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Reps and Warranties
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Representations and warranties (R&Ws) are legally binding statements primarily made by sellers assuring buyers that certain minimum asset quality requirements are met. These minimum quality guarantees are commonly given in all types of asset sales, ranging from consumer products to whole loans. The guarantees may extend for only a few months or for the life of the asset.

R&Ws on loan sales are especially interesting because banks and thrifts have increased sales dramatically in the 1990s and each sale tends to create new R&W liabilities that remain long after the sale is completed. Moreover, these liabilities are almost never tracked, recognized in accounting statements, or reserved for with specific reserves. As such, they are a largely unacknowledged source of risk that remains long after the related assets have disappeared from a seller's books.

R&W risk can be significant for institutions that actively purchase and sell loans, because R&W risk exposure increases each time a purchase or sale is made. The act of selling loans increases the seller's liability to honor R&W obligations it issues as part of the sale. Buyers also increase risk due to the possibility that sellers may not honor the R&Ws they issue. Understanding and controlling these risks are prerequisites for effective risk management of any institution that actively purchases or sells loans.

The early difficulties of the Resolution Trust Corporation (RTC) in trying to sell assets without R&Ws are discussed in the first section of this paper. This is followed by a discussion of the "lemons principle" that suggests that the offering of R&Ws is likely to be beneficial. R&Ws commonly made by market participants are then discussed in detail. This is followed by an analysis of the RTC's claims experience with R&Ws, and a comparison of the estimated costs and benefits of granting R&Ws. Conclusions and caveats are presented in the final section.
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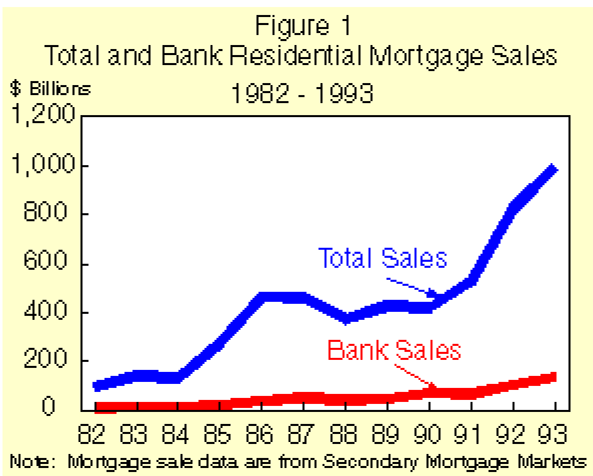
A $200 Billion Example

R&Ws, which have been granted for as long as sale contracts have existed, are used in all types of sales ranging from toasters to corporations. Sellers are often willing to give R&Ws because the risk of loss appears small as long as they are confident that they are well-managed and their product is of high quality. Buyers demand R&Ws because the potential problems may be difficult or costly to research, especially if they are numerous and data are not readily available to assess their risk. Buyers may be suspicious of products with no R&Ws due to a fear that a seller's unwillingness to offer them signals a higher risk of problems.

Figure 1 documents the explosion in sales of single-family mortgages that occurred during the 1980s. Because R&Ws are given in virtually all sales, including those to the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA), it is safe to assume that R&W liabilities grew in lockstep with sales activity. The success of the single-family market in the 1980s spread to other loan markets in the 1990s, as trading increased dramatically for all types of loans ranging from commercial mortgages to nonperforming consumer loans. R&Ws have necessarily also increased, especially for products that encounter more varied risks than single-family mortgages, such as commercial loans.

The experience of the RTC with R&Ws exemplifies the problems encountered by many market participants. The RTC was formed in August of 1989 with no sales experience and no policy for giving R&Ws. Initially, the RTC made several efforts to limit R&W liabilities created from the sales of loans and servicing rights. One approach granted R&Ws only from the receiverships created from the dissolved savings-and-loan associations (S&Ls), thereby limiting R&W liabilities to the receiverships. Other approaches included the granting of only very limited R&Ws and replacing R&Ws with rights to put back assets to the RTC in the event of problems.



Under the initial R&W policy, the RTC experienced great difficulty in selling its assets. The process was slow, prices were low, and buyers often resisted doing business with the RTC based on the terms it tried to dictate to the market. Buyers were highly suspicious of the credit quality of receiverships. In some cases, buyers required a portion of the sale proceeds to be placed in escrow to ensure that R&Ws issued by insolvent S&Ls could be honored. The limiting of R&Ws caused buyers to demand extensive reviews of loan and servicing files ("due diligence"), which were costly, time-consuming, and cumbersome to administer.

The RTC experimented with the sale of whole institutions and giving buyers rights to put back assets to the RTC after the sale and after they had been given a chance to research the loans. However, bidder interest showed little improvement and assets were often returned to the RTC. Also, the buyers of S&Ls and banks began teaming with Wall Street experts to buy whole S&Ls, then "flipping" (immediately reselling) the loans to the Wall Street partners, who in turn either securitized or otherwise resold the loans with R&Ws for a profit.

The RTC researched the costs and benefits of adopting more common sales practices, that is, performing due diligence prior to a sale and giving R&Ws. In May 1990, the RTC's Board of Directors approved the first policy permitting the use of R&Ws in loan and servicing rights sales. This policy expanded the R&Ws given and allowed the RTC in its corporate capacity to give R&Ws instead of only giving them from receiverships. However, the policy established several key restrictions, such as limiting R&Ws to a maximum of five years and indemnifying investors only in the event of an actual loss. As will be discussed later, these restrictions are more than is customary in the market because many situations require long-term indemnification and/or the repurchase of assets. Therefore, investors remained concerned about the risk of buying assets from the RTC.

In August 1990, the RTC's Board of Directors responded to market pressures by expanding its R&Ws to those customary or normal in the marketplace. In particular, R&W coverage was extended to cover the life of the loan and the RTC was permitted to resolve problems by repurchasing assets and/or substituting replacement loans. These revisions conformed RTC policy with market practices, thereby clearing the path for high-volume loan sales that competed directly with other loan sales in the market. It also helped to open the door to the development of securitization, a process that aimed to sell loans for higher prices than those achieved by selling loans directly to buyers as whole loans. 1 Indeed, R&Ws have since facilitated the sale of over $200 billion of loans and loan servicing for a vast array of loan types, many of which had never been sold in volume.

Although the expansion of R&Ws cleared the path for high-volume loan sales, it also increased the RTC's exposure to the risk of losses on R&W claims. Therefore, a R&W claims administration department was created to oversee related issues and to establish reserves to cover R&W claims costs. As will be discussed later, the experience of the RTC provides a rare example of the likelihood and magnitude of R&W claims and costs.

The Lemons Principle

Analysts unfamiliar with the whole-loan market occasionally claim that market efficiency will cause the financial benefit of higher prices on the sales of loans with R&Ws to equal the cost of granting R&Ws. This theory suggests that buyer competition will cause the price of loans with R&Ws to exceed the price of loans without R&Ws by an amount equal to the sellers' expected cost of granting the R&Ws. However, a classic principle of economics, known as the "lemons principle," suggests an alternative view, that the value of granting R&Ws should be greater than their cost.

The lemons principle is a response by Akerloff (1970) to the observation that the value of a new automobile declines significantly as soon as it is driven off the showroom floor. Akerloff explained this as a result of the fact that information relating to the quality of the automobile is not the same for the buyer as it is for the seller. That is, information is asymmetric in the sense that the seller is more likely than the buyer to be aware of the auto's problems and limitations, that is, better able to identify the auto as a "lemon." In the absence of complete information, buyers assume the worst and price the auto as if it were a lemon, even though it may in fact be in perfect running condition.

Information on the quality of a loan is as difficult (costly) to assess as information on the quality of an automobile. While recent payment history and loan characteristics are typically available from the servicer on, for example, a magnetic tape, it is always possible that the tape information is incorrect. More importantly, the tape will normally not show information about a host of potential problems such as underwriting equirements, policies used to obtain appraisals, sources of credit histories, mistakes made in originating or servicing the loans, and legal problems that either have or have not been identified. Fraud in any of these areas is always a possibility as well.

Buyers are acutely aware of the risks arising from the lack of information in a pool of loans. They control the risks by either: 1) requesting that the seller give R&Ws, 2) requesting that the seller perform extensive due diligence and make it available to bidders prior to the sale, or 3) bearing the cost of performing their own due diligence.

The experience of the RTC was that many whole-loan buyers would not even consider buying loans that did not have R&Ws customarily given in the market. Some buyers would consider loans with limited R&Ws, but only after performing extensive due diligence. Many buyers did not wish to bear the cost of their own due diligence and they were fearful that it would not address all risks. The final result was that the offering of loans with either no or limited R&Ws reduced the number of potential buyers significantly and complicated the sale with due diligence-related issues. Buyers that took the added risk and participated in the sales consequently discounted prices heavily based on the presumption of problems.

Discussions with financial advisors suggested that limiting R&Ws can cause price reductions of two percent to three percent for relatively clean portfolios of single-family mortgages. Higher discounts are likely for loans that are not as widely traded as single-family mortgages and for loans with documentation, underwriting, or servicing problems. The lemons principle suggests that these price discounts should exceed the cost of granting R&Ws and the payment of related claims. Actual RTC R&W claim costs shown below are consistent with this view. However, a comparison of R&W costs and benefits is reserved for later in this study, following a more detailed discussion of the nature of common loan-related R&Ws.

Common Representations and Warranties

R&Ws fall into two categories: 1) institutional, which deal with the legal authority of a firm to sell loans, and 2) loan-related, which deal with risks arising directly from the loans being sold. Most R&Ws are loan-related because the most likely source of problems are loan characteristics such as documentation, underwriting standards, and delinquency status. R&Ws cover a wide range of issues, from innocuous guarantees given in almost every sale to specialized guarantees used only for unique circumstances.

Institutional R&Ws are small in number and can often be used for many types of loan sales. As shown in section A of Table 1, these R&Ws focus on the nature of the institutional seller and its right to sell the assets. While they are found in many types of sale agreements, claims on institutional R&Ws are rare because sellers normally have full authority to execute sales and their obligations are valid and binding. Nevertheless, buyers consider them indispensable because a violation can result in extensive losses and/or litigation. For example, a buyer can seek to return all assets, and sue for return of its funds, if a seller does not have legal authority to sell a package of loans.

Loan R&Ws are used in many types of loan sales, but many must either be tailored, or written precisely, to meet the needs of each type of loan. Section B of Table 1 lists a number of R&Ws common to sales of most types of mortgages.

Items B-1 and B-2 are seemingly obvious guarantees that may be given by most sellers with little risk of subsequent claims. In fact, they are found in almost all contracts and result in claims only in unusual situations. For example, they became an issue in the RTC's sale of "participation" loans, that is, loans owned by two or more participants. Documentation on joint ownership for these loans was not always complete or available. Ownership guarantees greatly enhanced the ability to sell the loans because they relieved all parties of the need to find all documentation and resolve all ownership issues prior to sale.

Servicing-related issues, such as items B-3 and B-6 are most likely to result in claims. Because a host of loan characteristics change each month, incorrect information can be easily transmitted to a buyer. The loan balance or coupon could be incorrectly recorded on the seller's computer system or not received prior to transfer. The rate on an adjustable-rate loan may be tied to the wrong index or otherwise reset incorrectly. Mortgage insurance coverage may have lapsed due to failure to make timely payments. Real-estate taxes may not have been paid.

Table 1
Sample of Common Loan Reps and Warranties

A. Institutional
   1. Seller has taken action to authorize the execution, delivery, and performance of the sale agreement.
   2. All obligations of the seller are legal, valid, and binding.
   3. Obligations will not conflict with any provisions of any law.
   4. No action, suit or proceeding is pending against the seller that would materially affect the ability of the seller to carry out the transaction.

B. Found in Many Types of Mortgage Sales
   1. Seller is sole owner and holder of the mortgage loan.
   2. Seller has full right and authority to sell mortgage loan.
   3. Mortgage loan schedule information is correct in all material respects.
   4. The related note, mortgage and other agreements executed in connection therewith are genuine and each is a legal, valid and binding obligation of the maker enforceable except by limitations of bankruptcy, insolvency, reorganization or other similar laws.
   5. Seller is transferring the loan free and clear of any and all liens, pledges, charges or security interests of any nature encumbering the loan.
   6. All taxes, governmental assessments, insurance and utilities that came due prior to the closing date have been paid or an escrow account has been established.
   7. The related mortgaged property is free of mechanics' and materialmen's liens.
   8. There are no proceedings pending related to the property, and property is in good repair and free and clear of any damage.

C. Single-Family Mortgage Sales
   1. Mortgage loan is secured by a mortgage on a 1-4 family residential real property or a condominium unit or a unit in a planned unit development or is a co-op loan.
   2. Each mortgage loan was underwritten generally in accordance with FNMA or Federal Home Loan Mortgage Corporation (FHLMC) standards in effect at the time of origination except that 1) the original principal balance may exceed FNMA/FHLMC limits.
   3. Each mortgage loan with a loan-to-value ratio (LTV) greater than 80 percent is covered by a primary mortgage, FHA, or VA insurance policy.

Such policy is in full force and effect and insures the excess over a 75 percent LTV, and such policy shall remain in effect until the unpaid principal balance is reduced below 80 percent LTV.

4. Loan is serviced in accordance with the terms of the note.

D. Commercial Mortgage Sales

1. Borrower possesses all valid licenses, permits and other authorizations necessary to conduct business.

2. If required, seller has inspected or caused to be inspected property within the past 12 months.

3. Credit file includes environmental assessment that does not disclose any disqualifying conditions. If a disqualifying condition exists, remediated cost should be equal to or less than $10,000.

4. Seller represents that, as of the sale closing date, property does not contain hazardous materials such that the mortgage loan would be ineligible for purchase by FNMA (assuming that the loan were otherwise eligible for purchase). In the event of a breach of this representation, the seller will cure such breach or repurchase the affected mortgage loan.

E. Vehicle Loan Sales

1. Seller has not and does not make any representations, warrants or covenants regarding financial condition or status of obligor.

2. Seller has not transferred its interest in and to the vehicles to any other person. Seller has the right to sell its interest in and to the vehicles in accordance with the terms of the contract and free of liens.

3. Purchaser waives any claims or cause of action it might have against the seller for any loss, damage or expense caused by or to any vehicle.

4. Purchaser is a sophisticated buyer of contracts and loans similar to loans in package.

The wide variety of servicing problems implies that there is no single rule or procedure for dealing with them. Some can be easily identified and resolved soon after the sale is completed, either as a result of servicing the loans or a post-sale audit or reconciliation. Claims generated at this stage tend to relate to performing loans for which delinquency and default-related losses are not an issue. Claims generated at later stages are more likely to arise after a loan defaults and a careful check is made of the loan file. Incorrect real-estate tax payments and title problems are often caught at this point because back taxes must be paid and a title check made in order to complete the foreclosure process. Because delinquency and foreclosure may not occur until many years following a sale, R&W claims may not be made for a similar period. Thus, it is not surprising that buyers often require R&Ws for the life of the loan.

Section C of Table 1 contains a sample of R&Ws specific to single-family mortgage sales. This loan market is made unique by the widespread influence of the FHLMC and the FNMA. Firms that sell directly to the FHLMC and the FNMA must agree to voluminous R&W origination and servicing requirements stated in lengthy volumes published by the two agencies. Aside from these requirements providing the agencies with R&W protection, their wide publication and acceptance enable other mortgage market participants to adopt similar R&W requirements easily. As shown in item C-2, a simple R&W extends FHLMC and FNMA underwriting requirements to mortgage sales that do not involve either agency. Item C-3 is also a FHLMC and FNMA requirement even though it does not directly reference them by name.

Commercial-mortgage R&Ws differ significantly from those of single-family mortgages because the loan and underwriting characteristics are different and there is far less standardization of the origination and servicing functions. Also, the FHLMC and the FNMA are not permitted by their charters to purchase commercial mortgages, so standardized R&W guidelines and benchmarks are not as common as for single-family mortgages.

The unique aspects of commercial mortgages are evident in the four R&Ws listed in Section D of Table 1. Because commercial-mortgage borrowers are usually corporations, they may be required to have and maintain various licenses and authorizations required to conduct business. Servicers are often required to inspect periodically commercial properties and monitor the borrower's financial health by reviewing financial records. Environmental problems are a major issue, as suggested by items D-3 and D-4. Item D-4 is especially important because the cost of environmental clean-up can be very high and the requirement places this cost on the seller, even if the problem is unknown to anyone at the time of sale. In some cases the environmental clean-up costs exceed the value of the loan and may involve years of litigation to resolve.

The final sample of R&Ws applies to a group of loans unrelated to mortgages, namely, vehicle loans. Because these loans have relatively low balances and are collateralized by automobiles, lenders place much less reliance on the security gained from foreclosure and the subsequent sale of the underlying collateral. Extended or costly litigation between the borrower and the lender is unusual. These attributes combine to greatly simplify the types of R&Ws given. For example, one requirement might be that the seller guarantees its ownership or right to sell the loans (item E-2) in order to prevent fraud. Given the changed nature of product risk, sellers may be as likely as buyers to request R&Ws. Specifically, sellers may ask buyers to give R&Ws to the effect that they are sophisticated and capable of understanding the risks of the loans being sold (items E-3 and E-4).

Claims Trends

A consequence of the RTC's unprecedented sales volume is that it provides the large-scale R&W claims experience needed to gauge the likelihood of problems that normally have only a low likelihood of occurrence. The large program size also caused the creation of a claims administration department and a database of claims losses. These data provide one of the largest records of R&W claims costs and trends ever created.

Many interesting characteristics of the data can be observed by examining the claims experience of a sample of deals. Tables 2a and 2b provide such a sample for fixed-rate and adjustable-rate mortgage sales that occurred relatively early in the RTC's history (1991). [2] The sales chosen were five securitizations, three containing single-family mortgages (1991-11, -12, and -14) and two with multi-family mortgages (1991-M1 and -M5). Early securitizations provide convenient examples because their collateral characteristics are well-documented and claims experience is seasoned. A review of other sales around the same time found that the sample chosen was reasonably representative.

Table 2a

Rep and Warranty Claims Statistics For a Sample of RTC Sales

Mortgage Security	Initial Sale Data: Sale Date	Initial Sale Data: UPB $Mil	Initial Sale Data: Number Loans	Initial Sale Data: Type	Cured Claims: Number	Cured Claims: Average $000s	Repurchased Claims: Number	Repurchased Claims: Average $000s	Total Approved Claims: Number	Total Approved Claims: Average $000s
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Single-Family										
1991-11	10/91	$888	16,826	FX	28	$2	1	$ 32	29	$ 3
1991-12	10/91	527	2,330	ARM	9	2	0	0	9	2
1991-14	11/91	545	7,126	ARM	176	2	0	0	176	2
Multi-Family										
1991-M1	8/91	373	218	ARM	0	0	6	5,960	6	5,960
1991-M5	11/91	386	548	FX	0	0	1	1,536	1	1,536

Note: Data reflect all RTC R&W claims filed as of December 31, 1994, for all R&Ws contracted by the RTC at the corporate level. The UPB in column 2 is unpaid principal balance of collateral placed in trust as of the starting date of the security. The average claims figures in columns 6, 8, and 10 are computed by dividing total claims costs by the number of claims shown in columns 5, 7, and 9, respectively (rounded to $000s).

The initial sale data in columns 1-4 of Table 2a provide a snapshot of the sample. The loans were sold into security trusts between August and November 1991. These start dates imply three to four years of R&W claims experience prior to the 1994 database cutoff used for this study. The securities were mid-sized offerings in the $300-900 million range that contained considerable collateral variation.

Columns 5-10 of Table 2a break total approved claims into two components, cured and repurchased. A limitation of the data is that the costs of cured claims are recorded as the actual cost of curing the claims, whereas the cost of repurchases is recorded as the entire unpaid principal balance (UPB) of the repurchased loan. [3] The cost of curing a repurchase is not tracked because repurchased loans may be resold in a number of ways that create problems for tracking losses. For example, a repurchased delinquent loan might later have the delinquency cured and be included in a package of several thousand loans, none of which are priced separately when the securitization is completed. The important point is that the recorded cost of repurchases is many times larger than the cost of cures, and the two numbers should not be compared directly as a measure of claims costs.

In spite of data limitations, several points can be noted from the approved claims data in Table 2a. First, on the single-family mortgage side, the average claim for all three sales shown was only $2,000. This is because R&W problems for single-family mortgages tend to relate to relatively solvable and inexpensive problems such as tax penalties and incorrect payment adjustments. Second, on the multi-family mortgage side, all claims are repurchases. 4 Multi-family claims are more likely to relate to environmental or other problems that are not as easily solved as single-family problems. Repurchase may be required because the problems are either too costly or troublesome to resolve. Multi-family problems are aggravated further by large loan balances ($5,960,000 average balance for the six claims in 1991-M1 and $1,536,000 for the one claim in 1991-M5).

Table 2b

Rep and Warranty Claims Statistics For a Sample of RTC Sales (continued)

	Total Claims				Claim Filing Date			Claim Processing Time		
	Approved Claims		Denied/Other Claims							
Mortgage Sale (Security)	Number (1)	Average $000 (2)	Number (3)	Average $000 (4)	0-1 Yr (5)	1-2 Yr (6)	&gt2 Yrs (7)	0-2 Mo (8)	2-4 Mo (9)	&gt4 Mo (10)
Single-Family										
1991-11	29	$3	133	$15	1	26	135	65	29	68
1991-12	9	2	8	23	7	4	6	15	2	0
1991-14	176	2	165	25	44	57	240	44	108	189
Multi-Family										
1991-M1	6	$5,960	8	429	4	4	6	1	0	13
1991-M5	1	$1,536	6	3,090	2	1	4	6	1	0

Note: Data reflect all RTC R&W claims filed as of December 31, 1994, for all R&Ws contracted by the RTC at the corporate level for the five securities listed.

