighborhoods, minority investors do not have to make an initial bid. They can acquire these branches from a majority acquirer that purchased the minority branches from the RTC. In effect, minority acquirers can work in consortium with majority bidders and still receive the full benefits of the minority assistance. *The RTC Investor, 8/94, p. 4.*

RTC's Power to Subpoena Information
A federal appeals court in early 1994 limited the RTC's power to issue subpoenas for personal financial information to persons that the RTC may reasonably suspect may be liable for an institution's failure (see this *Review* , Winter 1995, p. 38). In December the U.S. Court of Appeals for the District of Columbia, in a case stemming from the 1990 failure of San Jacinto Savings and Loan Association, ruled that the agency, having sued a person, cannot use an administrative subpoena solely to determine that individual's net worth. *AB, 12/29/94, p. 2.*

Gross Negligence Standard Upheld in Bank Officials' Liability
The U.S. Court of Appeals for the Fifth Circuit ruled that bank officers and directors cannot be held personally liable under federal common law for anything less than gross negligence *(RTC v. Miramon, 6/21/94).* The Court said that the federal common law, which the RTC claimed would allow bank officers to be held liable for simple negligence, was preempted by FIRREA. The Act specifically provides that directors and officers of federally insured institutions may be held personally liable for damages in cases of 'gross negligence,' but that this provision does not impair any right of the RTC 'under other applicable law.' Stressing the limited role of the federal common law, the Court found that Congress spoke directly to the issue and thus preempted the federal common law.

The Court made no ruling on whether FIRREA preempts state common law that allows actions against bank directors and officials based on simple negligence. Several courts have held that such suits are not preempted. *BBR, 7/18/94, p. 94.*

Federal Reserve Board
Capital Guidelines

The FRB is amending, effective December 31, 1994, its capital guidelines for state member banks and bank holding companies to generally direct institutions to not include in regulatory capital the 'net unrealized holding gains (losses) on securities available for sale.' Net unrealized losses on equity securities with readily determinable fair market values will continue to be deducted from Tier 1 capital. The rule has the general effect of valuing available-for-sale securities at amortized cost, rather than at fair value (generally at market value), for purposes of calculating the risk-based and leverage capital ratios. The OCC and the OTS have adopted a similar rule for the institutions under their regulatory authority. *FR, 11/25/94, p. 60552; 12/8, p. 63241; Press Release, FRB, 12/5.*

The FRB adopted amendments, to be effective April 1, 1995, to its capital adequacy guidelines for state member banks and bank holding companies to establish a limitation on the amount of certain deferred tax assets that may be included in Tier 1 capital for risk-based and leverage capital purposes. The rule was developed in response to FASB Statement No. 109.

Under the final rule, deferred tax assets that can only be realized if an institution earns taxable income in the future are limited for regulatory capital purposes to the amount the institution expects to realize within one year of the quarter-end report date -- based on its projection of taxable income -- or ten percent of Tier 1 capital, whichever is less. Deferred tax assets that can be realized from taxes paid in prior carryback years would generally not be limited. *Press Release, FRB, 12/19/94.*

The FDIC has adopted these amendments with respect to banks subject to its supervisory authority. *PR-8-95, FDIC, 1/31/95.*

The FRB is amending its risk-based capital guidelines to recognize the risk-reducing benefits of qualifying bilateral netting contracts, implementing a recent revision to the Basle Accord. The effect of the final rule, to be effective December 31, 1994, is that state member banks and bank holding companies may net positive and negative mark-to-market values of interest-rate and exchange-rate contracts in determining the current exposure portion of the credit-equivalent amount of such contracts to be included in risk-weighted assets. The OCC, FDIC, and OTS have issued parallel rules. *FR, 12/7/94, p. 62987; Press Release, FRB, 12/2; AB, 12/30, p. 2; FIL-6-95, FDIC, 1/6/95; NEWS, OTS, 12/28/94.*

As part of its payment system risk-reduction program, the FRB, effective December 21, 1994, is integrating its policies on privately operated large-dollar multilateral netting systems into a single policy statement. Multilateral netting systems, including clearinghouse arrangements, have the potential to improve the efficiency of interbank settlements by reducing the costs of credit, liquidity and operations. However, these systems concentrate settlement and operational risks at a single point in the financial system. The FRB's statement incorporates the minimum standards for the design and operations of such systems contained in a report of the central banks of the Group of Ten countries published in November 1990 by the Bank for International Settlements. These standards are designed to provide a set of minimum standards that permit the advantages of multilateral netting to be gained, while controlling systemic risks. *FR, 12/29/94, p. 67534; Press Release, FRB, 12/21.*

The FRB modified its Policy Statement on Payment System Risk, doubling from 20 to 40 percent of risk-based capital the multiple associated with the *de minimis* net debit cap. Previously, an institution could request this cap which permitted daylight overdrafts up to 20 percent of risk-based capital. The FRB's action increases that limit to 40 percent. It is estimated that the change will eliminate 85 to 90 percent of cap overruns by institutions that currently have 'exempt from filing' or *'de minimis'* caps.

The FRB also approved administrative counseling flexibility for institutions that continue to exceed their net debit caps due to the posting of non-Fedwire transactions. Under this flexibility, the Reserve Banks will work with affected institutions on means of avoiding daylight overdrafts, but will not subject these institutions to routine counseling for daylight overdrafts. Effective: 10/13/94. *FR, 11/2/94, p. 54915; BBR, 11/7. p. 660.*

Bank Settlement on Derivatives' Risk Disclosure
Bankers Trust New York Corp. signed a 'written agreement' under which the banking firm is required by the Federal Reserve to take measures for ensuring that its customers are able to understand the risks and price fluctuations involved with leveraged derivatives. Several Bankers Trust customers, including Gibson Greetings Inc. and Proctor and Gamble Co., have suffered heavy losses on derivatives contracts. Among the requirements under the agreement, Bankers Trust will disclose the risks of the derivatives prior to their purchase. For some derivatives after purchase, the bank will report their value to the customer each day. Previously, the bank provided this information only after the customer requested it. The agreement also calls for the bank to take actions to improve internal training, supervision and controls for leveraged derivatives activities. Several employees have been suspended by the bank for violations of internal rules regarding the selling of leveraged derivatives. *The New York Times, 12/6/94, p. A1; WSJ, 12/6, p. A3.*

International Banking Operations
The FRB proposed amending its Regulation K to provide criteria for use in evaluating the operations of any foreign bank in the United States that is not subject to comprehensive supervision or regulation by its home-country supervisor. The Foreign Bank Supervision Enhancement Act requires the FRB to develop these criteria in consultation with the Treasury Department. When the FRB has determined that a foreign bank is not subject to comprehensive, consolidated, home-country supervision, the criteria will be used to decide whether the bank should be permitted to continue its U.S. operations with or without supervisory restraints, or whether these operations should be terminated. *Press Release, FRB, 12/9/94; FR, 12/13, p. 64171.*

Activities of State-Licensed Branches and Agencies of Foreign Banks
The FRB amended its Regulation K to set forth the application procedures for state-licensed branches and agencies of foreign banks seeking the Board's permission to engage in or continue to engage in an activity that is not permissible for a federal branch of a foreign bank and the requirements of divestiture and cessation plans. Section 202(a) of FDICIA provides that after December 19, 1992, a state-licensed branch or agency of a foreign bank may not engage in any activity that is not permissible for a federal branch of a foreign bank unless the FRB has determined that the activity is consistent with sound banking practice, and in the case of an insured branch, the FDIC has determined that the activity would pose no significant risk to the affected deposit insurance fund. The regulation is effective on January 1, 1995, except for one part effective December 5, 1994. *FR, 11/3/94, p. 55026.*

Tying Restrictions Are Revised
The FRB is adopting a final rule, effective January 23, 1995, amending its Regulation Y to permit a bank holding company or its nonbank subsidiary to offer a discount on its product or service on condition that a customer obtain any other product or service from that company or from any of its nonbank affiliates. The final rule would generally remove FRB-imposed restrictions on tying when no bank is involved in the arrangement and the products are separately available for purchase by the customer. The purposes of the amendment are to relieve bank holding companies of a competitive disadvantage, promote efficiency in the delivery of services, and provide benefits for consumers. *FR, 12/20/94, p. 65473.*

Banking Firm's Investment Powers Are Widened
The FRB approved a request for subsidiary banks of Norwest Corp. to inform customers about the products offered by Norwest Investment Services, a Section 20 subsidiary, through joint seminars, direct mail, letters on bank stationery, and statement stuffers. Among the offerings of Norwest Investment are stocks, bonds and mutual funds. About 30 banking firms operate Section 20 subsidiaries, through which since 1987 they have been granted limited powers by the FRB to underwrite and deal in securities. The FRB also gave approval for Norwest Investment to underwrite and deal in certain unrated municipal revenue bonds. This action should assist in broadening the market for the bonds of small municipalities. *AB, 12/6/94, p. 5; BBR, 12/12, p. 862.*

Applications Under Regulation Y
The FRB issued interim rules, with request for comments, implementing changes to the FRB's application procedures established by the Riegle Community Development and Regulatory Improvement Act of 1994 (RCDRIA). The RCDRIA makes certain revisions to the procedures that bank holding companies must follow to gain approval of bank and nonbank acquisition proposals under the Bank Holding Company Act. The RCDRIA establishes a prior notice procedure to replace the current application process for all proposals by bank holding companies to engage in nonbanking activities. It establishes a streamlined notice procedure for the formation of a new bank holding company as part of a reorganization by the existing shareholders of a bank. Also, it eliminates the need for prior FRB approval of certain 'Oakar' transactions whereby a bank acquires a thrift or thrift's assets. Because these amendments became effective upon enactment of the RCDRIA, the FRB has adopted interim rules implementing these changes. *Press Release, FRB, 10/27/94; FR, 11/2/94, pp. 54801, 54805.*

Appeals of Supervisory Decisions
The FRB requested comment on an internal appeals process for institutions wishing to appeal an adverse material supervisory determination. Section 309 of the RCDRIA requires the FRB (as well as other federal banking regulators) to establish an independent, intra-agency appellate process, which will be available to review material supervisory determinations made at insured depository institutions, such as an adverse examination report. The FRB is proposing guidelines for appeals that are consistent with current practice at the Reserve Banks and the specific requirements of Section 309. *Press Release, FRB, 12/22/94; FR, 12/29, p. 67297.*

Home Mortgage Disclosure
The FRB amended its Regulation C and the instructions and reporting forms that financial institutions must use in complying with the annual reporting requirements. The amendments respond to the statutory provisions regarding earlier availability of the Home Mortgage Disclosure Act (HMDA) disclosure statements to the public; provide clarifications; and are intended to help improve the quality of the HMDA data. The amendments require reporting in machine-readable format, except for institutions reporting 25 or fewer line entries, require institutions to update their loan application registers quarterly during the year as data are being collected; and make a number of other changes.

The rule is effective January 1, 1995, with required compliance for certain data beginning in calendar year 1995 and in 1996. *FR, 12/9/94, p. 63698; Letter to Financial Institutions, FFIEC, 12/9.*

The federal bank and thrift regulatory agencies have proposed changes to their regulations implementing the Community Reinvestment Act (CRA) under which the banks and savings associations that report data about their home mortgage lending pursuant to HMDA, and which have assets of $250 million or more, or are subsidiaries of a holding company with total banking and thrift assets of $250 million or more, would collect and report geographic information on loans and loan applications relating to property located outside the 'metropolitan statistical areas' (MSAs) in which these lenders have an office. Currently, geographic information is required only within MSAs where these lenders have an office. The new data would facilitate complete CRA assessments for institutions that do not qualify as small banks or thrifts. *FR, 10/7/94, p. 51323.*

Truth in Lending
The FRB proposed amendments to its Regulation Z to implement changes made to the Truth in Lending Act by the Riegle Community Development and Regulatory Improvement Act of 1994 that imposes new disclosure requirements and substantive limitations on mortgages bearing high rates or fees. More protections would be provided to consumers entering into high-rate, high- fee mortgages. The law also imposes new disclosure requirements for comparing the cost of reverse mortgages, which provide for periodic payments, based principally on a home's value, to primarily elderly homeowners. *FR, 12/2/94, p. 61832; Press Release, FRB, 11/29.*

The FRB proposed revisions to its official staff commentary to Regulation Z. The proposals relate to several issues of general interest, such as the treatment of various fees and taxes associated with real-estate-secured loans, and a creditor's responsibilities when investigating a claim of unauthorized use of a credit card. *FR, 12/14/94, p. 64351.*

The FRB solicited comments on whether consumers would benefit from having greater flexibility in waiving the right of recision in transactions with new creditors to refinance or consolidate home-secured loans (where no additional debt is incurred). Under present law, consumers may waive the right of recision in refinancings or consolidations with new creditors only when a bona fide personal emergency exists. *FR, 12/21/94, p. 65771; Press Release, FRB, 12/20.*

Truth in Savings
The FRB is reconsidering its action on January 4, 1995, in amending its Regulation DD requiring that the annual percentage yield (APY) reflect the frequency of interest payments. The original regulation is being left in place pending final action on the issue, except as indicated below. The FRB is seeking comment on the amendment, as well as the interest rate of return formula that was previously proposed but withdrawn last year. It adopted as an interim rule a narrowly drawn amendment to the Regulation to permit institutions to disclose an APY equal to the contract interest rate for time accounts with maturities greater than one year that do not compound but require interest distributions at least annually. *Press Release, FRB, 1/18/95; FR, 1/26, pp. 5128, 5142.*

The FRB amended its Regulation DD and the official staff commentary to implement changes made to the Truth in Savings Act by the Riegle Community Development and Regulatory Improvement Act of 1994. RCDRIA narrows the scope of accounts covered by TISA to accounts held by individuals for a personal, family or household purpose. Accounts held by unincorporated nonbusiness associations of individuals are no longer subject to TISA requirements. Effective date: September 23, 1994. *FR, 10/19/94, p. 52657.*

Equal Credit Opportunity
The FRB proposed revisions to the official staff commentary to its Regulation B. The proposed revisions provide guidance on several issues including disparate treatment, special-purpose credit programs, credit scoring systems, and marital status discrimination. *FR, 12/29/94, p. 67235; Press Release, FRB, 12/21.*

Public Welfare Investments
The FRB adopted revisions, effective January 9, 1995, under which bank holding companies that have received approval to engage in activities that promote community welfare may make similar investments permissible for state member banks. These investments would primarily benefit low- and moderate-income persons or small businesses, and address demonstrated community needs by providing housing, services, and jobs to low- and moderate-income communities. Investments that comply with specified requirements, and do not exceed five percent of the total consolidated capital stock and surplus of the bank holding company when aggregated with similar investments made by depository institutions controlled by the holding company, may be made without additional FRB or Federal Reserve Bank approval. *FR, 12/9/94, p 63712; Press Release, FRB, 12/7.*

Investment Advisor Activities
The FRB is seeking comment on a proposal that would allow a bank holding company and its bank and nonbank subsidiaries to purchase in their sole discretion in a fiduciary capacity, securities of an investment company advised by the holding company if this purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered. The OCC and FDIC recently have granted this authority to the banks they regulate. Many states have amended their laws to allow banks to engage in these types of transactions. *FR, 12/30/94, p. 67654; Press Release, FRB, 12/27.*

Recordkeeping For FundsTransfers
The Department of the Treasury and the FRB adopted a final rule, effective January 1, 1996, that requires each domestic financial institution involved in a wire transfer to collect and retain certain information for

five years. The amount and type of information depend upon the type of financial institution, its role in the particular wire transfer, the amount of the wire transfer, and the relationship of the parties to the transaction with the financial institution. The rule exempts wire transfers below $3,000.

