

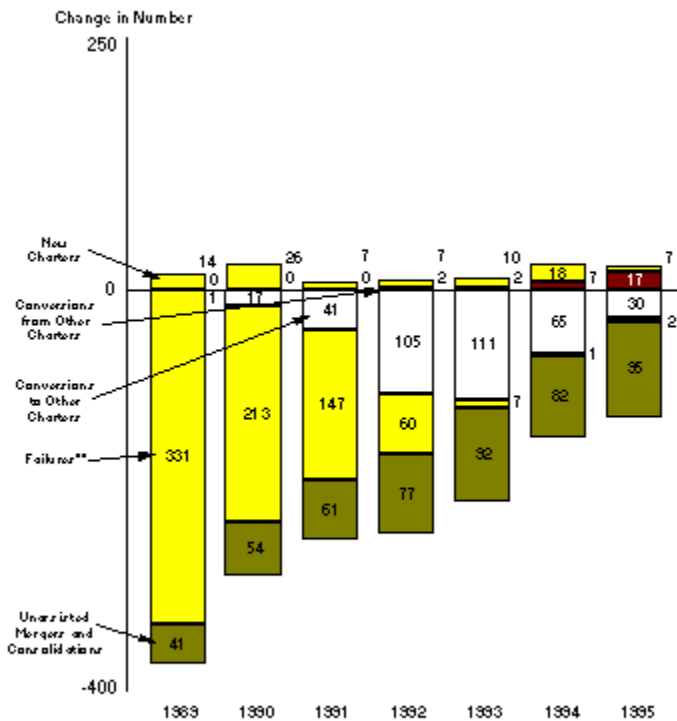
* Excludes 7 institutions that relinquished their charter and may have transferred operations to other charters.

** Failures do not include open-bank assistance transactions.

It is clear from these trends that the factors determining the number of institutions unassisted mergers and acquisitions, failures, new charters, and charter conversions have affected each of the agencies differently. As a result, each agency's share of institutions supervised has shifted. The FDIC's share has shown the greatest increase, rising from 49.1 percent of insured banks and thrifts in 1984 to 57.1 percent as of March 31, 1996 (Table 7). The OTS/FHLBB share experienced the greatest decrease, declining from 17.6 percent in 1984 to 12.0 percent at year-end 1995. During the same period, the OCC's share declined slightly, from 27.4 to 23.8 percent, and the Federal Reserve's share rose modestly, from 5.9 to 8.8 percent.

The shifts in shares of the number of institutions regulated can be largely explained by changes in the thrift industry. If only commercial banks are considered, the shares of the three bank regulatory agencies show little movement (Table 8). Between year-end 1984 and the end of the first quarter of 1996, the FDIC's share of the number of commercial banks supervised increased from 58.9 percent to 60.1 percent, and its share of industry assets under supervision shrank slightly, from 22.1 percent to 21.4 percent. The OCC's shares of institutions and assets supervised both showed small declines, while the Federal Reserve's shares both rose slightly.

Figure 14
Changes in the Number of OTS-Supervised Institutions*



* Excludes 24 institutions that relinquished their charter and may have transferred operations to other charters.

** Failures do not include open-bank assistance transactions.

The portion of the thrift industry supervised by the OTS/FHLBB has decreased over the last ten years, while that of the FDIC has increased (Table 9). The decline in the OTS/FHLBB share is largely a result of financial difficulties experienced by thrifts in the 1980s. Much of the shift has occurred since the creation of the RTC in 1989, when large numbers of insolvent savings-and-loan associations began to be resolved. From August 1989 through July 1995, 745 insolvent OTS-supervised thrifts were resolved by the RTC. In addition, large numbers of OTS institutions have either been acquired without government assistance or have converted their charters and are now supervised by one of the other federal regulators. From the end of 1984 to the end of the first quarter of 1996, the OTS/FHLBB's share of thrifts supervised declined from 92.2 percent to 70.6 percent, while the FDIC's share rose from 7.8 percent to 29.4 percent. During this period, the OTS/FHLBB's share of thrift assets supervised declined from 88.2 percent to 75.1 percent, while the FDIC's share rose from 11.8 percent to 24.9 percent.

The shrinkage in the number of commercial banks during the past ten years has been accompanied by an increase in industry size as measured by total assets. All three banking regulators have experienced significant increases in assets under supervision since the end of 1984, even as the OTS/FHLBB experienced a decline (Table 7). Total assets under Federal Reserve supervision grew by 117 percent, while assets under FDIC supervision increased by 70 percent, and those under OCC supervision grew by 60 percent. Assets under OTS/FHLBB supervision declined by 24 percent. The three banking agencies all had minor

increases in the share of assets supervised during this period. The FDIC's share rose from 18.9 percent to 22.1 percent; the OCC's share rose from 41.0 percent to 45.0 percent; and the Federal Reserve's share rose from 12.5 percent to 18.6 percent. The increases were at the expense of the OTS/FHLBB, which saw its share decline from 27.6 percent to 14.3 percent.

Table 8
Number of FDIC-Insured Commercial Banks
According to Primary Regulator

Yr./ Qtr.	FDIC		OCC		FRB		TOTAL
	No.	%of Total	No.	%of Total	No.	%of Total	
96:1	5,972	60.7	2,822	28.7	1,047	10.6	9,841
95:4	6,044	60.8	2,855	28.7	1,042	10.5	9,941
95:3	6,126	60.9	2,892	28.8	1,034	10.3	10,052
95:2	6,228	61.3	2,946	29.0	994	9.8	10,168
94:4	6,400	61.2	3,075	29.4	975	9.3	10,450
93:4	6,685	61.0	3,304	30.2	969	8.8	10,958
92:4	6,914	60.3	3,593	31.3	955	8.3	11,462
91:4	7,157	60.0	3,790	31.8	974	8.2	11,921
90:4	7,355	59.6	3,979	32.2	1,009	8.2	12,343
89:4	7,500	59.0	4,175	32.9	1,034	8.1	12,709
88:4	7,711	58.8	4,353	33.2	1,059	8.1	13,123
87:4	7,999	58.3	4,623	33.7	1,092	8.0	13,714
86:4	8,234	58.0	4,871	34.3	1,094	7.7	14,199
85:4	8,378	58.2	4,959	34.4	1,070	7.4	14,407
84:4	8,525	58.9	4,902	33.8	1,056	7.3	14,483
84:1	8,610	59.5	4,790	33.1	1,059	7.3	14,459

Assets of FDIC-Insured Commercial Banks
(Dollars in Millions)

Yr./ Qtr.	FDIC		OCC		FRB		TOTAL
	Assets	%of Total	Assets	%of Total	Assets	%of Total	
96:1	\$920,960	21.4	\$2,398,414	55.7	\$988,962	23.0	\$4,308,336
95:4	928,217	21.5	2,400,831	55.7	983,630	22.8	4,312,678
95:3	931,486	22.0	2,319,184	54.8	978,635	23.1	4,229,305
95:2	927,074	22.2	2,299,720	55.1	943,912	22.6	4,170,706
94:4	909,648	22.7	2,255,941	56.2	845,067	21.1	4,010,656
93:4	878,754	23.7	2,100,566	56.7	726,871	19.6	3,706,191
92:4	862,501	24.6	2,004,940	57.2	638,233	18.2	3,505,674
91:4	852,425	24.8	1,985,322	57.9	592,893	17.3	3,430,640
90:4	843,906	24.9	1,987,777	58.6	557,788	16.5	3,389,471
89:4	780,306	23.7	1,978,226	60.0	540,830	16.4	3,299,362
88:4	746,080	23.8	1,850,460	59.1	534,256	17.1	3,130,796
87:4	696,915	23.2	1,773,470	59.1	529,563	17.7	2,999,948
86:4	663,600	22.6	1,743,902	59.3	533,196	18.1	2,940,698
85:4	602,364	22.1	1,632,586	59.8	495,721	18.2	2,730,671
84:4	554,964	22.1	1,498,179	59.7	455,728	18.2	2,508,871
84:1	518,763	22.0	1,399,298	59.4	438,743	18.6	2,356,804

Source: FDIC Division of Research and Statistics, RIS Database

Three points summarize the trends in regulatory responsibilities over the last decade. First, the decline in the number of supervised institutions began with a wave of failures in the 1980s extending into the early 1990s. At the same time there was an increase in the pace of unassisted mergers that is still continuing and a sustained decline in new chartering activity. Second, mergers have increased the average sizes of supervised institutions¹⁴ and have led to a greater concentration of industry assets. Supervisory responsibilities, as measured by assets under supervision, have increased at the three banking agencies. Third, except for the declines experienced by the OTS/ FHLBB, there has been little change so far among the three bank regulatory agencies in shares of institutions and assets supervised. This stability in bank regulators' shares will probably not continue in light of the recent trend in large company mergers. Major acquisitions announced during 1995 involve changes in ownership of 10.2 percent of all commercial bank and thrift assets.

Table 9
Number of FDIC-Insured Savings Institutions
According to Primary Regulator*

Yr./ Qtr.	FDIC		OTS**		TOTAL
	No.	%of Total	No.	%of Total	
96:1	589	29.4	1416	70.6	2,005
95:4	593	29.2	1436	70.8	2,029
95:3	600	29.1	1460	70.9	2,060
95:2	604	29.0	1477	71.0	2,081
94:4	610	28.3	1,542	71.7	2,152
93:4	593	26.2	1,669	73.8	2,262
92:4	518	21.7	1,872	78.3	2,390
91:4	449	17.5	2,112	82.5	2,561
90:4	456	16.2	2,359	83.8	2,815
89:4	469	15.2	2,618	84.8	3,087
88:4	471	13.7	2,967	86.3	3,438
87:4	463	12.8	3,159	87.2	3,622
86:4	445	12.1	3,232	87.9	3,677
85:4	364	10.0	3,262	90.0	3,626
84:4	268	7.8	3,150	92.2	3,418
84:1	276	8.1	3,151	91.9	3,427

Assets of FDIC-Insured Savings Institutions
(Dollars in Millions)

Yr./ Qtr.	FDIC		OTS**		TOTAL
	Assets	%of Total	Assets	%of Total	
96:1	253,553	24.9	762,851	75.1	1,016,404
95:4	254,767	24.8	770,973	75.2	1,025,740
95:3	249,604	24.4	775,069	75.6	1,024,673
95:2	239,572	23.6	777,657	76.4	1,017,229
94:4	234,521	23.3	774,124	76.7	1,008,645
93:4	226,114	22.6	774,775	77.4	1,000,889
92:4	218,166	21.2	812,049	78.8	1,030,215
91:4	217,807	19.6	895,195	80.4	1,113,002
90:4	229,336	18.2	1,029,842	81.8	1,259,178

89:4	240,513	16.8	1,186,999	83.2	1,427,512
88:4	238,108	14.8	1,368,381	85.2	1,606,489
87:4	217,136	14.5	1,284,974	85.5	1,502,110
86:4	184,563	13.3	1,202,303	86.7	1,386,866
85:4	157,392	12.5	1,105,262	87.5	1,262,654
84:4	135,524	11.8	1,008,722	88.2	1,144,246
84:1	135,361	13.3	881,956	86.7	1,017,317

* Excludes institutions operating in RTC conservatorship.

** FHLBB prior to the enactment of FIRREA on August 9, 1989.

Source: FDIC Division of Research and Statistics, RIS Database

Table 6 illustrates how the drop in the number of smaller banks has coincided with an increase in the number of very large banks and the assets they hold. Between early 1984 and March 31, 1996, the number of banks and savings institutions with less than \$1 billion in assets declined by almost one-third, from 17,433 to 11,267. During that period, their share of industry assets declined from 40.2 percent to 24.6 percent. In contrast, the number of institutions with more than \$1 billion in assets increased from 453 to 579. The most significant increase in terms of industry asset share has taken place at the largest institutions. The number of institutions with over \$10 billion in assets increased almost threefold, from 28 in 1984 to 87 as of March 31, 1996. The proportion of bank and thrift assets held by this relatively small number of large institutions increased from 28 percent to 48 percent.