Table 2b begins by comparing approved claims to those either denied or subject to some other resolution status. 5 Relatively large percentages of the claims were denied or otherwise not approved. For example, in three sales (1991-12, 1991-14, and 1991-M1) approximately 50 percent of all claims were denied, while the remaining two sales had approximately 80 percent of all claims denied. Moreover, the average approved claim tended to cost considerably less than the average denied claim. Combining these statistics suggests that substantial savings accrue to reviewing claims carefully.

The remainder of Table 2b deals with the time required to file and process claims. The most interesting points are that large numbers of claims may be made several years after the loans are sold and a review of these claims may take considerable time and/or resources. In all of the cases shown the largest number of claims occurred in the longest filing date category (over two years) while the shortest category (up to one year) contained either the lowest or almost the lowest number of claims. This trend primarily results from the fact that RTC securities provide an indemnity against loss, which implies that claims are more likely to occur several years after the securities are created and after the loans have had time to default. In contrast, the RTC's non-securities sales generally did not indemnify against losses and their claims tended to occur in the first year following sale. This trend can be seen in Figure 2, which shows that R&W claims for sales consummated in 1991 peaked in 1992 and declined thereafter for every class of RTC sales except securities. Therefore, the likelihood of 1991 sales claims occurring in 1995 or later is low for all of the classes of RTC assets shown in Figure 2, with the exception of securities.

Compounding the filing time problems is the fact that substantial numbers of claims required a long period (over four months) to process, that is, to approve, deny, or otherwise conclude. The long processing times reinforce the notion that significant resources and costs may be required to administer claims even apart from the direct cost of curing claims and repurchasing loans.

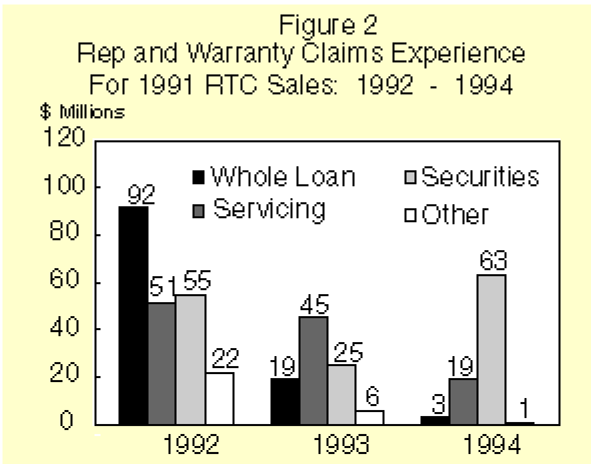


Figure 2
Rep and Warranty Claims Experience
For 1991 RTC Sales: 1992 - 1994

Table 3 *RTC Claims Losses by Product Type*

Product	UPB $Bil (1)	Claims Losses $Mil (2)	Claims Losses as % UPB (3)	UPB Repurchased $ Mil (4)	Estimated Losses Repurchases $ Mil (5)	Estimated Losses Repurchases as % UPB (6)	Estimated Total $ Mil (7)	Estimated Total as % UPB (8)
Servicing Rights	$ 139 B	$ 69 M	0.05%	$ 44 M	$ 0-7 M	0-0.01%	$69-76 M	0.05-0.06%
Single-Family Securitizations	23	27	0.12	83	0-13	0-0.06	27-40	0.12-0.18
Multi/Commercial/Other Securitizations	20	40	0.20	134	0-33	0-0.17	40-73	0.20-0.37
Whole Loans	25	12	0.05	178	0-27	0-0.11	12-39	0.05-0.16
Other	19	17	0.09	64	0-10	0-0.05	17-27	0.09-0.14

Total $ / Average % $226 B $165 M 0.07% $503 M $ 0-90 M 0-0.04% $165-255 M 0.07-0.11%

Note: Data reflect all RTC R&W claims paid as of December 31, 1994, for all R&Ws contracted by the RTC at the corporate level. Estimated losses in columns 5 and 6 are calculated as the likely range of losses on loans repurchased by the RTC to cure R&W deficiencies. These ranges assume a minimum loss of zero for all categories of loans. The maximum loss is 15 percent of UPB repurchased for all categories of loans except multi/commercial/other securitizations, and 25 percent of UPB repurchased for multi/commercial/other securitizations.

Costs vs. Benefits

An advantage of the RTC's experience is that its claims and sales data may be combined to compare the financial costs and benefits of granting R&Ws. That is, the data may be used to perform a cost/benefit analysis of the economic efficiency of granting R&Ws.

The cumulative claims loss experience for the RTC's R&Ws is shown in Table 3. These data include claims paid for all R&W agreements made by the RTC in its corporate capacity as of December 31, 1994. As such, they include the seasoned claims experience arising from sales completed in 1990 and 1991, as well as only recent claims experience from sales completed in 1994.

Column 1 of Table 3 displays the RTC's R&Ws by type of sale. Of the total $226 billion UPB covered by R&Ws, the largest component, $139 billion, or approximately 62 percent of the total, was given on sales of servicing rights. [6] The remaining 38 percent were from four similar-sized categories of loan sales: single-family securitizations, multi-family/commercial securitizations, whole loans, and "other" loan sales.

Claims losses for each sale type are shown in columns 2-8 of Table 3. The UPB of all loans covered by RTC corporate R&Ws is shown in column 1 in order to provide a benchmark for gauging the magnitude of the losses. The UPB is a useful benchmark because it reflects the maximum potential R&W loss in most circumstances. Losses are normally below the UPB because lenders may opt not to foreclose on properties with projected losses greater than the UPB. While it is possible for legal or environmental problems to cause losses to exceed the UPB, these situations are rare.

The most easily tracked costs are for cures, which equaled $165 million, or 0.07 percent (seven basis points) of the $226 billion UPB benchmark. The claims loss rate in column 3 was highest for multi-family/commercial securitizations (20 basis points) due to a higher likelihood of complicating factors such as environmental problems. The remaining claims loss rates ranged from five basis points for whole loans and servicing rights to 12 basis points for single-family securitizations. Whole-loan loss rates were the lowest because most RTC whole-loan sales were limited to either unusually clean packages of loans or loans with extensive due diligence.

As noted earlier, the cost of R&W claims resulting in repurchases was not tracked by the RTC. The fact that many repurchases cause either no or only small losses complicates matters. For example, a repurchase of high-quality adjustable-rate mortgages may be required because they were sold into a security containing only fixed-rate mortgages.

The problems of calculating losses on repurchases are dealt with by estimating potential losses as ranges (see columns 5 and 6) based on the UPB of loans repurchased, as shown in column 4. The range for each product has a lower limit of zero and an upper limit of 15 percent of the UPB of loans repurchased for all types of loans except multi-family and commercial loans. A 25 percent upper bound is used for multi-family and commercial loans due to their higher risk. The 15 percent and 25 percent upper bounds are chosen based on the authors' best estimates of higher-than-expected or "conservative" estimates of the average loss on repurchases. 7 Given the range estimates in column 5, column 6 estimates that repurchases add an upper limit of between one basis point and 17 basis points to the estimated R&W losses of the various product classes. The average upper limit loss across all products is four basis points.

The costs of granting R&Ws can now be directly compared to the benefits for a key asset class, single-family mortgages. As noted, financial advisers and early RTC experience estimated the benefit of granting R&Ws on single-family mortgages in the range of two percent to three percent (200 to 300 basis points) of the UPB sold. That is, single-family mortgages sold with R&Ws can be expected to sell for 200 to 300 basis points more than if they are sold without R&Ws.

A 200-to-300 basis point financial benefit for single-family mortgages compares very favorably with total R&W costs in columns 7 and 8 of Table 3. The cost category most directly applicable to single-family sales is single-family securitizations. Column 8 shows the cost of single-family securitizations as 12 to 18 basis points. However, because Figure 2 suggests that securitization claims may continue in the future, an adjustment needs to be made to recognize the possibility of future claims. If we project future single-family securitization R&W claims costs to equal all costs incurred through December 31, 1994, then the projected R&W cost implied by past securitization claims equals 24 to 36 basis points. 8 Thus, the cost of single-family mortgage R&Ws is only a small fraction of the 200-to-300 basis point benefit that accrues from granting them in single-family mortgage sales.

The dramatic excess of financial benefits over costs suggests that sellers of single-family mortgages are well-advised to grant R&Ws in spite of the expectation of some claims-related costs. Indeed, the excess may help to explain the RTC's experience that it is customary for sellers to grant R&Ws, and why sellers who do not grant R&Ws are viewed with suspicion by buyers who willingly pay a price premium to avoid the risk of purchasing a "lemon."

But does the cost/benefit analysis of the the RTC's single-family mortgage experience extend to sales of other types of financial assets, such as commercial mortgages or "other" loans? Three points suggest that the RTC's experience applies to many other types of assets. First, the R&W cost statistics in Table 3 are of the same order of magnitude for all types of assets. While the costs vary by product, all column 8 estimates are far below the 200-to-300 basis point range found for single-family mortgages. 9 Second, all types of loans are characterized by information problems similar to those of single-family mortgages. Moreover, the RTC's initial policy of limiting R&Ws resulted in the same liquidity and bidder interest problems regardless of the types of loan-related assets sold. Finally, it is a widespread market practice for sellers to give, and for buyers to request, R&Ws

for all types of financial assets.

The weight of evidence points to the conclusion that it is cost-effective to grant R&Ws in many types of loan sales. Given the lemons principle, we expect that the excess of benefits over costs increases as the quality or availability of risk-related information declines.

Conclusions

A number of interesting lessons may be drawn from the RTC's extensive R&W experience. First, R&Ws may represent significant risk because considerable expense may be required to cover claims costs and claims may continue for several years after the loans are sold. The risk may be a problem especially for firms that actively sell loans to the secondary markets because R&W liabilities grow with each sale. Second, administrative costs exacerbate the risk because claims may require additional expenses in the form of file reviews, the repurchase of assets, legal advice, and other problems. Finally, in spite of the likely costs and administrative problems, the experience of the RTC suggests that it is financially efficient for firms to grant R&Ws. R&W claims costs for single-family mortgages sold by the RTC were dramatically less than the financial benefits estimated to accrue from higher market prices on loans sold with R&Ws. The evidence points to a similar conclusion for many other types of assets as well.

Two caveats should be kept in mind regarding the RTC's experience relative to that of other institutions. First, the bulk of the RTC's claims experience occurred in a relatively favorable economic environment between 1992 and 1994. If this had been an extended period of unfavorable economic conditions, then claims-related losses could have been higher, especially for the default-sensitive portion of claims found in RTC securitizations. Similarly, an economic downturn could cause future claims experience, for the default-sensitive portion of the claims, to compare unfavorably from that documented in this paper. Second, the RTC's experience is made distinct by the fact that the S&Ls it took over, and whose assets it sold, were highly distressed. Therefore, the RTC may have been more likely to encounter R&W claims problems than, for example, healthy firms, and this may have affected both the benefits and the costs of granting R&Ws. While the net effect of these factors is difficult to quantify, the RTC's R&W claims experience nevertheless seems to provide a useful guide to projecting potential claims costs and trends, especially for firms that actively sell loans to the secondary markets.

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Banks and Mutual Funds
by Jay W. Golter

Mutual funds are the fastest-growing segment of the financial-services industry. Assets under management by mutual funds have grown from $134.8 billion in 1980, to $1,066.8 billion in 1990, to $2,161.5 billion at year-end 1994. In comparison to deposits at commercial banks and savings banks during those years, mutual fund investments equaled 8.3 percent of deposits in 1980, 37.3 percent of deposits in 1990, and 75.2 percent of deposits in 1994.

This paper first traces the growth of mutual funds. The next section describes the major functionaries employed by a mutual fund and the extent to which banks or bank affiliates have provided these services for mutual funds. The paper concludes with an examination of the ways that banks have entered the distribution channel by selling mutual funds to their customers.

History of Mutual Funds

A mutual fund offers shares to investors. The proceeds from the sale of shares are used to purchase a portfolio of investment assets, generally financial securities. In an open-ended mutual fund, investors may redeem shares previously purchased, or purchase new shares, at a price called the "net asset value," or NAV. The NAV is calculated at least daily, usually at the close of financial markets, to reflect the marked-to-market value of the *pro rata* portion of the portfolio represented by each share. As more fund shares are purchased (redeemed) by investors, the investment portfolio increases (decreases) in size. As the market value of the securities held in the portfolio increases (declines), the NAV increases (decreases). Portfolio earnings and losses are thus passed on directly to the investors.

Mutual funds in the United States can trace their origins to investment trusts established in England and Scotland in the early 19th century. [1] Those trusts actively provided capital to American businesses that emerged after the Civil War. The first American mutual funds were formed in 1924 in Boston and New York. Many closed-end [2] investment companies were formed during the years preceding the stock market crash of 1929. These companies tended to hold highly speculative portfolios and performed poorly during the crash. Investor confidence in all forms of mutual funds was further shaken by unscrupulous practices in some closed-end companies. [3]

Congress sought to address this problem in 1935 by ordering the Securities and Exchange Commission (SEC) to study the industry. The SEC'S report formed the foundation for the Investment Company Act of 1940, the primary statute that regulates mutual funds. In addition, a myriad of other statutes govern the management of mutual funds. Since the passage of the 1940 Act, the mutual fund industry has grown substantially in both absolute size and in terms of market share among financial-services providers.

Mutual fund portfolios are generally constructed in order to achieve specific investment objectives. Among the broad classification schemes are short-term (taxable and tax-exempt money-market funds) *versus* long-term (bond and equity) funds. Individual short-term funds may hold specialized portfolios; for example, some money-market funds invest entirely in U.S. Government instruments. Long-term funds are usually characterized by their investment strategies. Examples include funds that invest primarily in equities of small companies (small cap funds); equities with high dividend yields (income funds); bonds below investment grade (high-yield funds); securities issued by firms in particular industries (sector funds); securities issued in developing countries (emerging market funds); and balanced funds, which hold both equities and debt securities. In the *1994 Mutual Fund Fact Book*, the Investment Company Institute classified all mutual funds by 21 separate investment objectives.

Mutual fund sponsors often offer a variety of funds in which to invest. This enables investors to match their own investment needs and objectives with the strategy of a particular fund or combination of funds. The largest fund complex, Fidelity, offered 171 funds as of year-end 1993. 4 Only one other fund group, Merrill Lynch, offered more than 100 separate funds. Among the 34 fund groups that each sponsored funds with aggregate assets exceeding $10 billion, the average number of funds offered was 47. Two fund groups with historical ties to bank holding companies are included on this list. 5 Pacific Horizon Funds, which ranked 30th on the list with 19 funds and had a combined $11.5 billion in assets under management, was associated with Security Pacific National Bank and now performs many services for the mutual fund complex that was formed in the aftermath of that bank's merger with BankAmerica. Nations Funds, which is associated with NationsBank, ranked 33rd in size, encompassing 47 funds with a total of $10.5 billion in assets under management. As of year-end 1993, 93.6 percent of the assets managed by Pacific Horizon Funds and 72 percent of the assets managed by Nations Funds were in money-market funds. Thus, while the combined assets of the two fund families totaled slightly more than one percent of the industry's total, the $18.4 billion of money-market funds that the two complexes managed represented 3.3 percent of the short-term fund market.

In contrast, at year-end 1993, the Fidelity group had $219 billion in assets under management, or 10.6 percent of the total industry. The top five fund groups had $629.7 billion in assets under management, or 29.9 percent of the total industry. One group of note is Federated Funds, the 13th largest group at year-end 1993, with $29.3 billion in assets under management. Although Federated is not associated with any single bank holding company, the firm assists banks in establishing mutual fund sales programs and performs all necessary functions for banks that create their own mutual funds. It has been estimated 6 that 80 percent of Federated's sales occurred in banks.

Regulation

Mutual funds are governed by the Securities Act of 1933 (the 1933 Act), the Securities Exchange Act of 1934 (the 1934 Act), the Investment Company Act of 1940 (the 1940 Act), the Investment Advisers Act of 1940, relevant sections of the Internal Revenue Act and Blue Sky laws of each state in which a fund operates. The success of these statutes in creating a climate of investor confidence is evidenced by the extraordinary growth of the mutual fund industry over the past decades.

The Securities Act of 1933 and Securities Exchange Act of 1934. The 1933 Act requires mutual funds to file registration statements with the SEC. All purchasers of "securities" (the definition of which includes mutual fund shares) must be provided with a prospectus. The 1934 Act, among other provisions, requires that broker/dealers who sell mutual funds must register with the SEC.

Bank employees are exempt from this requirement as long as they do not receive transaction-related compensation (commissions).

The Investment Company Act of 1940. The 1940 Act requires that investment companies register with the SEC. The registration statements must include information about the investment objectives and strategies of the fund. These policies can not be changed without approval of the majority of investors in the fund. The Act also imposes restrictions on the amount of leverage that a fund may employ. Among other major provisions, the 1940 Act empowers the National Association of Securities Dealers (NASD) to regulate sales charges (loads) on mutual funds.

A fund's board of directors will determine which firms should be awarded contracts, and at what levels of compensation, for providing the services needed to maintain operations. Because a fund's sponsor may perform many of those services, and would have selected the original board, "there is obvious potential for conflict between the interests of the investment company sponsors and managers and the interests of the investment company shareholders." 7 The 1940 Act addresses this problem by establishing that the investment advisers and the board of directors of a fund have a fiduciary obligation to the investors of the fund. The composition of the board is further restricted by the 1940 Act to enhance its independence from sponsoring organizations or other "interested parties." Furthermore, shareholders must approve all management contracts. The 1940 Act also requires investment companies to provide semiannual statements to investors and empowers the SEC to establish appropriate accounting standards. The SEC is authorized to regulate all sales literature and advertisements of investment companies.

The Investment Advisers Act of 1940 . The investment adviser is the key provider of services to a mutual fund. The Advisers Act requires that investment advisers register with the SEC. However, banks (though not bank affiliates) acting as investment advisers to mutual funds are explicitly exempted from these provisions. The Advisers Act also imposes restrictions on the contracts that mutual funds enter into with their advisers. These provisions, which apply to banks as well as nonbank advisers, require that the terms of the agreement not exceed two years, that a majority of outside directors approve all renewals, and that the contract may be terminated, without penalty, by the fund at any time with 60 days' notice.

The Internal Revenue Act. Mutual funds can avoid a direct income tax assessment and pass taxable income and capital gains through to the fund's investors. Subchapter M of the Internal Revenue Code defines a series of tests that a mutual fund must pass in order to qualify as a "regulated investment company" (RIC). The failure of a mutual fund to meet all of the following requirements would result in an onerous tax obligation:

- The mutual fund must be registered under the 1940 Act for the entire taxable year.
- At least 90 percent of the RIC's gross income must be derived from dividends, interest, gains on sales of securities, and other qualifying income from investments in securities. Examples of non-qualifying income would include income derived from partnerships investing in real estate or oil drilling leases.
- Less than 30 percent of a RIC's gross income may be derived from the

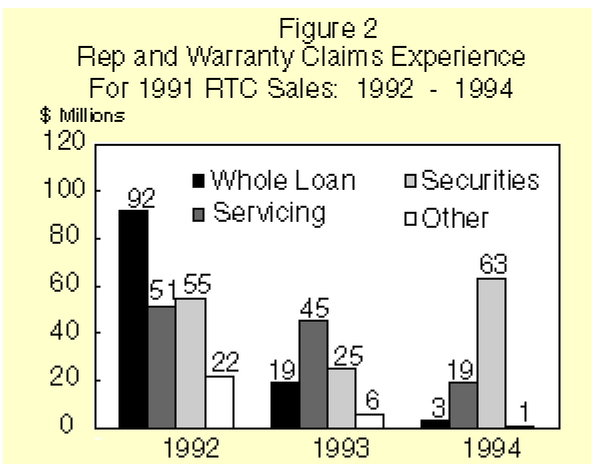
sale of instruments held less than three months.

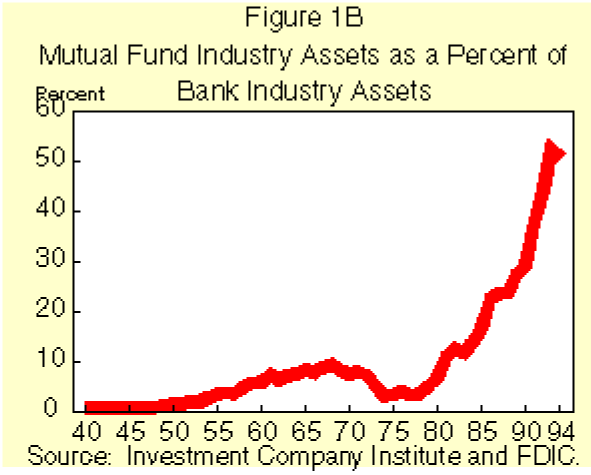
- At the end of each quarter, at least 50 percent of the RIC's portfolio must consist of cash, cash items, U.S. Government securities, securities of other RICs and other securities in which no one issuer's securities will exceed five percent of the RIC's assets and no more than ten percent of any issuer's outstanding voting securities are held by the RIC.
- At least 90 percent of the RIC's income must be distributed to the investors.