Under the Bank Secrecy Act of 1970, as amended in 1992, the FRB and the Treasury are authorized to impose recordkeeping requirements for domestic wire transfers by insured depository institutions whenever the agencies determine that such records have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. In addition, the 1992 amendment requires the Treasury and the Board to issue final regulations with regard to international transactions. *FR, 1/3/95, pp. 220, 231; Press Release, FRB, 12/22/94. See also related statement by OCC. FR, 1/3/95, p. 234.*

Disclosure Requirement Eliminated
The FRB adopted an interim rule, effective December 1, 1994 and with a request for comments, eliminating from its Regulation E the requirement that an electronic terminal receipt disclose a number or code that 'uniquely' identifies the consumer, the consumer's account, or the access device. This requirement currently poses a significant security risk for consumers and financial institutions. The Electronic Fund Transfer Act (EFTA) requires that when a consumer initiates an EFT at an electronic terminal, the financial institution must make a written receipt available to the consumer that identifies the consumer's account with the financial institution from or to which funds are transferred. To ensure adequate identification, the FRB's regulation has required since 1979 that the receipt show a number or code that is 'unique.' Under the amendment, the receipt will still provide sufficient information, such as the date, amount, and type of the transfer, and the location of the terminal, to allow the consumer to identify transfers. Each transaction on the periodic statement could be matched with the transaction receipt. *FR, 12/2/94, p. 61787.*

Imputed Income on Clearing Balances
The FRB proposed to modify the methodology for imputing clearing balance income to more closely parallel the practices of a private-sector provider. Specifically, comment is requested on changing the rate used to impute clearing balance income from the 90-day Treasury bill coupon- equivalent yield to a longer-term Treasury rate based on the earning asset maturity structure of the largest bank holding companies.

The Monetary Control Act of 1980 requires the Federal Reserve Banks to establish fees for their services similar to those of private-sector service providers. In establishing fees, the FRB considers the objectives of fostering competition, improving the efficiency of the payments mechanism, and providing financial services nationwide. The Federal Reserve imputes costs in the private-sector adjustment factor (PSAF) that are intended to mirror private-sector sales taxes, income taxes, cost of funds, and FDIC assessments. Capital structure, equity and debt rates, and an income-tax rate are derived from a model of the largest (in asset size) 50 bank holding companies. The intended effect of the proposal is to promote competitive equity with private-sector practices by matching the maturity structure for investment of clearing balances to the structure revealed in bank holding company data on investments. *Press Release, FRB, 8/16/94; FR, 8/19, p. 42832.*

Report Publication Requirement Eliminated
The FRB amended its Regulation H to remove the requirement that state member banks publish their Reports of Condition. The amendment, effective November 10, 1994, implements Section 308 of the Riegle Community Development and Regulatory Improvement Act of 1994. Banks' Call Reports, including their Reports of Condition, will continue to be publicly available through the National Technical Information Service of the U.S. Department of Commerce. Additionally, state member banks will continue to be required to advise shareholders, customers, and the general public of the availability of year-end Call Reports and other financial information. *FR, 11/10/94, p. 55987.*

Applications Approved For Firms to Operate in Mexico
The FRB approved applications for a number of U.S. banking companies to establish operations in Mexico, the first such approvals since a provision of the North American Free Trade Agreement (NAFTA)

became effective allowing U.S. and Canadian investors to acquire Mexican bank subsidiaries and establish financial holding companies. The firms receiving approval included Citibank Overseas Investment Corp., Morgan Guaranty International Finance Corp., Chemical International Finance Ltd., Republic National Bank of New York, Chase Manhattan Overseas Banking Corp., NationsBank Overseas Corp., and BankAmerica International Finance Corp.

Among the requirements set by Mexico, foreign banks must have a business plan showing how their operations would benefit the nation's economy. Foreign banks cannot comprise more than eight percent of the total Mexican banking system in the first year, increasing to 15 percent in 1999, and no one institution can comprise more than 1.5 percent until the year 2000. *BBR, 8/1/94, p. 173; Press Release, FRB, 7/27/94.*

Office of the Comptroller of the Currency

Policies and Procedures For Corporate Activities

The OCC is proposing to revise its rules governing corporate applications and notices, in order to modernize and clarify the rules, reduce regulatory burden, and eliminate unnecessary rules. The proposal would extensively revise and reorganize the agency's rules for national bank corporate activities.

Among its provisions, the proposal provides for a new expedited review procedure for many types of applications submitted by healthy, well-managed banks which should entail low levels of risk. A national bank that is well-capitalized, has a rating of 1 or 2 under the CAMEL rating system, has a Community Reinvestment Act rating of 'outstanding' or 'satisfactory,' and is not subject to a cease and desist order or other enforcement actions, would be defined as an 'eligible bank'. Eligible banks submitting filings for branches, corporate reorganizations, operating subsidiaries to engage in certain activities, and other specified filings would qualify to use the expedited approval process. *FR, 11/29/94, p. 61034.*

Concentrations of Credit and Nontraditional Activities

The OCC, FRB, FDIC and OTS issued a final rule to implement Section 305 of FDICIA requiring the agencies to revise their risk-based capital standards for insured depository institutions to ensure that those standards take adequate account of concentration of credit risk and risks of nontraditional activities. The final rule, to be effective January 17, 1995, explicitly identifies such risks, as well as an institution's ability to manage them, as important factors in assessing an institution's overall capital adequacy.

Concentrations of credit typically refer to situations when a lender has a relatively large portion of loans involving one borrower, industry, location, collateral or loan type. Nontraditional activities are considered those that have not customarily been part of the banking business but that start to be conducted as a result of developments in, for example, technology or financial markets. No mathematical formulas or explicit capital requirements for these two risks were adopted. Rather, a case-by-case approach will be used in assessing an institution's risks and overall capital adequacy. As an institution begins or significantly expands its participation in a nontraditional activity, the primary federal regulator will analyze the risks and request the appropriate capital and supervisory treatment. *FR, 12/15/94, p. 64561; FIL-85-94, FDIC, 12/19.*

Management of Derivatives

The OCC released a 93-page booklet of examination procedures that expand on the guidelines on derivatives activities of banks which the agency issued in October 1993. The procedures specify the responsibilities of a bank's board and senior management in managing derivatives activities, distinguishing between different types of derivatives users. There are procedures for evaluating each of several types of risk, including market, credit, liquidity, operations and legal risks. The procedures will 'give examiners detailed guidance for assessing whether banks have the necessary expertise, controls and procedures to manage the risks inherent in these complex instruments and use them in a safe and sound manner,' an OCC official said. *Risk Management of Financial Derivatives, OCC, October 1994; BBR, 10/31/94, p. 620; AB, 10/24, p. 1.*

Disclosures in Mutual Fund Sales

The OCC announced in May 1994, that in response to an interest expressed by a number of national banks in having the agency review disclosure materials they use in sales of mutual fund and annuity products, the agency would offer the opportunity for a one-time review of these disclosure materials. The OCC reported in September that it had completed a review of the materials. More than 700 national banks voluntarily submitted over 8500 different documents.

Each national bank that participated in the review will receive a personalized letter that will include a document-by-document analysis of the materials it submitted. All national banks were sent a summary of the types of problems identified in the review and the type of action the OCC believes will correct the problems. Some of the specific areas where problems and corrections were discussed are: conspicuousness of disclosure displays; nondeposit products and bank obligations; investment risk; disclosure of bank and affiliate relationships; and annuities disclosures. *Letter to National Banks, OCC, 5/4/94; Disclosure Materials Used in Selling Mutual Funds and Annuities, OCC, 9/12/94.*

The FDIC distributed copies of the OCC's study to FDIC-supervised banks. The agency endorses the recommendations in the study, and encourages each bank that sells mutual funds or annuities to the public to review the report and correct any problems they find in their own disclosures. *FIL-64-94, FDIC, 9/27/94.*

Examinations of Noncomplex Community Banks

The OCC adopted a policy and examination procedures for noncomplex community banks applicable only to the safety-and-soundness examinations of these banks. The new procedures are intended to improve efficiency and consistency in examinations, and reduce regulatory burden.

Noncomplex community banks are banks that have composite ratings of 1 or 2 under the Uniform Inter-agency Bank Rating System, and operate under stable conditions demonstrated by stable bank management and ownership, no significant change in operations since the last examination, and a local economy that poses no material threat to operations. The definition also includes having management that is effective and responsive in addressing risks and conditions facing the institution, consistent and strong financial performance, and few or limited nontraditional products. Use of the new procedures is mandatory, beginning October 1, 1994. *Bulletin 94-40, OCC, 6/20/94.*

State Regulation of Insurance Sales Upheld

A panel of the U.S. Court of Appeals for the 11th Circuit, affirming a trial court's decision, ruled that the McCarran-Ferguson Act overrides other federal laws and gives states the right to regulate bank insurance sales. Barnett Banks Inc. argued in this Florida case that the National Bank Act supersedes state insurance law. The state allows independent state-chartered banks to sell insurance, but as a result of the decision it can deny insurance licenses to national banks. *AB, 2/2/95, p. 1.*

Supreme Court Says Banks Can Sell Annuities

The U.S. Supreme Court in a unanimous opinion in the case of *NationsBank Corp. v. Variable Annuity Life Insurance Co* . (Valic), upheld a decision of the OCC in the case that began in 1990 that selling annuities is 'incidental' to banking and a permissible activity under the National Bank Act. The Court's ruling is said to mark the first time it has explicitly stated that the OCC has the authority to grant powers not expressly included in the National Bank Act. An OCC spokesperson said the decision establishes a framework for the OCC to extend additional powers to banks. She said that in order that the grant of a new power is 'reasonable' as required by the Court, it would be necessary for the agency to show that the new power resembles an existing one. *AB,<-3> 1/19/95, p. 1.*

Court Rules Banks Can Tie CD Rate to Stock Index

A U.S. district court judge upheld a 1988 decision by the OCC allowing Chase Manhattan Bank to offer a CD tied to the performance of the Standard and Poor's 500 composite index. In his ruling the judge cited the case of *NationsBank v. Valic,* (see above), in which the Supreme Court concluded that the OCC has broad authority to decide what powers can be exercised by national banks. The Chase case is said to be the last of a series of challenges to bank securities powers that were carried over from the late 1980s. *AB, 1/27/95, p. 2.*

Court Rules Bank Cannot Export Fees
In a case involving late fees on credit cards, the Superior Court of Pennsylvania ruled against their interstate export by a Bank One unit. In 1978, the U.S. Supreme Court ruled that a national bank could export interest rates outside its home state. The Pennsylvania court said that late fees, and charges for exceeding credit limits and for insufficient funds, which are not levied on a percentage basis, cannot be defined as interest. The decision runs contrary to the rulings of a number of other courts, including seven different appellate courts. *AB, 12/20/94, p. 14.*

Court Limits Banks' Sale of Insurance
A federal magistrate judge in Indiana, in the case of *NBD Bank v. Bennett*, ruled that the National Bank Act does not empower banks to sell insurance outside the small towns where they operate. She said that Congress, in allowing national banks to sell insurance from offices in towns with fewer than 5,000 residents, wanted to provide an incentive for banks to maintain their small-town branches.

The U.S. Court of Appeals for the District of Columbia ruled in 1993 that banks may sell insurance anywhere from a branch in a small town. *AB, 12/30/94, p. 1.*

CRA Enforcement Authority
The Justice Department, responding to a request from the OCC, issued a legal opinion on use of regulatory general enforcement authority against institutions rated in substantial noncompliance with the CRA. Justice said the Act empowers the regulators to deny applications from these institutions for changes in corporate structure. Because of the sanctions explicitly provided, the regulators cannot utilize their general enforcement authority. *Bank News, 1/95, p. 43.*

Appraisal Guidelines
The OCC, FDIC, FRB, and OTS jointly issued appraisal and evaluation guidelines, superseding guidelines issued in 1992. Title XI of FIRREA requires the agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions. Such real-estate appraisals are to be in writing and performed in accordance with uniform standards. Although the agencies' appraisal regulations exempt certain categories of real-estate-related financial transactions from the appraisal requirements, most real-estate transactions over $250,000 are considered federally related transactions and thus require appraisals. An agency may impose more-stringent appraisal requirements than the appraisal regulations require.

Among the specific topics addressed in the guidelines are elements of an effective real-estate appraisal and evaluation program, selection of individuals who may perform appraisals and evaluations, minimum appraisal standards, and program compliance. *Inter-agency Appraisal and Evaluation Guidelines, OCC, FDIC, FRB, and OTS, 10/27/94; Joint Release, PR-73-94, FDIC, 11/7/94.*

NASD and Regulatory Agencies Agree on Coordinating Examinations
The National Association of Securities Dealers (NASD) and the OCC, FRB, FDIC and OTS agreed in principle to coordinate their examinations of registered broker dealers selling mutual funds and other nondeposit investment products on the premises of depository institutions. The agreement is intended to ensure that their common interest in the supervision of broker dealers affiliated with depository institutions is addressed with a minimum of duplication of activity, and to promote regulatory consistency and reduce unnecessary burdens.

Among other things, the NASD and banking agencies will share examination schedules for depository institutions that have affiliated broker dealers, and they may request that an observer be present at each other's examination. The NASD will provide the banking agencies with access to findings and workpapers from its most recent examination of affiliated broker dealers. There is a reciprocal agreement for referrals of apparent violations of apparent securities laws, and banking laws and regulations, among the NASD and the banking agencies. *Joint Release, OCC, FDIC, FRB, OTS, NASD, 1/3/95.*

It was announced earlier that planning is under way to subject bank-employed brokers who sell mutual funds and other securities to the same licensing requirements as govern other such brokers. The NASD would administer entrance exams to bank brokers but have no further disciplinary authority. Comptroller of the Currency Eugene Ludwig expressed hope that a testing program can be established within the next year. *AB, 9/28/94, p. 2.*

Risk-Based Capital
The OCC and the FRB proposed amending their risk-based capital guidelines to modify the definition of the OECD-based group of countries, in which claims on governments and banks generally receive lower risk-weights than corresponding claims on these entities in non-OECD-based countries. The revisions are based on an announcement by the Basle Committee of a planned modification to the Basle Accord, the effect of which would be to exclude from the so-defined group of countries any country that has rescheduled its external sovereign debt within the previous five years. *FR, 10/14/94, p. 52100.*

The OCC issued a final rule to amend its risk-based capital guidelines to lower the risk-weight from 20 percent to zero percent for securities lending, repurchase agreement transactions, and certain collateralized accounts and financial exposures. One purpose of the rule is to ensure that the risk-weight assigned to transactions collateralized with cash or government securities more accurately reflects the minimal operational risk and near absence of credit risk in those transactions. *FR, 12/28/94, p. 66642.*

Equity Derivative Swaps Approved
The OCC gave approval, in a letter to Citibank N.A., for national banks and their operating subsidiaries to engage in equity swaps and equity index swaps. The agency said the equity swaps are essentially activities that have been approved for national banks in other forms. It said equity derivative swaps are incidental to the express power of national banks to receive deposits, make loans, and to the business of banking. *BBR, 9/19/94, p. 375.*

Approval For D.C. Bank to Branch Into MD
The OCC gave approval for the $77 million-asset Capital Bank in the District of Columbia to move its headquarters to Maryland and retain its existing offices in D.C. Under the OCC's regulations, a national bank may move its head office up to 30 miles even if the move crosses a state line. This is the first such approval for branching into a state where the banking firm had no existing operations. *AB, 10/21/94, p. 2.*

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which was signed into law on September 29, 1994, authorizes a bank holding company, beginning one year after enactment, to acquire a bank located in any state. It authorizes an insured bank, beginning June 1, 1997, to merge across state lines unless the affected states have 'opted-out' of interstate branching by enacting laws that prohibit interstate branching. Also, it authorizes, among other things, an insured bank to establish a *de novo* out-of-state branch if the host state expressly permits interstate branching through the establishment of *de novo* branches.