Implications

Consolidation within multibank organizations may simplify some aspects of supervision by decreasing the number of federal regulators that have jurisdiction over a banking organization. For example, many bank holding companies have multiple bank subsidiaries. The regulator of each subsidiary is determined by the subsidiary's charter and, if the charter is from a state, the subsidiary's Federal Reserve membership status. Thus, each of the four federal bank and thrift regulators may supervise a portion of a multibank holding company. When banks or thrifts merge, the resultant institution has only one primary federal regulator. In the case of a holding company with national banks the resultant institution would have two federal regulators. Although interstate branching, to the extent it encourages such consolidation, may simplify federal jurisdictions, it will complicate the task of state bank supervisors. Branching across state lines will result in a number of banking organizations that must answer to more than one state authority.

Finally, attention to communications and information-sharing both within and between federal and state regulators will assume increasing importance as a nationwide banking system evolves and more institutions find themselves subject to multiple regulatory jurisdictions. Organizations as disparate as the Basle Committee on Bank Supervision and the Conference of State Bank Supervisors have recognized the need for regulatory agencies to communicate adequately with each other.

Table 10
Shifts of Federally Insured Depository Institutions Among Primary
Federal Regulators If All Institutions Were Consolidated into
Largest Institution Under the Top Holder (Regulatory High Holder)

(as of March 31, 1996; excludes IBAs)			
		Assets	%
ofTotal	Number	(Millions)	Number
Assets			
Total	11,846	\$5,324,740	
Institutions regulated by FRB on 3/31/96	1,047	988,962	8.8%
18.6%			
Institutions that would be regulated by FRB	1,083	1,135,190	9.1
21.3			
Current regulator			
FDIC	88	60,686	
FRB	895	860,960	
OCC	88	207,948	
OTS	12	5,595	
Institutions regulated by FDIC on 3/31/96	6,561	1,174,513	55.4
22.1			
Institutions that would be regulated by FDIC:	6,177	984,126	52.1
18.5			
Current regulator			
FDIC	5,987	954,937	
FRB	46	5,545	
OCC	116	17,608	
OTS	28	6,036	
Institutions regulated by OCC on 3/31/96	2,822	2,398,414	23.8
45.0			
Institutions that would be regulated byOCC:	3,219	2,501,691	27.2
47.0			
Current regulator			
FDIC	474	156,407	
FRB	981	20,984	
OCC	2,611	2,172,007	
OTS	36	52,293	
Institutions regulated by OTS on3/31/96:	1,416	762,851	12.0
14.3			
Institutions that would be regulated byOTS:	1,367	703,733	11.5
13.2			
Current regulator			
FDIC	12	2,483	
FRB	8	1,473	
OCC	7	849	
OTS	1,340	698,927	
Institutions shifting to a new regulator:	1,013	637,909	8.6
12.0			

* Excludes insured branches of foreign banks.
Source: FDIC Division of Research and Statistics

The final chart, Table 10, shows how the balance among the regulators would shift if all bank holding companies were to merge all of their bank and thrift subsidiaries into the "lead" bank.¹⁵ It assumes that the largest subsidiary would retain its current charter and federal regulator. It is apparent that the consolidation process would bring many institutions under the supervision of new regulators. For example, 574 banks and thrifts that are currently regulated by the FDIC would

be consolidated into "lead" banks supervised either by the Federal Reserve (88 banks), the OCC (474), or the OTS (12). At the same time, 190 banks that are currently regulated by the Federal Reserve (46), the OCC (116) or the OTS (28) would be consolidated into "lead" banks supervised by the FDIC.

FDIC Banking Review

Banking Industry Consolidation: Financial Attributes of Merging Banks by John P. O'Keefe

Congress eliminated the remaining federal legal restrictions on interstate banking and branching in September 1994, with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act).¹ While many banking organizations had effectively circumvented legal barriers to interstate banking prior to the Riegle-Neal Act, they had to do so through the formation of multibank holding companies. Multibank holding companies may own and establish banks across states, provided they obtain a separate bank charter in each state.² Many industry observers expect, therefore, that the Riegle-Neal Act will facilitate the consolidation of multibank holding companies into multistate branch bank networks. Moreover, the reduced legal barriers to market entry might also encourage mergers between unaffiliated banking organizations. The potential for large structural change in the industry and the resultant reallocation of real and financial resources across markets is of interest to market participants and observers.

In order to analyze what form this structural change might take, this study draws upon merger and consolidation activity among depository institutions between January 1984 and June 1996. Merger and consolidation transactions for the period are used to develop financial profiles of participating banks. Next, those profiles are used to develop statistical models that predict the likelihood that a bank will become involved in a merger, either as the acquirer or target, in the near term. The Riegle-Neal Act represents an unprecedented change in the legal environment in which mergers occur. Empirical merger-prediction models draw upon known merger histories and cannot incorporate the effects that changes to the legal or regulatory environment might have upon mergers. Nevertheless, an understanding of the financial characteristics of many acquirers and target banks should be useful in predicting mergers and consolidations in the near term.

The merger forecasts presented here indicate that the current rapid pace of bank mergers and consolidations is likely to continue into the near future. In addition, the forecasts indicate a substantial divergence between the number of potential acquirers and target banks in several geographic regions. Consequently, the continued growth of interstate banking organizations is also likely. The first section of this study describes recent trends in mergers and consolidations, and discusses the impact of the thrift and banking crises during the 1980s upon industry restructuring. Section two reviews the incentives that bank owners and managers have to act upon the reduced legal restrictions on interstate banking. The potential for merger activity is examined in the third section. Specifically, the financial profiles of acquirers and targets in mergers and consolidations developed previously are used to form statistical models that relate the incidence of mergers and consolidations to important financial characteristics of banks. Those models are then used to predict the likelihood of an institution being a target bank or an acquirer in a merger or consolidation over a two-year horizon.

The study concludes with a discussion of the merger forecasts, as well as the geographic areas where interstate merger activity appears most likely to occur.

Recent Trends in Mergers and Consolidations

The recent legalization of full interstate branch banking could alter banking industry structure in two ways. First, many larger banking organizations used the multibank holding company organizational structure to form interstate banks before the passage of the Riegle-Neal Act. Some of these multibank holding companies might consolidate operations into multistate branch-bank networks if such networks offer advantages over existing organizational structures. Second, the ability to enter markets across state lines via branching might be a lower-cost alternative to the chartering of a new bank, as was required before the new legislation. Consequently, if barriers to market entry are reduced, there might be shifts in merger activity as banks implement their strategic merger plans.

The removal of legal impediments to interstate banking does not necessarily mean that more interstate banking organizations will develop. Mergers involve changes in ownership and, more importantly, can result in the reallocation of real and financial resources across markets. Such reallocations are motivated by the long-term expected risks and returns on invested capital. The present and expected future profitability of the industry will play an important role in such capital reallocations. In order to gain some perspective on what structural changes might occur, this section first examines recent merger and consolidation trends among depositories.

Table 1 shows the number of mergers and consolidations among commercial banks, savings banks and savings associations between January 1984 and June 1996. Mergers and consolidations were partitioned into five groups: (1) the formation of FDIC bridge banks; (2) RTC conservatorships; (3) FDIC-assisted failed-bank acquisitions; (4) FSLIC/RTC-assisted failed-thrift acquisitions; and (5) unassisted acquisitions. When a bank or thrift fails, the deposit insurer in its role as receiver has two general options to resolve the failure. The first is to liquidate the institution and compensate its creditors, particularly insured depositors; this type of resolution is known as a payoff. The second option is to sell some or all of the failed institution's operations intact to a financially sound bank or thrift; this type of resolution is known as a purchase-and-assumption transaction. The main criterion for selecting a resolution method is to select the method that is least costly to the deposit insurance fund.³ Only those transactions that involve keeping some portion of the failed institution's franchise intact are included in Table 1.

Table 1
Mergers and Consolidations: January 1984 - June 1996
(All Commercial Banks, Savings Banks and Savings

Associations)

Number and Percent of Regional Total

Region	FDIC Bridge Banks Total	RTC Conserva- torships	FDIC- Assisted	FSLIC/ RTC- Assisted
Unassisted				
Northeast	1 0.1%	59 7.7%	119 15.4%	78 10.1%
514 66.7%	771			

1991	0	0.0	166	17.6	118	12.5	145	15.3	516
54.6	945								
1992	0	0.0	54	7.3	109	14.8	64	8.7	508
69.1	735								
1993	20	2.9	23	3.4	37	5.4	8	1.2	594
87.1	682								
1994	1	0.1	58	8.0	13	1.8	1	0.1	655
90.0	728								
1995	0	0.0	1	0.1	6	0.8	2	0.3	723
98.8	732								
June 1996	0	0.0	0	0.0	3	0.8	0	0.0	362
99.2	365								
All	22	0.2%	595	6.2%	1,308	13.7%	921	9.7%	6,679
70.1%	9,525								

Regional differences in merger activity during the period have been driven in large part by economic conditions, as well as by changes in state banking laws. For example, the regional recessions in the Southwest and Northeast in the late 1980s and early 1990s, respectively, contributed to the high proportions of government-assisted mergers in those regions. Table 2 also shows that both the number and proportion of unassisted mergers rose steadily after 1990 as the economy improved.

Another interesting aspect of industry restructuring is the proportion of industry consolidation that has involved affiliated versus unaffiliated banks. Table 3 identifies consolidations of multibank holding companies versus mergers between unaffiliated banks. Because historical information on thrift holding company affiliations was not available, savings associations are excluded from Table 3. The data show a marked increase in consolidation activity in 1995, driven partly by the recent relaxation of federal restrictions on interstate banking and branching.

TABLE 3
Mergers and Consolidations
Commercial Banks and Savings Banks
January 1984 - December 1995

Total Year Mergers	Consolidations With Holding Co.		Banks in Multibank Holding*	Non-afflicted Transactions		Banks in One-Bank Holding
	Number	(Yearly %)	Company	Number	(Yearly %)	Companies
1984	107	(36.2%)	3,741	189	(63.9%)	11,032
296						
1985	188	(44.4)	4,127	235	(55.6)	10,670
423						
1986	165	(36.9)	4,510	282	(63.1)	10,159
447						
1987	333	(46.4)	4,422	284	(53.6)	9,766
717						

1988	420	(52.3)	4,226	283	(47.7)	9,388
803						
1989	286	(46.7)	4,067	327	(53.3)	9,131
613						
1990	286	(51.4)	3,925	271	(48.7)	8,892
557						
1991	314	(55.3)	3,677	254	(44.7)	8,708
568						
1992	264	(49.8)	3,474	266	(50.2)	8,522
530						
1993	261	(47.9)	3,375	284	(52.1)	8,192
545						
1994	298	(51.7)	3,287	278	(48.3)	7,790
576						
1995	402	(65.2)	3,073	215	(34.9)	7,459
617						
Total	3,324	(49.7%)		3,368	(50.3%)	
6,692						

*The number of banks in multibank holding companies, as well as in one-bank companies, are as of the calenday year-ends.

It is difficult to know what portions of the national merger trends seen in Tables 2 and 3 were driven by industry and regional economic conditions versus changes in federal and state banking laws. A state-by-state comparison of trends with associated changes in business and regulatory conditions would be too lengthy to present here. To gain some perspective on the impact that local economic conditions and changes in bank regulation can have upon merger activity, Tables 2b and 3b present bank and thrift merger trends for Texas depositories. Texas banking markets provide a useful illustration because of the severe changes in the state's economy and banking laws during the 1980s. Texas underwent a severe business downturn in the late 1980s. In addition, intrastate bank branching prohibitions in Texas were relaxed in 1987, permitting branching in contiguous counties; subsequently, statewide branching was permitted. Both events contributed to consolidations in Texas banking markets in the late 1980s and early 1990s.

Table 2b shows that merger activity in Texas increased sharply, from 41 to 233 transactions, between 1986 and 1987. Although a portion of this activity was due to commercial bank failures, most of the transactions involved unassisted mergers and consolidations. Table 3b shows that consolidations rose from 9 to 121 between 1986 and 1987. This increase was largely a result of the relaxation of state branching restrictions and consisted of unassisted transactions. Interestingly, mergers of non-affiliated banks between 1986 and 1987 also rose, from 23 to 96. While 45 of the 96 mergers in 1987 involved failed banks, the remaining 51 non-affiliate mergers represented a substantial increase over 1986 mergers.