Blue Sky Laws. States have authority, subject to the primacy of federal laws, to regulate the securities activities that occur within their respective borders. Mutual funds must register, and pay filing fees, with the state securities agency in each of the 50 states, Puerto Rico and the District of Columbia, in which the fund will be distributed. Because there are variances in the procedures followed by each of the 52 jurisdictions, Blue Sky law compliance can be complicated. 8

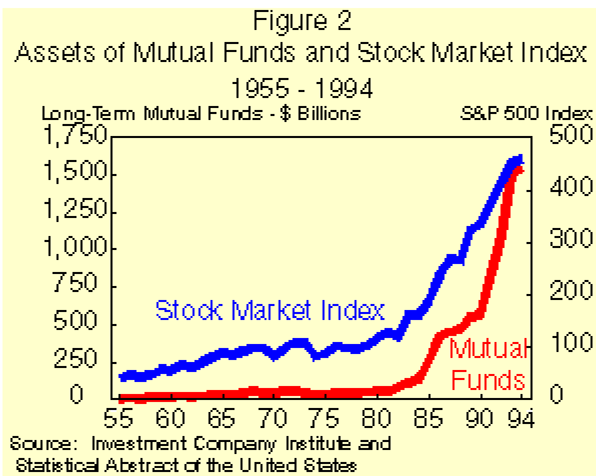
Growth

When the Investment Company Act of 1940 was enacted, the mutual fund industry consisted of 296,000 shareholder accounts investing in portfolios with an aggregate asset value of $448 million. 9 In contrast, FDIC-insured commercial and savings banks held combined assets of $72.7 billion, 10 or 162 times the assets held by the mutual fund industry. By year-end 1994, mutual funds held assets of $2.16 trillion, 11 while commercial and savings banks held assets of $4.01 trillion. 12 The growth of the two industries is shown in Figures 1A and 1B.





As shown in Figures 1A and 1B, the mutual fund industry has grown rapidly during the past 15 years. Figure 2 indicates that the intensity of some of the periods of growth can be explained by contemporary market conditions.



The bull market of the 1960s contributed to the run up in mutual fund assets. At the start of the 1960s, mutual funds held about $16 billion in assets. By the late 1960s, mutual fund assets exceeded $47 billion, a threefold increase. Mutual fund assets hit a temporary peak of $59.8 billion at year-end 1972. However, the effects of a prolonged bear market caught up with the industry, and the value of assets under management declined to $34.1 billion by year-end 1974. Although traditional (equity and bond) funds gradually began to increase in value the following year, they did not regain their asset level of 1972 until 1982. However, 1974 also marks the first year in which money-market mutual funds, first launched in 1971, 13 surpassed $1 billion in assets.

Money-market mutual funds invest in high-quality, short-term instruments. The 1940 Act imposes a series of tests on a fund portfolio to assure that standards of quality and liquidity are met. Funds that meet the standards are allowed to call themselves money-market mutual funds and to use the daily increase in portfolio value to issue new shares to investors such that the fund's net asset value is maintained at $1.00 per share. Because of the apparent safety of the portfolio, many investors view money-market mutual funds as a substitute for bank deposits. This attitude was reinforced when Merrill Lynch in 1977 introduced its "Cash Management Account," which allowed money-market account holders to withdraw their funds by writing a check, now a standard feature of retail-oriented money-market funds.

The rapid public acceptance of money-market funds may be explained by the previously imposed constraints on the ability of commercial banks and thrifts to provide their customers with alternative products that earned a market rate of interest. In 1933, the Federal Reserve Board was given authority to restrict the interest rates that member banks were permitted to pay depositors. These restrictions were codified in Regulation Q of the Federal Reserve Act. Authority to impose restrictions on nonmember banks was extended to the FDIC in 1935.

Until the late 1960s, market interest rates never exceeded the savings rates that regulators permitted banks to offer for time deposits. However, when Regulation Q became a binding constraint, the market created pressure for an alternative savings vehicle to develop. Ironically, the first move to relax Regulation Q helped to spur the development of money-market mutual funds. In 1970, the Penn Central Railroad became the first major firm to default on its commercial paper. Fearful that investors would abandon the market, and that commercial banks would not have the liquidity to provide bank loans to firms trying to refinance their short-term debt, the Federal Reserve Board removed interest-rate restrictions on certificates of deposit greater than $100,000. Although this easing of Regulation Q enabled banks to serve institutional and wealthy investors adequately, the retail investor was left without any means to earn market rates.

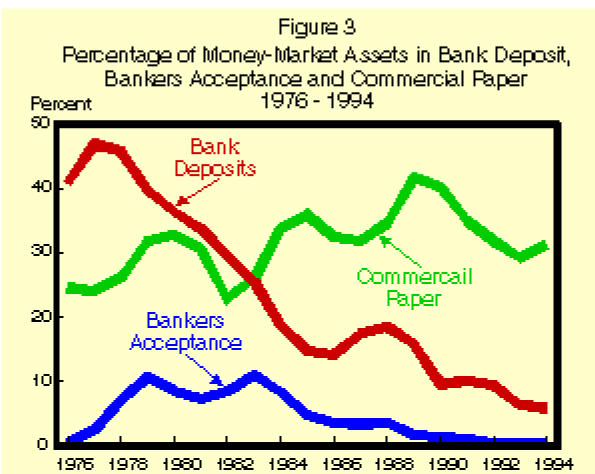


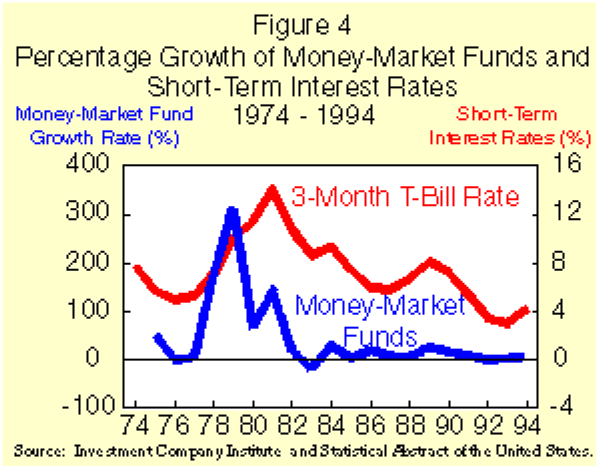
Figure 3 shows that in their early years of existence, money-market mutual funds held a large percentage of their investment portfolios in bank deposits. This represented an opportunity on their part to intermediate between banks and bank customers, thereby offering the latter the ability to aggregate funds and receive market rates. As money-market funds became established, direct investment in commercial paper became an increasing proportion of their portfolios, and bank instruments became less important.

As the 1970s ended, interest rates were still rising and money-market funds had grown to $45 billion. This movement of funds from the banking sector to the mutual fund industry was termed disintermediation, although a more appropriate term may have been *redesigned-intermediation* because depositors were using alternative channels of intermediation rather than directly financing commercial enterprises. Money-market funds function as intermediaries by bringing together entities with excess funds and entities in need of funds. Further, liquidity is provided to savers through the law of large numbers. That is because on an average day the amount of invested funds redeemed by savers is largely offset by the amount of additional funds invested by savers with new temporary surpluses. As intermediaries, mutual funds differ from banks by passing more risks back to investors. In particular, banks shield insured depositors from the credit risk associated with lending. Mutual funds, of course, pass on any changes in value, whether caused by changes in credit quality or interest-rate movements, directly to the investors.

As vehicles for bringing a class of short-term borrowers (those entities with access to the commercial paper market) and short-term investors together, money-market funds have certain advantages over banks. Although both intermediaries are highly regulated, the regulatory costs imposed on bank intermediation include variable costs. Specifically, banks are assessed reserve requirements and deposit insurance premiums on each additional dollar of deposits. In contrast, each additional dollar invested in a money-market fund can be used in full to purchase money-market instruments.

These efficiencies, combined with a possible increase in investors' willingness to bear risk, contributed to the growing acceptance of money-market mutual funds. However, a nascent industry faced at least two significant obstacles. The first was a need to attain investor confidence; the second was the development cost of the systems and infrastructure necessary to support the operations of a money-market fund. Regulation Q provided large returns to savers switching from bank products. Such returns may have been necessary to overcome depositors' concerns about the increased risk of the new intermediation channel. A large potential market, consisting of all retail bank depositors, thus existed to justify the early development costs incurred by money-market funds.

Congress responded to the reduction in bank deposits by passing the Depository Institutions Deregulation and Monetary Control Act of 1980, which mandated the gradual elimination of Regulation Q ceilings. In the interim, money-market fund assets grew rapidly. During 1980, money-market funds nearly doubled in size to $74.5 billion. In the following year they more than doubled to $181.9 billion. The Garn-St Germain Depository Institutions Act of 1982 enabled banks and thrifts to offer deposit accounts with attributes similar to money-market funds. However, the money-market fund had already become an important component of the financial system. Growth in these funds stabilized as banks were able to retain their depositors, albeit at a higher cost than prior to deregulation. Subsequent growth in assets under management by money-market funds has been related to periods characterized by high short-term interest rates, as shown in Figure 4.



A new product was introduced in 1976: money-market funds that invest only in short-term municipal obligations. The earnings received by investors in such accounts are therefore exempt from federal income taxes. These funds, which first reached an appreciable asset size in 1979, have grown at a stable pace, with one exception. In 1986, the assets held by tax-exempt money-market funds increased from $36.3 billion to $63.8 billion. That jump can probably be explained by the passage of the Tax Reform Act of 1986, which ended the preferential tax treatment conferred on many other types of investments.

The bull market of the 1980s was favorable to long-term mutual funds. The assets of mutual funds and money-market funds totaled $94.5 billion at the start of the decade. This equaled 5.1 percent of the $1.839 trillion in assets held by FDIC-insured commercial banks and mutual savings banks at that time. By year-end 1989, total mutual fund assets had grown tenfold to $982 billion, or 27.4 percent of the $3.579 trillion in assets held then by the banking industry. During the next four years, mutual fund assets more than doubled to $2.075 trillion. This represented 56 percent of the $3.706 trillion in assets held by BIF-member 14 depository institutions at year-end 1993.

On seven occasions during 1994 the Federal Reserve Board increased short-term interest rates. Secondary market prices of previously issued bonds fell, thus creating losses for mutual funds that held those instruments. This, in turn, led to investor redemptions, which caused assets held by the mutual fund industry to decrease even more. The stock market also performed poorly, resulting in losses or disappointing returns to investors in mutual funds that held equities. Furthermore, the attractiveness of bank deposits relative to mutual fund investments improved as CD rates increased and investors experienced the riskiness of mutual fund investments. By year-end 1994, mutual fund assets had increased by only $86.1 billion, the smallest annual increase since 1983, the last year in which assets under management declined. The mutual fund industry entered 1995 with a total of $2.162 trillion in assets, or 53.9 percent of the $4.010 trillion in assets held in BIF-member depository institutions.

Bank Involvement in the Mutual Fund Industry

Mutual funds are unusual among business enterprises in that they seldom have any direct employees. Instead, a fund is created with a board of directors (or trustees) that is responsible for contracting out a variety of functions to other entities. Some of these functions, such as fund attorney, are not appropriate for a bank organization to perform. Furthermore, banks are prohibited by Glass-Steagall restrictions from performing the functions of the fund underwriter. 15

However, there are several ways in which banks and bank holding companies are able to participate in the mutual fund industry. Banking organizations were first authorized by the Federal Reserve Board to become directly involved in mutual fund operations in 1972, the year in which mutual fund assets peaked. The authorization permitted holding companies to act as transfer agents, custodians, and investment advisers for mutual funds, subject to various restrictions. Over time, additional interpretations by bank regulators have relaxed many of those initial restrictions. 16 As the mutual fund industry developed into a major vehicle for financial intermediation, bank involvement with the industry grew. The most visible way is through sales of mutual funds to bank customers. Banks have become a significant component of the distribution channel.

Banks as Transfer Agents. Transfer agents maintain the records concerning customer accounts. They record purchase and redemption transactions and disburse payments of dividends, interest and capital gain distributions. They prepare confirmation notices of all investor transactions and report year-end tax and withholding information to the Internal Revenue Service. Banks and bank holding companies may be transfer agents for mutual funds as well as for other incorporated businesses.

Transfer agents must register with the appropriate regulatory agency as defined in the Securities Exchange Act of 1934. 17 Banks and subsidiaries of banks register with their primary federal regulator. 18 Transfer agencies that are subsidiaries of bank holding companies register with the Federal Reserve Board. All other transfer agents, including thrifts and subsidiaries of thrifts, must register with the SEC. When a bank is transfer agent for a proprietary fund, 19 the investment adviser may not maintain time deposits with affiliated banks and must keep the fund's transaction balances with affiliated banks at minimal levels.

Transfer agents may subcontract a portion of their activities to a shareholder servicer. This sub-agent handles the aspects of the service that most closely interface with the investor, for example, preparing regular statements or answering telephone inquiries. The shareholder servicing agent generally will be compensated based on a formula that incorporates the number of shareholders serviced and the amount of activity that occurs. 20 In 1986, the Federal Reserve Board explicitly permitted bank holding companies to receive fees for shareholder servicing. 21 The FDIC permitted state-chartered nonmember banks to conduct certain shareholder services in 1989. 22

A 1994 survey 23 of banks with proprietary funds indicated that approximately 29 percent were acting as their own transfer agent and an additional five percent were planning to do so. This same survey indicated that approximately 58 percent of the banks with proprietary funds performed shareholder servicing functions for their funds and an additional four percent were planning to do so. However, another analysis, which was conducted in March 1994, concluded that 65 of the 103 banks that offered proprietary funds to retail customers used affiliated transfer agents. 24

Banks as Custodians. Fund custodians execute the portfolio transactions that are directed by the investment adviser. They provide safekeeping of securities;

monitor events that affect the portfolio's securities such as splits, calls and tenders; report on cash balances and provide cash projections for the fund; and keep the investment adviser informed about changes in foreign and domestic tax laws or market practices that could affect the investment practices of the fund.

Although the 1940 Act permits funds to use banks, national securities exchange members, or the fund itself as custodian, the requirements of SEC rule 17f-1 are so strict that most custody is performed by banks. 25 Of the ten largest custodians 26 in 1993, only one, Brown Brothers Harriman, is not a bank. The eighth largest, Putnam Fiduciary Trust, is a chartered commercial bank, but it performs little or no traditional banking activity. The largest custodian, State Street Bank and Trust, acted as custodian for 1,704 funds with combined assets under management of $407.5 billion. The second-largest custodian, Chase Manhattan Bank, was custodian for 154 funds with combined assets of $173.9 billion.

In 1994, nearly 50 percent of the banks with proprietary funds acted as their own custodian and another 25 percent had plans to do so. 27 In March 1995, 53 of the 103 banks that offered proprietary funds to retail customers used affiliated custodians. 28

Banks as Investment Advisers. The most important functionary of a mutual fund is the investment adviser. This is also the function that offers the highest potential earnings within a mutual fund. An investment adviser is responsible for managing the investment portfolio in order to attain the greatest return consistent with the investment strategy established by the board of directors. Investment advisers in traditional fund structures would also perform such administrative functions as filing all required documents; providing accounting, data processing and clerical services; preparing financial statements; and coordinating the relationships among the various other entities, for example, transfer agents and legal counsel operating the funds. However, bank-sponsored funds often contract out the administrative tasks to a third party who acts as fund administrator.

Investment adviser fees are detailed in a contract that is reviewed annually by the board of directors. Generally, fees constitute a percentage of the funds under management; however, due to scale economies in portfolio management, contracts often will specify diminishing rates as the fund reaches specified levels. Performance incentives, and in some cases penalties, are also included in many advisory contracts. Bank revenues 29 from investment advisory activities grew steadily from $175 million in 1989 to about $450 million in 1993. In just the first three quarters of 1994, those revenues doubled to approximately $900 million. The growth is accounted for by both the increase in the size of bank proprietary funds and an increase in the percentage of such funds that was held in long-term funds, which provide higher management fees to the investment adviser.

Bank Distribution Channel. The most visible way in which banks have participated in the growth of mutual funds has been through the sale of mutual funds to bank customers and on bank premises. In 1991, 13 percent of all long-term fund sales occurred through banks. The bank share was 12.7 percent in 1992 and then increased to 14 percent in 1993. In absolute terms, banks sold $28.1 billion of long-term mutual funds in 1991, $43.8 billion in 1992, and $67.5 billion in 1993. 30 (An alternative estimate 31 indicates that bank sales of long-term mutual funds represented four percent of the market in 1992, eight percent in 1993 and nine percent in 1994.) Banks account for a larger percentage of money-market fund sales. In 1991, they accounted for 22.4 percent of all sales of short-term funds. This market share grew to 26.8 percent in 1992 and 28.7 percent in 1993. In absolute terms, banks sold $122.8 billion of money-market funds in 1991, $149.8 billion in 1992 and $165.9 billion in 1993. This pattern of sales indicates that banks are becoming more diverse in the types of funds that they sell. In 1991, 77 percent of the funds sold through banks were money-market funds; by 1993, this percentage had declined to 56 percent.

There are three basic ways in which a bank can offer mutual funds to its customers. The methods, in increasing order of complexity, are to offer third-party funds, private label funds, or proprietary funds. In addition, the bank must decide who will be making the actual sales presentation. The options are to use bank employees, employees of a broker/dealer affiliate or subsidiary, employees of an outside broker/dealer, or some combination thereof.

When a bank offers third-party funds, for example, funds sponsored by Fidelity, it receives a fee or commission. However, the bank may sacrifice any ongoing benefits from that customer's savings. In fact, the fund will communicate directly with the investor, potentially eroding the customer's ties with the bank.

A bank that wishes to maintain an identity with the customers buying funds may choose to establish a private label arrangement. In these arrangements, the sponsor creates a fund (or a group of funds) with a name that may be associated with the bank that will be selling the fund's shares. The bank, depending on its operational capacity, may perform some of the functions required of the fund, such as transfer agent or shareholder servicing agent. Communications between the fund and the customer may be tailored to enhance the connection between the bank and the customer. While this type of arrangement maintains the bank's relationship with its customers, it limits the financial benefits that the bank could reap from providing full services to the fund.

The establishment of a proprietary fund is an option available to banks that wish to retain the maximum benefit of providing mutual funds to their customers. In these arrangements, the bank, or an affiliate, becomes the investment adviser. Depending on the extent to which the bank felt it could perform specialized functions, the bank or its affiliates could also become fund administrator, custodian or transfer agent.

However, the formation of a new mutual fund involves considerable expense. According to one estimate 32 of the start-up costs, legal fees alone can range from $25,000 to $350,000 for a single bank-sponsored fund. In addition, the SEC and state securities commissions charge filing fees for registering the fund and its securities. A standard rule of thumb has been that a bond or equity fund had to exceed $100 million in assets in order to attain the economies of scale necessary to compete with other funds. Many observers believe that this threshold has increased during the past few years; however, there is no general consensus on what the new minimum level should be. 33

In order to attain the threshold level quickly, many banks have looked to their trust departments. Trust departments manage funds for individuals and institutional customers. Some of the investments are placed in collective investment funds (CIFs), which are managed in a manner similar to a mutual fund. Many banks have converted CIFs into proprietary mutual funds. Most of these conversions have occurred with CIFs holding funds for employee benefit plans because, in these cases only, there is no capital gains tax consequence.

Banks have been willing to incur the administrative costs of converting CIFs for several reasons. [34] First, trust departments are restricted from assessing fees on CIFs. However, mutual funds generate a variety of fees, including fees paid to the investment advisers, transfer agents, and custodians, some or all of whom may be affiliated with the bank. Second, mutual funds may advertise, subject to regulations of the NASD. CIFs, except for those restricted to employee benefit accounts, are prohibited from advertising performance results. Finally, mutual funds may receive investment funds from the public as well as from trust department customers. A fund may even issue a variety of "classes" of shares with different fee structures and balance and transaction minimums which are each targeted to different groups of potential customers. CIFs, however, are restricted from receiving personal funds that are not part of a fiduciary trust account. Furthermore, each CIF is restricted to investing funds from personal trusts or from agency accounts, increasing the difficulty of growing to take advantage of scale economies.

Trust department customers may also benefit from having funds invested in mutual funds rather than CIFs. First, the customer will be able to track the performance of the fund in the daily newspaper, and be better able to compare the performance with alternative funds. Also, distributions to beneficiaries of the trust funds in CIFs must be made in cash. Trust funds invested in mutual funds may make "in kind" distributions with mutual fund shares. In some cases, the recipients of these distributions will have more flexibility to time the realization of capital gains.

A 1995 study [35] estimates that, excluding the Dreyfus funds now managed by Mellon Bank, 60 percent of the bank-managed fund assets (75 percent of the assets managed by the ten banks with the largest portfolios) originated as trust department conversions. The U.S. General Accounting Office derived a different estimate of the level of trust conversions by assuming that any time a bank proprietary fund was launched with a large amount of assets, the funds came from converted trust accounts. Although this method fails to capture conversions of trust assets into already existing proprietary funds, trends can be discerned from Table 1.

Table 1
Estimated Trust Conversions ($ Millions)

Year	Money-Market Funds	Long-Term Funds	Total Conversions	Long-Term Fund Conversions as a Percent of Total Conversions
1985	$ 178	$ 0	$ 178	0%
1986	915	20	935	2
1987	2,128	55	2,183	3
1988	2,552	1,340	3,892	34
1989	2,056	1,024	3,080	33
1990	773	640	1,413	45

1991	802	2,123	2,925	73
1992	2,696	6,624	9,320	71
TOTAL	$12,100	$11,826	$23,926	49%

Source: Lipper Analytical Services as reported by U.S. General Accounting Office Trust Assets: Investment of Trust Assets in Bank Proprietary Mutual Funds.