Securities-Offering Disclosures
The OCC adopted amendments, effective April 3, 1995, to replace rules detailing the contents of offering documents covering national bank securities, and to require that offering documents conform to the information requirements contained in the Securities and Exchange Commission (SEC) registration form. The amendments are intended to reduce unnecessary regulatory burdens on national banks and enhance their ability to raise capital, while maintaining the %4 quality of disclosures provided to investors. The final rule generally treats national bank securities comparably to those of other corporations. Because the OCC rules will now actually reference the SEC rules, rather than parallel or copy them, the OCC rules will automatically remain current. *FR, 11/2/94, p. 54789.*

Contracting Outreach Program
The OCC adopted a rule, effective October 11, 1994, that is intended to ensure that businesses owned and controlled by members of minority groups, women and individuals with disabilities are provided the opportunity to participate in the agency's contracting processes. It also designates the official responsible for implementing the Outreach Program and its oversight. *FR, 9/8/94, p. 46325.*

Assessments and Fees to Be Reduced
The OCC adopted an interim rule, and requested comments on changing the method for the calculation of fees for examinations of fiduciary activities, and certain other examinations and investigations, to give the agency more flexibility for reducing existing rates.

The agency also has announced several reductions, among which are the supervision hourly rate, from $102 to $50, applications for ATMs, from $1,500 to $400, and applications for branch or head office changes, from $900 to $700, all to be effective January 1, 1995. *FR, 11/18/94, p. 59640; BBR, 11/7, p. 659; 11/18, p. 776; AB, 11/17, p. 2.*

Office of Thrift Supervision
Mergers and Charter Conversions
The OTS, effective September 29, 1994 and pursuant to Sections 501 and 502 of FDICIA, amended its regulations governing mergers and combinations involving federal savings associations to give associations more flexibility to change charters, either by charter conversion or by merging. For example, the rule allows federally chartered savings associations to convert directly to state or national banks, and establishes procedures non-thrifts must follow to convert to a federal savings association or savings bank. With the new rule, well-managed, well-capitalized savings associations that wish to change charters need only notify the OTS. Applications, subject to OTS approval or denial, are still required when the savings association has a CAMEL or Compliance rating of 3, 4, or 5; a less than satisfactory CRA rating; or fails its capital requirements.

The final regulations authorize federal stock associations to combine with any FDIC-insured depository institution, and authorizes federal mutual associations to combine with any FDIC-insured institution, provided that a mutual association is the resulting institution. In addition, certain combinations are authorized that involve federal associations and depository institutions not insured by the FDIC. Other amendments concern the procedures regarding applications to engage in the above-described actions. *NEWS, OTS, 8/30/94; FR, 8/30, p. 44615.*

Conversions From Mutual to Stock Form
On May 3, 1994, the OTS issued an interim final rule and a proposed rule, each with a request for comments (see this *Review* , Winter 1995, p. 46), on conversions from mutual to stock form and mutual savings-and-loan holding companies. A final rule, issued on November 22 and effective January 1, 1995, revised the interim rule by making local depositor preference in stock purchases optional rather than a requirement. A companion rule proposed in May requires a converting institution to meet the 'convenience and needs' of its community. The OTS will henceforth consider a conversion applicant's CRA performance and other related factors in evaluating such an application. Among other changes, the final rule deletes the 100-mile local area definition of the local community for purposes of local depositor preference. *FR, 11/30/94, p. 61247; NEWS, OTS, 11/22/94.*

Investments in Structured Notes
The OTS alerted savings associations to potential risks inherent in structured notes. These notes are debt securities with derivative-like characteristics that are issued by corporations and government-sponsored enterprises, including the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks. Structured notes take various forms and often contain complex rate-adjustment formulas and embedded options. They may be customized to meet the needs of a particular investor, or issued in a more generic form to meet the needs of a broader range of investors.

The agency said that while structured notes can be useful investments, they may, because of their complexity, be inappropriate for unsophisticated investors. Steps are indicated that savings associations should take before buying structured notes. For example, thrifts should make sure structured notes are consistent with their investment policy, that they thoroughly understand the risk/return characteristics of the instruments, and that they evaluate the effect of the investment on the institution's net portfolio value and earnings under different interest-rate scenarios. *NEWS, OTS, 8/16/94; Thrift Bulletin 65, 8/15.*

Manual Explains Interest-Rate- Risk Measurement

The OTS released a 300-page manual describing the computer model it uses to measure interest-rate risk (IRR) at the savings associations it regulates. Under the agency's capital regulation, savings institutions are required to hold capital as a cushion against potential losses if they have IRR above a certain level. The manual explains how the model is used to assess institutions' IRR and to calculate their capital requirements based on that risk. There is a general, non-technical discussion of OTS' approach to measuring IRR, and a detailed technical description of how the interest-rate sensitivity of institutions' assets, liabilities and off-balance- sheet items are estimated. *NEWS, OTS, 12/22/94.*

Interest-Rate-Risk Appeals Process

In August 1993, the OTS issued its final rule concerning the interest-rate-risk component of the risk-based capital requirement. The agency now proposes a process by which certain savings associations may appeal their IRR component calculated by the OTS. Three methods are proposed by which savings associations could be authorized to deviate from the interest-rate-risk methodology now in use by OTS. An institution could appeal its IRR component using appeals procedures described in the notice. An abbreviated certification process is available for certain highly capitalized institutions under specified conditions. This certification process may result in authorization for the institution to calculate its own IRR component for regulatory purposes. Finally, an institution could petition the OTS to change the methodology used in OTS' Net Portfolio Value Model.

Under the proposal, the agency would consider appeals related to the IRR component only from institutions whose capital level would fall to a lower prompt corrective action (PCA) category as a result of their IRR component. An institution would have to show that the IRR exposure calculated by the OTS would be made more accurate through the use of either more refined data or more appropriate assumptions than those used in the NPV model. Certain fundamental parameters and scenarios used in constructing the computer model could not be the basis of an appeal. An institution would have to file its appeal within six months after the end of the quarter on which the disputed interest-rate-risk component is based. An OTS appeals committee would issue a decision within 60 days.

The FRB, OCC, and the FDIC have published proposed rules to incorporate interest-rate-risk components in the risk-based capital requirements of commercial banks and expect to finalize these rules during the next year. *NEWS, OTS, 8/16/94.*

Inter-Affiliate Banking Expanded

The OTS Chief Counsel issued an opinion that federal savings associations regulated by the agency no longer must file a branch application to enter into inter-affiliate banking arrangements. Thus, affiliated federal associations may offer basic banking services to each other's customers without the need to obtain regulatory approval, even when the services are provided across state lines. *NEWS, OTS, 2/9/95.*

Annual Independent Audits

The OTS amended its annual independent audit requirements for savings associations to be more consistent with those applicable to other federally insured depository institutions. Pursuant to Section 112 of FDICIA, all insured depository institutions with total assets of $500 million or more are required to obtain an annual independent audit. The agency's rules are amended also to eliminate the mandatory annual independent audit requirement for small savings associations with composite CAMEL ratings of '1' or '2'. The OTS still can require an independent audit of any savings association with assets of less than $500 million, as needed for purposes of safety and soundness. Effective date:December 23, 1994 . *FR, 11/23/94, p. 60300.*

Capital Distributions
The OTS proposed amending its capital distributions regulation to conform to the system of prompt corrective action (PCA) established by FDICIA and by implementing its own regulations and those of other federal banking agencies. Under the proposal, which incorporates the PCA definition of capital distributions, a savings association that is not held by a savings-and-loan holding company and that has a composite CAMEL rating of '1' or '2' need not notify the OTS before making a capital distribution. Associations that would be at least adequately capitalized after making a capital distribution would be required to provide notice to the OTS. 'Troubled' associations and undercapitalized associations may make capital distributions only by filing for and receiving OTS approval, which may be granted only under certain limited conditions. The proposed regulation defines 'troubled condition' as a function of a savings association's composite examination rating, its capital condition, or on the basis of supervisory directives or designation by the OTS. *FR, 12/5/94, p. 62356.*

Funds-Cost Index May Be Eliminated
The OTS announced that its monthly median cost of funds, which is one of several indexes used to change interest rates on adjustable-rate mortgages (ARMs), may be terminated or modified. The index, compiled since December 1982, reflects the median interest rate that thrift institutions pay on deposits and on borrowed money. Comments are requested on whether the monthly index should be retained in light of a recent survey indicating relatively few ARM loans with rates tied to the index are made, and because other indexes, such as Treasury bills, are currently available to take its place. *NEWS, OTS, 10/17/94.*

Agency's Authority Upheld on Receivership
A federal appeals court ruled that the courts may not review a decision by the OTS to replace a conservator of a failed savings association with a receiver. The decision by the Tenth Circuit Court of Appeals came on an appeal by Franklin Savings Association, Ottawa, Kansas, and its holding company, Franklin Savings Corporation. The RTC was first appointed conservator for the association by the OTS in February 1990, and had its status changed to receiver in September 1992. The association was resolved by the RTC in June 1994. The court cited FIRREA as providing for judicial review of an 'appointment' of a conservator or receiver, but not for a 'replacement' of a conservator with a receiver. *NEWS, OTS, 9/21/94.*

Court Orders New Rulemaking in Conversion Regulation
A U.S. district judge found that the OTS failed to seek the required public comment on the local-depositor provision of an 'interim final rule' it issued in late April that, in mutual-to-stock conversions, gave priority stock purchase rights to depositors who live in a thrift's 'local community' or within 100 miles of a home or branch office (see this *Review* , Winter 1995, p. 46). The OTS' objective in adopting the rule was to restrict windfall profits for insiders, and speculators who deposit funds in distant thrifts in which they could purchase stock should the institution later convert. The judge nullified this part of the broader rule issued by the OTS, and ordered the agency to conduct new rulemaking, including seeking public comment. *WSJ, 10/3/94, p. A4.*

Application Decision Deferred Based on CRA Performance
The OTS deferred action on an application by Avondale Federal Savings Bank, Chicago, to convert from a mutual to stock association, based on 'needs to improve' CRA ratings the thrift has received. An OTS official said it was the agency's first deferral of a conversion application based on an institution's CRA compliance record. An Avondale spokesperson said the institution has taken steps to improve its CRA performance, including establishing special marketing plans for low-income neighborhoods, and improving its community relations. *BBR, 8/22/94, p. 247.*

Agency Continues to Reduce Staff
The OTS announced consolidations and realignments of certain functions and a year-end 1995 staffing target of 1,500. The projected cut in staff is a continuation of annual reductions that have shrunk the agency from 3,389 at year-end 1989 to 1,771 in September 1994. The 48-percent reduction in staff over the past five years has been achieved through a combination of attrition and formal reduction-in-force

actions. The OTS projects expenses for 1994 of $178.1 million, compared with $296.9 million for 1990. *NEWS, OTS, 9/13/94.*

Federal Financial Institutions Examination Council
Capital Treatment of Unrealized Gains/Losses

A task force of the FFIEC recommended to the member agencies that the net unrealized holding gains (losses) on available-for-sale debt securities not be included in regulatory capital for purposes of computing the leverage and risk-based capital ratios. Accordingly, when calculating these ratios, the amortized cost rather than the fair value of available-for-sale debt securities generally would be used. With regard to equity securities that have readily determinable fair values, it is recommended that they continue to be valued at the lower of cost or fair value for regulatory capital purposes. Examiners should continue their longstanding practice of considering any unrealized appreciation and depreciation on debt and equity securities not recognized in capital ratios when evaluating the adequacy of an institution's capital. These recommendations would continue the interim policies adopted by the FRB, FDIC, and OCC when FASB Statement No. 115 became effective, but would represent a reversal of the interim OTS policy issued in August 1993 to follow the Statement in computing savings associations' regulatory capital. *Press Release, FFIEC, 11/10/94; Accounting for Certain Investments in Debt and Equity Securities, Financial Accounting Standards Board, May 1993.*

The FFIEC issued a statement regarding the regulatory reporting treatment of allowances established under Statement No. 114, ' Accounting by Creditors' for Impairment of a Loan, FASB, and regulatory capital issues arising from Statement No. 109, 'Accounting for Income Taxes.' *Press Release, FFIEC, 11/18/94.*

Information on Reporting Changes

The FFIEC issued a 17-page booklet, for distribution to all insured banks, detailing the deletions and additions in the preparation of Call Reports for March 31, 1995. Among the changes thus far are: expansion of disclosures about a bank's involvement with off-balance-sheet derivatives; providing data on investments in high-risk mortgage securities and structured notes and on sales of proprietary mutual funds and annuities; reducing the level of detail regarding certain restructured loans and leases; and deleting items for total risk-based capital and average loans to states and political subdivisions. *BBR, 11/28/94, p. 780.*

National Credit Union Administration
Mergers or Conversions of Credit Unions

The NCUA is issuing an interim final rule, effective immediately, to clearly establish the agency's jurisdiction over all conversions by insured credit unions (see this *Review* , Winter 1995, p. 49). The interim rule requires that all mergers or conversions, involving one or more federally insured credit unions, including those where the resulting institution is not a credit union, must be approved by the NCUA Board. The rule also specifies that all notices are subject to NCUA approval. Comments on a number of related issues are requested. *FR, 9/23/94, p. 48790.*

Corporate Credit Unions

The NCUA amended, effective January 1, 1996, its regulations governing corporate credit unions to reduce the close ties between many corporate credit unions and credit union trade associations. Among the requirements in the final rule is that at least a majority of a corporate credit union's directors, including the chair, be representatives of member credit unions. A majority of a corporate credit union's directors may not be individuals who also serve as officers, directors, or employees of the same trade association or affiliated trade associations. The rule requires that the chief executive officer of a corporate credit union answer solely to the board of directors and not also serve as an employee of a trade association. Corporate officials must distance themselves from any decision involving another organization to which they belong. Corporate membership may not be linked to membership in a trade group.