Table 2b
Texas Mergers and Consolidations
(All Commercial Banks, Savings Banks and Savings
Associations)
Number and Percent of Yearly Total

Year Unassisted	FDIC Bridge Banks Total	FDIC Banks Total	RTC Conserva- torships	RTC Conserva- torships	FDIC- Assisted	FDIC- Assisted	FSLIC/ RTC- Assisted	FSLIC/ RTC- Assisted	
1984	0	0.0%	0	0.0%	6	40.0%	1	6.7%	8
53.3%	15								
1985	0	0.0	0	0.0	10	47.6	0	0.0	11
52.4	21								
1986	0	0.0	0	0.0	22	53.7	6	14.6	13
31.7	41								
1987	0	0.0	0	0.0	45	19.3	5	2.1	183
78.5	233								
1988	0	0.0	0	0.0	110	29.9	89	24.2	169
45.9	368								
1989	0	0.0	8	3.4	131	55.3	39	16.5	59
24.9	237								
1990	0	0.0	45	19.9	99	43.8	45	19.9	37
16.4	226								
1991	0	0.0	28	27.2	30	29.1	10	9.7	35
34.0	103								
1992	0	0.0	5	7.7	29	44.6	0	0.0	31
47.7	65								
1993	20	23.8	0	0.0	10	11.9	0	0.0	54
64.3	84								
1994	0	0.0	0	0.0	0	0.0	0	0.0	31
100.0	31								
1995	0	0.0	0	0.0	0	0.0	0	0.0	51
100.0	51								
June 1996	0	0.0	0	0.0	2	4.7	0	0.0	41
95.3	43								
All	20	1.3%	86	5.7%	494	32.5%	195	12.8%	723
47.6%	1,518								

Incentives for Mergers and Consolidations Merger Theory

There are two participants in all mergers, the acquiring firm and the target firm. Because of the high degree of regulatory oversight of bank mergers, nearly all bank mergers result from the joint decisions of the controlling directors and shareholders of both of the merging banks. A discussion of the decision on whether to merge should, therefore, consider both the acquiring and target bank's perspectives. This section reviews the potential motives underlying the merger decision, drawing upon the bank merger studies of Rose (1987), (1988).⁵

TABLE 3B
Texas Mergers and Consolidations
Commercial Banks and Savings Banks, January 1994 - December 1995

Consolidations	Banks in Multibanks	Non-afflicted	Banks in One-Bank
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Total Year Mergers	Within Holding Co.		Holding Companies*	Transactions		Holding Companies
	Number	(Yearly %)		Number	(Yearly%)	
1984 6	1	(16.7%)	757	5	(83.3%)	1,096
1985 16	7	(43.8)	819	9	(56.3)	1,117
1986 32	9	(28.1)	860	23	(71.9)	1,111
1987 217	121	(55.8)	675	96	(44.2)	1,091
1988 278	132	(47.5)	467	146	(52.5)	1,025
1989 190	50	(26.3)	323	140	(73.7)	990
1990 134	22	(16.4)	255	112	(83.6)	928
1991 63	19	(30.2)	223	44	(69.8)	898
1992 56	9	(16.1)	191	47	(83.9)	898
1993 78	24	(30.8)	172	54	(69.2)	839
1994 31	5	(16.1)	186	26	(83.9)	802
1995 47	15	(31.9)	193	32	(68.1)	755
Total 1,148	414	(36.1%)		734	(63.9%)	

*The number of banks in multibank holding companies, as well as in one-bank companies, are as of the calendar year-ends.

Merger motives can be classified into two broad categories: shareholder wealth maximization and managerial "well being." The notion that mergers are motivated by shareholder wealth maximization is a fundamental assumption of most economic theories on firm investment decisions. Under the wealth-maximization motive, mergers are treated like any other investment decision. Target firms in mergers are priced by bidders based upon the present discounted value of the expected returns on the acquisition, where the discount rate and return expectations consider the assumed firm's performance within the acquirer's portfolio of assets. In mergers, acquirers can share a portion of expected gains from the transaction with target firm owners to help encourage the merger. Such gains can result from post-merger improvements in the efficiency and profitability of the target bank's franchise or when the merged entity is expected to perform better than both of the individual firms. In either situation, the target bank's owners can be offered more than the current market value of their shares, because the "going concern value" of the target bank will be less than its value when combined with the acquirer's franchise.⁶ If the merged firm has greater long-term market value than the simple sum of the parts, merger synergies are said to have occurred. Specific sources of merger synergies are risk diversification in revenues

and costs, economies of scale and scope, and market power.

Investment theory shows that as one increases the number of assets in an investment portfolio whose returns are positively correlated, the total variance in the portfolio's return decreases and approaches the average covariance between individual asset returns.⁷ If bank mergers increase portfolio diversification, the risk-reduction will benefit bank owners. The potential for increased geographic loan exposure diversification is probably the most likely source of benefits from interstate banking and branching. The regional concentrations of bank failures during the 1980s and 1990s were fueled by many banks' geographic lending concentrations, particularly those in commercial real estate.

Economies of scale refer to the ability to spread fixed operating costs over larger output levels, thereby reducing average total production costs. For example, bank mergers can reduce average costs when overlapping branch offices are closed, or fixed information processing costs and advertising costs are spread over increased revenues. In addition, personnel costs can be reduced when tasks overlap. Acquirers can benefit from applying "fixed" managerial and technical expertise to a larger business operation. Economies of scope are similar in nature, except that the cost savings result from applying fixed resources to a broader range of services, as opposed to simply increasing the level of the current mix of services. In addition, economies of scale can be achieved in financing. The costs of issuing debt and equity include a substantial fixed component. Consequently, larger banking organizations can spread fixed financing costs over larger equity issues, reducing per share issuance costs.

Mergers can also enhance market shares for acquirers for both balance-sheet and off-balance-sheet activities. This can confer some pricing advantages and improve profitability; however, there are limits to the extent to which mergers can be used to garner market power. Federal antitrust laws and regulatory policies restrict merger transactions in banking and other industries and are intended to prevent undue concentrations of market power. The primary federal antitrust laws that restrict merger activity are the Clayton Act of 1914, the Sherman Act of 1890 and the Federal Trade Commission Act of 1914. The Bank Merger Act of 1960, which was amended in 1966, clarifies federal bank regulators' role regarding bank merger policy. The U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC) are responsible for ensuring that bank merger transactions do not violate federal antitrust laws. The DOJ and the FTC have developed and published horizontal merger guidelines that present their policies and interpretation of appropriate merger practices.⁸

If a bank's owners or equity shareholders are not well represented on the firm's board of directors, the merger decision can be driven by managers' interests rather than those of shareholders. For example, managers seeking to protect their employment positions might actively block takeover attempts by many means, such as making preemptive acquisitions to ensure the firm is "too big to be a target." Since the assumed firm's management is often placed at risk of job loss in a merger, there is the potential for this motive to cause a divergence between shareholders' interests and managers' interests among targeted firms. The fact that managerial compensation usually increases with the revenues and assets of the firm also gives acquiring firms' managers an empire-building motive. This motive might not translate into increased wealth for their shareholders.

Finally, third-party influences on the merger decision can result in mergers with

little or no benefit to either acquirers or target banks. Third parties involved in facilitating the transaction, such as investment bankers and securities dealers and underwriters, can profit from a merger transaction even when it does not produce the expected benefits to the acquiring firm's shareholders.⁹ As Rose (1988) points out, with such a large and diverse array of possible motives for mergers it is not unexpected that empirical studies differ in explaining why mergers occur. One can expect that some combination of the previous factors have influenced bank mergers over the past decade. The empirical analysis of merger motives developed in this study draws upon the motive of shareholder wealth maximization.

Practical Considerations: Identifying Likely Targets and Acquirers

Banks that are actively seeking to expand operations through mergers can have unique characteristics that distinguish them from their peers. Businesses that are in an expansion mode should be perceived to be in sound financial condition and could be expected to be outperforming their peers. An adequate equity capital base and healthy profit rates are necessary to attract the additional capital often needed to finance mergers. Conversely, managements that are not successfully operating an organization could not be expected to do any better with expanded responsibilities and should not be engaged in mergers.

While these traits could be found among banks actively seeking mergers, such banks might not always be able to translate their abilities into action, that is, acquire other banks. One reason for inaction might be the lack of worthwhile merger candidates within a bank's geographic market or targeted new markets. State and federal restrictions on branching and interstate banking might also have limited the scope of merger candidates available to some banks. Prior to the Riegle-Neal Act, regional banking compacts limited banks' ability to acquire banks in states that did not have reciprocal agreements. Finally, a variety of factors, such as expectations of regional and national economic recessions, or constraints on existing managements' ability to assume new responsibilities, can delay merger activity. Thus, while acquirers could have common characteristics, these traits might also be present in banks not active in merger markets.

Similar generalizations might be possible for target banks in mergers. Target banks might be underperforming their peers and could benefit from mergers. Inefficient scale and scope of operations can, at times, only be overcome with difficulty when banks have limited access to capital markets. While target banks might be underperforming peers, one would not expect acquirers to seek out targets with substantial problems or weak franchises. Hence, targets are likely to have deficiencies that can be remedied without substantial cost to acquirers. Deficiencies need not always be present in target banks, however. One commonly cited example is that of owner-managers of closely held banks. These owners can choose takeovers as a means to cash out on their investment at retirement, particularly when leaving the business to family members is not a consideration. Finally, as with acquirers, to be a target bank implies that acquisition mode banks must exist within the target's geographic market or out-of-market acquirers must find the potential target's market attractive. While many target banks might have common traits, one can expect these traits also to be present among banks that have not yet become merger targets.

If one can identify potential acquirers and targets within markets, more might be said about the likelihood of future merger activity. One first needs to identify

common traits of acquirers and target banks. This section looks at the financial characteristics of both groups in three ways. First, acquirers' and target banks' income statements and balance sheets are reviewed to learn whether certain attributes appear just before mergers occur, or whether they are longstanding. Second, comparisons of financial characteristics with peer groups are made to determine whether acquirers and targets differ from banks of similar size and location. Third, acquirers are compared with their targets to investigate possible motives for mergers such as portfolio diversification and improvements in operating efficiency.

The attractiveness of target banks' franchises to potential acquirers is influenced by market demographics, as well as current and expected future economic conditions in the local and regional markets. Demographic data and economic activity measures might aid in explaining merger activity. This study relied, however, upon the financial statements of banks, as well as bank examiners' assessments (CAMEL ratings) of banks' financial condition in analyzing merger activity. Both market demographics and business cycles affect financial statements; therefore, these factors are not entirely ignored when relying upon financial statements. Moreover, because the geographic scope of most banks' markets is not well known, relating merger activity to demographic and economic activity measures involves uncertainties. For example, high commercial property vacancy rates in a particular market might be expected to reduce the attractiveness of area target banks with substantial commercial real-estate loan exposures; however, banks do not report geographic loan exposures to federal bank regulators. Thus, the relevance of local vacancy rates to all potential target banks is uncertain. Banks do report nonperforming asset levels that directly show the effect of market conditions upon bank asset quality.

Peer Group Comparisons

In order to learn how acquirers and target banks differ from each other and their peers, a sample of 890 mergers occurring among commercial banks and savings banks between January 1984 and December 1995 was obtained. To help ensure that banks' financial profiles would not be distorted by the accounting changes that can appear with mergers and consolidations, acquirers were required to not have made acquisitions nor consolidations over the eight quarters prior to a merger.¹⁰ All financial trends were tracked over the eight quarters prior to mergers. Second, only mergers between unaffiliated organizations were considered; consolidations of banks within the same holding company were excluded. Finally, all government-assisted mergers were excluded because of the unique nature of such mergers.¹¹ The characteristics of the sample of acquirers and their target banks are given in Tables 4, 5 and 6. As shown in these tables, the sample of mergers is fairly diverse across geographic regions and over time.