By 1988, as banks started to expand their fund offerings, bond and equity portfolios in trust departments became significant sources of assets for conversion into mutual funds. According to one 1994 study of proprietary funds, [36] trust conversions accounted for approximately 30 percent of the new money that flowed into bank proprietary funds in 1992. The following year, trust conversions accounted for only about 15 percent of the total. Proprietary funds represent a growing proportion of mutual fund sales at banks. By 1985, 25 banks [37] had established proprietary mutual funds. At year-end 1994, 119 banks were offering proprietary funds. [38] One survey [39] indicated that in 1991, 44.7 percent of bank mutual fund sales involved proprietary funds. This percentage dipped to 40.6 percent in 1992, but grew to 48.7 percent in 1993. The drop in 1992 may have been due to the relatively modest growth industry-wide in money-market mutual funds at a time when long-term funds were growing quickly. At that time, bank proprietary funds were mostly represented by short-term funds.

In 1990, banks sponsored 517 mutual funds [40] (16 percent of the funds offered industry-wide), of which 252 (49 percent) were money-market funds. These 517 funds held $85.9 billion in assets (eight percent of the industry total), of which $73 billion, or 85 percent, were in money-market funds. By 1992, banks sponsored 892 funds (20 percent of the industry total), of which 377 (42 percent) were money-market funds. These 892 funds held $158.8 billion (ten percent of the industry), of which $111 billion, or 70 percent, were in money-market funds. As of March 1995, banks sponsored 2,208 funds (28 percent of the industry), of which 578 (26 percent) were money-market funds. These 2,208 funds held $327.7 billion in assets (15 percent of the industry), of which $189.2 billion, or 58 percent, were money-market funds. Not only are bank proprietary funds a growing segment of the mutual fund industry, but banks also are sponsoring a growing variety of fund types, and managing increasingly-diverse portfolios.

It is too soon to evaluate the long-term importance and profitability to the banking industry of the sale of mutual funds. The outcome will depend on how efficiently banks are able to provide services and products relative to alternative sources. In order to thrive, individual banks may need to establish a national presence for their mutual fund programs so that they can better realize scale economies. Opportunities to consolidate mutual fund operations will act as an additional incentive to the consolidation that is occurring within the banking industry and that is expected to continue as full interstate banking becomes a reality. In addition, further innovations in the structure and administration of bank proprietary mutual funds should occur as each firm finds its place in the mutual fund world.

Market Share by the Numbers

A review of the literature on bank involvement in the mutual fund industry quickly reveals a lack of agreement on the extent of bank penetration of the market. The apparent discrepancies are caused by differing methodologies and different definitions of bank sales.

Since 1994, all banks and savings-and-loan associations have been required to report the volumes of mutual fund and annuity sales as part of the quarterly Report of Condition and Income (Call Reports). A comparison of some of the definitions described in the Call Report instruction manual 1 with the definitions used in other studies explains some of the variations in reported results.

Call Report totals differ from many other data sources because participation is compulsory. Many figures cited in the accompanying article are derived from surveys taken among willing participants. As such, they necessarily represent less than the full universe of banks participating in the market. Mutual funds are similarly compelled to file regular reports with the SEC on portfolio size and composition.

Classification

Some analysts classify all funds in which the investment adviser is a bank or bank affiliate as "bank related." Although this method yields useful results, some sources of conflict with other estimates will occur. First, sales at banks of third-party funds are not included in the analysis. Similarly, sales of bank-related funds that take place through other channels, such as third-party distributors, are included. In addition, the fund sponsor is not always clearly identified. For example, if an independent mutual fund sponsor offered a fund that only held municipal bonds issued within one state (so that investor income would be tax-exempt at both the federal level and state level for residents of that state), it might utilize a leading local bank's specialized knowledge of the area by selecting it to be the investment adviser. 2

Unfortunately, some classification problems exist among the banks filing Call Reports. For example, an informal survey of several banks with proprietary funds determined that Mellon Bank has included all of the fund sales made by its Dreyfus affiliate in the sales total. 3 However, Chase Manhattan Bank and other banks with proprietary funds that are sold outside of the bank's own channel reported only the portion of the fund's sales that occurred on the bank's premises or to the bank's customers. As inconsistencies across reporting banks are discovered, the Call Report instructions may be modified to ensure uniformity. However, as bank involvement in the mutual fund industry develops, innovations and changes in fund structures and distribution systems may make it increasingly difficult to precisely define banks' sales volume.

Flows vs. Stocks

The Call Report requires quarterly data on the level of fund sales (a flow). However, banks do not report on the volume of funds under management (a stock). The SEC filings report asset levels. Changes in portfolio size across reporting periods can be attributed to several factors, including: sales; redemptions; fund performance; expenses; levels of investor reinvestment of earnings; and the purchase of, or merger with, another fund. Measurements of bank involvement in the mutual fund industry based on market share of new sales will not necessarily move in tandem with measurements of the percentage of mutual fund assets managed by bank-related entities.

Sales Charges

Many mutual funds, and most of the funds sold through banks, are sold with an associated sales charge or "load." In the case of "front loaded" funds, the charge, which is used to pay sales commissions and marketing expenses, is taken at the time of sale. In the case of "back loads" (contingent deferred sales charges), charges are taken out of the fund over time and when the funds are withdrawn. The Investment Company Institute (ICI) requires that its members report sales figures net of front loads, but without adjustment for back loads. The Call Report instructions are silent on whether to report sales net of charges. Large institutions that have proprietary funds that have been reporting to the ICI appear to have applied the same method when reporting on the Call Report. However, it is not clear whether all banks are calculating sales in the same manner.

Exchanges and Reinvestments

Many mutual fund families permit investors to open several funds with differing investment strategies. The investor is then permitted to transfer money among these funds without incurring new sales charges. Also, most mutual funds permit investors to automatically reinvest earnings and capital gains distributions. Mutual fund companies provide the ICI with separate figures for sales, redemptions, exchanges, and reinvested earnings. However, banks are instructed to include reinvestments and exchanges in the Call Report sales totals.

Money-Market Sales

It is more difficult to define a money-market sale than to define the sale of a long-term fund. Many investors treat money-market funds like a transaction account, increasing and decreasing the balance frequently during reporting periods. This is especially true in the commercial bank environment where many commercial customers have arrangements with the bank to sweep excess funds from a non-interest-bearing transaction account into a money-market fund at the end of each day. The funds are then restored to the transaction account the next morning. Banks are instructed to report the daily average of these sweeps during the quarter, rather than the aggregate amount of all funds swept during the quarter. This procedure, if correctly followed, would reflect fairly the activity over a reporting period. However, the same activity would also be reported in each subsequent quarter, thus producing an inflated impression of the sales volume over a year.

Reported Sales Volume

The Call Report requires that banks report separate sales volumes for money-market mutual funds, equity mutual funds, bond mutual funds, all other mutual funds (for example, balanced funds that include debt instruments and equities), and annuities. As of 1995, banks must report the aggregated total of sales of proprietary products among those sales. Results are as follows:

Bank and Thrift Sales of Mutual Funds ($ in Thousands)

Quarter	Money-Market Funds	Equity	Bond	Other	Proprietary [4]
Q1, 94	$109,731,971	$4,576,083	$ 3,361,389	$1,457,198	N/A

Q2, 94	93,392,669	3,185,274	3,486,109	1,484,284	N/A
Q3, 94	131,191,366	4,975,811	3,085,619	3,464,703	N/A
Q4, 94	146,237,577	3,923,607	3,733,798	3,066,925	N/A
Q1, 95	140,154,679	4,156,618	3,401,001	1,470,019	$117,087,618
Q2, 95	164,355,672	5,354,626	3,183,745	1,109,702	146,443,097

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Vol. 8 No. 3 - Article III - Published: February, 1996 - Full Article

Recent Developments Affecting Depository Institutions
by Benjamin B. Christopher
(a financial economist in the FDIC's Division of Research and Statistics.)

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

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: risk-based capital standards, safety-and-soundness standards, supervision of U.S. operations of foreign banks, CRA regulations, single-borrower lending limits, affordable housing loan appraisals, and HMDA reporting requirements. 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 to Be Reduced For Most BIF-Insured Banks
The FDIC Board of Directors voted to reduce significantly the deposit insurance premiums paid by most banks but to keep existing assessment rates intact for savings associations. The decision closely resembles a proposal issued for public comment earlier this year (see this *Review*, Spring 1995, p. 25). The reduction in premium rates for banks is required by current law based on the anticipated recapitalization of the Bank Insurance Fund (BIF). Under the new rate structure, the best-rated institutions insured by the BIF will pay four cents per $100 of domestic deposits, down from the current rate of 23 cents per $100. The weakest institutions will continue to pay 31 cents per $100. Approximately 92 percent of the nearly 11,000 BIF-insured institutions would pay the lowest rate. The reductions in premiums will decrease the expenses of BIF members by approximately $4.4 billion annually.

Chairman Ricki Helfer said that widening the spread between the rates paid by the strongest and the weakest BIF-insured institutions (eight basis points under the current system, and 27 basis points under the new one) promotes the fundamental goals of a risk-related insurance system. "The wider range of insurance rates gives weak banks a big incentive to get healthy and encourages all banks to avoid unnecessary risk-taking," she said.

The latest FDIC projections indicate that the BIF likely was recapitalized, with reserves of $1.25 for every $100 of estimated insured deposits (or a reserve ratio of 1.25 percent), during the second quarter of 1995. The new BIF assessment rates will apply from the first day of the month after the BIF is recapitalized. The soonest the recapitalization of the BIF can be confirmed is in early September, when the agency finishes processing banks' "Call Reports" for the period ended June 30, 1995. Assuming that the BIF recapitalized during the second quarter, BIF members that have overpaid their assessments based on the newly-adopted premium rate schedule can expect to receive a refund of any overpayment plus interest.

In connection with the new rate schedule, the FDIC Board established a process for quickly raising or lowering all rates for BIF-insured institutions if changing conditions warrant a timely change. Under this new system, the Board would have the flexibility to adjust the entire BIF assessment rate schedule twice a year without having to seek public comment first, but only within a range of no more than five cents per $100 above or below the premium schedule adopted. *PR-50-95, FDIC, 8/8/95.*

The BIF Increased to 1.22 Percent of Insured Deposits in First Quarter

During the first quarter of 1995, the BIF rose by $1.3 billion to $23.2 billion. This growth reflects continuing high levels of assessment income, increased investment income, and continuing minimal bank failures. The fund balance amounted to 1.22 percent of estimated insured deposits at year-end 1994, about $516 million below the legislatively mandated level of 1.25 percent. Total revenues to the BIF in the first quarter were $1.65 billion, which included net assessment revenues of $1.4 billion and interest income on fund investments of $221 million. Non-assessment income amounted to 80 percent of the first quarter's expenses and losses. The fund's liquid assets comprise 79 percent of the fund balance.

The Savings Association Insurance Fund (SAIF) continued to grow slowly in the first quarter of 1995. Total revenues amounted to $283 million, and operating expenses were $4 million, resulting in the net income added to the fund of $279 million. The SAIF balance increased to $2.2 billion, or 0.32 percent of estimated insured deposits, from $1.9 billion and 0.28 percent at year-end 1994. *First Quarter 1995 Financial Management Report, FDIC, 5/30/95.*

Recapitalization of the SAIF

In testimony in late July, Chairman Ricki Helfer described the difficulties facing the SAIF, and discussed recommendations, which reflect discussions and analyses by the Department of the Treasury, the OTS, and the FDIC, for resolving those difficulties. At the current pace, and under reasonably optimistic assumptions, the SAIF is unlikely to reach the minimum designated reserve ratio of 1.25 percent until the year 2002.

A principal reason the SAIF is undercapitalized is that SAIF assessments have been diverted to purposes other than building the fund. Since 1989, $7.4 billion --- approximately three-quarters of SAIF assessments --- have been diverted from the fund to pay off obligations arising from the government's efforts to handle the thrift failures of the 1980s. The Resolution Funding Corporation (REFCORP) received $1.1 billion, the Federal Savings and Loan Insurance Corporation Resolution Fund (FRF) received $2 billion, and the Financing Corporation (FICO) has received $4.3 billion. Without these diversions, the SAIF would have reached its designated reserve ratio of 1.25 percent last year. Only the FICO obligation remains, but under current law it has an annual call of up to the first $793 million in SAIF assessments until the year 2017, with decreasing calls for two additional years thereafter. In 1995, the FICO draw is expected to amount to approximately 45 percent of all SAIF assessments. On July 1, 1995, the SAIF's potential obligations increased when it assumed responsibility from the RTC for resolving all new failures of SAIF-insured thrifts.

The FDIC strongly supports a proposal developed on an inter-agency basis for resolving the problems of the SAIF. Under this proposal, briefly summarized, the SAIF would be capitalized through a special up-front cash assesssment on SAIF-assessable deposits. The special assessment would amount to approximately 85 to 90 basis points, or 85 to 90 cents for every $100 of assessable deposits. A special assessment of this magnitude would produce approximately $6.6 billion, increasing the SAIF's balance to $8.8 billion and the reserve ratio to 1.25 percent. The special assessment would be based on SAIF-assessable deposits held as of March 31, 1995, and would be due on January 1, 1996. After the SAIF is capitalized, it's risk-related assessment schedule would be similar to the final schedule adopted for the BIF. Among other elements of the proposal are: the responsibility for the FICO payments would be spread proportionally over all FDIC-insured institutions; the BIF and the SAIF would be merged as soon as practicable, after a number of additional issues related to the merger are resolved. The FDIC and the

OTS also recommended making unspent RTC funds available as a kind of reinsurance policy against extraordinary, unanticipated SAIF losses to limit the potential future costs to taxpayers from the existing full faith and credit guarantee of the U.S. Government that the SAIF enjoys. *Testimony, Chairman Ricki Helfer, Committee on Banking, Housing and Urban Affairs, U.S. Senate, 7/28/95.*

GAO Audits

The U.S. General Accounting Office, reporting on its audits of the financial statements of the BIF, the SAIF, and the FRF on December 31, 1993 and 1994, said the statements, taken as a whole, were reliable in all material respects. FDIC management fairly stated that internal controls in place on December 31, 1994, were effective in safeguarding assets against unauthorized acquisition, use or disposition. There was no reportable noncompliance with laws and regulations that were tested.

The report presents the GAO's recommendations to improve the FDIC's internal controls, discusses the improvements in the banking and savings association industries that have significantlyaccelerated the recapitalization of the BIF, and discusses the agency's concerns about the capitalization of the SAIF. *Financial Audit Federal Deposit Insurance Corporation's 1994 and 1993 Financial Statements, U.S. General Accounting Office, March 1995.*

Bank Exposure to Interest-Rate Risk

The FDIC is amending its risk-based capital standards to include a bank's exposure to changes in interest rates as a factor in evaluating the institution's capital adequacy, implementing Section 305 of the FDIC Improvement Act of 1991. The revised rule is scheduled to take effect 30 days after it appears in the *Federal Register*. The FDIC's rule applies only to state-chartered commercial banks that are not members of the Federal Reserve System and FDIC-supervised savings banks. The Board of Governors (FRB) and the Office of the Comptroller of the Currency (OCC) are expected to issue similar revisions to their capital standards for the commercial banks they supervise. A policy statement is being proposed that would serve as the basis for measuring and monitoring interest-rate risk. After an evaluation of the reliability and the accuracy of this framework, the regulators will consider proposing a regulation that would set definitive capital requirements. To avoid unnecessary regulatory burden, low-risk institutions, primarily small banks, would be exempted from having to complete the additional paperwork required to monitor interest-rate exposure. The FDIC estimates that approximately 7,025 out of the 10,847 commercial banks and FDIC-supervised savings banks nationwide would be exempt from additional reports. *PR-42-95, FDIC, 6/27/95.*

Capital Maintenance

The FDIC is amending its risk-based capital standards for insured state nonmember banks to implement a provision of the Riegle Community Development and Regulatory Improvement Act of 1994 (RCDRIA) of 1994 which states that the amount of risk-based capital required to be maintained by any insured depository institution, with respect to assets transferred with recourse, may not exceed the maximum amount of recourse for which the institution is contractually liable under the recourse agreement. The amendment is effective on April 27, 1995. *FR, 3/28/95, p. 15858; 4/10, p. 17986 (OCC).*

Policy Statement on Collateralized Letters of Credit

The FDIC issued a policy statement assuring the financial markets that certain collateralized letters of credit issued by insured banks and thrifts prior to the enactment of FIRREA on August 9, 1989, will continue to be treated substantially the same by the agency, as conservator or receiver for an insured depository institution, as they are now being treated by the RTC. The policy statement, effective immediately, is intended to remove doubts the financial markets may have about the FDIC's treatment of these instruments when the agency assumes responsibility for thrift receiverships from the RTC on July 1, 1995. These letters of credit include those issued by banks and thrifts as collateral for state or municipal bonds that finance low- and moderate-income housing developments and similar projects. The policy statement explains the limited circumstances when the FDIC would seek to repudiate a collateralized letter of credit issued by an insured institution that fails. *PR-36-95, FDIC, 5/19/95, and Policy Statement.*

Management Official Interlocks

The FDIC is withdrawing a proposed amendment to its regulations that implement the Depository Institution Management Interlocks Act. The proposal would have created limited exceptions to the prohibition on management official interlocks for depository institutions that control only a small percentage of the total deposits in the community or relevant metropolitan statistical area in which the institutions are located (see this *Review*, Winter 1995, p. 33). Section 338 of the RCDRIA modified the authority of the federal banking agencies to create regulatory exceptions to the bar on management interlocks. The FDIC Board believes the proposed amendment is not consistent with the limited authority to create exceptions on a bank-specific and case-by-case basis given the FDIC under the Interlocks Act as amended. *FR, 2/7/95, p. 7139.*

Limits on "Golden Parachutes" Proposed

The FDIC issued a proposal under which troubled holding companies, banks and thrifts would be prohibited from making "golden parachute" payments, which are typically large cash amounts paid to executives who resign just before an institution is closed or sold, subject to certain exceptions. Also, any holding company or FDIC-insured institution would be limited in its payments for an employee's or director's liabilities or legal expenses when that person is the subject of an enforcement proceeding. The proposed regulation would provide guidance to the industry on which payments would be considered legitimate and which would be considered abusive or improper. The regulation would implement anti-fraud legislation enacted in 1990, pursuant to which the FDIC issued an initial proposal in 1991. *PR-24-95, FDIC, 3/21/95.*

Payable Through Accounts

The FDIC issued guidelines that include more information about "payable through" accounts and suggested internal controls and procedures. Also called "pass by" accounts, these generally are checking accounts marketed to foreign banks that otherwise would not have the ability to offer their customers access to the U.S. banking system. U.S. banking entities that process large numbers of checks on accounts where signature cards have been completed abroad and submitted in bulk may have undertaken little or no effort independently to obtain or verify information about the individuals and businesses who use the accounts. Regulators are concerned that the use of these accounts may contribute to unsafe and unsound banking practices and other misconduct, including money laundering and related criminal activities. It is noted that the traditional use of "payable through" accounts by financial organizations in the U.S., such as by credit unions and investment companies, has not been a cause for concern. *FIL-30-95, FDIC, 4/7/95.*

FDIC's Right to Revoke Deposit Insurance Upheld

The U.S. Court of Appeals for the 4th Circuit upheld the FDIC's decision to terminate the deposit insurance of Doolin Security Savings Bank, New Martinsville, W. VA., for the bank's refusal to pay its insurance premium in full. Doolin protested in 1993 its not being placed in the FDIC's lowest risk-based premium category, citing the agency's failure to base its decision on objective criteria. In deciding for the FDIC, and upholding the decision of an administrative law judge, the court said the agency's decision was not unreasonable "that the subjective supervisory reports of primary regulators are relevant to determining whether an institution would cause the insurance fund to incur a loss." Following a 15-day period in which Doolin could ask for a rehearing, the bank will have 60 days to pay the remaining $15,000 on its assessed premium before its deposit insurance would be withdrawn. *AB, 5/22/95, p.2.*

Recordkeeping For Securities Transactions

The FDIC amended its regulation that establishes recordkeeping and confirmation requirements for securities transactions undertaken by an insured state nonmember bank for its customers. The action responds to reports from some banks of practical difficulties in complying with the requirements. The amendment, effective February 7, 1995, provides for a waiver of the requirements for good cause, affording the FDIC more flexibility in applying its requirements. *FR, %-4 2/7/95, p. 7111.*

The FDIC is waiving under certain circumstances its requirement that state nonmember banks carrying out securities transactions for customers disclose on the confirmation statement or separately the portion of the fee charged to customers represented by the amount of the bank's commission. This action, effective immediately, will eliminate a disparity in the rules for state nonmember banks in relation to state member and national banks, which are not required to provide the disclosures. Bank customers will continue to receive information about their transactions under existing securities industry standards, including disclosure of the total fees paid in connection with securities transactions. *PR-22-95, FDIC, 3/21/95.*

Housing Recovery Continuing at Slower Pace

The FDIC's latest quarterly survey of real-estate markets showed continuing improvement in many areas of the country, particularly for commercial properties. While the assessments of local housing markets across the country remained favorable overall, some continuing loss of momentum in that sector was indicated.

The national composite index of survey results fell to 61 in April from 62 in January 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 401 participants in the latest survey were polled in late April.

The composite index for housing fell in April to 57 from 58 in January, continuing a decline in the index that began with the July 1994, survey. The proportion of respondents observing worsening conditions --- 18 percent --- was the highest to date. Thirty-two percent of the respondents reported excess supply of residential real estate in April, up from 28 percent in January. Declining from 69 percent in April 1991, this percentage reached a low of 27 percent in July 1994. Among other indicators of housing markets, 73 percent of the respondents in April reported new-home construction at "average" or "above-average" levels, down from 1994's average of 76 percent. The proportion of respondents who thought home sales were "above-average" --- 19 percent --- has declined in four consecutive surveys.