As of early 1994 there were 44 corporate credit unions serving the nation's 13,000 natural person credit unions. The corporate credit union system provides liquidity, investment and payment services to credit unions. *FR, 4/19/94, p. 18503,; 11/17, p. 59357; AB, 11/14, p. 1.*

The NCUA placed the $1.4 billion-asset Capital Corporate Federal Credit Union into conservatorship, after Capital suffered large losses and was unable to meet withdrawals. The Corporate, based in a Maryland suburb of Washington, D.C., had invested heavily in collateralized mortgage obligations, whose value fell sharply when interest rates rose. The agency reportedly has moved quickly to sell off the investment portfolio, causing concern in the industry that the Corporate, which has 483 credit union members, will be liquidated. Latest information indicates that the credit union's $74 million in capital will cover any loss. *AB, 2/2/95, p. 1; 2/17, p. 1.*

CAMEL Rating System Is Revised
The NCUA is restructuring its credit union rating system to give examiners more flexibility to consider both qualitative and quantitative factors when assigning supervisory ratings to federally insured credit unions. Changes in the new system focus in particular on evaluating the condition and performance of credit unions in absolute terms rather than against peer averages or predetermined benchmarks. Numerous revisions are made in the various financial ratios used for evaluation purposes. Other changes include expansion of management review to include business strategy/financial performance; internal controls; management conduct; and service to members. *Letter to Credit Unions, No. 161, NCUA, 12/94; BBR, 1/9/95, p. 78.*

Courts Uphold the NCUA on Credit Union Expansions
The U.S. Court of Appeals for the Sixth Circuit, in Cincinnati, upheld a NCUA decision permitting Portland Federal Credit Union, Portland, Michigan, to expand its service area from Portland, which has a population of 4,000, to a surrounding area having a population of about 70,000. The decision comes from the highest court yet to rule on the 'common bond' issue, following losses by bankers of decisions in three states. They have sued the NCUA in six states, and state regulators in two, charging excessively liberal policies in allowing credit unions to expand their territories. Some of these cases involve the ability of credit unions to serve unrelated groups of people, not communities. Also, the appellate court in the Portland case said its decision is confined to the facts of that case. *AB, 12/9/94, p. 1; BBR, 12/12, p. 882.*

The U.S. District Court for the District of Columbia agreed with the NCUA's interpretation of the common bond, saying it was 'a reasonable construction of an ambiguous statute.' The case began in 1990 when four North Carolina banks and the American Bankers Association sued the NCUA, claiming a violation of the Federal Credit Union Act, for permitting AT&T Family Federal Credit Union to enroll employees of groups unrelated to its original sponsor. *AB, 9/16/94, p. 4.*

Truth in Savings
The NCUA published its official staff commentary to Part 707 of its Regulations. As required by the Riegle Community Development and Regulatory Improvement Act of 1994, the accounts of unincorporated business associations are exempted from coverage of Part 707. Effective date: 1/1/95. *FR, 11/21/94, p. 59887.*

The NCUA early in 1994 extended the date for compliance with its Truth-in-Savings regulation, to March 31, 1995 for credit unions of an asset size between $500,000 and $1 million as of December 31, 1993, that are not automated, and to June 30, 1995 for credit unions of less than $500,000 that are not automated. The compliance date for all other credit unions remained January 1, 1995. Subsequently, the agency extended compliance to January 1, 1996 for credit unions of an asset size of $2 million or less as of December 31, 1993, that are not automated. *FR, 8/3/94, p. 39425.*

Supervisory Review Committee
The NCUA proposed a review process pursuant to a requirement of the Riegle Community Development and Regulatory Improvement Act of 1994 that the federal banking agencies each establish an appeals

process to review material supervisory determinations made with respect to insured institutions . *FR, 11/17/94, p. 59437.*

Loan Interest Rates
The NCUA is continuing an 18 percent federal credit union loan rate ceiling for the period from September 9, 1994 through March 8, 1996. Loans and line of credit balances existing prior to May 15, 1987 may continue to bear their contractual rate of interest, not to exceed 21 percent. The current rate ceiling was scheduled to revert to 15 percent on September 9, 1994, unless otherwise provided by the NCUA Board. The Board said a 15 percent ceiling would restrict certain categories of credit and adversely affect the financial condition of a number of federal credit unions. *FR, 8/3/94, p. 39423.*

Federal Housing Finance Board
FHLBank System Membership Now Over 5,000
The Federal Home Loan Bank System has increased by 1,800 members since the enactment of FIRREA in August 1989, which made it possible for commercial banks and credit unions to voluntarily join the System. As of July 31, 1994, a total of 4,936 financial institutions were members of the System, including 2,736 commercial banks, 2,112 thrifts, 70 credit unions and 18 insurance companies. Currently, System members hold $925 billion in residential mortgage loans, about one-third of all home mortgage debt outstanding in the United States. After approval, an institution becomes a member by purchasing District Bank stock. Members receive a competitive dividend return on their stock investment. Included among the statutory requirements for membership in the System are that an institution must make long-term mortgage loans, and it must have at least ten percent of its total assets in residential mortgage loans. Through the 12 member-owned, FHFB-regulated District FHLBanks, the System provides long-term loans on many types of mortgage collateral, and provides liquidity for housing finance by means of advances (loans) to member institutions. Advances are made at interest rates that are lower than those in the commercial market, particularly on longer-term funds. The System raises funds by selling consolidated obligations to retail and institutional investors. Because the System has a stand-alone Triple-A credit rating and is a government-sponsored enterprise, it can raise debt at rates only slightly higher than rates on Treasury securities. *NEWS, FHFB, 9/93; 7/94; News Release, FHLBank System, 9/30/94.*

Under FIRREA, the FHLBanks were required to implement an Affordable Housing Program with subsidized loans to member institutions for financing housing projects in low-income communities. At mid-1994, outstanding commitments under the program amounted to $272 million, for nearly 1,900 projects involving construction or rehabilitation of about 72,000 housing units for low-income families. Also, the program's resources have leveraged $3.8 billion in development funds to date, with a leveraging ratio of over 13 to 1. *BBR, 8/29/94, p. 286.*

STATE LEGISLATION AND REGULATION

Bank Loses Insurance Power in BHC Takeover
Arkansas: The state's Supreme Court ruled that the Arkansas Bank and Trust Company, with total assets of about $400 million, lost its right to operate an insurance company, which had been grandfathered when the bank was acquired in 1990 by First Commercial Corp., a multibank holding company. The Court, in a split decision, held that First Commercial acts as a bank and thus a provision of the law preventing transfer of the right to another bank is applicable. Divestiture is required under the decision. *AB, 11/17/92, p. 2.*

Acquisitions of Banks
Illinois: A new law, effective June 29, 1994, eliminates the current prohibition, which has threatened Illinois' reciprocal banking status with other states, on purchases by bank holding companies of banks in the state that are less than ten years old. *Illinois Banker, 9/94, p. 24.*

Lending Limits
Illinois: New legislation, effective June 29, 1994, raises the lending limits for state banks consistent with

changes being made for national banks. While state banks have a higher lending limit (currently 20 percent) than national banks (currently 15 percent), the state's lending limit is based on definitions of capital and surplus that do not include numerous capital-related accounts that have been added to the federal definition over time. *Illinois Banker, 9/94, p. 24.*

Kansas: An amendment, effective July 1, 1994, increases the lending limit for active officers and employees of state-chartered banks from five percent to 15 percent of unimpaired capital stock and unimpaired surplus.

The amount of any loan in excess of which the prior approval of a bank's board of directors is required is raised to $50,000 from $10,000. *The Kansas Banker, 7/94, p. 31.*

Reverse Mortgage Loans
Illinois: An omnibus banking law, effective January 1, 1995, authorizes banks to make reverse mortgage loans for any purpose to persons under age 62. Presently, these loans can be made to persons of this age only for home improvements and repairs or the payment of insurance premiums and residential real-estate taxes. The loans are not similarly restricted for those 62 and over. *Illinois Banker, 9/94, p.20.*

Credit Cards Accepted For Taxes
Kansas: A new law, effective July 1, 1994, permits the state Director of Taxation and county treasurers to accept credit-card payment for any taxes or fees assessed by these offices. The type of cards accepted is subject to the discretion of the state and local officials. *The Kansas Banker, 7/94, p. 31.*

Credit Union's Membership Base Expanded
Maine: The Banking Superintendent approved the conversion of the $15 million-asset Saco Valley Federal Credit Union to a state charter, under which the institution's membership base will widen to include persons who live or work in ten communities. The official said the larger base would help Saco Valley survive cutbacks by its membership's employers, and that competitor banks should not be materially impacted. The agency denied six communities requested by Saco Valley, some of which are 40 miles from its headquarters, for reasons of the lack of a common bond, and doubts concerning Saco's ability to serve the towns. *AB, 9/9/94, p. 11.*

Depositor Reimbursement Law Ruled Unconstitutional
Nebraska: The state Supreme Court ruled that a 1993 state law that appropriated $16.5 million to reimburse depositors of three failed industrial loan companies is unconstitutional. Deposits of the companies were insured by the Nebraska Depository Institution Guaranty Corp., which did not have the assets to meet its insurance commitments. The basis for the Court's decision was the fact, which the state did not contest, that the depositors' claims were not legal obligations of the state. *BBR, 7/25/94, p. 132.*

Bank Protection Against Foreign Government Actions
New York: New legislation, effective immediately, protects state-chartered banks and trust companies and national banks in the state from repayment claims of depositors in their foreign subsidiaries, if payment is made impossible by war, civil strife or an act of a foreign government, unless the deposit contract specifically provides that the home office would pay off these deposits. Legislation enacted initially by the state in 1937 has protected banks in such circumstances, but the courts have ruled in two recent cases that this protection does not cover the claims of depositors in their foreign branches. *BBR, 8/1/94, p. 158.*

Basic Checking Services
New York: The state Banking Board approved a proposal for low-cost checking accounts at state-chartered banking institutions, as required under the state's Omnibus Consumer Protection and Banking Deregulation Act of 1994. Basic checking accounts would require an initial deposit of no more than $25, and with no minimum required balance. Banks could impose a $3 maximum monthly maintenance charge, and would provide at no additional cost a minimum of eight withdrawal transactions per month,

including institution-operated automated teller machine transactions. Extra fees could be charged to customers for withdrawals or deposits at ATMs not operated by their bank, for more than eight withdrawals, and use of other charge services. *BBR, 8/1/94, p. 158; 10/31, p. 633; AB, 11/10, p. 4.*

Derivatives and Foreign-Exchange Contracts
New York: An amended law, closing a legal loophole, provides that agreements involving oral telephone trades and screen-to-screen trades cannot be nullified and are enforceable if there is an admissible tape recording or similar electronic evidence. These transactions now comprise 99 percent of the market. Also, a written confirmation within five days of the trade not objected to within three days results in a legally binding trade. Under the state's existing law, agreements for trades that could not be performed within a year, and foreign-exchange contracts of any length, must be in writing to be enforceable. *BBR, 8/1/94, p. 157.*

Low-Income Loan Program
New York: The New York Mortgage Coalition, a group comprising 14 New York-area banks, announced that in its first year it had made 191 mortgage loans to low-income and moderate-income borrowers totaling more than $215 million. Of loan applicants referred to the Coalition from community groups through April 1994, 78 percent have been approved and some are pending. The denial rates -- 16 percent for black applicants, 13 percent for Hispanics, and ten percent for whites are well below the national averages in Home Mortgage Disclosure Act (HMDA) data compiled by the FFIEC. *AB, 8/23/94, p. 9.*

Mutual Thrift Conversions
New York: The Banking Department proposed regulations which in mutual-to-stock conversions would: limit stock-based compensation for officials of converting institutions; place restrictions on the proxy process; require a detailed explanation of stock-appraisal methodology; require in-depth information on the planned use of the stock offering proceeds; and require a justification for any planned stock repurchases, which would be subject to limitations contained in the guidelines of OTS. *BBR, 8/29/94, p. 289.*

The Banking Board proposed amendments to its savings bank conversion regulation that, in these conversions would specifically prohibit special interest payments to depositors. Only depositors would be allowed to conduct proxy solicitations against management. Stock grants and stock options for officers, trustees, and directors at the time of a conversion would be prohibited, but stockholders could approve these actions at the firm's first annual meeting. The Banking Department noted that the regulation generally conforms to a new interim rule adopted by the OTS. *BBR, 8/1/94, p. 157.*

Interstate Banking
South Carolina: As a result of amendments to become effective July 1, 1996, to the state's bank holding company statute, bank holding companies outside the region will have the same acquisition options in the state as holding companies in the states within the Southeast regional banking compact. Similar extensions of interstate banking rights to states outside the region have been enacted as of July 1994 in Georgia, North Carolina, and Virginia. *BBR, 7/25/94, p. 121.*

Credit Union Expansion Policy
Washington: Since taking office in November 1993, the Director of Financial Institutions has allowed eight state-chartered credit unions to take communities into their customer base. The credit unions serve 13 communities with a population of about 324,000. The official said the state wants to create an environment that promotes competition and eliminates unnecessary barriers to business. Previously, these expansions were permitted only in exceptional cases, such as when a credit union's sponsor was undergoing an employment reduction. *AB, 8/19/94, p. 7.*

BANK AND THRIFT PERFORMANCE

Commercial Banks' Nine-Month Earnings Set Record
Commercial banks earned a record $11.8 billion (preliminary) in the third quarter of 1994, and for the first nine months their profits totaled $34 billion, a record for any nine-month period and $1.4 billion ahead of the first nine months of last year. The third quarter's performance reflected strong loan growth, which increased the industry's interest-earning assets and raised the average yields on those assets. Loan growth was led by increases in home mortgages, consumer loans and loans to businesses. Banks reduced their securities holdings for the second consecutive quarter. Provisioning for loan losses, reflecting continuing declines in troubled loans, was the lowest in ten years. Charge-offs of $2.4 billion were the least since the first quarter of 1985.

Commercial banks' average return on assets (ROA) rose to an annualized 1.21 percent in the third quarter, from 1.16 percent in the second quarter. Nearly 96 percent of all commercial banks reported a profit in the third quarter. Chairman Ricki Helfer said the data indicate that the commercial banking industry has never been in better shape, but as the insurer of banks and thrifts, the FDIC will be monitoring such areas as derivatives investments and loan approval standards.

FDIC-insured, private-sector savings banks and savings-and-loan associations reported earnings of $2.1 billion in the third quarter, an improvement of $349 million from the previous quarter and $950 million from a year ago. Lower overhead expenses and reduced provision for future loan losses were the main factors contributing to the earnings improvement. The thrift industry's average ROA rose to an annalized 0.86 percent in the third quarter, from 0.73 percent in the previous quarter and 0.48 percent a year ago. Ninety-three percent of all savings institutions were profitable in the third quarter. *FDIC Quarterly Banking Profile, Third Quarter, 1994; PR-81-94, FDIC, 12/15/94.*

One in Five Banks Selling Mutual Funds or Annuities
Data from Call Reports show that in the first quarter of 1994, about one in five insured commercial banks in the U.S. (2,261 banks) sold mutual funds or annuities to their customers. Of that group, 51 percent sold both mutual funds and annuities, while 30 percent sold only mutual funds and the remaining 19 percent sold only annuities.

Approximately 14 percent of banks with assets of less than $100 million sold mutual funds or annuities, compared with 66 percent of banks with assets of $1 billion to $15 billion, and 100 percent of banks with assets of more than $15 billion. While bank sales of money-market mutual funds were far larger than sales of long-term (equity and bond) funds $97.7 billion *versus* $9.5 billion many more banks sold long-term funds than money-market funds, and this was true for all asset categories except the largest (above $15 billion in assets).