All comparisons of financial performance were made based upon mean values of income statement and balance-sheet variables, expressed as a percent of bank assets, or, for loan portfolio analysis, as a percent of gross loans and leases. Financial ratios were computed over each of the eight quarters prior to mergers. In order to determine whether the financial performance of acquirers and targets differed from that of their peers, samples of peer banks were selected for both groups. The peer groups consisted of banks of similar size, regional geographic location, and timing of financial data as the target banks (acquirers). Financial trends were computed using an abstract time measure, the number of quarters from a merger. As a result, each quarter consists of data "pooled" from several points in time for the 890 banks. For comparability, peer banks that had

contemporaneous financial data with the target banks (acquirers) were selected. The mean values of several important financial ratios and their differences between groups of banks are available from the author upon request. The results of that analysis are summarized next.

Table 4
Sample of 890 Mergers Commercial Banks and Savings Banks,
1984 - 1995(Dollars in Billions)

Region	Acquirer Number	Location* (Percent)	Acquirers' Assets	Targets' Assets
Northeast	56	(6)	\$72.6	\$17.8
Mid-Atlantic	36	(4)	47.8	6.6
Southeast	138	(16)	115.9	7.3
Centrall	40	(16)	39.1	9.0
Midwest	253	(28)	46.6	9.3
Southwest	140	(16)	63.2	16.4
West	127	(14)	226.0	75.2
Total	890	\$611.3	\$141.6	

* The regional locations of target banks were the same as those for their acquirers in all but one instance.

Table 5
Sample of 890 Mergers
Commercial Banks and Savings Banks 1984 - 1995

Asset Size	Acquirers		Target Banks	
	Number	(Percent)	Number	(Percent)
\$5 Billion or More	20	(2)	3	(0)
\$5 Billion to \$1 Billion	64	(7)	15	(2)
\$500 Million to \$1Billion	57	(6)	10	(1)
\$100 Million to \$500Million	273	(31)	99	(11)
\$50 Million to \$100Million	185	(21)	127	(14)
\$25 Million to \$50Million	175	(20)	192	(22)
Under \$25 Million	116	(13)	444	(50)
Total	890		890	

Income and Expenses

The sample of target banks had significantly higher average loan-loss provisions and total noninterest expenses than did their acquirers.¹² These higher expenses were not offset, on average, by interest and noninterest income among target

banks. The result was a significantly lower average return on assets (ROA) among target banks than for their acquirers during the eight quarters before mergers took place. Net interest margins did not differ significantly between the sample of acquirers and their targets, however. The target banks were also typically much smaller than their acquirers. As a result, profit rates on assets (ROA) might differ due to bank size and capitalization. Targets could offset a lower ROA by increasing leverage; however, this will also increase the volatility in profits. This was not the case, however, because the target banks' equity capitalization was somewhat higher, on average, than that of their acquirers. In order to control for the effect of bank size on performance, peer bank comparisons also were made and are discussed next.

Table 6
Sample of 890 Mergers
Commercial Banks and Savings Banks
1984 - 1995

Year	Number	(Percent)	Median Ratio of Target-to- Acquirer Assets*
1986	77	(9)	22.3%
1987	93	(10)	30.2
1988	99	(11)	34.1
1989	68	(8)	28.1
1990	61	(7)	21.9
1991	77	(9)	27.8
1992	93	(10)	31.7
1993	103	(12)	26.3
1994	124	(14)	26.8
1995	95	(11)	22.4
Total	890		

*Asset values were measured as of the quarter-end prior to the merger.

Target banks had significantly higher rates of loan-loss provisioning and expenses on premises than did their peers. The result was that target banks' ROAs were significantly lower than those of their peers over most of the pre-acquisition period. Target banks were both less efficient than their peers and riskier based upon loan-loss provisioning. There were no significant differences between the net interest margins of target banks and their peers over the eight quarters prior to acquisition. Acquirers had significantly higher net interest margins than did their peers over the pre-acquisition period. Acquirers, however, did not have significantly different loan-loss provisions nor noninterest expenses than their peers. The result was that acquirers had marginally higher ROAs than did their peers during the pre-acquisition period, but the divergence in profit rates was not

statistically significant.

Portfolio Composition: Assets

Target banks were, on average, significantly more liquid than their acquirers, with a greater proportion of their assets in cash balances, federal funds sold and resale agreements than their acquirers. Correspondingly, acquirers had significantly higher proportions of total assets comprised of gross loans and leases than did their targets. Acquirers might find target banks' liquid asset levels attractive because these assets can be turned into loans at low cost if lending opportunities exist. One negative aspect of targets was their significantly higher proportions of other real estate owned, which includes repossessed real estate, than those of acquirers.

Target banks had significantly higher proportions of their assets in cash balances, federal funds sold and resale agreements than did their peers; however, targets also had significantly lower levels of securities than did peer banks. Target banks also held significantly higher proportions of their assets in gross loans and leases. Moreover, as one might expect, target banks had higher levels of assets in bank premises and other fixed assets. This might explain the higher overhead expenses found for target banks as compared with their peers. Finally, target banks had higher asset concentrations in other real estate owned, which includes repossessed assets. This latter finding supports the prior statement that targets might be riskier, on average, than their peers in terms of the credit quality of assets.

Surprisingly, acquirers compared to their peers in much the same way that target banks compared to their peers. Acquirers had higher asset concentrations in cash balances, federal funds sold and resale agreements than did their peers. In addition, acquirers held lower proportions of assets in securities and more in gross loans and leases than did peer banks. Finally, acquirers had higher proportions of assets in premises and other fixed assets than their peers. However, there were no significant differences between acquirers and their peers with respect to levels of other real estate owned.

Portfolio Composition: Liabilities

There were several differences between acquirer and target banks' liability composition, as measured as a percent of total assets. Acquirers had slightly lower levels of deposit funding than did their target banks and relied more on federal funds purchased and repurchase agreements, other borrowed money, banks' liabilities on acceptances outstanding, and subordinated debt. Interestingly, acquirers had significantly higher levels of volatile liabilities than did target banks and, consequently, lower levels of core deposits. Acquirers might, therefore, seek target banks with a more stable core deposit base. Equity capitalization was slightly lower among acquirers than target banks, but the difference was not statistically significant in most instances. Because target banks were, on average, about one-quarter the asset size of their acquirers, one might have expected significantly higher capitalization for the small target banks than for the larger acquirers, based upon historical capitalization rates across bank size groups. This asset size difference can explain some of the divergence in liability composition difference between acquirers and targets.

Target banks had higher levels of total deposit funding than did their peers but no

significant differences existed for other major liability items, including large time deposit accounts and brokered deposits. Target banks, however, did have significantly lower equity capitalization rates than their peers. Although acquirers' deposit funding levels were similar to those of their peers, acquirers relied significantly more on volatile liabilities. In addition, acquirers had higher levels of federal funds purchased and repurchase agreements than did peer banks. The higher reliance upon volatile liabilities among acquirers could be an important motivator in mergers. Finally, acquirers had significantly lower equity capitalization rates than their peers. Because one must judge capital adequacy in relation to a bank's entire operations, including important factors such as loan-loss reserves, nonperforming asset levels, and profitability, these lower capitalization rates do not necessarily imply acquirers had weaker capital positions than their peers.

Portfolio Composition: Loans

There were some significant differences in the loan concentrations of acquirers and their target banks. Comparisons of loan portfolio composition, as a percent of gross loans and leases, indicated that acquirers had a slightly different mix of loans than did target banks and acquirers appear to have somewhat riskier loan concentrations than target banks. Acquirers had significantly higher average loan-to-asset ratios than did target banks and higher concentrations of both short- and long-term commercial real-estate loans (construction and land development loans and loans secured by nonfarm nonresidential real estate) than did target banks. Acquirers also had significantly higher concentrations of commercial and industrial loans and municipal loans than did target banks. Conversely, acquirers had lower proportions of loans in 1-to-4 family residential mortgages, consumer loans and loans to officers, directors and principal shareholders (insider loans) than did their targets.

Target banks had significantly higher ratios of gross loans and leases to assets than their peers. Target banks differed from their peers primarily in terms of real-estate lending, with higher loan concentrations in all areas of real-estate loans, including commercial real estate, than that of peer banks. Acquirers had significantly higher ratios of gross loans and leases than their peers. Among major loan categories, acquirers were somewhat more heavily concentrated in real-estate loans, particularly loans secured by nonfarm nonresidential properties (long-term commercial real-estate loans).

Predicting Acquirers and Target Banks

The previous section indicated that the sample of acquirers and their target banks differed systematically from each other and their peers prior to mergers. If these differences in financial characteristics are common and persistent over time, as the prior analysis indicates, it might be possible to use this information to identify banks that will become acquirers or targets in mergers. This section presents the results of logit estimation of models predicting the likelihood of being an acquirer or target bank in a merger. Logit estimation is used to relate mergers, either from the acquirers' or target banks' perspective, to a number of the factors, both endogenous and exogenous to a bank that the previous analysis indicated can affect the incidence of mergers.¹³ Because acquirers differ from their target banks, and both groups differ from their peers, separate logit estimations were obtained for acquirers and target banks.

Acquirers and their target banks appear to differ from their peers in terms of many

important financial characteristics. Therefore, logit models were formed relating the incidence of mergers to the major attributes of banks' financial condition: capital adequacy, asset quality, management, earnings, and liquidity (henceforth, CAMEL attributes). Broad measures of bank condition were used in order to obtain models that would be robust across time and geographic regions. Therefore, details on loan portfolio composition and other factors likely to be correlated with time or location were excluded from the logit analysis.

To obtain general measures of condition, bank assets were partitioned into broad groups based upon earnings, liquidity, risk, and asset quality. Total assets were first partitioned into risk and nonrisk assets. Nonrisk assets were defined as the sum of cash balances due, securities, and federal funds sold plus resale agreements. Risk assets were, therefore, defined as total assets minus nonrisk assets. Nonrisk assets were further partitioned into two groups, noninterest-bearing nonrisk assets (that is, noninterest-bearing cash balances due) and interest-bearing nonrisk assets (that is, the sum of interest-bearing cash balances due, securities, and federal funds sold plus resale agreements). Risk assets were partitioned into performing and nonperforming risk assets. Nonperforming risk assets were defined as the sum of loans and leases past due 90 days or more, nonaccrual loans and leases, other real estate owned, and goodwill.

Two additional aspects of banks' asset portfolios were included in the analysis: lending levels and loan portfolio concentration. The proportion of banks' total assets comprised of loans and investment securities with maturities of five years or more was included as a measure of asset liquidity. In addition, a summary measure of loan-portfolio concentration was devised and included in the analysis. Specifically, total bank loans were divided into 15 well-defined categories of loans, which comprised nearly all of total loans. Next, the loan portfolio shares were obtained for these loan categories and the sum of squared shares were computed to form a concentration index analogous to the Herfindahl-Hirschman Index (HHI).¹⁴

The peer group analysis also indicated that measures of operating expense and profitability would be useful in predicting merger activity. Three components of noninterest expense were considered: expenses on salaries and employee benefits, expenses on fixed assets and premises, and all other noninterest expense. Bank profitability was measured by the return on earning assets (ROEA), which was defined as the ratio of operating income to earning assets. Operating income was measured by income before taxes and extraordinary items, gross of loan-loss provisions. Earning assets were defined as the sum of interest-earning cash balances, securities, federal funds and repurchase agreements sold, net loans and leases, and assets held in trade accounts, minus nonperforming assets.

Profitability and financial health are ultimately reflected in banks' capital adequacy; therefore, bank equity capital and loan-loss reserves were included in the models. Further, a bank's deposit franchise appeared to be an important factor in merger decisions. The main deposit measure considered was core deposits, defined as total deposits minus volatile liabilities. Volatile liabilities were defined as the sum of time deposits of \$100,000 or more, all foreign-office deposits, federal funds purchased and securities sold under repurchase agreements, demand notes issued to the U.S. Treasury, and other borrowed money. Previous studies have also shown core deposit growth rates, as well as growth rates in gross loans and leases, might be important terms in predicting

target banks.