For commercial real estate, the composite index in April was 68, unchanged from January, and down by a moderate 5 percent from its survey high of 73 in April 1994. This index registered a low of 46 in January 1992. In April, 38 percent of the respondents thought conditions in their local commercial real-estate markets were better than three months earlier, the same percentage as in January, while the three percent seeing worsening conditions was down slightly. Fifty-three percent of respondents nationally reported excess supply in commercial real-estate markets, up from 52 percent in January, following consecutive declines since July 1993, when the figure was 82 percent.

Regionally, the indexes in April for both residential and commercial real-estate markets were equal to or off by not more than one point from the national indexes, except in the Northeast and West. The most significant improvement in April occurred in the Midwest, this being the only region where improvements were seen in both the commercial and residential real-estate markets. It may be noted that the Midwest's indexes had dropped sharply in January from the October 1994, survey. The indexes for the South, which were several points above the national data in January, declined to near those figures in April. In the

Northeast, following significant gains in late 1993 and early in 1994, the indexes began a decline that continued for commercial markets in April. The proportion of respondents there reporting excess supply conditions in both commercial and residential markets continued to be the highest of any region. In California, 26 percent of the respondents saw improvements in commercial markets in April, and 18 percent in residential, representing small increases from January. Excess supply in commercial real estate was reported by 93 percent of the respondents. In contrast, for the West outside of California, 61 percent reported improvement in commercial real estate, compared to 38 percent nationally, and only 29 percent reported excess supply. Residential markets also were seen as stronger than average in those states. *Survey of Real Estate Trends; FDIC, April 1995.*

Reorganization and New Division of Insurance

The FDIC has created a Division of Insurance, whose mission will include identifying and assessing existing and emerging risks to the deposit insurance funds. Chairman Ricki Helfer said that "establishing this new division as a formal element in the structure of the organization is the next logical step in our effort to shift the FDIC from an agency that resolves bank failures to an agency working to keep banks open and operating safely and soundly." The new division is one of several organizational changes approved by the FDIC Board to enhance the Corporation's decision-making processes and to achieve the goals established by the agency's strategic plan which the Board adopted on April 24, 1995. Under the revised organizational structure, the Corporation's divisions and offices will generally report to one of the three deputies to the Chairman. A number of management changes were also announced, effective June 18, 1995. *PR-30-95, FDIC, 4/24/95; PR-33, 5/17.*

Bankers to Be Surveyed on Ways to Improve Examination Process

The FDIC will conduct surveys among bankers across the country aimed at improving the quality of safety-and-soundness examinations, detecting and changing aspects of the agency's examination process that may be inefficient, and reducing regulatory burden. The program, which is expected to run for one year, builds on previous informal surveys conducted on a regional basis by the Division of Supervision.

Chairman Ricki Helfer said "the emphasis in this program is on two-way communication, timely analysis and effective follow-up **...** these elements are essential if the FDIC is to maintain an efficient supervisory program and work effectively with bankers to encourage safe and sound banking operations." *PR-25-95, FDIC, 3/24/95.*

As of early May, the Office of Thrift Supervision (OTS) had begun a similar program for evaluating its examiners, and the OCC was planning to start a program in June. *AB, 5/9.*

Final Guidelines For Appeals Process

The FDIC approved final guidelines establishing an appeals process for material supervisory determinations made by agency examiners and regional supervisory officials, implementing a requirement applicable to the federal banking agencies and the NCUA under the RCDRIA of 1994. Under the new guidelines, institutions have 60 days following receipt of written notice of a material supervisory determination to appeal that determination to a special Supervision Appeals Review Committee established in the Washington office. This Committee will consider and decide the appeal, and notify the institution of its decision within 60 days.

Institutions may appeal a variety of material supervisory determinations, including those relating to: examination ratings, such as CAMEL, compliance, and Community Reinvestment Act ratings; the adequacy of loan-loss reserve provisions; disputed asset classifications exceeding ten percent of total capital; and violations of law or regulations. Decisions to take prompt corrective action pursuant to Section 38 of the Federal Deposit Insurance Act, determinations for which other appeals procedures exist, and decisions to initiate formal or informal enforcement actions are not appealable under the new guidelines. There are also provisions designed to protect institutions from possible retaliation as a result of filing an appeal. *PR-21-95, FDIC, 3/21/95; FIL-28-95, 4/4; FR, 3/28, p. 15923.*

Deposit Activities of Foreign Banks

Pursuant to Section 107 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, the FDIC proposed to amend its regulations to restrict the amount and types of initial deposits of less than $100,000 that could be accepted by an uninsured, state-licensed U.S. branch of a foreign bank. The proposal is intended to afford equal competitive opportunity to foreign and domestic banks. *FIL-48-95, FDIC, 7/19/95; FR, 7/13, p. 36074.*

Examinations Workshop For Minority Bankers

The FDIC will conduct a workshop at the National Bankers Association Annual convention this year on how bankers can prepare for examinations and how they can work with examiners in addressing any problems they may have. The convention will be held in New York City in September. Announcing the FDIC's participation which responded to a request from the NBA, Chairman Ricki Helfer said the workshop is an example of how the agency's focus has changed from resolving failed banks to concentrating on helping banks and other financial institutions to stay open and operate safely and soundly. Section 308 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 calls on the FDIC to provide minority-owned banks with technical assistance and educational programs. *PR-17-95, FDIC, 3/6/95.*

Deposit Insurance Seminars

Beginning in May and through August 1995, the FDIC will conduct 22 seminars in 11 cities nationwide for bank officers and employees who have oversight responsibilities relating to the dissemination of accurate deposit insurance information. Instruction will be presented also on uninsured deposit-like products and how to assist employees and customers to distinguish them from insured deposits. *FIL-33-95, FDIC, 4/28/95.*

Information Availability Is Enhanced

To improve public access to information, the FDIC is now offering a new telephone service, "Action Update," which provides a recorded message about the most recent press releases and directives to institutions (Financial Institution Letters), as well as brief descriptions of the FDIC Board of Directors' most recent actions, a description of new publications, and a list of significant events. Callers can access the new service by dialing 202-898-7210, and can obtain copies of the documents referenced by calling 202-898-6996. FDIC press releases and certain other documents also are available through a fax retrieval system. *PR-41-95, FDIC, 6/19/95.*

Study of Bidder Competition and Resolution Policies

This study, by three FDIC staff members, investigates whether the changes in the FDIC's failure-resolution policies mandated by the FDIC Improvement Act of 1991 (FDICIA) decreased failure-resolution costs. Prior to FDICIA, the winning bid for a failed bank's assets and liabilities was not required to be the bid that minimized the FDIC's resolution costs. Generally, bids were divided into three categories according to whether the bidder proposed assuming virtually all, some, or few of the failed bank's assets. These three types of bids are termed whole-bank bids, purchase-and-assumption (P&A) bids, and deposit-transfer bids, respectively. Whole-bank bids were considered first, and if the most competitively priced whole-bank bid was less costly than a deposit payoff, that whole-bank bid was selected. If no whole-bank bid passed the cost test, the P&A bids were considered. Finally, if no P&A bids passed the cost test, the deposit-transfer bids were considered. If no bids passed the cost test, the FDIC conducted a deposit payoff.

FDICIA eliminated the preference to select whole-bank bids over P&A bids and P&A bids over deposit-transfer bids. The Act required that the winning bid be chosen solely on the basis of minimizing the FDIC's resolution costs. The least-cost resolution rule went into effect immediately upon passage of FDICIA on December 19, 1991. Because competition among bidders for failed banks prior to FDICIA was based not only on the cost to the FDIC, but also on the type of bid, it is possible that winning bids were not always cost minimizing to the FDIC. Based on the FDIC's actual and estimated losses on resolutions in the study period, the aggregate resolution costs were found to have decreased substantially after enactment of FDICIA. *"Acquirer Gains in FDIC-Assisted Bank Mergers: The Influence of Bidder Competition and FDIC Resolution Policies," Matthew T. Billett, Jane F. Coburn, and John P. O'Keefe, May 1995.*

Resolution Trust Corporation

Agency on Schedule to Sunset at Year-end

Established on August 9, 1989, to deal with the failure of much of the U.S. savings-and-loan industry, the RTC is completing its mission and is scheduled to terminate on December 31, 1995. The agency was created by amendments to the Federal Home Loan Bank Act made by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). This legislation, as subsequently amended, gives the RTC responsibility for resolving savings institutions that were previously FSLIC-insured and that became insolvent before July 1, 1995; and liquidating the assets of those institutions. Savings associations that become insolvent after July 1, 1995, become the responsibility of the Savings Association Insurance Fund (SAIF) administered by the FDIC.

At sunset, all RTC assets and liabilities will be transferred to the FSLIC Resolution Fund (FRF), a fund administered by the FDIC, and the FDIC will succeed the RTC as conservator and receiver for any institutions under RTC control at that time. All RTC staff will also be returned to the FDIC, as provided by FIRREA. As required under the RTC Completion Act, the FDIC/RTC Transition Task Force was established in February of 1994 to effectuate this transfer in a coordinated manner. The Task Force is required by statute to resolve differences in the operations of the two corporations; to recommend which systems of the RTC should be preserved for use by the FDIC; to recommend procedures that would promote an orderly transfer; and to recommend which management enhancement goals and reforms applicable to the RTC should apply to the FDIC.

From its inception on August 9, 1989 to June 16, 1995, the RTC resolved all 747 institutions taken over through that date, protecting 25 million deposit accounts and $221 billion in deposits. Through April 30, the RTC had disposed of assets with a book value of $445 billion, leaving $20 billion (book value) of assets in its inventory. Recoveries from sales and collections totaled $388 billion, averaging 87 percent of original book value. The Congress has authorized $105 billion in loss funds for the RTC. The estimated total resolution costs, as of June 20, 1995, were $87 billion to $95 billion. = *Testimony, Committee on Banking, Housing and Urban Affairs, U.S. Senate, June 20, 1995, J.E. Ryan, Acting CEO, RTC; FDIC/RTC Transition Task Force.*

Federal Reserve Board

Evaluating the Risk Management of Derivative Contracts

The FRB issued a guidance for evaluating the risk-management practices used by banking institutions in acquiring and managing securities and off-balance-sheet (OBS) derivative contracts for nontrading purposes. It focuses on institutions' investments in cash securities and "end-user" derivatives activities, supplementing existing guidances and directives. Nontrading activities in this guidance involve the use of securities (both available-for-sale and held-to-maturity) and OBS derivative contracts that involve longer time periods than typically are associated with trading activities. Nontrading activities involve the full array of cash securities (including fixed- and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage derivative products), money-market instruments, and OBS derivative contracts (including swaps, futures, and options).

The overview of the guidance identifies basic factors that examiners should consider in evaluating the elements of a sound risk-management process, and contains specific guidance for evaluating an institution's management of each of the risks involved in these activities, including credit, market, liquidity, operating and legal risks. In evaluating an institution's risk-management process, examiners should consider the nature and size of its holdings. Examiners should focus particular attention on evaluating an institution's understanding of the risks involved in the instruments it holds. Banking organizations should ensure that their capital positions are sufficiently strong to support all the risks associated with nontrading activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. In evaluating the adequacy of an institution's capital, examiners should consider any unrecognized net depreciation or appreciation in an institution's securities and derivative holdings. *SR 95-17 (SUP), Division of Banking Supervision and Regulation, FRB, 3/28/95.*

Capital Requirements

The FRB requested comment on a proposal to amend its risk-based capital requirements to incorporate a measure for market risk in foreign-exchange and commodity activities and in the trading of debt and equity instruments. The effect of the proposed rules would be that, in addition to existing capital requirements for credit risk, certain institutions would be required to hold capital based on the measure of their market risk exposure. The proposed rule is based on a proposal issued by the Basle Committee on Banking Supervision and would go into effect at the end of 1997.

The FRB also is requesting comment on a possible approach to setting capital requirements for market risk that would require a bank to specify the amount of capital it chose to allocate to support market risks. If cumulative losses over some subsequent trading interval exceed the commitment, the bank would be subject to regulatory penalties, such as fines, higher capital requirements, or restrictions on trading activities. *Press Release, FRB, 7/14/95; FR, 7/25, p. 38142; p. 38082 (inter-agency proposal).*

The FRB is amending, effective March 22, 1995, its risk-based capital guidelines for state member banks and bank holding companies to implement Section 350 of the RCDRIA. Section 350 states that the amount of risk-based capital required to be maintained by any insured depository institution, with respect to assets transferred with recourse, may not exceed the maximum amount of recourse for which the institution is contractually liable under the recourse agreement. Currently, under the guidelines an institution could be required to hold capital in excess of the maximum amount of loss possible under the contractual terms of the resource obligation. *Press Release, FRB, 2/7/95; FR, 2/13, p. 8177.*

The FRB issued a proposal, implementing Section 208 of the Riegle Act, that would have the effect of lowering the capital requirement for small-business loans and leases on personal property that have been transferred with recourse by qualifying banking organizations. For the general purpose of calculating risk-based and leverage capital ratios, qualifying institutions that transfer small-business obligations with recourse would be required to maintain capital only against the amount of recourse retained, subject to certain conditions. *Press Release, FRB, 1/26/95; FR, 2/1, p. 6043.*

The FRB, the OCC, the FDIC and the OTS issued an interim final rule, effective August 1, 1995, amending the capital adequacy guidelines for banks, bank holding companies, and savings associations to treat originated mortgage servicing rights (OMSRs) the same as purchased mortgage servicing rights (PMSRs) for regulatory capital purposes. Under the interim rule, which was developed in response to Financial Accounting Standards Board Statement No. 122, both OMSRs and PMSRs are included in regulatory capital when determining Tier 1 (core) capital for purposes of the agencies' risk-based and leverage capital standards, and in calculating tangible equity for purposes of prompt corrective action subject to the regulatory capital limitations that previously applied only to PMSRs. *Press Release, FRB, 7/27/95; FR, 8/1, p. 39226.*

Safety-and-Soundness Standards

The FRB issued final guidelines and a final rule, both effective August 9, 1995, regarding safety-and-soundness standards for state member banks as required by Section 132 of the FDICIA. As amended by the Community Development Act, Section 132 no longer requires the FRB, the OCC, the FDIC and the OTS to prescribe quantitative standards relating to asset quality and earnings but rather, mandates that the agencies prescribe standards that they deem appropriate. The agencies are therefore proposing asset quality and earnings standards, in guidelines form, that emphasize monitoring, reporting and preventive or corrective action. The guidelines set forth broad, principle-based standards that establish the objectives that proper operations and management should achieve, while leaving the methods for achieving those objectives to each institution. The rule establishes deadlines for submission and review of safety-and-soundness compliance plans that the federal bank regulatory agencies may require for insured depositories that fail to meet the guidelines. *Press Release, FRB, 7/7/95; FR, 7/10, p. 35674 (inter-agency proposal).*

Supervision of Foreign Banks' U.S. Operations

The FRB advised the Federal Reserve Banks that the banking supervisory authorities whose responsibilities include the U.S. operations of foreign banking organizations have developed a program of supervision relating to FBOs. The Board said that Reserve Banks should fully coordinate their FBO supervision activities with the appropriate state banking departments and regional offices of the other federal agencies in their districts. The FRB will designate a foreign bank's entire U.S. operation a single rating, regardless of how many units exist, which will diminish the negative impact on the entire institution of a poor rating at a small unit. Greater emphasis will be given to the foreign bank's risk-management, internal controls, and compliance activities. The guidelines require foreign banks to be a source of strength to their U.S. operations. *AB, 4/19/95, p. 3; SR 95-22 (Sup. IB), Div. of Banking Supervision and Regulation, FRB, 3/31.*

Tying Restrictions Are Revised

The FRB is adopting, effective May 26, 1995, a regulatory "safe harbor" from the anti-tying restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970 and the Board's Regulation Y. The safe harbor permits any bank or nonbank subsidiary of a bank holding company to offer a "combined-balance discount," which is a discount based on a customer maintaining a combined minimum balance in products specified by the company offering the discount.

The BHC Act Amendments of 1970 generally prohibit a bank from tying a product or service to another product or service offered by the bank or any of its affiliates. The Board is authorized to grant exceptions to its restrictions by regulation or order. *FR, 4/25/95, p. 20186.*

Community Reinvestment Act Revised Regulations

The FRB issued a revised Regulation BB, and related conforming amendments to its Home Mortgage Disclosure Act regulation (Regulation C). Parallel regulations are being issued by the OCC, the FDIC and the OTS for institutions they supervise. The new CRA rule emphasizes performance over process and documentation. The 12 old CRA assessment factors for large retail banks and thrifts are replaced with three tests: for lending, services, and investments.

Institutions will no longer have to maintain extensive documentation of directors' participation in formulating and reviewing CRA policies, will no longer have to prepare a formal CRA statement, and will not have to document their efforts to market services in low- and moderate-income communities. Banks and thrifts will be evaluated based on loans made, services provided and investments in their communities. The rule emphasizes direct lending. A streamlined examination process is provided for independent banks and thrifts with assets under $250 million, or banks and thrifts with assets under $250 million that are members of a holding company with assets of under $1 billion. Larger institutions will collect and report to regulators aggregated data on their small-business and small-farm loans by census tract. They will not collect or report data on race and gender of small-business borrowers. HMDA data collection will be expanded for large institutions to include collection and reporting of mortgage loans outside the metropolitan statistical areas (MSAs) where the institutions have branch offices.

Under the final rule, there are no "safe harbors" from CRA protests. Institutions will continue to make their CRA ratings public, and the public will have an opportunity to comment on CRA performance before the start of a scheduled examination. The FRB, the FDIC, the OCC and the OTS will work together to develop and adopt uniform examination procedures. Joint examiner training programs will be developed and implemented. The rule becomes effective on July 1, 1995; some provisions become operational on January 1, 1996, and July 1, 1997. *Press Release, FRB, 4/14/95; NEWS and "CRA Regulation Facts," OTS, 4/19; FR, 5/4, pp. 22156, 22223; FIL-35-95, FDIC, 5/17/95.*

Equal Credit Opportunity

The FRB proposed amending its Regulation B to eliminate the general prohibition on collecting data relating to an applicant's race, color, sex, religion, and national origin, giving creditors the option to ask applicants to provide the information on a voluntary basis.

Creditors have expressed a variety of reasons for wanting to collect these data: to better audit their lending programs to ensure that they are in compliance with fair lending laws; to respond more effectively to CRA protests; and to collect data so that they can better evaluate their community outreach programs and the effectiveness of their marketing programs. Some regulatory agencies and community groups say the data may increase their ability to detect discrimination.

The proposal would allow data collection only; consideration of an applicant's race, color, sex, religion, and national origin in a credit decision would still be prohibited. *FR, 4/26/95, p. 20436; Press Release, FRB, 4/21.*

The FRB revised, effective June 5, 1995, the official staff commentary to its Regulation B. The commentary applies and interprets the requirements of the Regulation and is a substitute for individual staff interpretations. Issues on which the revisions provide guidance include disparate treatment, special purpose credit programs, credit scoring systems, and marital status discrimination. *FR, 6/7/95, p. 29965.*

Information on Banks' Selling Mutual Funds

The Federal Reserve will soon begin a nationwide education campaign about the sale of mutual funds and annuities at banks. The campaign will begin with a series of seminars for retirees and those planning for retirement. The seminars will be hosted by the 12 Federal Reserve Banks and will emphasize that mutual funds and annuities, unlike certificates of deposit, are not insured by the FDIC or in any way guaranteed by the banks that sell them. The Federal Reserve developed the program in cooperation with the American Association of Retired Persons, and conducted pilot seminars in the Boston area in late 1994. *Press Release, FRB, 3/20/95.*

Truth in Lending

The FRB amended its Regulation Z to implement changes made to the Truth in Lending Act by the RCDRIA, which imposes new disclosure requirements and substantive limitations on closed-end home-equity mortgage loans bearing rates or fees above a certain percentage or amount. The law also imposes new disclosure requirements to assist consumers in comparing the cost of reverse mortgage transactions, which provide periodic advances primarily to elderly homeowners and rely principally on the home's value for repayment. The rule is effective March 22, 1995, with compliance optional until October 1, 1995. *Press Release, FRB, 3/16/95; FR, 3/24, p. 15463.*

The FRB revised the official staff commentary to its Regulation Z to clarify regulatory provisions and provide further guidance on certain 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 the unauthorized use of a credit card. The rule is effective April 1, 1995, with compliance optional until October 1, 1995.