Sales of mutual funds and annuities still account for a small portion of bank revenue. On average, fees and other income from sales of these products represented slightly less than four percent of noninterest income at selling banks in the first quarter. There were, however, significant variations among institutions. Fifty-one banks, all of which had assets of less than $400 million and most were below $100 million, reported mutual fund and annuity income of at least 20 percent of their noninterest income. More than 500 banks reported ratios of five percent to 20 percent.

One limitation of the study is that the gross sales data are not adjusted for redemptions, reinvested dividends, or transfers among funds, thus banks' involvement may be overstated. Also, the revenue data may reflect income and fees earned on sales from previous quarters, and they do not separate income from mutual funds and income from annuities. *AB, 8/25/94, p. 12; Central Banker, Federal Reserve Bank of St. Louis, Summer 1994.*

Only Small Minority of Buyers Think Bank-Sold Mutual Funds Are Insured
A survey released in December 1994 by the Consumer Bankers Association showed that 21 percent of household financial decision makers and five percent of bank mutual fund customers thought investments in mutual funds are federally insured. However, the Association said customers need more information

about other risks in mutual funds, such as variable rates of return, possible loss of principal, and commission or management charges, whether the funds are purchased from banks or other sources.

The survey, conducted by the Roper Organization, included interviews with a random group of 700 financial decision makers at households with at least $30,000 in annual income, and 139 bank mutual fund customers randomly selected from lists supplied by banks. *BBR, 12/19/94, p. 916; The Arkansas Banker Magazine, 12/94, p. 15.*

Decline in Credit Union Assets
Assets of the nation's largest federally insured credit unions those with over $50 million in assets fell 0.7 percent in the third quarter of 1994 to $199.5 billion, according to the NCUA. It was the first quarterly decline since the third quarter of 1988. Deposits fell by 1.1 percent, while total loans grew 3.4 percent. An industry analyst attributed the decline in deposits mainly to a healthy economy in which consumers are spending more and saving less. He predicted that developing liquidity pressures may result in credit unions raising their loan rates in the coming months. The capital-to-assets ratio increased from 9.5 percent to 9.8 percent in the quarter. *AB, 11/18/94, p. 3.*

Check Fraud Problem Getting More Attention
Check fraud at banks rose by 136 percent in the two years through 1993, to 1.27 million cases, and banks' losses from check fraud rose by 43 percent to $815 million, according to a survey by the American Bankers Association. Regionally, the percentage of banks experiencing losses ranged from more than 80 percent in the Northeast to just under 50 percent in the Midwest. The proportion of banks experiencing check fraud losses also varied by the size of the institution -- almost 90 percent of banks with more than $5 billion in assets compared to 54 percent of banks with $500 million or less in assets. Discussing the causes for the rapid increase in check fraud losses, the ABA cited the availability to forgers of inexpensive desktop publishing software and laser printing equipment. Also, customers are not properly safeguarding account information. *AB, 12/1/94, p. 1.*

In an earlier report, the ABA said that only 1.7 percent of banks above $1 billion in assets in a survey verified signatures on all checks before payment. About one-third of the banks with assets of less than $100 million verified all check signatures. *AB, 8/25/94, p. 14.*

Kmart Corp. is installing electronic check readers that determine if a check is genuine based on the strength of its magnetic ink line. The firm has completed a 200-store pilot program with the MICR identification device and plans to install them in all its 2,400 stores by late Spring.

Use of 'positive pay' programs to protect against fraudulent checks is increasing among corporate clients of large banks. In these programs the corporate customer sends informaton electronically to the financial institution on items it has issued, enabling that institution to notify the customer if items are presented which it may not have issued. Some institutions are initiating systems in which images of questionable checks are sent over the phone lines back to the customer. *AB, 1/18/94, p. 20.*

NASD Bans Members' Use of Bank Logos
The National Association of Securities Dealers is prohibiting the use of bank logos on advertisements and sales literature for member firms. Bank names may appear non-prominently in members' advertising and sales literature solely for the purpose of identifying the location where broker-dealer services are available. *Notice to Members, NASD, November 1994; AB, 12/2/94, p. 1.*

Credit Life Insurance Called Too Expensive
A report of the National Insurance Consumer Organization and the Consumer Federation of America said that the premiums charged for credit life insurance are too high, and that only three states -- New York, Maine, and Vermont -- and the District of Columbia, meet the standard set by the National Association of Insurance Commissioners of a 60 percent payout-to-premium ratio. If all states achieved that standard, consumers would save an additional $530 million annually, the report estimated. In most states, the

payout rate is 44 cents per dollar, up from 37 cents five years ago. During that period, 18 states took action to lower their credit life insurance rates. Over 60 percent of the savings, estimated at $200 million, went to consumers in Georgia, Texas, Vermont and North Carolina.

A CFA official noted that instances of discrimination against borrowers who choose not to purchase credit life insurance are declining. *AB, 7/26/94, p. 2; BBR, 8/1, p. 153.*

Off-Premises ATMs Show Strong Growth
The 50 largest U.S. banking firms increased the number of ATMs outside their offices by 20.6 percent in the 12 months ending June 30, 1994, and their branch-based ATMs by only 5.4 percent, according to a survey by the *American Banker,* bringing the number of the two categories of ATMs held by these institutions to nearly 8,000, and more than 21,000, respectively. The top five banking organizations in numbers of ATMs were BankAmerica Corp., Nations- Bank Corp., Wells Fargo & Co., Citicorp, and First Interstate Corp. An estimated 75 percent of all ATM transactions are cash withdrawals. *AB, 11/30/94, p. 1.*

More Credit Unions Issuing Debt Cards
Debit cards are first among new products planned by credit unions for next year, according to a recent survey of 800 institutions by the Credit Union National Association. About 500 credit unions issue debit cards, a CUNA official said, including 200 that issued the cards through a CUNA services subsidiary. The cards have advantages to credit unions of avoiding the costs associated with paper check processing, and they generate interchange income in fees from merchants based on card transactions. About 29 percent of credit union member households have a debit card. *AB, 9/16/94, p. 6.*

U.S. Financial-Services Transactions With Foreign Persons
The Bureau of Economic Analysis of the U.S. Department of Commerce will conduct a survey in which, for the first time, comprehensive information will be collected on trade in financial services between U.S. financial-services providers and unaffiliated foreign persons. The information collected will be used in monitoring U.S. services trade and formulating U.S. international trade policy, compiling the U.S. balance of payments and national income and product accounts, assessing U.S. competitiveness in international trade in services and improving the ability of U.S. businesses to identify and evaluate market opportunities.

Reporting is required from U.S. financial-services providers who have sales to or purchases from unaffiliated foreign persons in all covered financial services combined in excess of $1 million during the reporting year. The providers meeting these criteria must supply data on the amount of their sales or purchases of each covered type of service, disaggregated by country. Providers that have covered transactions of less than $1 million during the reporting year are asked to provide, on a voluntary basis, estimates of their total sales or purchases by type of financial service. Beginning with the year 1994, the surveys will be conducted every five years, and it is anticipated that in the interim year the information will be updated by the use of more limited surveys based on a sample of companies. *FR, 7/28/94, p. 38387.*

Internal Controls Reporting Fails Cost-Benefit Test
A recent study found that banks spent about $100 million in 1993 complying with a provision of FDICIA that requires banks with assets in excess of $500 million to file a report with regulators each year, the accuracy of which must be attested to by a certified public accountant, regarding their internal controls in place. The costs include amounts paid for documentation, training, and accountants' fees. A total of 48 banks were surveyed, including 16 of the largest in the nation. Costs in these institutions, which ranged from $50,000 to $3.5 millon per bank, were projected to estimate the costs for the industry. In the view of Dr. Curtis C. Verschoor of DePaul University, who conducted the study in conjunction with the Bank Administration Institute, the costs far outweigh the benefits to managements for preventing loan losses. *AB, 10/6/94, p. 8.*

RECENT ARTICLES AND STUDIES

Uses and Regulation of Financial Derivatives
This study by the U.S. General Accounting Office notes that derivatives have enabled commercial corporations, governments, financial firms, and other institutions in the United States and worldwide to reduce their exposure to fluctuations in interest rates, currency exchange rates, and the prices of equities and commodities. Derivatives also have enabled users to reduce funding costs and speculate on changes in market rates and prices. There are concerns, heightened by recent reports of major losses from derivatives, that knowledge of how to manage and oversee risks associated with derivatives may not have kept pace with their increased use. The principal objectives of this study were to determine: (a) what risks derivatives might pose to individual firms and to the financial system and how firms and regulators are attempting to control these risks, (b) whether gaps and inconsistencies exist in U.S. regulation of derivatives, (c) whether under existing accounting rules market participants and investors are provided adequate information about firms' use of derivatives, and (d) the regulatory implications of the international use of derivatives. The four basic types of derivative products, which can be combined to create more complex derivatives, focused upon here were forwards, futures, options, and swaps.

While thousands of institutions use derivatives, over-the-counter (OTC) dealing in forwards, options and swaps is concentrated among a relatively few financial firms worldwide. As of December 1992, the top seven domestic bank OTC derivatives dealers accounted for more than 90 percent of total U.S. bank derivatives activity. The top five U.S. securities firms dealing in OTC derivatives accounted for about 87 percent of total derivatives activity for all U.S. securities firms. U.S. dealers were a major part of world activity and accounted for about half of the total volume of OTC derivatives activity worldwide. The combination of global involvement, concentration, and linkages means that the sudden failure or abrupt withdrawal from trading of any of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole.

While the supervision of banks' derivatives activities has improved, weaknesses remain, including insufficient regulatory reporting, inadequate documentation and testing of internal controls. Significant gaps and weaknesses exist in the regulation of many major OTC derivatives dealers. For example, securities regulators have limited authority to oversee the financial activities of securities firm affiliates that conduct the OTC derivatives activities. Insurance companies' OTC derivatives affiliates are subject to limited state regulation and have no federal oversight, yet OTC derivatives affiliates of securities and insurance firms constitute a rapidly growing component of the derivatives markets. The GAO found also that accounting standards for derivatives, particularly those used for hedging purposes by end-users, were incomplete and inconsistent and have not kept pace with business practices.

Among the GAO's recommendations was that Congress require federal regulation for the safety and soundness of all major U.S. OTC derivatives dealers. Congress should bring the currently unregulated OTC derivatives activities of securities and insurance companies' affiliates under the supervision of one or more of the existing federal financial regulators. It is recommended that the appropriate authorities work closely with industry representatives to: (a) develop and maintain accurate, current, and centralized information that is accessible to all regulators, including information on the extent of major OTC dealers' counterparty concentrations and the sources and amounts of their derivatives earnings; (b) develop and adopt a consistent set of capital standards for OTC derivatives dealers sufficient to ensure that all of the major risks associated with derivatives are reflected in capital; (c) establish specific requirements for independent, knowledgeable audit committees and internal control reporting for all major OTC derivatives dealers; and (d) perform comprehensive annual examinations of the adequacy of major OTC derivatives dealers' risk-management systems using a consistent set of standards established for this purpose and including consideration of the internal control assessments performed by boards of directors, management, and auditors. *Financial Derivatives Actions Needed to Protect the Financial System, U.S. General Accounting Office, May 1994.*

The strong growth in derivatives market activity continued in the second quarter of 1994, based on regulatory report data for such off-balance-sheet instruments as swaps, options and forward contracts, but not including some types of derivatives such as collateralized mortgage obligations. During the quarter, 704 banks had derivatives in their portfolios, down from 713 banks in the first quarter but 661 more than a year earlier. Depending upon the method of measurement used, the ten banks with the largest derivatives holdings accounted for between 92.7 percent and 95 percent of the total for the industry. *AB, 9/30/94, p. 1.*

Home-Buying Process Studied For Sources of Discrimination

The Cuyahoga County Department of Community Development, the Federal Reserve Bank of Cleveland, the Greater Cleveland Roundtable, and the Ohio Civil Rights Commission are major participants in the Cleveland Residential Housing and Mortgage Credit Project, which is conducting a comprehensive study of the home-buying process in its mission to ensure non-discriminatory access to residential mortgage credit in the Greater Cleveland area.

Initially, task groups were assigned to analyze specifically identified decision points in the home-buying process for discriminatory acts that could potentially occur in each stage of the process. The studies have focused on four critical decision points: (1) the initial contact with the real-estate agent; (2) the initial contact with the lender; (3) the interface with the secondary market; and (4) the appraisal process. The analyses and recommendations of the four task groups were presented in June 1994.

In the realtor-contact phase, one problem is that agents, because of lack of knowledge about certain types of financing, may inappropriately refer the purchaser to a loan source with which they are familiar while omitting other available options. The seller, typically given the decision as to acceptable financing, may specify conventional only or a similar exclusion. But the purchaser, because of the down payment, past credit problems or other reasons, may find conventional financing impossible to obtain, or it may be less appropriate then other sources of loans. Among the %-3 group's recommendations is that restrictions should not appear in multiple listing service information regardless of the type of financing being proposed. All offers ought to be presented for the seller's consideration, regardless of the type of financing being proposed. A comprehensive summary of available financing programs, written in 'user friendly' terminology will be prepared by the study group for use by real-estate agents. Also, a continuing education class for real-estate agents will be developed that will emphasize the variety of financing options and the potential for discrimination when advising buyers and sellers of financing.

Initial contacts with lenders can result, because of deliberate prescreening or inadequate lender training, in customers not being given full information about credit availability. The analysis focuses on the many ways that discrimination may occur before the loan process begins, for example, by offering more information options to some customers than others, or asking some to wait longer than others. It is noted that when loan originators provide general information about loan products, it is considered to be an inquiry; however, responses to specific questions about an applicant's eligibility for a mortgage loan are reported as applications under federal guidelines. Lenders obviously may have an incentive for treating potential borrowers differently because of the variance in the cost of servicing the customer. Loans of a nontraditional type may take longer to process. The practice of taking applications in central locations rather than through outlying offices, can cause discrimination. Officials in the central offices will probably not be as familiar with many of these customers, and there may be feelings of intimidation on the part of the latter. The report recommends that an industry-wide training and certification program be developed for loan originators, reinforced by an ongoing evaluation process. A code of conduct should be established by which institutions would commit themselves to the program.

Guidelines issued by Fannie Mae or other agencies to provide information to lenders for determining whether a particular loan will qualify for inclusion in a loan pool, for sale on the secondary market, are often interpreted incorrectly, especially by smaller institutions, which can result in the elimination of some potential borrowers. The guidelines require, for example, that lenders verify the source of a down payment, and details about the borrower's credit history. However, the standard requirements may not be appropriate for some potential customers, and representatives from Fannie Mae have noted that, with proper documentation, loans with exceptions in these areas can be acceptable in the secondary market. It is recommended that a formal, ongoing plan should be adopted for the training and education of officials of lending institutions about the programs offered by, and the guidelines of, secondary-market companies. A curriculum should be instituted in high schools to educate students about the importance of a good credit rating, the importance of a good savings pattern, the home-buying process and related topics.