Bank performance also varies systematically with bank asset size. It was hypothesized that the influence of asset size upon performance and condition decreases as total assets increase; therefore, the logarithm of bank assets was included as a size measure. In addition, de novo or recently established banks often have unusual financial characteristics when compared to established banks. These banks can also be precluded from being targets for a period after establishment by their chartering authority. Consequently, a de novo bank dummy variable, set equal to one for all banks in existence for three years or less (as of the model estimation date) and zero for all other banks, was included.

Because bank mergers require regulatory approval before transactions can proceed, bank regulators' assessments of banks' financial condition were particularly relevant to merger prediction. Bank regulators rate five aspects of banks' condition during periodic safety-and-soundness examinations: capital adequacy, asset quality, management, earnings, and liquidity. Banks receive ratings in each of the five CAMEL component areas that vary in integer levels from "1" to "5." Generally speaking, ratings of "3," "4," or "5" are given to banks considered to have moderate to serious deficiencies, respectively, that need to be addressed by bank management. These deficiencies can present risks that increase the chances of failure. Banks rated "1" are considered to be performing well-above-average, while a rating of "2" is given to banks with adequate performance, as dictated by regulatory safety-and-soundness standards. To gauge the extent of regulatory concern regarding banks' condition, the five CAMEL component ratings were included in the analysis using dummy variables set equal to one for banks rated "3," "4," or "5" for the component area and zero otherwise.

Equation 1 presents the most general form of the predictive equation, henceforth referred to as model 1.¹⁵ Model 1 was used to predict the likelihood of being either an acquirer or a target bank. Model 1 was estimated separately for target banks and acquirers, yielding two different sets of coefficient estimates. Finally, to control further for systematic differences in condition measures across bank asset-size groups, all balance-sheet variables were measured as percents of bank assets, and income and expense items were measured as percents of average assets. A second model, which excluded the bank examination terms, was also tested and is presented below (model 2). Comparisons of models 1 and 2 allow one to see the additional information that bank examination ratings add to merger prediction.

A stepwise logit estimation procedure was used in all estimations. This procedure systematically identifies those terms that have a significant relationship with the likelihood of being an acquirer or target bank and excludes all other terms. This allows one to include several measures of the same attribute in the logit model, allowing the estimation procedure to isolate the most important factors in terms of predicting merger activity.

The samples of banks used in estimating the models consisted of all commercial banks and savings banks reporting financial data at year-ends between 1984 and 1995. Further, two different samples of "merger events" were used for estimating the models. In the first sample all unassisted mergers between unaffiliated banks, as well as consolidations of member banks of a multibank holding company (affiliates) were defined as merger events. Assisted mergers were not counted as

merger events, but were, however, left in the population of all other nonmerging banks. The assisted mergers were excluded from the definition of merger events because identification of assisted target banks would yield bank-failure prediction models rather than the type of target-bank prediction models of interest to this study. As shown in Tables 1 and 2, the proportions of assisted transactions were quite high during part of the estimation period; therefore, the "failure-prediction" results could best be avoided by the exclusion of assisted transactions. In addition, while consolidations might be of interest to some groups, such consolidations do not alter the actual number of economic agents or banking firms. Therefore, a second sample of merger events was defined as all unassisted mergers between unaffiliated banks. Banks involved in consolidations and assisted mergers were, however, left in the population of nonmerging banks. By construction, these two samples of merger events will allow for predictions on both aspects of industry consolidation from the population of banks.

$$\begin{aligned}
 1.) \text{ Likelihood of Merger}_{it,t+1} = & \beta_0 + \beta_1(\text{Interest-earning nonrisk assets})_{it,1} \\
 & + \beta_2(\text{Noninterest-earning nonrisk assets})_{it,1} \\
 & + \beta_3(\text{Performing risk assets})_{it,1} \\
 & + \beta_4(\text{Loan portfolio concentration index})_{it,1} \\
 & + \beta_5(\text{Total loans plus securities with maturities over 5 years})_{it,1} \\
 & + \beta_6(\text{Expenses on salaries and benefits})_{it,1} \\
 & + \beta_7(\text{Expenses on premises and fixed assets})_{it,1} \\
 & + \beta_8(\text{All other noninterest expenses})_{it,1} \\
 & + \beta_9(\text{Return on earning assets})_{it,1} \\
 & + \beta_{10}(\text{Equity Capital})_{it,1} \\
 & + \beta_{11}(\text{Loan-loss allowance})_{it,1} \\
 & + \beta_{12}(\text{Core deposits})_{it,1} \\
 & + \beta_{13}(\text{Core deposit growth})_{it,1} \\
 & + \beta_{14}(\text{Gross loans growth rate})_{it,1} \\
 & + \beta_{15}(\text{De novo bank dummy})_{it,1} \\
 & + \beta_{16}(\text{Capital adequacy rating dummy})_{it,1} \\
 & + \beta_{17}(\text{Asset quality rating dummy})_{it,1} \\
 & + \beta_{18}(\text{Management rating dummy})_{it,1} \\
 & + \beta_{19}(\text{Earnings rating dummy})_{it,1} \\
 & + \beta_{20}(\text{Liquidity rating dummy})_{it,1} \\
 & + \beta_{21}(\text{Logarithm of total assets})_{it,1} + e_{it}
 \end{aligned}$$

The models were estimated by relating year-end financial and related data, to the incidence of mergers and consolidations over the subsequent two years. Estimates were obtained separately for target banks and acquirers. Nine sets of estimates were obtained, starting with 1985 and ending at 1993. The stepwise logit estimations are presented in the Appendix in Tables A-1 through A-6. In interpreting the results, a positive (negative) coefficient estimate, k , implies that an increase in that variable will increase (decrease) the likelihood of being an acquirer (or target) bank.¹⁶

Tables A-1 through A-6 also give some indication of the accuracy of the prediction models. To do this, estimated probabilities of being an acquirer or target bank were obtained for each period. Next, a critical probability value was chosen and banks whose estimated transaction probabilities were above that critical value

were labelled likely acquirers or targets. A critical probability value of five percent was used in all "in-sample" merger forecasts. The five percent value was chosen based upon a subjective judgment that this value yielded fair predictive power. Finally, another measure of logit models' explanatory power is the pseudo R2 statistic.¹⁷ The pseudo R2 statistic is equal to 1 when the model perfectly predicts bank mergers, and zero when the explanatory variables provide no predictive information. For values between zero and 1, the pseudo R2 statistic measures "the percent of uncertainty in the data explained by the empirical results."¹⁸

Results of Logit Estimations

The results of the logit estimations were generally consistent with the profit-maximization, cost-reduction motives often given for mergers and consolidations. For brevity, the discussion will focus on positive results and will not attempt to explain why certain factors tested did not affect merger activity. Generally speaking, estimates of models 1 and 2 for target banks suggest that target banks had lower earnings, higher expenses on fixed assets and more liquid asset portfolios than non-target banks (all other banks). Table A-1 shows that the likelihood of being a target bank in an unassisted merger or consolidation increased with the proportion of liquid assets. In addition, the likelihood of being a target rose with expenses on premises and fixed assets, as well as with all other noninterest expenses. Interestingly, Table A-1 shows that the probability of being a target declined as expenses on employee salaries and benefits rose. This latter result, however, did not appear when consolidations were excluded from the definition of merger events (see Tables A-2 and A-3). The employee expense result in Table A-1 seems at odds with the cost-reduction motive for consolidations and might be related to high "trimming costs" that result from paying accrued benefits and severance pay when personnel is cut back. While such costs can occur with all mergers, in consolidations the willingness to incur such costs might play a larger role in decisions.

The coefficient estimates for the examination indexes for the five CAMEL component areas also suggest some additional characteristics of target banks. Comparisons of Tables A-1 and A-2 indicate that the likelihood of being a target in a consolidation decreases among banks with poorly rated management (Table A-1), but the management rating was not a factor in mergers of unaffiliated banks (Table A-2). The management rating might be expected to be related to acquirers' desire to keep some staff and management of assumed banks. The "human capital" value of the acquired banks' staff can come from knowledge of the local market or general experience and expertise. The result that target banks' management quality is not a determinant of mergers of unaffiliated banks could indicate acquirers' willingness to replace key staff.

Because the management of targets in consolidations is from the same holding company organization as the acquirers, the role of the management rating in Table A-1 might actually be driven by the overall organization involved in the consolidation. If this is the case, then the interpretation of the management rating among targets could have more to do with the acquirer side of the transaction. Results for the predictions of acquiring banks (Tables A-4 and A-5) show that the likelihood of being an acquirer decreases among banks with poor management ratings. This result is logical, given the importance of acquiring banks' management in obtaining regulatory approval of mergers, as well as shareholders' support. Tables A-1 and A-2 also show that the likelihood of being a target bank decreases the poorer the bank's earnings performance, perhaps indicating weaker franchises. In addition, comparisons of Tables A-1 and A-2 show that smaller

banks are more likely to become targets in mergers of unaffiliated banks, but size is not a significant factor in consolidations. The results of model 2 in Table A-3 support the previous results and indicate the importance of some factors, such as earnings strength, to target-bank prediction can be captured by returns on earning assets or by examiners' ratings of earnings strength.

Tables A-4 through A-6 present similar tests of models relating banks' financial condition to the likelihood of being an acquirer in a merger or consolidation. Those results generally support the premise that acquirers are larger banks with well-rated management. Banks with more-liquid portfolios and lower loan concentration (loan HHI index) were also more likely to be acquirers. While these results agree with prior expectations regarding the characteristics of acquiring banks, the most striking result is how few factors were useful in predicting acquirers. Stated differently, the results clearly show how difficult it is to forecast merger activity. Of the 22 factors used to explain the characteristics of acquirers, only four appeared to be consistent in significance: asset size, liquidity, loan concentration, and the quality of management.

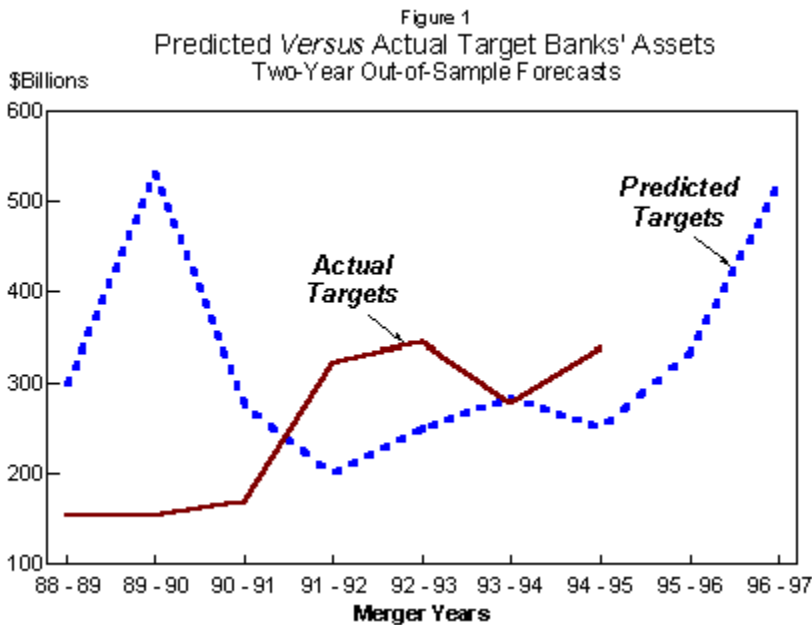
These results are consistent with a very common portrayal of bank mergers, whereby a large, well-run bank acquires a much smaller, less efficient bank. The target bank offers favorable attributes, such as liquidity. The acquirer is also able to correct any deficiencies of the target bank, thereby maintaining efficiencies for the combined organization. While this study does not investigate the post-merger performance of acquirers, the pre-merger profiles of targets and acquirers fit the scenario.