The Truth in Lending Act requires creditors to disclose credit terms and the cost of credit as an annual percentage rate (APR). The Act requires additional disclosures for loans secured by a consumer's home, and permits consumers to cancel certain transactions that involve their principal dwelling. It also imposes limitations on some credit transactions secured by a consumer's principal dwelling. *Press Release, FRB, 3/28/95.*

Pursuant to requirements of the RCDRIA, the FRB requested comment on how rules for credit advertising could be modified to increase consumer benefit and decrease creditor costs, and on how current rules could be modified, if at all, for radio and television advertisements without diminishing consumer protection. Under present law, creditors that state a rate in an advertisement must state the APR. Stating the APR or other terms triggers additional disclosure requirements such as annual fees imposed on a credit line or the repayment terms for an installment loan. *FR, 6/27/95, p. 33151.*

Home Mortgage Disclosure

The FRB published for comment a staff commentary to its Regulation C. The proposed commentary provides guidance on various issues including the treatment under the Regulation of prequalifications, participations, refinancings, home-equity lines, mergers, and loan applications received through a broker. *FR, 6/7/95, p. 30013.*

Loans to Bank Officers

The FRB is revising, effective immediately, its Regulation O to implement a provision of the RCDRIA that eliminates a requirement for prior approval of the board of directors before a member bank may make a loan to an executive officer that is secured by a first lien on the officer's residence. *FR, 4/7/95, p. 17635.*

Insider Lending Limits

The National Bank Act and Regulation O establish the limit for single-borrower loans to any insider of a member bank and insider of the bank's affiliates to be 15 percent of the bank's unimpaired capital and unimpaired surplus for loans that are not fully secured, and an additional ten percent for loans that are fully secured by certain readily marketable collateral. The FRB amended its regulation to conform the definition of unimpaired capital and unimpaired surplus to the definitions recently adopted by the OCC in calculating the limit on loans by a national bank to a single borrower. Under that revised definition, a national bank's "capital and surplus" are equal to Tier 1 and Tier 2 capital included in the calculation of the bank's risk-based capital together with the amount of the bank's allowance for loan and lease losses not included in this calculation. *FR, 4/20/95, p. 19689; Press Release, FRB, 6/8.*

Suspicious Activity Reports

The FRB proposed to revise its regulations on reporting of suspicious activities by the domestic and foreign banking organizations supervised by the Federal Reserve, including the reporting of suspected violations of the Bank Secrecy Act (BSA). The principal proposed changes to the FRB's current criminal referral reporting rules include: a) simplifying and shortening the referral form; b) raising the mandatory reporting thresholds for criminal offenses, thereby reducing banking organizations' reporting burdens; c) filing only one form with a single repository, rather than submitting multiple copies to several federal law enforcement and banking agencies, thereby further reducing reporting burdens; and d) clarifying the criminal referral and suspicious financial transaction reporting requirements of the FRB, the OCC, the FDIC, the OTS, and the National Credit Union Administration and the Treasury Department associated with suspicious financial transactions. The above supervisory agencies, working with the Treasury's Financial Crimes Enforcement Network (FinCEN), are developing computer software to assist financial institutions in preparing and filing Suspicious Activity Reports (SARs). *FR, 7/3/95, p. 34481; 7/17, p. 36366 (OTS notice).*

Required Reporting Is Reduced For BHCs

The FRB adopted several revisions to its FR Y-6 which is an annual report filed by large bank holding companies, excluding foreign banking organizations. The report consists of consolidated and parent company financial statements in the company's own format, and is the Federal Reserve's principal source of internally generated and independently audited financial data on individual bank holding companies and their banking and nonbanking subsidiaries. Among the burden-reducing changes are: 1) eliminating the requirement to submit consolidated and parent company financial statements; 2) revising the requirement for audited financial statements to include only holding companies with assets of $500 million or more (raised from $150 million) and 3) eliminating the requirement to submit nonbank subsidiary financial statements which, as currently proposed, would be incorporated into an expanded standardized FR Y-11 report (financial statement of nonbank subsidiaries). Holding companies must still make available their annual reports and their Securities and Exchange Commission reports of financial condition. *FR, 3/6/95, p. 12215; AB, 3/14, p. 3.*

Establishment of Loan Production Offices

The FRB issued, effective April 6, 1995, an interpretation of its Regulation H that allows a state member bank to establish a back office facility that is not accessible to the public without such a facility being considered to be a branch. Loans originated by a loan production office may be approved at a back office location, rather than at the main office or a branch of the bank, without the loan production office being considered to be a branch, if the proceeds of those loans are received by customers at locations other than a loan production office or back office facility. This interpretation is intended to provide parity between state member banks and national banks with respect to the establishment of loan production offices and back office facilities. *FR, 4/6/95, p. 17436.*

Mortgage Unit May Sell Employment Histories

The FRB granted approval for an Iowa-based mortgage unit of Norwest Corp., Minneapolis, to sell employment histories to third-party depository institutions and affiliates for use in their banking activities. While the decision is the first of its kind, the expansion of banking powers is said to be small. A 1994 decision of the Board allowed Comerica Corp. to provide employment information and histories to depository institutions in connection with career counseling services. The mortgage firm's release of certain information, which it will gather from state employment departments and other sources, will depend upon the individual's prior consent. The firm will be subject to the Fair Credit Reporting Act. *BBR, 5/15/95, p. 951.*

Title Abstracting Approved as Banking-Related Activity

The FRB granted approval for First National Co., Storm Lake, Iowa, to engage in realty title abstracting through an acquisition. For the first time this activity as a source of fee income would be available to bank holding companies. Normally the realty title abstracting business involves recreating each county's title records, often converting them to electronic form, and then charging a fee for the title search. Permission for national banks to acquire title abstractors was granted by the OCC seven years ago. *AB, 7/5/95, p. 2.*

Data Processing Limits Under Reg. Y Are Broadened

The FRB gave approval for BNCCORP Inc. of Bismarck, ND to acquire a data processing firm and to include providing non-financial information in its data processing services. Under Regulation Y, bank holding companies can provide data processing and transmission services, databases, and access facilities, if the data are "financial, banking, or economic" in nature. The FRB said that in this case the non-financial information would be provided only as a part of a larger package of data processing services to a financial institution, and would not be offered on a stand-alone basis or to customers other than financial institutions. *BBR, 1/16/95, p. 98.*

Geographic Market Defined For EPT Network Services

The FRB granted approval for Electronic Payment Services Inc., Wilmington, Delaware, a joint venture subsidiary of four large bank holding companies, to acquire the ATM assets and some POS assets of National City Corp., a Cleveland-based bank holding company, and also approved National City to become a member of the joint venture. EPS provides data processing and transmission services to banks and retail merchants who are members of the ATM and POS network MAC. The four members of the joint venture are Bank One Corp., Columbus, CoreStates Financial Corp., Philadelphia, PNC Bank Corp., Pittsburgh, and KeyCorp, Cleveland. The FRB defined the appropriate geographic market in this case to be MAC's Mideast region, consisting of western Pennsylvania, Ohio, Indiana, Kentucky and West Virginia. A FRB study suggests that the geographic market for network access is an area significantly larger than local markets, and the markets for network services and ATM processing are thought to be at least regional. The FRB rejected arguments that the geographic markets should be defined on the basis of the boundaries of cities or states. *BBR, 3/16/95, p. 517.*

Electronic Fund Transfers

The FRB amended, effective April 24, 1995, its Regulation E to eliminate 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 posed a significant security risk to consumers and financial institutions by making information accessible to criminals that could be used to make fraudulent fund withdrawals. *Press Release, FRB, 3/16/95.*

Payments System Risk; Daylight Overdrafts

The FRB revised the increase in the fee charged to depository institutions for daylight overdrafts incurred in their accounts at the Reserve Banks that had been scheduled to take effect on April 13, 1995. The current effective daily fee of ten basis points was implemented in April 1994, with scheduled increases to 20 basis points on April 13, 1995, and to 25 basis points on April 11, 1996. In the aggregate, daylight overdrafts in Federal Reserve accounts have fallen by roughly 40 percent in response to the initial ten-basis-point fee. As a result of the sizeable reductions, as well as concerns about the possible effects of further rapid fee increases, the Board approved an increase in the fee to an effective daily rate of 15 basis points rather than 20 basis points. (The 15-basis-point fee equals an annual rate of 36 basis points, quoted on the basis of a 360-day year and a 24-hour day.) The Board will evaluate the desirability of any further increases in the daylight overdraft fee, based on the objectives of the payments system risk program, two years after the implementation of the 15-basis-point fee. *Press Release, FRB, 3/2/95; FR, 3/7, p. 12559.*

Fed Acts to Cut Costs of Services, Improve Efficiency

The FRB and the Federal Reserve Banks are undertaking a number of major consolidation and other budget-cutting measures. For example, a majority of the Federal Reserve Banks have implemented early-retirement programs during the last few years. Other recent or ongoing actions include: a) consolidation of mainframe data processing from the previous 12 sites to three: a hub in East Rutherford, NJ, with backup facilitates at the Dallas and Richmond Federal Reserve Banks; b) consolidation of supervision and decision-making on financial services such as check clearing and funds transfer at the St. Louis Federal Reserve Bank; and c) replacement of varied software used by the different Federal Reserve Banks with standardized systems. Individual Federal Reserve Banks are centralizing a number of operations, for example, the Atlanta Bank has brought its check processing sites down to five from 12. *AB, 5/17/95, p. 1.*

"Purposes and Functions" Is Updated

The FRB is publishing the eighth edition of *Purposes and Functions*, a paperback book first published in 1939 that explains the structure and operations of the Federal Reserve System. The revised and updated edition has been designed to appeal to a general audience and can supplement college-level classroom texts on the Federal Reserve's role in monetary policy and the global economy. *Press Release, FRB, 3/2/95.*

Office of the Comptroller of the Currency

Enhancing the Supervision of Bank Lending

Comptroller of the Currency Eugene Ludwig said that the agency's supervisory activities for safety and soundness in the credit area will be strengthened because of warning signs of slippage of credit quality. Among the steps being planned, a National Credit Committee, whose members include some of the agency's most senior and experienced credit analysts, will work with examiners in charge of supervision at larger national banks to ensure that adequate credit quality supervision is in place. Among the warning signals noted is a recent decline in the standard minimum payment on credit cards from five percent to two percent of the outstanding balance, and significant increases in high loan-to-value second-mortgage and home-equity lending. Some of the questions for bank managements and the examiners are the extent that the bank: 1) is taking risk into account in the pricing of loans; 2) is making exceptions to credit standard policies; 3) has compensation or other policies that encourage lending officers to lower credit standards; and 4) has significant credit concentrations in its portfolio. Also, how independent and effective is the credit review function; and are stress tests being performed on all or a portion of the credit portfolio to determine how loans will be repaid when the customer, the industry and/or the economy turn down. *News %0 Release, OCC, 4/8/95.*

In February 1995, the OCC decided to include information about concentrations of credit in the reports of examination of national banks. Examiners will report such concentrations amounting to over 25 percent of the bank's capital structure in the report of examination. Effective May 19, 1995, this reporting was extended to federal branches and agencies of foreign banks where credit concentrations exceed ten percent of the total assets of the branch or agency. *Bulletin No. 95-7, OCC, 2/8/95; Bulletin No. 95-26, 5/19.*

Interest-Rate Risk

Reaffirming and updating its statement issued in January 1990, the OCC said that during the past five years national bank managers have improved their interest-rate-risk management systems, in particular by: 1) advancing from measuring risk in simple repricing ("gap") reports to using simulation models to quantify and control the amount of short-term earnings that may be at risk; and 2) developing or enhancing ways to measure and control exposures arising from medium- and long-term positions. The agency's statement notes that the value of many banks' medium- and long-term instruments are highly sensitive to changes in interest rates, particularly those containing option features, such as the possibility of loan prepayments or the withdrawal of funds. Financial instruments such as collateralized mortgage obligations (CMOs), structured notes, credit-card lines, indexed CDs, and off-balance-sheet derivative instruments provide financial institutions with more services to offer customers and more tools for risk management, but the complexity of many of these instruments makes it more difficult to determine the sensitivity of their values to changes in interest rates.

Risk measurement systems should be able to identify and quantify the major sources of a bank's interest-rate-risk exposure on a timely basis. Where there are significant medium- and long-term positions, managers should be able to assess the longer-term impact of changes in interest rates on the earnings and capital of the bank. Senior management and the board or a committee thereof should receive reports on the bank's interest-rate risk on at least a quarterly basis, but more frequently as appropriate to the level of current and potential risk. The board's tolerance for interest-rate-risk exposure should be clearly communicated to senior management. Clear lines of responsibility should be established for measuring and managing risk exposures. *Advisory Letter 95-1, OCC, 2/8/95.*

In June, the agency provided question-and-answer information regarding its guidance issued on February 8. *Bulletin No. 95-28, OCC, 6/20/95.*

More Information Provided on Derivatives Activity

Bank Call Report data for the first quarter of 1995 include new information that provides a better measure of the market size, credit risk exposure, and revenue from bank derivatives activity. The notional amount of derivatives in commercial bank portfolios, which is an indicator of the level of derivatives activity, increased by 14 percent in the quarter. Nine commercial banks account for 93 percent of the total notional amount. First-quarter Call Report data include, for the first time, the gross negative and positive fair values of derivative positions, credit risk exposure in the form of "bilaterally netted" current exposure, the distribution of derivatives contracts by type, revenue from derivatives transactions and the diversification of earnings sources, and information on high-risk mortgage securities and on structured note holdings. *News Release, OCC, 3/31/95; 6/14.*

OCC and SEC Agree on Joint Examinations

The OCC and the Securities and Exchange Commission agreed to conduct joint examinations of certain entities in which both agencies have regulatory and supervisory interests. These entities are mutual funds advised by national banks or their subsidiaries and national banks and national bank subsidiaries providing advisory and other investment services to mutual funds. Among the areas of common interest to be evaluated are: systems of internal control used to ensure compliance with regulatory requirements, including disclosures to investors; risk management systems used by the adviser to monitor and control the risks in light of the fund's objectives; and management of conflicts of interest between the adviser and the advised funds or other advisory clients and the advised funds. The scope and staffing of particular examinations will be determined by both agencies on a case-by-case basis. Documents prepared or obtained by either agency in connection with a joint examination will be treated as confidential. Coordination of these examinations will enable the agencies to reduce the regulatory burden on banks involved in mutual fund activities, minimize government intrusion into bank operations, and also protect the interests of bank depositors and investors. *Joint Release, OCC and SEC, 6/12/95.*

Lending Limits

The OCC, effective March 17, 1995, revised its rules governing national bank lending limits, in order to eliminate inefficient and unduly burdensome requirements and refocus the lending limit rules on the areas of greatest safety-and-soundness concern. The final rule alters the definition of "capital and surplus" upon which lending limits are based. The new lending limit calculation draws upon risk-based capital components that a bank must already calculate for Call Report purposes. Thus, most national banks generally will be required to calculate their lending limit only once every quarter, rather than every time they propose to make a loan. A new exception to the lending limits will allow a bank to advance funds to renew and complete the funding of a qualifying loan where the additional advance will protect the position of the bank. The final rule also allows a bank to advance funds to pay taxes, insurance and other necessary expenses to protect its interest in the collateral securing a loan, and clarifies when a loan is considered "nonconforming." *FR, 2/15/95, p. 8526.*

The FRB adopted a conforming amendment to its Regulation O. *FR, 6/13/95, p. 31053.*

Court Upholds State Limits on Bank Insurance Activities

The U.S. Court of Appeals for the Eleventh Circuit denied a petition by Barnett Bank of Marion County, N.A. to rehear a ruling that would allow Florida's insurance commissioner to block Barnett's ownership of an insurance agency under state law (*Barnett Bank of Marion County, N.A. v. Gallagher*). A panel of the Court, affirming a trial court's decision, ruled in January that the McCarran-Ferguson Act overrides other federal laws and gives states the right to regulate bank insurance sales. The denial of the petition appears to conflict with a decision of the Sixth Circuit that federal law preempts a Kentucky anti-affiliation law (*Owensboro National Bank v. Stephens*), and a review by the U.S. Supreme Court is expected.

The Louisiana Court of Appeals upheld a state law that limits bank insurance sales in the state (*First Advantage Insurance, Inc. v. Green*). The court held that McCarran-Ferguson protects a state law that prohibits banks from selling insurance (except for credit life, credit health, and accident insurance) from preemption by the National Bank Act. *AB, 4/12/95, p. 3; BBR, 4/3, p. 693; 3/13, p. 541.*

Courts Rule on Retirement Account

A federal judge in New Mexico prohibited the state insurance regulator from interfering with a national bank's sale of the retirement CD (*First National Bank of Santa Fe v. Chavez*). The retirement certificate of deposit is a FDIC-insured product that is similar to an uninsured annuity. A customer makes one or a series of payments into a tax-deferred account and after reaching a designated age receives regular lifetime payments from the bank. In January the U.S. Supreme Court ruled in the Valic case (see this *Review*, Spring 1995, p. 39) that selling annuities is "incidental" to banking and a permissible activity under the National Bank Act. *AB, 2/21/95, p. 2.*

A judge in the U.S. District Court in Illinois ruled that the retirement CD is an annuity, and therefore should be regulated as an insurance product. *AB, 6/6/95, p. 18.*

Loans to Distributor of Bank's Mutual Funds

The OCC issued a no-objection letter with respect to a proposed financing arrangement under which Crestar Bank, N.A., Washington, DC, would provide loans to the distributor of the bank's mutual funds to finance the payment of brokerage commissions to a brokerage affiliate of the bank. The OCC's decision was made contingent upon the loans being structured on terms and conditions substantially the same as loans and extensions of credit provided to other nonaffiliates, and that any such loan be fully collateralized by a cash deposit or an equivalent amount of U.S. Government securities. *Letter Regarding Proposed Financing Arrangement, OCC, 3/13/95.*

Decision on Bank Officer's Services Not Reviewable

The U.S. District Court for Kansas ruled (*Hammond v. OCC*) that it lacked jurisdiction to review an OCC decision disapproving a proposed appointment of an executive to serve as president, chief executive officer, and a board member of a national bank. The OCC said the individual lacked the necessary integrity for the positions, having engaged in a tying violation while president of another bank. *BBR, 4/17/95, p. 795.*

Tying Restrictions

The OCC reminded national banks of their obligations under the antitying law, whose purpose is to keep banks from using bank credit and other services to coerce customers and reduce competition. The guidance includes, among other things, examples of tying arrangements that, unless exempted by the Board, are prohibited. For example, a bank may not condition the extension of credit or the reduction of the price of credit on the customer purchasing credit-related insurance from the bank. Also included are suggested systems and controls, and suggested audit and compliance programs. *Bulletin No. 95-20, OCC, 4/14/95.*

Bank Reports Do Not Violate Privacy Laws

A U.S. district court in Texas ruled that Marfa National Bank, Marfa, TX, was not violating financial privacy laws, but was complying with the Bank Secrecy Act when it reported two depositors suspected of engaging in actions to avoid coverage by the bank's currency transaction reports. *AB, 6/22/95, p. 9.*

Community Development Bank Chartered

The OCC issued a charter to Neighborhood Development Bank, N.A., which will serve the low- and moderate-income and minority neighborhoods of southeast San Diego, CA. The institution is the first bank focusing on community lending to be federally chartered, and an application has been filed with the Federal Reserve to establish a holding company, Neighborhood Bancorp. The bank will seek funding as a community development financial institution under the CDFI Fund, which was created by the RCDRIA. The OCC has granted approval for Wells Fargo Bank, N.A. to make an equity investment in both the bank and the proposed holding company. *BBR, 2/13/95, p. 316.*

Appraisals For Affordable Housing Loans

In a joint policy statement, the OCC, the OTS, the FDIC, and the FRB clarified that federally regulated financial institutions should ensure that appraisals of affordable housing projects consider and discuss the effect of certain types of financial assistance, such as low-income housing tax credits, subsidies and grants on the estimate of market value for such projects. Such financial assistance creates an incentive for developers and investors to undertake the project. When the benefits of such financial assistance are not appropriately reflected in the project's appraisal, the estimated cash flow of the project is negatively affected, resulting in a lower market value, and a loan-to-value ratio that may be too low to meet supervisory standards. The apppraisal should discuss the value of the financial assistance that would survive sale or foreclosure, and consider the effect of financial assistance that does not necessarily transfer to new ownership, when applicable. *Joint Release, OCC, FDIC, FRB, OTS, 3/10/95.*

Agency to Request Feedback on Examination Process

The OCC will begin surveying bankers at the conclusion of each examination to get their immediate feedback on how well the agency is doing its job in areas such as the effectiveness of its communications with banks, the reasonableness of agency requests for data and information, the quality of examiners' decision-making during the exam process, and quality of written exam reports. Completing the survey is voluntary; however, bankers will be asked to fill in their name in order to facilitate follow-up work by the OCC. The survey forms will be sent directly to the agency's Ombudsman, who will be responsible for analyzing and summarizing the responses. *News Release, OCC, 4/17/95.*

Approvals For Interstate Branching

Federal banking law dating from 1886 allows a national bank to move its main office up to 30 miles, even across a state line, and the OCC has approved the operation of the former main offices, following the moves, as branches. Among the recent approvals under this authority were: PNC Bank, Northern Kentucky, will move from Ft. Mitchell, Kentucky to Cincinnati, Ohio, combining two subsidiaries into a single Ohio bank with> ten Kentucky branches and 60 Ohio branches; NationsBank Middle Atlantic will move from Bethesda, Maryland to McLean, Virginia, consolidating subsidiaries into a single Virginia bank with branches in Virginia, Maryland and the District of Columbia; American National Bank and Trust Company of Wisconsin will move its main office from Genoa City, Wisconsin to Libertyville, Illinois, merging into an Illinois bank that will have 20 branches in Illinois and Wisconsin. The 30-mile rule has been used by about a dozen banks in the past year, and the OCC expects about the same number of applications in 1995. In recent approvals the OCC has argued that state laws prohibiting out-of-state banks from owning branches violates the U.S. Constitution's commerce clause, and also that these laws are preempted by federal law. *AB, 3/13/95, p. 2; 3/20, p. 2.*

Interpretive Rulings: Additions, Eliminations, Revisions

The OCC is proposing to revise the interpretive rulings that appear in part 7 of Title 12 of the Code of Federal Regulations. This proposal updates and streamlines OCC regulations and seeks to eliminate regulatory requirements that impose ineffective, inefficient and costly regulatory burdens on national banks. *FR, 3/3/95, p. 11924.*

Comments Sought on Various Issues

Among the issues on which the OCC is seeking comments are permitting banks to sell their excess data processing capacity, whether to prohibit states from barring national banks from engaging in actions permitted by federal rules through the use of restrictive licensing laws, and expanding the definition of interest rates that national banks may charge by including annual fees, late fees, and other fees. *AB, 3/3/95, p. 1.*