Property appraisals play a 'pivotal role' in the economic health of neighborhoods: in individual cases, an appraisal that is too low can result in inadequate loan availability for the customer. The report discusses the interacting process of market values and appraisals, from the perspective of the impact that individual appraisals can have on values throughout a community, currently and over time. The recommendation of the task group was that an industry group be formed to address the education of appraisers and the process of identifying qualified appraisers. Another task group representing the lending institutions should be concerned with the training for evaluating appraisals and the review process for low appraisals. *Community Reinvestment Forum, Federal Reserve Bank of Cleveland, Special Issue 1994.*

Defining the Roles of Accountants, Bankers and Regulators
This report observes that despite the advantages found in the experience in other countries in respect to a close working relationship among regulators, bankers, and external auditors, such a relationship has not been the norm in the U.S. The role of external auditors in banking began to expand in the late 1960s as most major banks adopted a holding company structure subject to broader public disclosure and audit requirements and the banking agencies expanded the financial reporting required for regulatory purposes. At the same time, the managing of banks was becoming increasingly complex, with increasing competition, rapid financial innovation and technological change. New banking laws increased the cost and complexity of bank regulation and reporting. The information needs of managers, the financial markets and regulators grew in scope and complexity. While these developments would indicate a need for closer cooperation, the relationship among regulators, bankers and external auditors has suffered in the past several years from the effects of the savings-and-loan industry debacle, large loan losses among U.S. banks and the aggressive legislative and regulatory responses to those events. As a result, the working relationships among regulators, bank management and external auditors have become increasingly contentious.

Under FIRREA, regulatory scrutiny of management decisions was greatly expanded. For example, the hiring of directors and senior officers was subjected to regulatory approval not only at troubled institutions but at any institution chartered or undergoing a change of control within the previous two years. Removal authority by regulators was extended to reach major shareholders and external auditors and other advisers, and to permit industry-wide disqualification. Administrative penalties were increased substantially, as were maximum prison sentences, and penalties were applied to a broader range of offenses.

FDICIA continued FIRREA's emphasis on enforcement and its approach to mandated, aggressive regulatory action against troubled institutions. But while FIRREA focused on savings-and-loan failures, FDICIA changed extensively the rules of the regulatory system, expanding its reach into the relationships between regulators, bank management and their external advisers. In many cases, legislated rules were substituted for regulatory judgment. Federal regulators were given expanded authority over many areas of management decision-making, substituting their rulemaking for case-by-case judgment over basic operations. Examiners were given much greater authority over regulated banks, and legal penalties and examiner sanctions were increased dramatically. FDICIA mandated additional reports by the management of larger institutions. External auditors were, in turn, required to attest to management's assertions regarding internal controls and safety-and-soundness compliance, and to report any material weaknesses and violations.

To ensure that excessive regulation did not lessen the availability of credit to sound borrowers, the FDIC, FRB, and OTS in 1991 issued a series of policy statements on the workout of problem loans, valuation of real-estate loans and review and classification of commercial real-estate loans. Steps have been taken to improve communication between regulators and external auditors. In July 1992, the regulators issued a joint statement that sought to encourage full and candid contacts with external auditors to ensure that they are fully informed of all bank interactions with regulators and all documents provided to regulators by financial institutions.

In March 1993, the four supervisory agencies announced plans to reduce documentation, encourage character loans, reduce appraisal requirements, streamline the appeals and complaint process, and reduce the burden of the examination process. Additional actions were announced in May and June, including procedures for returning certain nonaccrual loans to accrual status, and procedures for eliminating duplicative exams by the primary regulator and the FDIC, as back-up regulator, and coordinating exams where duplication is required. In December 1993, the FFIEC issued an inter-agency policy statement on loss reserves, including a formula for calculating reserve levels, in an effort to provide an objective standard against which bank management and their external auditors can assess the adequacy of reserves. Of particular note, the policy represents a guideline rather than a safe harbor. At the same time, the policy statement recognized the limits of the examiner's ability to assess asset quality and the stronger position of management to accumulate up-to-date information necessary to estimate losses accurately on specific loans or classes of loans.

It may be noted that at the time of this study's completion, the Riegle Community Development and Regulatory Improvement Act of 1994 was in the process of enactment. A number of the Act's provisions are directly relevant to the study's concerns, among which is a requirement for the federal banking agencies to coordinate their examinations and to develop a system for selecting a lead agency to manage unified examinations, authority for the federal agencies to establish certain standards by guidelines instead of regulations, and a requirement concerning review and elimination of outmoded regulations and policies.

Among the study's overall conclusions and recommendations is that while regulators, management and external auditors have different responsibilities and priorities, it is important that there be basic agreement in their conclusions in respect to the financial condition of an institution, with reconciliation of any differences in assumptions and methodologies in order to reach a common understanding. Financial reporting should be based on GAAP accounting rules, and where additional information or more stringent reporting standards are essential for regulatory purposes, these additional requirements should consist of well-defined and well-publicized adjustments to GAAP reports. Duplicate regulatory examinations should be eliminated, and normal regulatory review limited to a single examination, coordinated among the various regulatory agencies, in any relevant time period.

The accounting profession and the regulators should jointly identify areas for reliance on one another's work and eliminate duplicative analysis. A first step has already been taken in the area of internal controls as a result of the external auditor's report mandated by FDICIA. Another area for consideration would be complex computer systems and risk models. As confidence grows, additional opportunities for mutual reliance could be identified.

A final recommendation is for the establishment of a permanent board, consisting of representatives of each of the federal bank regulatory agencies, the SEC, the accounting profession and the banking industry. Its functions would include: recommending areas in which external auditors and regulators could rely on one another's work and achieving consensus on the specific terms and conditions of any such division of labor; reviewing regulatory enforcement issues with a view toward encouraging a more open and public process of formulating and implementing enforcement policy; and identifying areas in which external auditors and regulators require training to keep pace with the evolution of financial institutions and instruments and cross-training to understand better the objectives and procedures of the other.
Defining the Roles of Accountants, Bankers and Regulators in the United States, Group of Thirty, Washington, DC, 1994.

Vol. 8 No. 2 - Article III - Published: June 1995 - Full Article

Recent Developments Affecting Depository Institutions

by Benjamin B. Christopher

REGULATORY AGENCY ACTIONS

Inter-Agency Actions

The federal bank and thrift regulatory agencies are engaging in joint or coordinated efforts in a number of regulatory areas that are mentioned specifically in this issue of the *Review* , among which are: Community Reinvestment Act compliance evaluation; risk-based capital requirements; capital-requirements accounting; appraisal guidelines; and examinations of bank-affiliate sellers of mutual funds. For full information on the inter-agency actions included in this issue, reference is necessary to the pages devoted to each of the agencies and the Federal Financial Institutions Examination Council.

Federal Deposit Insurance Corporation

Assessments

The FDIC proposed changes in its risk-related insurance premium system, including a significant reduction in rates paid by well-capitalized and well-managed banks. No change is proposed at this time in the insurance rates paid by savings associations. Under the proposal, premiums paid by about 90 percent of BIF-insured institutions would fall to four cents per $100 of domestic deposits, from their current rate of 23 cents per $100. The 31-cent rate currently paid by the lowest-rated BIF-institutions would continue.

Present law requires the BIF to have an average assessment rate of 23 cents per $100 of deposits until the Fund amounts to $1.25 per $100 of insured deposits. As of the third quarter of 1994, the Fund balance of $19.4 billion represented $1.03 per $100 of insured deposits. The FDIC projects that the 1.25 ratio will be reached between May 1 and July 31, 1995. Premiums can be reduced 'because of the efforts of the banking industry to make their individual institutions stronger' and to make their insurance fund stronger, said Chairman Ricki Helfer. The proposed new assessment rate would not be implemented until it can be verified that the BIF has been recapitalized.

The FDIC also is considering a process for adjusting BIF rates quickly in response to changing conditions. As proposed, the entire assessment rate schedule could be raised or lowered twice a year, within a range of five cents per $100 without first seeking public comment.

The FDIC proposed retaining the existing assessment rate schedule for the Savings Association Insurance Fund (SAIF). Under the existing SAIF assessment rate schedule, which averages 24 cents per $100, the Fund is projected to be capitalized in the year 2002. As of the third quarter of 1994, the SAIF had an estimated balance of under $2.0 billion, this representing a ratio of 26 cents per $100 of insured deposits. The SAIF also will assume from the Resolution Trust Corporation the responsibility for resolving failed thrifts, starting July 1, 1995. Comments were requested additionally on the proposal to keep SAIF assessment rates unchanged, and on the potential impact of a substantial premium differential between BIF-insured and SAIF-insured institutions. *PR-6-95, FDIC, 1/31/95.*

The FDIC is seeking comments on whether the deposit insurance assessment base should be redefined and, if so, how. Broadly stated, the assessment base is defined as an institution's total domestic deposits as of the end of a quarter. The definition of the assessment base has remained substantially the same since 1935. Until recently, the FDIC did not have statutory authority to change the definition. However, the FDIC Improvement Act of 1991 (FDICIA) gave the agency the ability to determine the assessment base, starting January 1, 1994. Among the key questions on which the agency is seeking guidance is whether it should begin charging insurance premiums for deposits that U.S. banks have in their foreign offices and for certain nondeposit liabilities and 'off-balance-sheet' items. Comments also are sought on whether assessments should be based on an average level of deposits held by the institution rather than quarter-end figures. The latter question is intended in part to address situations where institutions temporarily shift funds out of the assessment base at the end of a quarter solely to reduce their insurance payments. If the FDIC Board finds revisions to be warranted, it will propose specific amendments and invite public comment. *PR-64-94, FDIC, 9/27/94; FR, 10/5, p. 50710.*

The FDIC is taking steps to modernize the way deposit insurance premiums are collected to make the process more efficient and less burdensome. Institutions currently mail a check to the FDIC twice a year after determining how much they owe for deposit insurance, based on their assigned risk-related assessment rate and their deposit base. Under a new rule scheduled to take effect April 1, 1995:

> (a) The FDIC will compute the assessment owed, thereby improving the accuracy and relieving each institution of the burden of performing the calculation;
> (b) The agency will arrange for each institution's payment electronically through the Automated Clearing House (ACH) Network;
> (c) Each semiannual insurance assessment will be paid in quarterly installments, based on an invoice prepared by the FDIC showing the insurance calculation and information on any adjustments from previous quarters.

The revisions delete from the assessment regulation the existing references to experience factors, which are not available for use after 1994.

The new rule also changes the way insurance premiums are collected from insured institutions that acquire deposits through mergers or other transactions in the latter half of a semiannual assessment period. When such a transaction occurs, the surviving institution's payments will be adjusted to account for the increased insurance risk the deposits may pose. *PR-83-94, FDIC, 12/20/94; FR, 12/29, p. 67153.*

Required New Disclosures of 'Pass Through' Coverage
The FDIC adopted new rules requiring insured institutions to provide timely disclosures to depositors in certain retirement accounts and employee benefit plans about whether their funds qualify for ' pass through' insurance coverage. In general, ' pass through' insurance means that the share of each participant in the account, rather than the total account balance, is insured up to $100,000. A 1991 law and FDIC regulations that went into effect in 1992 provide for pass through deposit insurance for employee benefit plan accounts if the insured institution satisfies certain capital standards.

At issue are deposits in accounts such as 401(k) retirement accounts, Keogh plan accounts, and corporate pension plan and profit-sharing plan accounts. Among the new required disclosures are the institution's 'prompt corrective action' (PCA) category, and whether the deposits are believed to be eligible for ' pass through' insurance (must be disclosed in writing when an affected account is opened, and upon request of the account manager); and notification if new, rolled-over or renewed deposits will not be eligible for 'pass through' insurance (must be disclosed in writing within ten days of when an existing account is believed to be no longer eligible for 'pass through' insurance coverage).

The new rules become effective July 1, 1995; however, holders of employee benefit plan deposits made between December 19, 1992 and July 1, 1995, will receive specified disclosures if at the time of deposit the account was not eligible for pass through insurance coverage. *PR-7-95, FDIC, 1/31/95; FR, 2/9, p. 770.*

Brochure on Insurance Coverage
In an effort to reduce continuing customer confusion, the FDIC is now offering a free brochure, 'Insured or Not Insured - A Guide to What Is and Is *Not* Protected by FDIC Insurance.' The brochure explains the term mutual funds, advises purchasers to obtain definitive information, states clearly that 'mutual funds' are not deposits and therefore are not insured by the FDIC or any federal agency, and explains the difference between FDIC coverage of deposits and insurance from other sources that may be available

on certain other bank products. The brochure also includes a discussion of the insurance aspects of Treasury securities, safe deposit boxes and robberies. Institutions that sell nondeposit products either directly or through a third party are strongly urged to provide this brochure to anyone who inquires about, or purchases, such products. *FIL-53-94, FDIC, 7/20/94.*

BIF Rises to $19.4 Billion in Third Quarter; Agency Staff Reduced
The Bank Insurance Fund (BIF) increased to $19.4 billion as of September 30, 1994, up 48 percent from the 1993 year-end level of $13.1 billion. The Fund balance amounted to 1.03 percent of insured deposits on September 30. As a result of the improving financial health of the banking industry, the estimated liability for the cost of anticipated bank failures declined to $1.46 billion, from $3.00 billion at the end of 1993. BIF revenue for the nine-month period totaled $5.00 billion, of which $4.22 billion was assessments earned. Expenses and losses were a negative $1.23 billion, this amount representing mainly provision for insurance losses of minus $1.66 billion.

The FDIC reported that its current staff of 12,116 is 421 less than the initial projected 1995 year-end staff level, and 1,200 below the year-end authorized level. Staff levels decreased by 820 during the third quarter, and 2,103 (14.8 percent) for the year-to-date. Most of these reductions were related to office closings in Houston, Denver, Orlando, Encino, and San Antonio. *Financial Management Report, 3rd Quarter 1994, FDIC.*

Thirteen Banks Failed Last Year
In 1994, there were 13 failures of BIF-insured banks, which had assets of just under $1.6 billion, down from 41 failed banks, with assets of $3.5 billion, the year before. The number of closures in 1994 was the lowest since the year 1981.

The FDIC's 'problem' list at the end of the third quarter consisted of 293 commercial banks, with assets of $36 billion, and 84 savings institutions, with $59 billion in assets. From year-end 1993, the total number of 'problem' institutions declined by 195, and their assets were down by $239 billion. *FDIC Quarterly Banking Profile, Third Quarter 1994; FDIC Office of Corporate Communications.*

Supervisory Guidance on Mortgage Derivative Products
The FDIC has updated and distributed to FDIC-supervised banks its supervisory guidance to examiners on mortgage derivative products. The new guidance incorporates the provisions of the Federal Financial Institutions Examination Council's (FFIEC) interim revision to its Supervisory Policy Statement on Securities Activities, which addressed the application of Statement No. 115 of the Financial Accounting Standards Board (FASB) to mortgage derivative products.