Forecasts of Acquirers and Targets

An important test of the usefulness of a forecasting model's predictive power is how well it predicts events that occur outside of the period used in estimating the model. For example, estimates obtained by logit estimations that related 1990 financial data to 1991 and 1992 merger events can be applied to 1992 financial data to forecast likely targets (acquirers) in 1993 and 1994. A series of such "out-of-sample" forecasts were made for the period 1987 to 1997 and are presented in this section. Forecasts on the number and asset size of the group of potential target banks and acquirers can be done in two ways. First, estimates of the probability of being a target can be obtained for an out-of-sample period for all banks. Second, all banks whose measured probabilities of being a target are above some critical probability value can be designated potential targets. Comparisons of actual targets with predicted targets will give an indication of model accuracy, much like the in-sample forecasts presented in Tables 1 through 3. The same approach can also be used to predict acquirers. One difficulty with this approach is the lack of any guide for selecting a critical probability. In practice, the lower the critical probability, the more likely one will correctly forecast actual targets or acquirers. However, this will also result in a large number of nonmerging banks being identified as targets or acquirers.

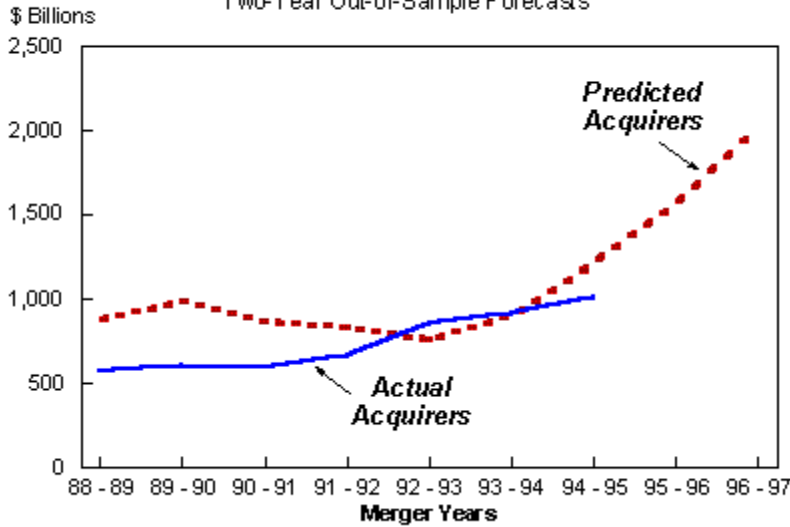
Because the models assign all banks some probability of being a target bank, one can simply take the sum of the predicted probabilities of being a target as the number of predicted targets during the two-year forecast period. While this alternative approach cannot be used to identify individual banks likely to be engaged in mergers, it can give an indication of the total level of merger activity predicted by the model. Whether these banks are large or small in asset size is also of interest. To measure the asset size of the potential target-bank group, one

can multiply each bank's predicted probability of being a target by its total assets. Such statistical forecasts of the size of the target and acquiring bank populations were made for the period 1987 to 1997, based upon the logit estimations of unassisted mergers and consolidations (Tables A-1 and A-4). Those forecasts are shown in Figures 1 and 2, along with the size of the actual target and acquiring bank populations. More specifically, Figure 1 shows the asset size of all target banks as of the start of the two-year forecast period, as well as that of the forecasted targets. Figure 2 shows similar forecasts for acquirers.



Figures 1 and 2 show that the asset sizes of groups of potential targets and acquirers have been rising since 1990. The same is true of groups of actual merging banks. There are two interesting aspects of these forecasts. First, the large overestimation of forecasted target banks for the 1989 to 1990 period (Figure 1). This result might be due, in large part, to the higher proportion of assisted mergers in those two years. Assisted mergers accounted for about half of all transactions in 1989 and 1990 (Table 2). The forecasts shown in Figures 1 and 2 are for unassisted transactions. Many banks that fit the profile of target banks might not have been acquired during 1989 and 1990 because acquirers made government-assisted acquisitions instead. Acquirers might prefer an assisted acquisition over an unassisted acquisition because of the risk-reducing assurances the government typically grants to failed-bank acquirers.¹⁹ A second feature of the forecasts is the dramatic increase in the size of both the target and acquiring bank populations for the period 1996 to 1997. While the actual extent of mergers and consolidations will fluctuate with economic and regulatory events, Figures 1 and 2 indicate a substantial potential for continued industry consolidation in the near future.

Figure 2
 Predicted Versus Actual Acquirers' Assets
 Two-Year Out-of-Sample Forecasts



Note: Acquirers counted only once in cases where two or more mergers occurred during the period.

Changes in States' Banking

Markets

The Riegle-Neal Act will undoubtedly contribute to the continued increase in interstate banking organizations, particularly through the advent of interstate bank branching. Many industry observers are, therefore, curious about which geographic regions will undergo the greatest change. Such information would be particularly helpful to state and federal bank regulators who wish to know the future demands upon their organizations. The previous sections showed the difficulties in profiling acquirers and target banks. Forecasting the geographic location of merger activity adds additional unknowns to the forecasting question by requiring one to know the likely pairs of targets and acquirers. Predicting pairs of merging banks is extremely difficult because those decisions are driven by the individual characteristics of both sides of the transaction. Statistical forecasts, however, are driven by the average attributes of groups. Consequently, this section looks at the geographic distribution of future merger activity indirectly, through forecasts of potential targets and acquirers at the state level.

Figure 3
 Projections of Merger Activity: 1996-1997
 Ratio of Projected Target-Bank Assets-to-Acquirer Assets
 (All Commercial Banks and Savings Banks)

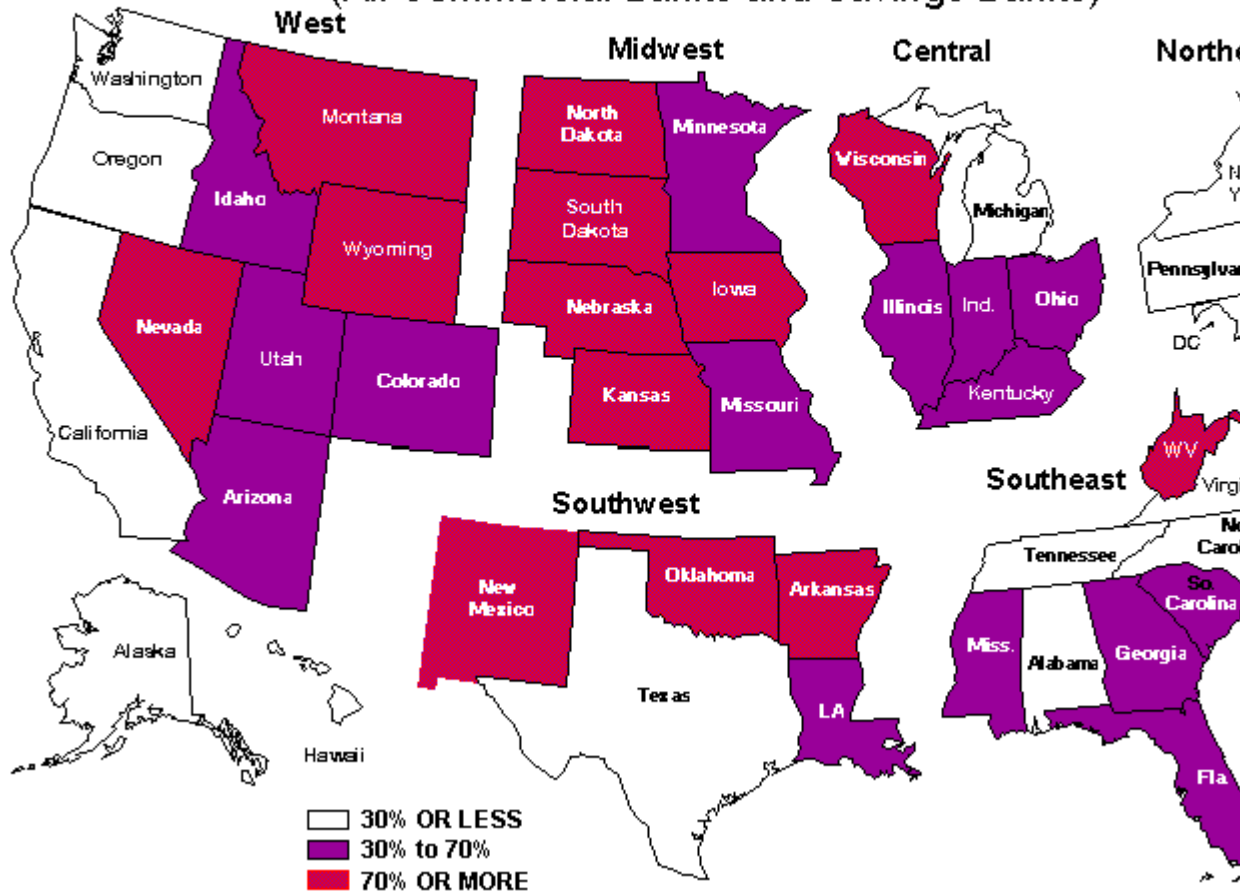


Figure 3 and Table 7 compare forecasts of the relative size of groups of potential targets and acquirers within each state for the period 1996 to 1997. Those forecasts were done using the same methodology outlined previously for national forecasts of unassisted bank mergers and consolidations. Target banks in mergers and consolidations are typically much smaller in asset size than acquirers. Table 6 showed that for a sample of 890 mergers between 1984 and 1995, the ratios of target-bank assets-to-acquirer assets averaged about 26 percent. To gauge the extent of potential targets and acquirers within each state, Figure 3 shows the ratio of forecasted target banks' assets to acquirers' assets within each state. There might be greater potential for interstate activity in regions where there is a high relative surplus of target banks, as indicated by a ratio of target-bank assets to acquirer assets much higher than the average rate of 26 percent.

Figure 1 shows the Midwest region has a high concentration of states where potential target banks' assets exceed 70 percent of potential acquirers' assets. Conversely, in regions where potential target banks are relatively few compared to potential acquirers, acquirers might be encouraged to look outside their geographic markets. Figure 3 shows this is the case in California and Texas, as well as in several large East Coast markets where potential target banks' assets averaged 30 percent or less than acquirers' assets. Following this line of reasoning, one might infer from Figure 3 forecasts of increased mergers between coastal banks and Midwestern banks in the near future. There are, however, some

important caveats to such predictions. First, acquirers might not seek out small banks that fit the profiles of targets if market demographics are not attractive and offer limited growth opportunities. Second, the models this study develops can, at best, only give an indication of banks that have the attributes of acquirers and targets in mergers. Forecasting which banks will pair up in mergers requires more information than these statistical models can provide.

Table 7
Projected Acquirers and Target

Banks: 1996 - 1997

Unassisted Mergers &

Consolidations

Dollars in

Thousands

Targets' Assets	Projected State Assets	Projected Acquirer Ratio	Number of Projected Banks Acquirer	State Banking Assets State	of Acquirers	Projected Target Assets Number	Projected State Number	Projected State Ratio
AK	1,555,104	27.8	9	5,603,888	1.4	493,232	0.7	8.8
AL	27,535,026	48.9	186	56,322,295	12.8	6,149,388	15.5	10.9
AR	3,947,776	13.5	243	29,157,505	16.7	3,328,037	24.9	11.4
AZ	23,173,264	45.1	34	51,393,634	4.6	7,866,666	3.3	15.3
CA	246,549,406	67.0	383	368,222,678	29.8	42,646,860	36.4	11.6
CO	11,621,795	31.1	231	37,351,782	13.1	5,083,485	19.0	13.6
CT	23,148,034	34.6	86	66,818,979	7.1	9,746,381	8.9	14.6
DC	2,231,971	22.7	13	9,836,783	1.3	1,374,280	1.6	14.0
DE	6,672,123	6.0	42	111,177,750	2.2	3,539,376	2.8	3.2
FL	60,004,077	39.8	333	150,762,005	30.8	21,325,205	33.1	14.1
GA	69,383,306	52.3	383	132,670,009	27.4	25,315,300	34.2	19.1
HI	11,278,133	51.9	14	21,722,636	2.1	2,547,194	1.1	11.7
IA	8,265,976	19.7	491	42,018,384	25.2	4,567,017	46.4	10.9
ID	5,201,836	40.4	18	12,890,701	2.6	2,330,384	2.2	18.1
IL	80,644,262	33.0	917	244,479,856	56.4	26,336,931	86.7	10.8
IN	23,341,953	33.3	221	70,041,613	21.1	9,802,370	22.7	14.0
KS	4,961,034	15.8	433	31,428,922	18.0	3,578,873	37.8	11.4