Disclosures of Information

The OCC proposed clarifications and technical amendments to its rules relating to the availability and release of information to update and streamline its regulations and reduce unnecessary regulatory costs and other burdens. *FR, 3/27/95, p. 15705.*

History Text Reissued

First published in 1968, *The Comptroller and Bank Supervision: A Historical Appraisal* has been reissued. The updated version includes a discussion of the changes in banking that have occurred over the past 30 years and the many legislative and regulatory changes that have shaped the current banking environment. *News Release, OCC, 6/12/95.*

Treasury Shortens Currency Transaction Report

The Treasury Department has revised the report that banks must file on their currency transactions exceeding $10,000, effective October 1 of this year. The new report will be more than one-third shorter than the former one. The box item used for reporting suspicious transactions will be eliminated, and instead banks will use for this purpose the criminal referral form, which also is being revised. Banks will no longer be required to identify the number of $100 bills involved in transactions covered by the report. While the old form required the signatures of two employees, in the future only one signature will be needed. *AB, 5/18/95, p. 9.*

Office of Thrift Supervision

Simplified Application For New Thrifts

The OTS proposed a simplified rule that would reduce the paperwork and administrative costs imposed on organizers of new federal savings associations and federal savings banks. The standard initial capitalization would formally decrease from $3 million to $2 million, the same as the requirement for deposit insurance imposed by the FDIC. The OTS would reserve the right to impose higher or lower initial capital requirements on a case-by-case basis. *NEWS, OTS, 3/6/95; FR, 3/6/95, p. 12103.*

Calculations For Loan Limits Are Simplified

The OTS is amending, effective March 28, 1995, its loans-to-one-borrower rule, to reflect recent changes to the OCC's lending limits regulation. The Home Owners' Loan Act requires that savings association lending limits parallel those applicable to national banks. This interim final rule amends OTS' regulation so that thrifts, like national banks, will use regulatory capital as the starting point for determining "unimpaired capital and unimpaired surplus" for LTOB purposes. The revised rule allows savings associations to figure loan limits by using the same calculations they already make to determine capital adequacy. Thus, thrifts avoid having to complete a complex extra worksheet and like national banks will find it substantially easier to calculate lending limits. The changes also remove other outdated or redundant provisions. *NEWS, OTS, 3/28/95; FR, 3/28. p. 15861.*

Community Development Investments

The OTS will not take enforcement action against thrift institutions for making investments in projects outside areas receiving "concentrated development assistance" under Title 1 of the Housing and Community Development Act (HCDA), provided certain standards are met. Federal associations no longer need to apply to the OTS for case-by-case no-action letters for investments that meet the investment standards. Associations may participate directly in real-estate investments that meet the standards and in a limited partnership or corporation that invests exclusively in real-estate investments that meet the standards. Among the standards set forth are: the investment must be located in a Title 1 Community Development Block Grant entitlement community, in a nonentitlement community that has not been specifically excluded by the state in statewide submissions for CDBG funds, or in an area that participates in the Small Cities Program; and the investment must be made in a residential housing project that benefits low- and moderate-income persons. In regard to investments that do not meet the standards, but that are consistent with program objectives embodied in the Home Owners' Loan Act, associations may continue to seek case-by-case OTS no-action review by the chief counsel. *NEWS, OTS, 6/7/95.*

Court Rules on Capital Agreements

The U.S. Court of Appeals for the District of Columbia, in a case involving the failed Great Life Savings Association of Sunrise, Florida, ruled that the OTS cannot compel compliance with capital infusion agreements made with buyers of troubled thrifts unless it shows that the buyer has been "unjustly enriched." Before 1990, purchasers of thrifts were required by regulators to guarantee that the institutions would always be fully capitalized. *AB, 7/19/95, p. 4.*

Release of Unpublished Information

The OTS issued a final rule describing the procedures that requesters must follow to obtain unpublished information by document or testimony and the criteria on which the agency will evaluate requests for such information. The rule includes requests for release of records that are exempt from disclosure under the Freedom of Information Act (FOIA), such as examination and related reports, and information relating to the business operations and finances of individual savings associations. Requesters who obtain unpublished OTS information may not disclose such information without the agency's authorization. The final rule, for the first time, authorizes savings associations to release their examination reports and related supervisory correspondence to their holding companies, and similarly authorizes holding companies to release their examination reports and related supervisory correspondence to their subsidiary savings associations. Reports and other information released under this rule remain the property of the OTS, regardless of where such reports or information are physically located. FR, 5/30/95, p. 28027.

Filing Fee Changes

The OTS has reduced fee levels for certain applications to more accurately reflect the agency's actual processing costs. Fees are lowered for Permission to Organize applications and Holding Company applications, and the fee is eliminated for processing service corporation applications for participation in Community Development Corporations. OTS' policy on the waiver of filing fees is clarified. *Thrift Bulletin 48-13, OTS, 3/31/95.*

Thrift to Offer Services on the Internet

The OTS gave approval for Cardinal Bancshares, Lexington, KY, to change a subsidiary, Security First Network Bank, Pineville, into an on-line bank serving customers on the Internet. The bank will offer services similar to those available from some banks by telephone. While a number of banks now offer information about their services on the Internet, Security First is unique in that it plans to do most of its business on-line, and will use the Internet for actual checking account transactions, not just information. Requirements to be imposed by the OTS include company-paid independent tests of certain security systems, and a report from the bank in six months on its lending to low- and moderate-income applicants, and precise definition of the community it is serving. Security First plans to make checking accounts the focus of its Internet operations and restrict its lending chiefly to the rural southeastern Kentucky county where it will maintain its only brick-and-mortar branch. *AB, 5/12/95, p. 3.*

Federal Financial Institutions Examination Council

Guidelines For Relying on State Examinations

The FFIEC adopted guidelines, effective on June 27, 1995, that establish standards for determining the acceptability of state reports of examination. A federal banking agency may conduct an annual, on-site examination of an insured depository institution in alternate 12-month periods (except those insured institutions with total assets of less than $250 million for which an 18-month examination cycle is permitted) if the federal banking agency determines that a state examination of that institution conducted during the intervening period is adequate.

The federal and state banking agencies have worked together, to varying degrees, in several areas, among which are conducting alternate, joint and concurrent safety-and-soundness examinations; processing examination reports and applications; using common examination report and application forms; and developing and issuing informal and formal enforcement actions. Currently, the federal banking agencies, individually, have entered into formal or informal arrangements or working agreements with most state banking departments in a number of supervisory areas, among which are the number of institutions to be examined on an alternating basis; the frequency of safety-and-soundness examinations; the type of examinations to be conducted (independent, joint, or concurrent) by each agency; and the responsibilities of each agency for processing reports of examination, and for conducting specialty examinations (compliance, information systems, trust, *etc*.).

Under the guidelines, the federal banking agencies will accept and rely on state reports of examination in all cases in which it is determined that state examinations enable the federal banking agencies to carry out effectively their supervisory responsibilities. Among the criteria that may be considered in determining the acceptability of a state report of examination are the completeness of the examination report; adequacy of documentation; and the adequacy of any formal or informal arrangement or working agreement between a state banking department and a federal banking agency. *FR, 6/27/95, p. 33206.*

Home Loans to Minorities Up Sharply in 1994

Disclosure statements from more than 9,800 lenders (including commercial banks, savings associations, credit unions, and mortgage companies) covered by the Home Mortgage Disclosure Act (HMDA) show that the number of their conventional home purchase loans rose in 1994 from 1993 by 27.0 percent for lower-income households, and 12.5 percent for the highest income households, the FFIEC reported. The numbers increased by 54.7 percent for blacks, 42.0 percent for hispanics, 23.8 percent for native Americans, 18.6 percent for Asians, and 15.7 percent for whites. Denial rates for those loans in 1994 were 33.4 percent for blacks (34.0 percent in 1993), 31.6 percent (27.8) for native Americans, 24.6 percent (25.1) for hispanics, 16.4 percent (15.3) for whites, and 12.0 percent (14.6) for Asians. The data suggest that the affordable home loan programs that mortgage originators have initiated in recent years --- to benefit low-income, moderate-income, and minority households and neighborhoods --- may be having an impact, the FFIEC said.

The FFIEC prepared and distributed the individual disclosure statements for lenders on behalf of its five member agencies and HUD. Upon request, lenders are required to make the statements available at their home office within three business days of receipt, and at certain branch offices in other metropolitan areas within ten business days of receipt. *Press Release, FFIEC, 7/18/95.*

Guide to HMDA Reporting

The FFIEC prepared an interim edition of the *Guide* to take account of amendments that the FRB adopted to its Regulation C in December 1994. 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 FFIEC will publish and distribute a more comprehensive edition of the *Guide* to HMDA respondents by year-end for use with 1996 data. The *Guide* was developed by the Department of Housing and Urban Development and member agencies of the FFIEC. *A Guide to HMDA Reporting --- Getting it Right!, FFIEC, March 1995.*

National Credit Union Administration

Corporate Credit Unions

The NCUA proposed a rule to strengthen the capital of corporate credit unions, reduce the risk of their investments, and improve asset-liability management. The rule would return corporate credit unions to their primary functions of serving as liquidity centers and service providers.

Specifically, the proposed rule would, among other things, limit corporate credit union membership to credit unions and other specified groups; restrict lending to member credit unions and limit lending to 100 percent of primary capital; set borrowing limits to meet liquidity needs at ten times capital or 50 percent of shares, whichever is less; and establish minimum primary capital at four percent, phased in over the next three and one-half years. Also, the proposal would require that 75 percent of overnight investments be matched with assets of similar terms; allow up to 25 percent of investments to be matched with variable-rate securities, with up to three-years maturity, that reprice monthly; require that term accounts be fully matched; and provide specific divestiture requirements. *"Letter to Credit Unions No. 168," NCUA, 4/24/95; FR, 4/26, p. 20438; 5/23, p. 27240; BBR, 4/17. p. 785.*

The assets, liabilities, and field of membership of Capital Corporate Federal Credit Union were acquired by Mid-Atlantic Corporate Federal Credit Union, of Harrisburg, PA. CapCorp had been operating under NCUA conservatorship since January 31, 1995 (see this *Review*, Spring 1995, p. 44). Losses from CapCorp's investment portfolio are estimated at about $61 million, all of which will be absorbed by its primary and secondary capital, with no loss to the National Credit Union Share Insurance Fund. *BBR, 4/17/95, p. 787.*

Divestitures of Risky Investments

The NCUA issued a clarification of its position on divestiture of Collateralized Mortgage Obligations (CMOs) and Real Estate Mortgage Investment Conduits (REMICs) that fail one or more parts of the high-risk securities test (HRST). A review by the agency of credit unions that have reported large investments in CMOs and REMICs indicated that 57 percent of these credit unions were holding at least one security that failed one or more parts of the HRST; 29 percent of these credit unions ran the HRST semiannually or less often; and 39 percent of the managers did not have an adequate understanding of the risks involved in these investments.

Federal credit unions are prohibited from purchasing fixed-rate CMOs or REMICS that fail any one of the three parts of the HRST, which are the average life test, average life sensitivity test, and price sensitivity test. When a credit union is holding securities that fail one or more parts of the HRST, it should immediately dispose of them *or*, within five business days of discovery, submit to the NCUA a written action plan. A credit union will be required to sell HRST-failed assets, in accordance with a written directive, if the examiner does not feel that a suitable action plan has been developed. *Letter to Credit Unions No. 169, NCUA, April 1995.*

Mergers or Conversions of Federally Insured Credit Unions to Non-Credit Union Status

The NCUA adopted with minor change the interim rule it issued in September 1994 (see this *Review*, Spring 1995, p. 44) with additional requirements to ensure an informed membership vote, to safeguard against potential safety-and-soundness problems and to prevent breaches of fiduciary duty. Key provisions are: NCUA Board approval is required in advance of any transaction whereby a federally insured credit union transfers all or any part of its members' shares or similar accounts to any non-credit union institution; a majority of all members of record must vote to approve the transaction; directors must agree to receive no benefits in excess of those available to the members; notice to members must be preapproved by the NCUA Board and must include all pertinent information required by the rule as well as any additional information deemed necessary on a case-by-case basis; FISCUs may only engage in the transaction if they obtain approval from the state authority to proceed with the merger or conversion; and FISCUs must follow the rule's provisions (part 708a) unless they obtain a waiver from the NCUA. *FR, 3/8/95, p. 12659.*

Credit Union Conversion to Savings Bank Approved

The NCUA approved the application of the $52.9 million-asset Lusitania Federal Credit Union, Newark, NJ, to convert to a federal mutual savings bank. It was the first such approval granted by the NCUA for a charter change, which would be transacted under the agency's rules in effect before the amendments that were adopted late last year. Only 20 percent of the credit union's total membership will be required to approve the conversion, while under the new rules a majority vote would have been necessary. If Lusitania's membership approves the conversion, the institution will be supervised by the OTS, and its deposits insured under the SAIF. *BBR, 5/29/95, p. 1054.*

Court Restricts CU Expansion

A U.S. District Court judge in Washington, DC ruled that the NCUA exceeded its authority when it permitted Communicators Federal Credit Union to expand its membership to anyone over 50 years old living or working within 25 miles of Houston, TX. In this case brought in 1994 by the Texas Bankers Association, the judge said NCUA's broad interpretation would render the common bond limitation meaningless. The NCUA has won previous court decisions involving credit unions taking into membership existing unrelated groups, each comprised of persons having a common bond within the group. The judge upheld the NCUA in allowing Communicators to add seven unrelated occupational groups, stating that where the law is "ambiguous" the courts must defer to the regulatory agencies. Communicators, originally sponsored by Southwestern Bell Telephone Co., now serves 93 different groups with a membership of over 38,000. *AB, 6/5/95, p. 1.*

Banks Can Sue Over CU Expansion

A judge in the U.S. District Court in Montana ruled that a group of seven banks in Montana can sue to negate an expansion in 1992 by the Missoula Federal Credit Union over a 3,600 square mile area in the western part of the state. The NCUA argued in the suit brought in 1993 that bankers did not have the right to sue because the Federal Credit Union Act was not designed to protect banks. The banks have " a competitive interest in limiting the expansion of MFCU pursuant to the common bond provision," the judge wrote. *AB, 4/17/95, p. 15.*

Appraisals

The NCUA proposed amending its regulation regarding the appraisals of real estate, adopted pursuant to Title XI of FIRREA, to clarify and expand the circumstances in which a Title XI appraisal is not required. The Board proposes to eliminate standards that parallel standards issued by the Appraisal Foundation, and to amend the regulation concerning appraiser independence to permit credit unions to use appraisals prepared for other financial-service institutions. Other parts of the proposal would simplify compliance for both credit unions and appraisers and reduce costs without affecting the reliability of appraisals used in connection with federally related transactions. *FR, 3/13/95, p. 13388.*

Incentive Compensation For CU Employees

The NCUA proposed to clarify its regulations that prohibit officials and certain employees of federally insured credit unions from receiving either incentive pay or outside compensation for certain activities related to credit union lending, and to authorize lending-related compensation in certain situations where it is currently prohibited, and to prohibit it in other situations.

The structure of the regulation would be changed to a broad prohibition, with specific exceptions, against an official or employee receiving compensation in connection with any loan made by the credit union. The proposal would allow loan officers to receive incentive pay; however, the incentives for making recommended or final decisions to approve or disapprove loans could not be based on the number or dollar amount of loans approved. The regulation also would require that the board of directors establish written policies and controls for any incentive plan and monitor compliance on at least a quarterly basis. *FR, 4/20/95, p. 19690.*

Guidelines For the Supervisory Review Committee

The NCUA issued a final Interpretive Ruling and Policy Statement, pursuant to the RCDRIA, concerning the establishment of an independent appellate process to review material supervisory determinations. In the final IRPS, which is effective March 22, 1995, a three-member supervisory review committee, and the time frames for committee action, are provided. *FR, 3/20/95, p. 14795.*

Operating Fee Exemptions

The NCUA proposed to exempt natural-person federal credit unions with assets of $500,000 and less from paying operating fees, and fees assessed on credit unions with assets between $500,000 and $750,000 would be cut by 40 percent. The NCUA currently does not assess operating fees on credit unions with assets of up to $50,000, which exempts only 59 institutions. The restructured operating fees would exempt a total of 839 credit unions, 780 of which currently pay an average fee between $100 and $117. An additional 349 institutions with assets of $500,000 to $750,000 would pay a minimum fee of $100, instead of the current average fee of $167. The total projected revenue shortfall from the proposed cuts in operating fees would be spread among all other federal natural-person credit unions. A $100 million-asset credit union is currently assessed $26,890 in operating fees, while a $500 million-asset credit union pays $265,000, which amounted to only .73 percent of their total operating expenses for 1994. *NCUA NEWS, 6/14/95.*

STATE LEGISLATION AND REGULATION

Interstate Banking/Branching

Interstate Regulatory Plan Developed

A plan developed by the Conference of State Bank Supervisors and approved by 45 state banking supervisors, would establish mechanisms to enable state-chartered banks to take advantage of the interstate banking provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, and be subject in respect to these activities to a single regulator. Implementation of the plan would be dependent upon states enacting the enabling legislation. Primary responsibility for conducting safety-and-soundness and compliance examinations would belong to an institution's home-state regulator, but the home state would coordinate its activities with the host states and federal authorities, and would use host-state examiners. The home state would share examination information and reports with the host state and federal regulators. The home state would have authority over applications for new branches, bank powers and mergers, subject to certain requirements involving analysis of the antitrust impact in the host state and compliance with its laws, and consultation with other regulators before approving any actions in other states. *AB, 5/9/95, p. 2.*

Alabama: A new law enacted pursuant to the Riegle-Neal Act allows nationwide banking, effective September 29, 1995. It permits interstate branching through merger and acquisition as of May 1997. *BBR, 6/5/95, p. 1089.*

Colorado: The Governor signed a bill that allows interstate branching in the state after June 1, 1997. The new law prohibits "*de novo*" interstate branching, and allows out-of-state banks to buy only branches that have existed for at least five years. *BBR, 5/29/95, p. 1050.*

Connecticut: The Governor signed legislation that "opts-in" under the Riegle-Neal Act, permitting merger transactions between in-state and out-of-state banks, and allowing *de novo* interstate branching. A five-year age limitation is imposed on target institutions, and a 30-percent limit on concentration of deposits in both interstate and intrastate acquisitions, mergers, and consolidations. *BBR, 7/17/95, p. 107.*

Idaho: A new law, to be effective July 1, 1995, allows out-of-state banking firms to convert banks they own in the state into branches. Under the Riegle-Neal Act, a bank holding company may convert a bank into a bank branch unless the state in which the bank is located enacts "opt-out" legislation before June 1, 1997. Continuing existing Idaho banking provisions, the new law does not permit *de novo* entry, only entry by acquisition. Also, it does not allow the purchase of branches only, the entire bank must be purchased. *BBR, 3/20/95, p. 589.*

Maryland: The legislature passed an "opt-in" bill which, if signed by the Governor, would become effective on September 29, 1995. Contingent upon reciprocity, an out-of-state bank could branch in Maryland either *de novo* or by acquiring an existing branch. *AB, 4/13/95, p. 9.*

Minnesota: A new law requires banks to be at least five years old before they are eligible to be purchased by out-of-state banking organizations. The law also places a 30-percent deposit cap on interstate banking operations. *Northwestern Financial Review, 6/3/95, p. 21.*

North Dakota: A recently enacted law "opts-in" under the Riegle-Neal Act by allowing interstate branching by consolidation after May 31, 1997. The law removes certain existing restrictions on interstate banking, including requirements for reciprocity, and lending commitments from out-of-state bank holding companies acquiring in-state banks. The legislation also expands intrastate banking by permitting banks to establish a "facility" anywhere in the state, starting August 1, 1996, and with no limit on the number of "facilities" a bank may have. "Facilities" will include bank paying and receiving stations, drive-in/walk-up facilities and banking offices. In-state commercial banks are permitted to purchase branches of savings-and-loan associations that were in existence on March 1 of this year and convert them into their own branch facilities. *BBR, 5/1/95, p. 869.*

Oregon: Oregon became the first state to enact "opt-in" legislation under the Riegle-Neal Act. The state's law went into effect on February 28, 1995. *BBR, 3/13/95, p. 535.*

Pennsylvania: An "opt-in" law, taking effect immediately, allows out-of-state banks to branch into the state either by acquisition or *de novo*, with a reciprocity requirement until June 1, 1997. State-chartered banks are given the same rights as national banks to branch into other states that allow interstate branching. *AB, 7/25/95, p. 10.*

Tennessee: The legislature voted "opt-in" legislation to be effective June 1, 1997, under the Riegle-Neal Act. *BBR, 4/24/95, p. 820.*

Texas: The Governor signed legislation that prohibits out-of-state banks from branching into Texas until at least September 1999, when the issue again will be taken up by the legislature. Texas allows out-of-state banking organizations to operate in the state through separately chartered banks. Texas banks will be able to branch outside the state in cases where federal regulators approve national bank 30-mile relocations. *BBR, 5/1/95, p. 868; AB, 5/12, p. 6.*

Utah: The Governor is expected to sign an "opt-in" bill that would take effect June 1, 1995. The bill prohibits *de novo* branching, and requires that an institution be at least five years old before being acquired by an out-of-state bank. *BBR, 3/13/95, p. 535.*

Virginia: New legislation creates a procedure for out-of-state banking firms to establish branches in the state beginning July 1, 1995, if those banks' home states have similar procedures allowing entry by Virginia banks. *BBR, 4/10/95, p. 747.*

Lending Limits

Iowa: Revisions in the state's banking code, now awaiting the Governor's signature, set the lending limit for state-chartered banks at 15 percent of their aggregate capital, defined as common and preferred stock, surplus, undivided profits, and loan-loss reserves. Banks could use another ten percent of aggregate capital to make loans on breeder livestock, in addition to the 15 percent general lending limit. *AB, 4/17/95, p. 9.*