The FDIC's guidance states that a mortgage derivative product that was non-high-risk at purchase and designated as held-to-maturity later becomes high-risk, the security will not be subject to redesignation as available-for-sale or trading if the institution can continue to demonstrate a positive intent and ability to hold the security to maturity. However, examiners will continue to consider any unrealized net depreciation in held-to-maturity, high-risk mortgage derivative products in the evaluation of an institution's capital adequacy. Mortgage derivative products that expose an institution to risk of loss of principal or book value may be classified in accordance with the provisions in attached exhibits. The entire amount of unrealized losses (not just any amounts scheduled as loss) on available-for-sale debt securities *that are adversely classified* must be deducted from Tier 1 capital before calculating regulatory capital ratios. No such adjustment to regulatory capital calculations is necessary for adversely classified trading securities, as unrealized gains and losses on trading securities are included in an institution's earnings. *FIL-82-94, FDIC, 12/13/94.*

Supervisory Guidance For Structured Notes
The FDIC issued a supervisory guidance to the agency's examiners and to FDIC-supervised banks on the characteristics, risks and examination treatment of structured notes. Since 1990, U.S. Government-sponsored enterprises, private corporations, and multilateral development banks have issued structured

notes, with the Federal Home Loan Banks the most predominant issuers. Banks have increased their investment in structured notes. These securities typically contain embedded options such as caps, calls, and floors and have cash flows that are linked to indices such as interest rates, foreign-exchange rates, commodities prices, prepayment rates, and other financial variables. The cash-flow uncertainty of structured notes, caused by movements in interest rates, foreign-exchange rates, and other indices, may expose banks to greater market risk, liquidity risk, operating risk, or interconnection risk than traditional medium-term notes. As a result, bank investments in structured notes warrant increased supervisory attention to ensure that bank management understands the nature of the risks in the securities and has the ability to measure, monitor, and manage these risks. Specific examination guidance regarding the characteristics and risks in structured notes is provided. *FIL-61-94, FDIC, 8/31/94.*

Management of Interest-Rate Risk

The FDIC issued a guidance to its examiners and to FDIC-supervised banks on the assessment and management of interest-rate risk in financial institutions. The guidance considers such factors as the size of the institution, capital adequacy, earnings and the complexity of the institution's business. The management of interest-rate risk may range from the formation of formal management committees and the use of complex measurement systems to informal management oversight and the use of simple measurement tools in smaller, more basic, bank operations.

Interest-rate-risk management can be defined as the management of the potential impact of interest-rate movements on an institution's net interest income and market value. Applicable to all banks in various degrees, interest-rate risk management in larger institutions can be segmented into several parts which are discussed in the guidance: (a) the establishment of an interest-rate-risk management committee that is approved by and reports to the board of directors or assumption of such responsibility by the full board; (b) written policies and procedures, including risk limits; (c) a written interest-rate-risk management strategy or strategies; (d) an appropriate measurement and monitoring system(s) to quantify interest-rate-risk exposure; (e) the evaluation of interest-rate-risk exposure. *FIL-60-94, FDIC, 8/26/94.*

Rapid-Growth Rule Rescinded

Effective November 7, 1994, the FDIC rescinded a section of its regulations on notification of rapid growth. Currently, all insured banks, except insured bankers' banks, are required to give the FDIC prior notice of planned rapid growth as a result of any 'special funding plan or arrangement.' For purposes of this requirement, such a funding plan is any effort to increase the assets of a bank through the solicitation and acceptance of fully insured deposits obtained from or through the mediation of brokers or affiliates (which would include insured brokered deposits); the solicitation of fully insured deposits outside a bank's normal trade area; or secured borrowings, including repurchase agreements. The recission will lessen the regulatory burden on banks which are currently also required to comply with the FDIC's brokered deposit regulation and the prompt corrective action rule, both of which were designed in part to address the same risks resulting from rapid growth. *FR, 10/6/94, p. 50826.*

Task Force on Risks From Capital Market Instruments

FDIC Chairman Ricki Helfer announced the creation of a special task force to analyze and make recommendations regarding the potential risks posed to the federal deposit insurance funds by capital market instruments, including derivatives. The recommended actions will include those necessary to enhance the agency's ability to respond appropriately to the possibility that failed banks could be involved in these capital market activities and to situations in which these activities could pose a systemic risk that threatens the deposit insurance funds or the financial system. The FDIC noted the unprecedented growth in capital market instruments and the advances in technology that enable practitioners, including insured depository institutions, to condition their income streams on increasingly complex financial relationships. To the extent that these complexities including the global nature of the inter-linkages between market participants are not well-understood or are mismanaged, capital market instruments can result in losses that may take management and regulators by surprise. The agency said there is no reason to believe that the capital market activities of any insured financial institution pose a significant risk at this time to the deposit insurance funds. *PR-72-94, FDIC, 11/7/94.*

Early-Warning System on Loan Underwriting Standards
The FDIC plans to establish a system designed to identify any relaxation in the underwriting standards for bank lending before problems occur. The new program will commence with pilot projects in all eight of the agency's supervisory regions, and will involve periodic surveys of bank examiners to identify changes in underwriting standards as they occur. Chairman Ricki Helfer said 'this effort will allow the FDIC to analyze systematically the findings of our field personnel who observe lending practices on a day-to-day basis, and then to work with banking institutions to correct any problems before they are serious.'

FDIC personnel at selected, regularly-scheduled bank examinations during the first quarter of 1995 will be asked to report on the prevalence of specific lending and investment practices that have led to difficulties in the past, such as commercial real-estate loans based on unrealistic cash-flow projections, and to identify new practices that could have implications for the safety and soundness of the banking system. *PR-79-94, FDIC, 12/13/94.*

Revised Proposal on CRA Compliance Evaluation
The FDIC, the Office of the Comptroller of the Currency (OCC), the Federal Reserbe Board (FRB) and the Office of Thrift Supervision (OTS) modified a proposal that the agencies published in December 1993, (see this *Review* , Spring/Summer 1994, p. 40) to change the way institutions are evaluated under the Community Reinvestment Act (CRA). The revised proposal retains the structure and principles of the December plan; for example, both would replace the 12 factors now used to evaluate an institution's CRA performance with a more objective, performance-based system. However, the revised plan would make the performance tests more flexible, simplify data reporting requirements and increase the importance of community development lending, such as loans for affordable housing and economic development in low- and moderate-income areas. The revised proposal gives greater recognition to the importance of all types of lending to low- and moderate-income individuals and neighborhoods, treats community development lending as a principal component of lending performance, and clarifies that an institution's loans outside its service area to low- and moderate-income individuals and to small businesses and small farms could be considered as part of its CRA performance.

As in the December proposal, large financial institutions (generally those with $250 million or more in assets) would be evaluated for their CRA performance under three 'tests' -- a lending test, an investment test and a service test. However, under the revised proposal, the tests would be less rigid and would allow the examiner more flexibility to take into account the characteristics and needs of a community and the capacity and limits of an institution. Large institutions also would be required to file new data about their lending and investments, but less than what was proposed in December. A new reporting requirement is data on an institution's loans to small businesses and small farms that would include information on the race and gender of the borrowers. Small banks and thrifts would be evaluated under a streamlined method that would not subject them to additional reports of loan data. The revised proposal would not require, as initially proposed, a small institution to have at least a 60 percent loan-to-deposit ratio in its community in order to be given a 'satisfactory' CRA rating. The agencies instead propose to consider each institution's financial condition and the credit needs of the community in evaluating lending performance under CRA. *PR-135-93, FDIC, 12/9/93; FIL-67-94, 10/12/94; FR, 10/7, p. 51232.*

Self-Testing Guide on Fair Lending
The FDIC issued a 56-page booklet on self-testing for fair lending practices. The guide is designed to help lenders compare the treatment of loan applicants and identify differences that may be discriminatory, and offers suggestions on how to correct discriminatory practices and improve lending performance.

> Among the topics included are:
> (a) How to plan and manage a pre-application testing program. The focus here is the point where an applicant inquires about a loan, gathers information and receives counseling or an invitation to apply. Financial institutions are encouraged to take whatever steps are necessary, including some form of pre-application testing, to inspect the treatment of potential applicants, as a means of helping to prevent illegal discrimination, improving customer service and attaining lending goals.

(b) Treatment of applicants after submission of an application through a comparative analysis of loan files. Examples are provided of how loan product features, underwriting standards, or instances of lender assistance to borrowers can be compared to identify unequal treatment that may constitute discrimination. The use of comparative file analysis is discussed with reference to applications where disparate treatment may occur regarding applicants who are neither clearly qualified nor clearly unqualified for a loan.
(c) How to identify and correct specific forms of discrimination, that may occur as overt or subtle discrimination, disparate treatment, disparate impact, an individual instance of discrimination or a pattern or practice of discrimination.
(d) Criteria used by the regulatory agencies in taking enforcement actions and seeking remedial measures.
(e) The importance of providing training on multicultural awareness, and on race, gender, and handicap sensitivity, to all levels of an institution's staff. *Side By Side: A Guide to Fair Lending, FDIC, August 1994.*

Audit Reports
Under an FDIC proposal that could affect approximately 70 institutions, annual audit reports on a separate, bank-only basis would be eliminated for institutions with over $9 billion in assets, if they are rated '1' or '2' on the CAMEL system and are subsidiaries of multibank holding companies. Instead, these institutions could be included in the holding company's annual report.

Another proposal relating to procedures for determining compliance with certain laws and regulations, that would affect about 1,000 banks, includes new formatting and modifications of certain procedures so that they are more efficient and less burdensome. *PR-9-95, FDIC, 2/2/95.*

FDIC Will Test Consumer Disclosures in Bank Sales of Mutual Funds
The FDIC announced that it has hired a market research firm to study whether institutions are doing a good job explaining to consumers the distinctions between FDIC-insured deposits and uninsured products being offered by banks and thrifts, such as mutual funds. The agency's action is in response to concerns from lawmakers, bank customers and other regulators that confusion still exists despite various educational efforts by the industry and regulators about insured and uninsured bank products. To implement the study, trained representatives of the research firm, in person and by telephone, will pose as consumers asking typical questions about mutual funds, annuities and other nondeposit investment products, in the process of surveying a random, nationwide sample of several thousand locations of FDIC-insured banks and thrifts that sell these products. While the study is not intended to be used as an enforcement tool, if significant problems are found at an FDIC-supervised institution, the agency will seek appropriate corrective measures, and will refer problems found at other institutions to their primary regulator for follow-up. Results of the study are expected to be publicly available by mid-1995. *PR-80-94, FDIC, 12/13/94.*

Mutual-to-Stock Conversions The FDIC issued a final rule, to become effective January 1, 1995, that addresses the conversion by mutual savings banks to stock form of ownership. The rule, applicable to the approximately 600 state-chartered mutual savings banks supervised by the FDIC, combines elements of an interim rule adopted in February 1994 and a rule proposed in June. A proposed policy statement issued in February, and a separate request for comment issued in May on certain fundamentals of the conversion process have been withdrawn.

Among the requirements, which, under the final rule, a bank that proposes to convert must meet are: provide 60 days' advance notice to the FDIC of plans to convert, and if the FDIC finds any features to be unfair or unsafe it can object to and prevent the transaction; submit a full, independent appraisal report on the institution's value; and obtain a favorable vote on the conversion by depositors. Proxies are not permitted that are obtained from depositors in advance when they open an account. Eligible depositors must be given a priority over other buyers, including employee stock ownership plans, in purchasing stock when it is first offered, and bank management is permitted, but not required, to give preference to eligible local depositors. A bank generally is not permitted to buy back its stock within the first year after conversion. After one year, stock repurchases are subject to case-by-case review by the FDIC. The bank must submit a business plan detailing the use of capital to be acquired in the conversion and expected earnings.

The final regulation does not prohibit conversions through a merger with an existing institution or an acquisition by a holding company; however, because of the abuses that have been associated with such conversions, the FDIC will scrutinize closely these proposed transactions. *PR-77-94, FDIC, 11/22/94; FR, 11/30, p. 61233.*

Capital Rule For Unrealized Gains and Losses on Securities
The FDIC adopted a final rule, effective January 27, 1995, that clarifies the regulatory capital treatment for unrealized gains and losses on securities that are 'available for sale.' Statement No. 115 of the Financial Accounting Standards Board requires institutions to recognize as a separate component of stockholders' equity any holding gains and losses on securities that are deemed available-for-sale. In general, this refers to securities that a bank does not have a positive intent and ability to hold to maturity but also does not intend to actively trade. Banks already are required by the banking regulators to follow FASB 115 for the quarterly Reports of Condition and Income (Call Report), under instructions issued in 1993 by the FFIEC. At issue, however, has been the application of FASB 115 to regulatory capital standards.

The FDIC and the other banking regulators previously proposed to require that net unrealized gains or losses on all available-for-sale securities (debt as well as equity securities) be included in determining Tier 1 capital (see this *Review* , Winter 1995, p. 35). The FDIC has joined with the FRB and OCC in rejecting that earlier proposal. Instead, the FDIC is adopting only technical changes to conform the wording in its leverage and risk-based capital rules with the terminology used in FASB 115. A similar rule is expected to be issued by the OTS for the institutions it regulates. FDIC Chairman Ricki Helfer said: We believe bank regulatory capital levels would be unnecessarily volatile, without appreciable benefits to the safety and soundness of the banking system, if institutions were required to include all unrealized securities losses in their regulatory capital calculations.

The new rule closely tracks an interim guidance jointly issued by the three bank regulatory agencies in December 1993, and the capital treatment recommended by an inter-agency task force of the FFIEC in November 1994. Under the final rule, net unrealized holding losses on available-for-sale equity securities (but not debt securities) with readily determinable fair values will be deducted from the elements that determine Tier 1 capital. All other unrealized holding gains or losses on available-for-sale securities will be excluded from the definition of Tier 1 capital. However, the extent of any unrealized appreciation or depreciation on securities will continue to be a factor that FDIC examiners consider in their overall assessment of an institution's capital adequacy. The amortized cost rather than the fair value of available-for-sale debt securities generally will continue to be used when calculating leverage and risk-based capital ratios. Banks also should continue to use the amortized cost of available-for-sale debt securities when reporting average total assets and risk-based capital data in the Call Report. *PR-85-94, FDIC, 12/20/94; FR, 11/25, p. 60552; 12/28, p. 66662.*

Proposed New Appeals Process
The FDIC proposed guidelines for a new process that institutions could use to appeal supervisory decisions involving examination ratings, adverse classifications of significant assets, and the adequacy of loan-loss reserves. An 'independent' appeals process for 'material supervisory determinations' is required by Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994 for the FDIC as well as the other federal regulators of banks, thrifts and credit unions. The law defines an independent appeals process as one where the review is by an agency official who does not directly or indirectly report to the person who made the supervisory determination being questioned.

The new program would replace a less formal appeals process adopted by the FDIC in February 1992. Under the proposed guidelines, an institution first would be encouraged to attempt to resolve the disputed matter with the regional office of the agency's division that made the supervisory determination. However, the institution could file an appeal with the Washington-based director of the appropriate division within 60 days after receiving written notification of the initial FDIC decision. That division director either would grant the change requested by the institution or promptly refer the matter to a special committee consisting of the FDIC's Vice Chairman, General Counsel, an internal ombudsman and supervisory division directors. This committee would decide the appeal and notify the institution of its decision. From the time the FDIC receives an appeal, it would reach a final decision and notify the institution within 60 days.