KY	276	49,638,651	6,351,407	12.8
13,750,515	27.7	19.8	28.3	
LA	190	46,221,952	4,849,155	10.5
13,249,696	28.7	12.8	17.3	
MA	235	163,138,452	15,034,191	9.2
57,059,667	35.0	13.3	17.7	
MD	93	69,033,564	8,662,148	12.5
34,804,499	50.4	9.3	8.5	
ME	37	15,212,125	2,047,830	13.5
4,177,485	27.5	3.5	3.0	
MI	180	118,900,391	15,425,932	13.0
65,769,103	55.3	16.2	16.1	
MN	525	70,201,176	8,555,405	12.2
26,564,292	37.8	27.1	45.4	
MO	459	80,481,252	14,834,989	18.4
31,330,691	38.9	31.0	44.8	
MS	112	27,183,016	2,558,715	9.4
7,543,576	27.8	9.2	9.6	
MT	104	8,193,543	963,920	11.8
1,854,750	22.6	5.1	8.4	
NC	104	185,083,269	34,073,825	18.4
137,493,851	74.3	10.8	8.8	
ND	127	8,036,833	785,129	9.8
1,096,467	13.6	5.8	10.8	
NE	336	26,688,333	3,269,710	12.3
4,815,469	18.0	15.2	30.7	
NH	42	17,763,748	3,996,050	22.5
4,154,242	23.4	3.2	4.6	
NJ	110	121,721,651	15,039,922	12.4
52,692,790	43.3	11.3	10.5	
NM	68	14,773,677	1,726,965	11.7
2,844,086	19.3	5.3	6.4	
NV	25	26,334,174	2,106,497	8.0
3,954,798	15.0	2.3	2.0	
NY	214	987,473,090	78,001,125	7.9
518,616,102	52.5	21.6	16.1	
OH	287	162,398,816	22,490,673	13.8
70,605,006	43.5	26.5	28.6	
OK	342	34,526,994	3,880,763	11.2
6,424,699	18.6	17.2	28.0	
OR	45	31,570,733	4,249,998	13.5
15,703,178	49.7	5.5	3.3	
PA	271	202,354,452	24,778,430	12.2
105,860,073	52.3	25.0	26.0	
RI	11	22,708,039	2,644,297	11.6
10,814,279	47.6	1.9	0.8	
SC	71	24,588,928	3,061,755	12.5
9,148,011	37.2	6.2	5.7	
SD	116	28,614,803	633,473	2.2
513,370	1.8	4.5	9.0	
TN	240	66,595,870	6,865,736	10.3
22,540,387	33.8	18.8	22.5	
TX	948	210,076,213	22,519,635	10.7
82,562,199	39.3	53.8	84.8	
UT	45	19,912,754	2,468,610	12.4
6,939,982	34.9	3.9	4.3	

VA	158	77,818,910	7,401,301	9.5
32,086,378	41.2	13.5	15.0	
VT	25	7,659,631	954,146	12.5
1,300,318	17.0	2.5	2.8	
WA	99	74,214,908	12,243,496	16.5
44,599,653	60.1	10.4	8.1	
WI	411	69,320,911	8,476,630	12.2
16,290,528	23.5	30.5	41.7	
WV	118	21,255,773	2,177,964	10.2
3,874,201	18.2	7.6	10.8	
WY	53	8,348,581	874,505	10.5
1,288,045	15.4	3.1	5.2	
U.S. Total	10,514	4,539,944,633	520,035,306	11.5
2,021,837,462	44.5	725.9	962.9	

*Note that all asset values were based upon December 1995 Call reports.

TABLE A-1
Model 1. - Predicting Targets in Mergers & Consolidations

Stepwise Logit Estimation of the Relationships Between Banks' Year-End Financial Condition and the Incidence of Mergers and Consolidations Over the Succeeding Two Years.

(FDIC-Assisted Mergers not classified as Mergers)

Estimated Coefficients (Standard Error)

Explanatory Variables	1989	1990	1991	1985 1992	1986 1993	1987	1988	
Intercept	2.5419	-3.4490	-3.5004	-14.6565	-8.3238	-1.2914	0.8515	-
	(0.1197)	(0.2711)	(0.2986)	(2.0932)	(1.8343)	(0.1912)	(0.5576)	
Interest-Bearing	-	-	-	0.1016	0.0734	-	-0.0284	
Nonrisk Assets				(0.0211)	(0.0182)		(0.0052)	
Noninterest-Bearing	0.0651	0.0583	0.0671	0.1586	0.1169	0.0425	-	
Nonrisk Assets	(0.0116)	(0.0118)	(0.0106)	(0.0234)	(0.0201)	(0.0117)		
Performing	-	-	-	0.1292	0.1011	0.0260	-	
Risk Assets				(0.0215)	(0.0181)	(0.0051)		
Loan Portfolio	-	-	-	-	-0.0001	-0.0001	-0.0001	
Concentration (HHI)					-0.0001	(0.00004)	(0.00003)	(0.00004)
	(0.00003)							

Total Loans plus Securities	-0.0187	-0.0343	-0.0277	-0.0211		
-	-	-	-	-		
with >= 5 yrs maturity	(0.0074)	(0.0058)	(0.0052)	(0.0054)		
Expense on Salaries	-0.5489	-0.7900	-1.1888	-0.7964		-
0.6928	-0.6459	-0.5842	-0.6311	-0.7580		
and Benefits	(0.0745)	(0.0851)	(0.0949)	(0.0841)		
(0.0809)	(0.0884)	(0.0848)	(0.0835)	(0.0797)		
Expense on Premises		0.7369	0.5554	0.6779		-
-	0.6687	0.4559	0.5536	0.3629		
and Fixed Assets	(0.1106)	(0.1205)	(0.1342)			
(0.1438)	(0.1538)	(0.1582)	(0.1686)			
All Other Noninterest	0.3942	0.4095	0.3247	0.2832		
0.4356	0.3417	0.1873	0.1771	0.3090		
Expense	(0.0507)	(0.0553)	(0.0538)	(0.0338)		
(0.0446)	(0.0443)	(0.0351)	(0.0391)	(0.0423)		
Return on Earning	-	-0.1838	-0.1024	-0.1465		
-	-	-	-0.0743			
Assets		(0.0322)	(0.0311)	(0.0262)		
(0.0310)						
Equity Capital	-	-	-	-		
-	-	-	-	-		
Loan-Loss Allowance	-	0.1612	0.1616	-		
-	0.2356	0.2334	0.2480	0.2382		
				(0.0552)	(0.0493)	
(0.0501)	(0.0480)	(0.0519)	(0.0507)			
Core Deposits	-	-0.0134	-	-		
-	0.0065	0.0092	0.0142	-		
				(0.0025)		
(0.0032)	(0.0035)	(0.0036)				
Core Deposit Growth	-	-	-	-		
-	-	-	-	0.0010		
(0.0004)						
Growth in Gross Loans	-	-	-	-		
-	-	-	-	-		
De Novo Bank Dummy	-0.4653	-0.5728	-	-		
-	-	-	-	-		
	(0.1843)	(0.1745)				
Supervisory Concern	-	-	-	-0.4513		
-	-0.2678	-	-	-		
for Capital Dummy				(0.1317)		
(0.1197)						
Supervisory Concern	-	-	-	-		
-	-	-	-	-		
for Asset Quality Dummy						
Supervisory Concern	-	-0.3865	-0.4438	-0.3366		
-	-0.3290	-0.2460	-0.2149	-0.4336		
for Management Quality Du		(0.0923)	(0.0951)	(0.1130)		
(0.1041)	(0.0923)	(0.0888)	(0.0980)			
Supervisory Concern	-	-	0.1901	0.4982		
-	0.3831	0.4713	0.4263	0.2438		
for Earnings Dummy			(0.0838)	(0.0919)		
(0.0934)	(0.0885)	(0.0859)	(0.0945)			

Supervisory Concern			-	0.2757	-	-
-	-	-	-	-	-	-
for Liquidity Dummy				(0.1061)		
Log of Total Assets			0.0947	0.0710	-	-
-	-	-	0.0697	-		
			(0.0297)	(0.0297)		
(0.0274)						
2x Log of Likelihood			5875	7082	6646	5647
5705	5864	6085	6678	7213		
Number of Observations			13,822	14,037	13,642	13,081
12,715	12,395	12,024	11,659	11,272		
Pseudo R2			0.040	0.065	0.047	0.040
0.027	0.037	0.032	0.032	0.031		
In-Sample of 10% Critical Probability						
Correct Predictions (%)						
Targets			18.7	45.5	36.1	18.2
14.2	24.9	28.7	41.1	63.1		
Nontargets			92.7	83.1	86.5	93.3
95.6	91.1	87.0	77.2	58.3		
Incorrect Predictions (%)						
False Failures or Type I			7.3	16.9	13.5	6.7
4.4	8.9	13.0	22.8	41.7		
Missed Failures or Type I			81.3	54.5	63.9	81.8
85.8	75.1	71.3	58.9	36.9		
Total Correct Predictions (%)			88.5	80.2	82.9	88.8
90.6	86.6	82.8	74.1	58.8		
Number of Targets			801	1,072	965	775
783	830	878	1,016	1,154		
Number of Nontargets			13,021	12,965	12,677	12,306
11,932	11,565	11,146	10,643	10,119		

Table A-2
Model 1 - Predicting Targets in Non-affiliate
Mergers

Stepwise Logit Estimation of the Relationships Between Banks' Year-
end Financial Condition
and the Incidence of Mergers Over the Succeeding
Two Years.

(Consolidations and FDIC-Assisted Mergers Not
Classified as Mergers)

Estimated Coefficients (Standard Errors)

Explanatory
Variables

1989	1990	1991	1985	1986	1987	1988
			1992	1993		

Intercept				-5.6309	-3.2043	-1.0598	-4.2086	-
0.7494	-0.7118	-1.6850	-1.8376	-3.0233				
			(0.4245)	(0.2347)	(0.7064)	(1.0652)		
(0.7197)	(0.6216)	(0.5133)	(0.4645)	(0.2228)				
Interest-Bearing			--	--	-0.0264	--	--	--
--	--	--	--	--				
Nonrisk Assets					(0.0072)			
Noninterest-Bearing			0.0531	0.0493	--	0.0389		
0.0446	--	0.0380	0.0384	--				
Nonrisk Assets			(0.0132)	(0.0116)		(0.0196)		
(0.0189)		(0.0126)	(0.0146)					
Performing			--	0.0240	--	--		
--	--	--	--	--				
Risk Assets				(0.0086)				
Loan Portfolio			--	--	--	--		
--	--	--	--	0.0001				
Concentration (HHI)								
(0.00003)								
Total Loans Plus Securities			--	-0.0318	-0.0344	--		
--	--	-0.0094	-0.0111	-0.0138				
with >= 5 yrs Maturity				(0.0088)	(0.0077)			
(0.0040)	(0.0036)	(0.0033)						
Expense on Salaries			--	--	--	--		
--	--	--	--	--				
and Benefits								
Expense on Premises			0.5498	--	--	--		
--	--	0.2409	--	--				
and Fixed Assets			(0.0999)					
(0.1079)								
All Other Noninterest			--	--	--	0.0966		
0.1093	0.1501	--	--	--				
Expense						(0.0390)		
(0.0513)	(0.0387)							
Return on Earning			--	-0.1727	--	--		
--	--	--	--	--				
Assets				(0.0306)				
Equity Capital			--	--	--	--		
--	--	--	--	--				
Loan-Loss Allowance			--	--	--	--		
--	--	0.2510	0.1628	0.2067				
(0.0653)	(0.0704)	(0.0631)						
Core Deposits			0.0158	--	--	0.0217		
--	--	--	--	--				
			(0.0050)			(0.0076)		
Core Deposit Growth			--	--	--	--		
--	--	--	--	--				
Growth in Gross Loans			--	--	--	--		
--	--	--	--	--				
De Novo Bank Dummy			--	--	--	--		
--	--	--	--	--				
Supervisory Concern for			--	--	--	--		
--	--	--	--	0.3752				