Interest-Rate Restrictions Eliminated

Maine: A new law allows the state's banks to export interest rates into other states, and also deregulates bank credit-card fees. The revised credit code is now similar to Delaware's, putting Maine in a position to become a location for credit-card issuers. The new law identifies specific allowable credit-card charges, such as periodic charges, transaction charges, and late fees, and treats them as interest so they can be exported. A major reform law last year eliminated an 18-percent ceiling on interest rates, and the $12 maximum on annual fees, and replaced a prohibition on late fees with a five percent or $10 maximum fee. *BBR, 6/5/95, p. 1087.*

Lenders Allowed to Own Insurance Agencies

Michigan: A new law regulates the relationship between insurance firms and financial institutions, and in some cases allows lenders to own agencies and sell insurance. A lender may not require a borrower to buy any policy through a particular agency, nor may a lender fix or vary the terms of a loan as an inducement to purchase insurance. A lender generally is not allowed to require a person to buy any insurance product from the lender or an affiliate as a condition of making a loan. Among other provisions, lenders are allowed to provide names, addresses and similar information to agents or affiliated agencies, but cannot disclose account information or documents such as credit reports and financial statements. *BBR, 1/23/95, p. 176.*

Savings Bank Powers

Minnesota: The Governor signed a bill that updates state-chartered savings association laws. The state has 16 federal savings banks and no state-chartered savings banks. Savings banks are granted powers similar to powers possessed by the state's commercial banks. *Northwestern Financial Review, 6/3/95, p. 21.*

Securities Losses Cause For Concern

Minnesota: The Commerce Commissioner warned the 411 state-chartered banks that those with unusually high depreciation in securities portfolios or suspected of speculating "will receive special attention in examinations or targeted visitations." In part because of rising interest rates, the banks' portfolios shrank in 1994 by 3.5 percent. State officials emphasized that no individual banks are in danger at this time. They are concerned, however, that some banks have invested in sophisticated products such as financial derivatives without adequate knowledge about these instruments. *AB, 3/1/95, p. 9.*

Loan Limits, Charter Conversions

Mississippi: The Governor signed legislation, effective March 8, 1995, designed to clarify, modernize and improve various regulations that apply to commercial banks chartered by the state. Among the regulations involved are those governing loans to insiders, single-borrower loan limits, conversions of national banks to state-chartered banks, requirements applicable to the acquisition of branches, and conversion from federal savings associations to state-chartered associations. The mandatory examination cycle is lengthened from 12 months to 18 months. *The Mississippi Banker, May 1995, p. 6.*

Subsidized Loan Program

New York: Recently enacted legislation extends the state's linked-deposit loan program until April 1, 1998, and allows savings banks and savings-and-loan associations to participate. Under the program the state accepts below-market interest rates on certain state deposits in commercial banks that agree to make low-interest loans to small businesses. The program thus far has provided 155 small-business loans amounting to $66 million. *BBR, 4/24/95, p. 821.*

Constraints on Accountant Liability Suits

New Jersey: A new law makes accountants liable only for those financial statements they approve in writing for a specific user. Thus, each time anyone other than the client intends to use such a financial statement, the written verification procedure would be required. *AB, 4/20/95, p. 20.*

Environmental Liability

Michigan: A new law, revising legislation enacted in 1989-1990, changes the focus from ownership status to causation in creating environmental liability. Among other changes, the law revises the degree of cleanup that will be required based on the intended use of the property. *Legislative-Legal Bulletin, Michigan Bankers Association, 6/5/95, p. 2.*

Mississippi: The Governor signed legislation, effective July 1, 1995, that addresses lender liability and creates a limited environmental self-evaluation privilege. The limited privilege concerns the discovery or admissibility of information relating to voluntary self-evaluations in judicial and administrative proceedings. The state's existing penalty policy is amended to include a new and substantial mitigating policy for voluntary self-disclosure of non-compliance. The privilege does not apply in cases of fraud and in certain other cases. Mississippi became the eleventh state to enact environmental self-evaluation privilege/voluntary self-disclosure legislation, and the fourth state to allow voluntary self-disclosure to count as a mitigating factor. *BBR, 4/17/95, p. 782.*

Pennsylvania: Under a new law, lender environmental liability is changed from strict, joint and several liability to a direct causation standard. Instead of a "participation in management" concept, the new law holds a bank liable if the lender or its agents directly cause an immediate release or directly exacerbate a release of a regulated substance, or the lender or its agents knowingly and willfully compelled the borrower to take an action that caused an immediate release or violated a state environmental law. *BBR, 6/12/95, p. 1153.*

Texas: A new law, effective on signing, will protect companies that voluntarily disclose environmental violations found in self-audits from criminal, civil, or administrative penalties, provided they correct the non-compliance within a "reasonable" period of time. A decision by an administrative hearing officer that an audit is, or is not, privileged may be appealed in state district court. Thirteen other states have environmental audit privilege laws, including eight that have taken action in 1995. *BBR, 6/5/95, p. 1103.*

Banking Laws Updated

Texas: A new law, effective September 1, 1995, generally updates and recodifies the existing banking code. Among substantive changes is the elimination of the three-member Banking Board and transfer of its bank-chartering authority to the banking Commissioner. *BBR, 7/3/95, p. 18.*

New Banks

West Virginia: Citizens Southern Bank, Beckley, opened for business on June 12, the first new bank in the state in the past thirteen years. At least three more banks are being organized and expect to open soon. Among the reasons for the renewed interest in new banks is the turnaround in the economy of the state. The number of banks in West Virginia has declined to 140 from 235 a decade ago. The fact that most communities are now being served by branches of regional institutions has created opportunities for more locally owned banks, the organizers believe. *AB, 6/16/95, p. 7.*

BANK AND THRIFT PERFORMANCE

Commercial Banks' Earnings Strong in First Quarter

FDIC-insured commercial banks reported net income of $11.1 billion (preliminary) in the first quarter of 1995, an increase of nearly $400 million from the previous three months. This followed record earnings of $44.7 billion for the year 1994, up by 3.7 percent from 1993. The main contributors to the improved earnings in the quarter were reductions in certain expense items, including noninterest expenses, securities losses, and provision for loan losses. Net interest income declined slightly, but still was $2.5 billion higher than in the same quarter a year ago.

Assets of insured commercial banks grew by 2.6 percent in the first quarter to $4.1 trillion. The increase in commercial and industrial loans of $32.7 billion was the largest quarterly increase in the more than 20 years that banks have reported quarterly loan data. The C&I loan growth was evident in all regions, but the largest share occurred at banks in the Northeast Region, while overall loan growth was strongest in Southeast Region banks. Banks' securities holdings declined for the fourth consecutive quarter, falling by $9.7 billion, most of which was in mortgage-backed securities. Noncurrent loans were up by $1.6 billion to $32.2 billion, the first quarterly rise since the first quarter of 1991. Most of the increase was in noncurrent real- estate loans, a substantial portion of which resulted from a new accounting rule (FASB 114) that caused some banks to report as nonaccrual loans assets that were previously reported as other real estate owned (OREO).

Total deposits at insured commercial banks fell slightly in the quarter, due to declines in demand and savings deposits in domestic offices, while deposits in foreign offices and time deposits in domestic offices both increased. A $105-billion rise in nondeposit liabilities was attributable mostly to higher trading account liabilities concentrated in a few large banks. Equity capital climbed by $12.1 billion in the first quarter to $324.2 billion, one-third of the increase resulting from new GAAP accounting rules. Banks' unrealized losses on available-for-sale securities, which under the new rules are deducted from equity capital, fell by $6.3 billion during the quarter, producing a $4.1 billion rise (net of tax effects) in equity capital. The ratio of equity capital to assets was 7.88 percent at the end of the quarter.

The number of insured commercial banks reporting financial results declined by 209 during the first quarter to 10,241. The number of banks absorbed through unassisted mergers and consolidations rose to 228, a quarterly high, over four-fifths of which resulted from consolidations within bank holding companies.

There were 215 commercial banks on the FDIC's "Problem List" on March 31, down from 247 at year-end 1994, and 383 a year ago. The assets of the problem banks totaled $27 billion, compared to $33 billion at year-end 1994 and $53 billion on March 31, 1994. Six insured banks, with assets totaling $867 million, have failed in 1995 (through July 31). *FDIC Quarterly Banking Profile, First Quarter 1995; PR-40-95, FDIC, 6/14/95.*

FDIC-insured, private-sector savings institutions earned $1.7 billion (preliminary) in the first quarter of 1995, up by $122 million from the fourth quarter and $448 million higher than in the first quarter of 1994. Earnings for the year 1994 totaled $6.4 billion. Over 94 percent of all savings institutions were profitable in the first quarter.

Industry assets rose by $5.2 billion in the quarter to $1.0 trillion, marking the third consecutive quarterly increase. The largest growth category was loans secured by 1-4 family residential properties. Deposits rose by $7.4 billion, the first quarterly increase since 1988. Other borrowed funds declined for the first time since 1992. Equity capital rose by $1.8 billion during the quarter, as thrifts retained over $900 million of their earnings, and also they reported an increase of $1.1 billion in the fair value of available-for-sale securities. The industry's first-quarter capital ratio of 8.07 percent was the highest since 1952. Noncurrent real-estate loans as a percent of total real-estate loans declined to 2.10 from 2.19 at the end of 1994, and 3.18 in the first quarter of 1994.

The number of savings institutions declined during the first quarter by 34 to 2,118, as takeovers by commercial banks and consolidation within the industry continued. Following 27 conversions from mutual to stock ownership, the number of stock-owned thrifts exceeded mutuals, with 1,066 institutions holding $830 billion in assets, compared to 1,052 mutuals holding $184 billion in assets. Seventy-one savings institutions with $39 billion in assets were on the FDIC's "Problem List" on March 31, both numbers unchanged from year-end 1994, and down from 118 institutions with assets of $89 billion in the first quarter of 1994.

Banks' Loans Grew Faster Than Securities in 1994

Half of the 117 bank investment managers surveyed by the American Bankers Association reduced their securities portfolios as a percentage of total assets last year, while only 23 percent increased the securities percentage. Analysts said that excess liquidity and low loan demand in the banking system in 1990-1993 were reversed in 1994. *AB, 4/3/95. p. 1.*

Banks Raise Mutual Funds Market Share

The assets of bank-managed mutual funds grew 7.3 percent in the first quarter of this year, exceeding the 6.2 percent growth rate of the mutual funds industry. The first-quarter increase brought the banks' share of the $2.3 trillion mutual fund business to 14.3 percent, up from 10.5 percent in March 1994. Most banks reportedly have been building mutual fund assets by reorganizing trust assets and acquiring mutual fund management companies. According to a survey prepared for the *American Banker*, Mellon Bank Corp., PNC Bank Corp., and NationsBank are the top three bank mutual fund management companies.

While the recent growth in mutual funds managed by banks, and the industry, has been strongest in equity funds, money-market mutual funds represent 57.8 percent of bank-managed mutual fund assets, compared to 29.5 percent for the mutual funds industry. Banks generally are said to be attempting to move closer to the industry average because of the higher potential profits in stock and bond funds. Of the 115 banks with proprietary mutual funds, 55 had less than $1 billion in fund assets under management at the end of March. Some of the smaller organizations may depart from the industry because of insufficient diversification and other reasons. *AB, 5/10/95, pp. 1, 23.*

Small Banks to Reduce Derivatives Investments

While 84 percent of more than 800 community banks recently surveyed currently invest in financial derivatives, less than 60 percent plan to invest in these instruments in the future. The complexity of financial derivatives and sharp declines in portfolio values with rising interest rates are seen as principal reasons for the decline. The largest decline expected is for structured notes, which is one of the more complex kinds of derivatives, and which also has had the most growth in the past year. *AB, 5/16/95, p. 1.*

Bank Fee Increases Exceed Inflation, Study Says

The annual maintenance costs to consumers for interest-bearing checking accounts rose by 11 percent, to $219, between 1993 and April 1995, and the costs for regular checking accounts rose ten percent, to $202, according to a study by the U.S. Public Interest Research Group. Among other findings, maintenance fees for savings accounts increased nine percent, to $31 a year, and the average checking-account balance required to avoid fees increased by 30 percent, to $1,242. Surveying 271 banks in 25 states and the District of Columbia, the highest fee states were reported to be Maryland, Florida, North Carolina, and Illinois, and also the District of Columbia, while the lower fees were found in Hawaii, Idaho, New Mexico, Maine and Washington. The American Bankers Association disputed the study's results, noting the survey's limited coverage, and the fact that the data do not reflect service quality improvements, and also the rising costs of administering consumer deposits which are making some accounts unprofitable. *WSJ, 8/9/95, p. A2.*

Credit Unions' Asset Growth Slows

Total assets of federally insured credit unions increased 4.5 percent in 1994, the smallest rate of growth since 1948. In the last six months, assets fell slightly, from $289.7 billion at midyear to $289.5 billion at year-end. The profitability of federally insured credit unions declined during 1994, as measured by a fall in the ratio of net income to average assets to 1.2 percent from 1.4 percent in 1993. There were 588 credit unions reporting a net loss in 1994, an increase of 58 from 1993. First-quarter 1995 data for the 1,160 federally insured credit unions with assets over $50 million show a two percent increase in assets to $206.4 billion. These institutions experienced a slight decline in return on assets in the quarter, from 1.2

percent to 1.1 percent, while their capital-to-assets ratio rose to 10.1 percent from ten percent. *Letter to Credit Unions No. 166, NCUA, March 1995; NCUA NEWS, 6/2/95.*

Bankers Surveyed on Regulatory Burden

According to the results of a recent survey by KPMG Peat Marwick, the Community Reinvestment Act and Fair-Lending are at the top of regulations that bankers consider to be the most burdensome. The three regulatory areas next in order of perceived burden are asset quality, truth-in-lending and truth-in-savings. Ninety-one percent of bank CEOs said the CRA was their first choice for regulatory reform, and 96 percent believed the Act should be extended to nonbank financial-service companies. Eighty percent of the CEOs said they had reviewed fair-lending policies and procedures for discrimination, however only 23 percent have tested their bank by using mystery shoppers, while 43 percent have done a quantitative analysis of application and loan files. A total of 1,311 banker questionnaires were sent out and 660 were completed and returned. *AB, 3/23/95, p. 16.*

Minority Discrimination Case Settled

Northern Trust Co., Chicago, and three suburban affiliates agreed to pay $566,500 to minorities to settle a Justice Department complaint that, in 1992 and 1993, Northern's employees made special efforts to qualify white applicants for mortgage loans but did not give similar assistance to minority applicants. The firm does not believe it violated the law, an official said. It was the sixth major fair-housing case filed and settled by the Justice Department, and is said to be unique in that Justice documented it with a review of individual loan files, rather than with statistical analyses. A Justice official said the message from the case is that "institutions should look at the procedures they use to process applications for financing and make sure they are affording minority applicants an opportunity to present qualifications that is comparable to the opportunity being afforded to white applicants." *AB, 6/2/95, p. 1.*

ATM Use Continues Growth

A telephone survey in six states --- Arkansas, Louisiana, Texas, Oklahoma, New Mexico and Colorado --- found that 60 percent of persons having a checking or savings account with a financial institution have an ATM card, up from 49 percent in 1993. The increase occurred in all states surveyed, among all age categories, both genders, and in all types of financial institutions. Cardholders used their card 3.47 times during a two-week period to make purchases this year, up from 1.62 times during the same period in 1993. *Texas Banking, June 1995, p. 9.*

RECENT ARTICLES AND STUDIES

Efficiency Improvement From Mergers Is Questioned

This study by Tanya Azarchs, published by Standard & Poor's, analyzes the results of mergers involving the nation's 30 largest banking companies, to determine whether these transactions resulted in increases in efficiency in the surviving institutions. Comparing institutions that merged with those that did not, using data for 1990 through 1994, the study found no advantages in efficiency, as defined here, that could be attributed specifically to the mergers. While cost savings occured in many cases, the author generally believes these benefits could have been realized by management implementation without mergers.

Expense/income ratios for the general population of banking organizations show that the ratios each year of firms having assets of $100 million or less were much higher than the industry average of about 70 percent. Beyond $1 billion in assets, increasing size does not appear generally to result in further cost efficiencies. The firms in the study group that had undergone significant mergers were not more efficient than those not involved in mergers, and the most efficient institutions were not more likely to be among those that merged. The non-merging firms generally experienced the greatest improvement in efficiency during the period. One of the benefits from mergers is that they can provide a politically acceptable justification and opportune situation for implementing what are otherwise very difficult cost cuts. However, the "real" benefits are more likely to be those that can result from a company's diversification --- an important factor in S&P ratings --- or the enhancement of market position where being a leader in a product line has tangible benefits such as enabling the firm to charge premium prices or attract clients. *Standard & Poor's Creditweek, January 2, 1995.*

Interstate Banking: Experience in Three States

This GAO report to Congress discusses interstate banking in three states --- California, Washington and Arizona --- that have allowed both interstate and intrastate banking for a number of years. The report evaluates the experience in these states, for the period 1985 through mid-1993, to determine whether their interstate banking laws have had any effect on the market share and number of large banks, the viability of the smaller banks, and the availability of credit to small businesses. *Interstate Banking: Experiences in Three States, U.S. General Accounting Office, December 1994.*

Outlook For Debit Cards

Debit cards have been the greatest disappointment thus far in the payments revolution but may be turning the corner, say Gordon H. Sellon, Jr. and John P. Caskey in this article. The authors analyze the factors that have limited the success of debit cards and examine prospects for their future growth. The failure of debit cards to reach their usage potential has resulted largely from, first, coordination issues among payments system participants that affect incentives to adopt new payments technology, and second, the inefficient pricing of existing methods of payment.

For the debit card to replace existing payment methods, not only must the merchant accept it, consumers must be willing to use it for retail purposes. Based on convenience and other non-cost factors, debit cards could replace cash transactions for some consumers, for example, because they find carrying a debit card to be more secure compared with checks. A debit card can be faster in checkout time, while checks have an advantage in delayed clearance, and they also permit more detailed recordkeeping. Some convenience users of credit cards could find advantages in debit cards in avoiding having to write monthly settlement checks, and making it easier to enforce personal budgets. Also, some retail stores permit personal debit card holders to receive cash, which is rarely permitted with credit cards. In summary, the outlook for acceptance of debit cards by consumers is believed to be the most favorable where they value its convenience, and with consumers who have limited access to existing payments media.

The acceptance of debit cards by merchants is more likely to be based on cost factors. But if debit cards are seen as a way to increase sales volume or as necessary to maintain market share, they may be adopted even with a cost disadvantage. Promotional programs of an informational or educational nature could be a key factor in determining the speed of debit card growth in the future. Also critical are technological developments, for example, the falling cost of debit card readers has influenced merchants' decisions to offer debit cards. Developments affecting alternative payments methods --- for example, check imaging and truncation may make checking more automated and less costly --- could also importantly affect debit card usage. *Economic Review, Federal Reserve Bank of Kansas City, 4th Quarter 1994, pp. 79-94.*

The Electronic Purse

This article by John Wenninger and David Laster discusses how an electronic purse system might work, the advantages of the system for consumers, merchants, and issuers, and the difficulties that could arise. The electronic purse, which is a multipurpose prepaid card the size of a credit card, could if successful bring fundamental change in the U.S. payments system.

In contrast to "closed system" cards which have one or a few possible uses, such as transportation cards, the electronic purse is in an "open system" card that can be used in a variety of locations for a broad range of purchases. In this system, a bank issues the cards to customers who then transfer value from their accounts to the cards at an ATM, a personal computer, or a specially equipped telephone. Funds are deducted directly from the cards and transferred to the terminals of the vendors, who in turn move the funds into their bank accounts whenever they wish to do so. As funds are spent from the cards, consumers can replace these funds from their accounts. Systems of the above type, while not in existence currently in the U.S., are operating in other countries, for example, Denmark and Finland.

For the electronic purse to have sufficient flexibility and protection against fraud they would probably require smart-card technology employing a plastic card in which one or more computer chips are embedded and having a capability of storing, retrieving and manipulating data. Regarding usage of such systems in the U.S., various issues are unsettled, for example, whether the transactions should be traceable, requiring a consideration of the benefits for law enforcement against the recordkeeping requirements which could be quite burdensome and expensive.

The advantages to consumers would appear to derive mainly from the convenience factor in the use of the card for small transactions, reducing the need for carrying cash and speeding transactions because the customer would always have the "exact change." Among the possible obstacles could be the creation of numbers of incompatible systems requiring consumers to carry several different cards. Similar advantages in respect to time-saving and enhanced security from reducing the handling of cash would also apply for merchants. Other benefits to them would be that prepaid cards will likely have lower transactions fees than on-line debit cards and unlike checks, offer assured payment, and perhaps open new markets such as pay-per-view television. If merchants, however, were required to pay transaction fees and purchase new card readers or retrofit existing ones, they could be reluctant to accept electronic purses unless their use generates enough new business to justify the costs.

Regarding the issuers of the cards, a significant advantage, with increased uses for electronic purses and the number of cards issued, could be the "float" from their earnings on investment of customer balances held in electronic purses. Among other issues involved in establishing the electronic purse is whether organizations other than banks would issue the cards. Some potential is seen for facilitating some kinds of money laudering. For example, if card systems allow person-to-person transfers of value and transfers over specially equipped phone lines, it would enable holders of prepaid card value to move funds rapidly to remote locations where they could make several smaller, undetected deposits. *Current Issues in Economics and Finance, April 1995, Federal Reserve Bank of New York.*