Certain types of determinations would not be subject to this appeals process, including decisions to appoint a conservator or receiver for a failing institution; 'prompt corrective action' taken when an institution's capital falls below specified levels; formal enforcement actions; and risk classifications for deposit insurance premiums (review of these determinations is covered by other FDIC procedures). The proposed guidelines also contain safeguards against possible retaliation by FDIC examiners. *PR-84-94, FDIC, 12/20/94; FR, 12/28, p. 66965.*

The OCC has issued a similar request for comments. *FR, 12/22/94, p. 66067.*

Applications For Merger Transactions
The FDIC amended its requirements to provide that in emergency cases necessitating prompt action, an applicant for a transaction under the Bank Merger Act will be required to publish only twice during the statutory ten-day period, with the second publication on the tenth day or the newspaper's publication date closest to ten days after the first publication, instead of daily for ten days as presently required. In non-emergency cases, publication will be required only three times at approximately two-week intervals. The regulation brings the FDIC's notice requirements into greater conformance with those of the other federal banking agencies, gives applicants more flexibility, and lessens regulatory burden. *12/28/94, p. 66653.*

Remote Service Facilities
The FDIC is revising its requirements, effective immediately, for the establishment and relocation of remote service facilities (RSFs) in order to lessen the regulatory burden on state nonmember banks and state-licensed branches of foreign banks. Prior to the revisions, banks desiring to establish an initial RSF were required to comply with all the application and publication requirements applicable to the establishment of a 'brick and mortar' branch office. Successive RSFs could be established or relocated without a formal application under somewhat less involved requirements. The amended regulation provides that a state nonmember bank or an insured state-licensed branch of a foreign bank whose recent CRA rating is Satisfactory or better may establish and operate or relocate an RSF by filing a letter with the appropriate FDIC regional director. The letter must state the location of the RSF and information indicating compliance with the National Historic Preservation Act. Unless the institution is notified otherwise by the FDIC within seven days of receipt of the letter, the institution may establish or relocate the RSF. The public notice requirements are being dispensed with in this case. *8/23/94, p. 43281; FIL-59-94, FDIC, 8/24.*

Loans to Executive Officers
The FDIC amended its regulations to except loans which are fully secured by certain types of collateral from the general limit on 'other purpose' loans to executive officers of insured nonmember banks. The FDIC's rules place limits on loans that a bank can make to its executive officers for purposes other than an education or a home, such as commercial loans, farm loans and other types of consumer loans. When secured by any of the specified types of collateral, which in part include a perfected security interest in a segregated deposit account in the lending bank, a loan may be made in any amount and will not be subject to the limit for other purpose loans set forth elsewhere in the regulation. The amendment parallels recent changes by the FRB to that agency's regulations on insider loans. *FR, 8/16/94, p. 41990; 12/28, p. 66666; FIL-5-95, FDIC, 1/5/95.*

Foreign Banks
The FDIC is amending its regulations, effective January 1, 1995, concerning applications procedures and plans for divestiture or cessation of activities by state-licensed insured branches of foreign banks. FDICIA

provides that after December 19, 1992, such a branch may not engage in any activity that is not permissible for a federal branch of a foreign bank without the approval of the FRB and the FDIC. In the event that an application to begin or to continue to engage in an activity is denied by the FRB or FDIC, or the foreign bank elects not to continue the activity, a plan of divestiture or cessation must be submitted and the transaction completed within one year, or sooner if the FDIC so directs. *11/28/94, p. 60703.*

Courts Again Decide For Gross Negligence Standard
The U.S. Court of Appeals for the Sixth Circuit, in the case of *FDIC v. Bates* , ruled that the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires regulators to meet a gross negligence standard in suits against officers and regulators. It was the third federal appeals court decision upholding the gross negligence standard, which generally makes it more difficult for regulators to prove negligence than would a simple negligence standard.*AB, 12/29/94, p. 2.*

Agency Uses Self-Appointment Authority
The FDIC appointed itself receiver of the $3.2 million-deposit The Meriden Trust and Safe Deposit Company, Meriden, Connecticut, and on July 7, 1994, took possession of and closed the bank. This was the first exercise of the agency's self-appointment authority which it received in 1991. The announcement said the bank would reopen the following day as a 'bridge bank,' New Meriden Trust and Safe Deposit Company, National Association. Meriden Trust's closing was the direct result of the 1991 failure of an affiliated institution, Central Bank of Meriden. The FDIC used its 'cross guaranty' authority to assess Central Bank's affiliated insured depository institution for potential losses to the deposit insurance fund, resulting in Meriden Trust's insolvency. *PR-41-94, FDIC, 7/7/94.*

Real-Estate Recovery Less Widespread Than Earlier
While reports of improvement in real-estate conditions continued overall to substantially exceed reports of decline, the margin of difference diminished in the FDIC's quarterly survey for the third consecutive time.

The national composite index of survey results fell to 62 in January from 67 in October and 72 in July 1994. Values of the index above 50 indicate more respondents believed conditions were improving than declining, compared to the previous quarter, while values below 50 indicate the opposite. The surveys, which began in April 1991, are based on interviews across the country with senior examiners and asset managers of federal bank and thrift regulatory agencies. The 407 participants in the latest survey were polled in late January.

In residential markets, the index declined to 58 in January from 64 in October. Over half of the January respondents reported local housing conditions unchanged, while 32 percent saw continuing improvement down from 41 percent in October and 17 percent reported a decline. The recovery continued to be somewhat more widespread in commercial real-estate markets, as 38 percent of the respondents in January reported gains in that sector, while only 4 percent saw worsening conditions. These results were, however, somewhat less favorable than in October, when the percentages were 44 and less than one, respectively.

As another indicator of the recovery in real estate, where the results were better than in the previous surveys, 28 percent of the respondents assessing local housing markets, and slightly over one-half for commercial real estate, reported an excess supply in the markets.

Regionally, respondents in January reported small differences in the overall indexes, as the index for the West mirrored the national average. The evaluations for the South and Northeast were slightly more positive than for the nation as a whole, but were below the average in the Midwest, where the 22 percent of responses indicating improvement in local housing markets was down from 40 percent in the October survey. More than three-fourths of reports in California indicated commercial property sales were below average for that area. *Survey of Real Estate Trends, FDIC, January 1995.*

Agency Will Sell Mortgage-Backed Securities
The FDIC will issue approximately $761.4 million of securities backed by commercial mortgage loans. The issue is the FDIC's first entry into the mortgage-backed securities market. The certificates will evidence beneficial ownership interests in real-estate loans that were originated by failed depository institutions nationwide that were insured by the Bank Insurance Fund (BIF). The issue consists of $264.0 million of floating-rate Class I certificates and $497.4 million of fixed-rate Class II certificates. The certificates include a limited FDIC guaranty provided solely by the BIF against credit losses and other shortfalls due to credit defaults. The guaranty will be limited to a maximum of 32.5 percent of the principal amount of the collateral outstanding; any additional losses will be borne by the holders of the certificates. Except under the limited guaranty, the certificates are not guaranteed by the FDIC or any other government agency. The offering of the securities will be made only by means of a prospectus. *PR-51-94, FDIC, 8/9/94.*

Standards of Ethical Conduct For FDIC Employees
The FDIC, with the concurrence of the Office of Government Ethics (OGE), proposes to issue regulations for the employees of the Corporation that would supplement the Standards of Ethical Conduct for Employees of the Executive Branch issued by the OGE. The proposed rule would establish prohibitions on borrowing and extensions of credit; prohibitions on the ownership of certain financial interests; prohibitions on the purchase of property controlled by the Corporation or the Resolution Trust Corporation; limitations on official dealings with former employers and clients; disqualification requirements relating to employment of family members outside the Corporation; and limitations on outside employment activities. *FR, 7/12/94, p. 35480.*

Treasury Reduces BSA Information Requirements
The Treasury Department issued a final rule, effective immediately, rescinding a requirement adopted pursuant to the Bank Secrecy Act for financial institutions to maintain a chronological log, and reducing substantially the amount of information required to be recorded. The BSA prohibits financial institutions from issuing or selling bank checks or drafts, cashier's checks, money orders or traveler's checks for $3,000 or more in currency unless the financial institution verifies and records the identity of the purchaser. Treasury also withdrew a proposal that would have required banks with deposits over $100 million, and certain nonbank financial institutions, regardless of asset size, to maintain specific systems to aggregate currency transactions, and would have required financial institutions that file more than 1,000 Currency Transaction Reports per year to file by magnetic media. *FR, 10/17/94, pp. 52250, 52275.*

Resolution Trust Corporation
Audit Report by the General Accounting Office (GAO)
A GAO report of its audit of the RTC's statements of financial position as of December 31, 1993 and 1992, found that: (a) the Corporation's financial statements were reliable in all material respects; (b) internal controls as of December 31, 1993, were effective in safeguarding assets against unauthorized acquisition, use, or disposition; (c) there was no material noncompliance with laws and regulations that were tested; and (d) the Corporation adequately addressed the material weakness and reportable conditions that were identified in the GAO's 1992 audit. The report noted that although the Corporation used the best available information to estimate securitization credit losses and future losses arising from representations and warranties, significant uncertainties exist. The limited claims experience raises the risk that the amount of future losses may significantly increase or decrease. These future losses will be affected by the behavior of the economy, interest rates, and real-estate markets as well as the performance of the collateral underlying the transactions. The Chairman of the Thrift Depositor Protection Oversight Board announced a management reform agenda in March 1993, which included requirements that the Corporation strengthen its internal controls in several areas. Among the steps the Corporation has taken to enhance its internal controls is the oversight of contractors that perform services for receiverships. However, audits of some contractors are continuing to identify contractor performance problems, such as poor asset management and disposition practices and questionable billings, which could result in increased expenses or reduced recoveries on assets.

The report contains estimates of unused loss funds after completion of the RTC's resolution activities. Based on total loss funding made available of $105 billion, and estimated loss funding needs of $92 billion, the estimated unused loss funds would total $13 billion. However, if actual asset recoveries are less than estimated or future resolution costs are greater than anticipated, the RTC will need to use additional loss funds. Loss funds not used by the Corporation are available for losses incurred by the Savings Association Insurance Fund (SAIF), subject to the conditions set forth in the RTC Completion Act. Funds in excess of the amounts needed by both the RTC and SAIF will be returned to the general fund of the Treasury. Under the RTC Completion Act, the Corporation will terminate on or before December 31, 1995. All remaining assets and liabilities will be transferred to the FSLIC Resolution Fund, which is managed by the FDIC. *Annual Management Report, RTC, submitted to Congress on June 30, 1994, containing Opinion Letter from the U.S. General Accounting Office.*

Operations Update

The resolution, in December 1994, of one institution under the Accelerated Resolution Program brought the total number of resolutions to 774 since the inception of the RTC in 1989. As of December 31, the RTC had one institution to be resolved.

As of November 30, 1994, the assets under RTC management had decreased to $31 billion, consisting of $4 billion in cash and securities, $5 billion in performing 1-4 family mortgages, $5 billion in other performing loans, $7 billion in delinquent loans, $2 billion in real estate, $5 billion in investments in subsidiaries, and $3 billion in other assets. The conservatorship program held $3 billion in gross assets on November 30. Assets in receiverships remaining from the institutions closed by the RTC amounted to $28 billion. Because many of the relatively marketable assets have been sold before an institution enters a receivership, most of the assets retained by the RTC in receivership consisted of lower-quality, less-marketable assets. Thus, real estate and delinquent loans represented 32 percent of receivership assets.

From inception through November, the RTC collected $156 billion from securities, $103 billion from 1-4 family mortgages, $54 billion from other mortgages, $30 billion from non-mortgage loans, $16 billion from real estate, and $21 billion from other assets. The recoveries, which have amounted to 88 percent of book value reductions, included 98 percent from securities, 96 percent from 1-4 family mortgages, 77 percent from other mortgages, 90 percent from non-mortgage loans, 55 percent from real estate, and 65 percent from other assets. Through the end of November the RTC also had collected $19.3 billion in receivership income. The thrifts closed through November held $240 billion in assets at the time of closure. Estimated resolution costs for these closures totaled $88.2 billion. *RTC Review , January 1995.*

Marketing Real Property on an Individual Basis

In September 1994, the RTC adopted an interim rule, implementing the marketing provisions contained in the FHLBank Act and the RTC Completion Act, to provide policies and procedures for the marketing of real-estate-owned (REO) assets on an individual basis, and for the disposition of REO assets with a book value of more than $400,000 and nonperforming real-estate loans with a book value of more than $1 million. The agency subsequently adopted the interim rule without change as a final rule to be effective December 23, 1994. *FR, 9/19/94, p. 47790; 11/23, p. 60304.*

Affordable Housing Disposition Program

The RTC is amending its regulations to implement provisions of the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act of 1991 and other statutes enacted in 1992 and 1993 that changed the manner in which the RTC is to identify, market and sell certain affordable housing properties. The regulations as amended will enhance the availability and affordability of residential real property for very-low-income, lower-income and moderate-income families and individuals. An interim final rule became effective October 19, 1994, and this rule was adopted in October without change as a final rule to be effective January 12, 1995. *FR, 10/19/94, p. 52669; 12/13, p. 64111.*

Affordable Housing Unification Plan

The RTC reported that in the four-month period beginning in June 1994, RTC-FDIC joint sales of single-family and multifamily affordable housing properties totalled over $6.8 million. In April 1994, the FDIC

In March 1993, the four supervisory agencies announced plans to reduce documentation, encourage character loans, reduce appraisal requirements, streamline the appeals and complaint process, and reduce the burden of the examination process. Additional actions were announced in May and June, including procedures for returning certain nonaccrual loans to accrual status, and procedures for eliminating duplicative exams by the primary regulator and the FDIC, as back-up regulator, and coordinating exams where duplication is required. In December 1993, the FFIEC issued an inter-agency policy statement on loss reserves, including a formula for calculating reserve levels, in an effort to provide an objective standard against which bank management and their external auditors can assess the adequacy of reserves. Of particular note, the policy represents a guideline rather than a safe harbor. At the same time, the policy statement recognized the limits of the examiner's ability to assess asset quality and the stronger position of management to accumulate up-to-date information necessary to estimate losses accurately on specific loans or classes of loans.

It may be noted that at the time of this study's completion, the Riegle Community Development and Regulatory Improvement Act of 1994 was in the process of enactment. A number of the Act's provisions are directly relevant to the study's concerns, among which is a requirement for the federal banking agencies to coordinate their examinations and to develop a system for selecting a lead agency to manage unified examinations, authority for the federal agencies to establish certain standards by guidelines instead of regulations, and a requirement concerning review and elimination of outmoded regulations and policies.

Among the study's overall conclusions and recommendations is that while regulators, management and external auditors have different responsibilities and priorities, it is important that there be basic agreement in their conclusions in respect to the financial condition of an institution, with reconciliation of any differences in assumptions and methodologies in order to reach a common understanding. Financial reporting should be based on GAAP accounting rules, and where additional information or more stringent reporting standards are essential for regulatory purposes, these additional requirements should consist of well-defined and well-publicized adjustments to GAAP reports. Duplicate regulatory examinations should be eliminated, and normal regulatory review limited to a single examination, coordinated among the various regulatory agencies, in any relevant time period.

The accounting profession and the regulators should jointly identify areas for reliance on one another's work and eliminate duplicative analysis. A first step has already been taken in the area of internal controls as a result of the external auditor's report mandated by FDICIA. Another area for consideration would be complex computer systems and risk models. As confidence grows, additional opportunities for mutual reliance could be identified.

A final recommendation is for the establishment of a permanent board, consisting of representatives of each of the federal bank regulatory agencies, the SEC, the accounting profession and the banking industry. Its functions would include: recommending areas in which external auditors and regulators could rely on one another's work and achieving consensus on the specific terms and conditions of any such division of labor; reviewing regulatory enforcement issues with a view toward encouraging a more open and public process of formulating and implementing enforcement policy; and identifying areas in which external auditors and regulators require training to keep pace with the evolution of financial institutions and instruments and cross-training to understand better the objectives and procedures of the other.
Defining the Roles of Accountants, Bankers and Regulators in the United States, Group of Thirty, Washington, DC, 1994.