Capital Dummy								
(0.1516)								
Supervisory Concern for	--	--	--	--	--	--	--	--
-- 0.4802 0.4651 0.3618	--	--	--	--	--	--	--	--
Asset Quality Dummy								
(0.1471) (0.1359) (0.1234)								
Supervisory Concern for	0.3625	--	--	--	--	--	--	--
-- -- --	--	--	--	--	--	--	--	--
Management Quality Dummy	(0.1155)							
Supervisory Concern for	--	--	0.5912	0.5999				
0.5115 0.6305 0.4400 0.7165 0.7940								
Earnings Dummy			(0.1206)	(0.1382)				
(0.1430) (0.1485) (0.1329) (0.1156) (0.1173)								
Supervisory Concern for	--	0.3835	--	--				
-- -- -- 0.3154 --								
Liquidity Dummy			(0.1440)					
(0.1469)								
Log of Total Assets	--	--	--	-0.2014	-			
0.3684 -0.3480 -0.1975 -0.1351 --								
				(0.0668)				
(0.0661) (0.0576) (0.0463) (0.0407)								

-2x Log of Likelihood	3206	3355	2810	2223	2091
2537 3168 3772 3768					
Number of Observations	13,822	14,037	13,345	13,081	12,715
12,115 12,024 11,659 11,272					
Pseudo R2	0.020	0.028	0.018	0.030	0.034
0.052 0.045 0.046 0.036					

In-Sample at 4% Critical Probability
Correct Predictions (%)

Targets	15.4	22.2	5.4	7.9	13.6
38.2 42.7 56.6 49.8					
Nontargets	93.0	91.1	96.6	97.4	96.9
86.4 78.6 69.1 72.5					

Incorrect Predictions (%)

False Targets or Type II Error	7.0	8.9	3.4	2.6	3.1
13.6 21.4 30.9 27.5					
Missed Targets or Type I Error	84.6	77.8	94.6	92.1	86.4
61.8 57.3 43.4 50.2					
Total Correct Predictions (%)	91.1	89.3	94.6	95.8	95.5
85.3 77.5 68.6 71.6					
Number of Targets	351	374	297	227	213
280 372 472 470					
Number of Nontargets	13,471	3,663	13,345	12,854	12,502
12,115 11,652 11,187 10,803					

Table A-3

Model 2 - Predicting Targets in Non-affiliate Mergers
 Stepwise Logit Estimation of the Relationships Between Banks' Year-end
 Financial Condition
 and the Incidence of Mergers Over the Succeeding Two Years.
 (Consolidations and FDIC-Assisted Mergers Not Classified as Mergers)
 Estimated Coefficients (Standard Errors)

Explanatory Variables		1985	1986	1987	1988	1989
1990	1991	1992	1993			
Intercept		-5.6860	-3.2075	-2.6312	-0.8507	-0.2565
0.4328	-1.8917	-1.8731	-2.1432	(0.4264)	(0.2337)	(0.5478)
(0.6148)	(0.5002)	(0.4600)	(0.4522)	(0.6630)	(0.7052)	
Interest-Bearing		--	--	--	--	--
--	--	--	--			
Nonrisk Assets						
Noninterest-Bearing		0.0533	0.0494	0.0547	0.0400	0.0512
--	0.0504	0.0411	--	(0.0130)	(0.0116)	(0.0164)
(0.0124)	(0.0149)			(0.0187)	(0.0182)	
Performing		--	0.0228	--	--	--
--	--	--	--			
Risk Assets			(0.0086)			
Loan Portfolio		--	--	--	--	--
--	--	--	0.0001			
Concentration (HHI)						
(0.00003)						
Total Loans Plus Securities		--	-0.0293	--	--	--
--	--	-0.0074	-0.0109			
with >= 5 yrs Maturity				(0.0087)		
(0.0035)	(0.0035)					
Expense on Salaries		--	--	--	--	--
--	--	--	--			
and Benefits						
Expense on Premises		0.5631	--	--	--	--
0.2709	0.3398	0.4089	0.4173			
and Fixed Assets			(0.0974)			
(0.1138)	(0.0993)	(0.1296)	(0.1375)			
All Other Noninterest		--	--	--	--	0.1371
0.1273	--	--	--			
Expense						(0.0446)
(0.0461)						
Return on Earning		--	-0.1827	-0.1227	-0.1313	--
0.0761	--	-0.0925	-0.1251			--
Assets			(0.0292)	(0.0311)	(0.0332)	
(0.0228)		(0.0304)	(0.0379)			
Equity Capital		--	--	--	--	--
--	--	--	--			
Loan-Loss Allowance		--	--	--	--	--
0.2507	0.3878	0.3628	0.3226			
(0.0721)	(0.0564)	0.0605	(0.0607)			

Core Deposits				0.0178	--	--	--	--	
--	--	--	--						
				(0.0050)					
Core Deposit Growth				--	--	--	--	--	
--	--	--	--						
Growth in Gross Loans				--	--	--	--	--	
--	--	--	--						
De Novo Bank Dummy				--	--	--	-1.2575	--	
--	--	--	--						
							(0.5865)		
Log of Total Assets				--	--	-0.1236	-0.3002	-0.4028	-
0.3561	-0.2205	-0.1348	-0.0834						
						(0.0505)	(0.0623)	(0.0655)	
(0.0576)	(0.0452)	(0.0408)	(0.0405)						
-2x Log of Likelihood				3240	3391	2829	2253	2110	
2571	3218	3847	817						
Number of Observations				13,928	14,110	13,695	13,116	12,740	
12,412	12,035	11,660	11,272						
Pseudo R2				0.017	0.024	0.012	0.024	0.029	
0.040	0.030	0.027	0.023						
In-Sample at 4% Critical Probability									
Correct Predictions (%)									
Targets				12.7	19.1	5.1	7.0	8.9	
24.3	32.3	56.4	60.4						
Nontargets				94.8	92.5	97.7	98.6	98.0	
93.5	85.1	64.8	60.0						
Incorrect Predictions (%)									
False Targets or Type II Error				5.2	7.5	2.3	1.4	2.0	
6.5	14.9	35.2	40.0						
Missed Targets or Type I Error				87.3	80.9	94.9	93.0	91.1	
75.7	67.7	43.6	39.6						
Total Correct Predictions (%)				92.7	90.5	95.7	97.0	96.5	
91.9	83.5	64.5	60.0						
Number of Targets				354	377	297	229	214	
280	372	472	470						
Number of Nontargets				13,574	13,733	13,398	12,887	12,526	
12,132	11,663	11,188	10,803						

Table A-4
Model 1 - Predicting Acquirers in Mergers and
Consolidations
Stepwise Logit Estimation of the Relationships Between Banks' Year-
end Financial Condition
and the Incidence of Mergers and Consolidations Over the
Succeeding Two Years.
(FDIC-Assisted Mergers Not Classified as Mergers)
Estimated Coefficients (Standard Errors)

Explanatory

Variables	1985	1986	1987	1988	1989
1990 1991 1992 1993					
Intercept	-10.4927	-8.6842	-8.4512	-8.2614	-8.7272
8.9289 -9.1472 -9.3531 -8.4877					
	(0.4298)	(0.5009)	(0.4077)	(0.4733)	(0.4273)
(0.3883) (0.3567) (0.3425) (0.3916)					
Interest-Bearing	--	--	--	-0.0080	--
-- -- -- -0.0119					
Nonrisk Assets				(0.0035)	
(0.0031)					
Noninterest-Bearing	0.0515	0.0546	0.0977	0.0715	0.0838
0.0776 0.0485 0.0338 --					
Nonrisk Assets	(0.0131)	(0.0110)	(0.0135)	(0.0138)	(0.0150)
(0.0137) (0.0128) (0.0153)					
Performing	0.0156	--	0.0081	--	0.0119
-- -- -- --					
Risk Assets	(0.0040)		(0.0035)		(0.0038)
Loan Portfolio	-0.0002	-0.0002	-0.0003	-0.0002	-0.0002
0.0003 0.0003 -0.0002 -0.0003					
Concentration (HHI)					
(0.00006)(0.00006)(0.00005)(0.00006)(0.00005)(0.00006)(0.00005)(0.00004)(0.00005)					
Total Loans Plus Securities	--	--	--	--	--
0.0076 -- -- --					
with >= 5 yrs Maturity					
(0.0038)					
Expense on Salaries	--	--	-0.4633	--	-0.3692
-- -- -- --					
and Benefits			(0.1226)		(0.1100)
Expense on Premises	--	0.4342	0.5809	--	--
-- -- -- --					
and Fixed Assets		(0.1372)	(0.1961)		
All Other Noninterest	--	--	--	--	0.1761
0.1117 0.1114 0.1048 --					
Expense					(0.0538)
(0.0447) (0.0370) (0.0373)					
Return on Earning	--	--	--	0.0798	--
-- -- -- --					
Assets				(0.0365)	
Equity Capital	--	-8.5427	--	--	--
-- -- -- --					
		(3.0338)			
Loan-Loss Allowance	--	0.1604	--	--	--
-- -- -- --					
		(0.0761)			
Core Deposits	--	--	--	--	--
-- -- -- --					
Core Deposit Growth	--	--	--	--	--
-- -- -- 0.0016					
(0.0005)					
Growth in Gross Loans	--	--	--	--	--
-- -- -- --					
De Novo Bank Dummy	--	--	--	--	--
-- -- 0.6053 --					

(0.2901)								
Supervisory Concern for	-0.4026	-0.5235	--	--	--	--	--	-
0.4078	--	--	--					
Capital Dummy	(0.1451)	(0.1438)						
(0.1356)								
Supervisory Concern for	--	--	--	--	--	--	--	
--	--	--	--					
Asset Quality Dummy								
Supervisory Concern for	--	--	-0.4088	-0.6075	-0.5297			
--	-0.3587	-0.5921	-0.6023					
Management Quality Dummy			(0.1218)	(0.1414)	(0.1335)			
(0.1153)	(0.1155)	(0.1426)						
Supervisory Concern for	--	--	--	--	--			
--	--	--	--					
Earnings Dummy								
Supervisory Concern for	--	0.3247	--	--	--			
--	-0.4286	--	--					
Liquidity Dummy		(0.1436)						
(0.1658)								
Log of Total Assets	0.5751	0.5028	0.4810	0.4853	0.4674			
0.4877	0.5723	0.5900	0.6134					
			(0.0311)	(0.0375)	(0.0302)	(0.0309)		
(0.0320)	(0.0299)	(0.0275)	(0.0269)	(0.0276)				
-2x Log of Likelihood	3623	4161	4070	3694	3677			
3862	4001	4205	4220					
Number of Observations	13,822	14,037	13,642	13,081	12,715			
12,395	12,024	11,659	11,272					
Pseudo R2	0.121	0.122	0.110	0.110	0.110			
0.099	0.112	0.116	0.137					
In-Sample at 10% Critical								
Probability Correct								
Predictions (%)								
Acquirers	26.8	32.0	26.7	25.8	26.9			
26.6	32.5	36.2	41.2					
Nonacquirers	96.1	94.6	95.0	95.6	95.3			
95.3	94.0	92.8	90.7					
Incorrect Predictions (%)								
False Acquirers or Type II Error	3.9	5.4	5.0	4.4	4.7			
4.7	6.0	7.2	9.3					
Missed Acquirers or Type I Error	73.2	68.0	73.3	74.2	73.1			
73.4	67.5	63.8	58.8					
Total Correct Predictions (%)	93.7	92.1	92.3	93.0	92.7			
92.4	91.1	89.8	87.9					
Number of Acquirers	473	565	544	485	487			
515	557	605	636					
Number of Nonacquirers	13,349	13,472	13,098	12,596	12,228			
11,880	11,467	11,054	10,637					

Table A-5
Model 1 - Predicting Acquirers in Non-affiliate

Mergers

Stepwise Logit Estimation of the Relationships Between Banks' Year-
end Financial Condition
and the Incidence of Mergers Over the Succeeding Two
Years.

Consolidations and FDIC-Assisted Mergers Not Classified
as Mergers)

Estimated Coefficients (Standard Errors)

Explanatory				1985	1986	1987	1988	
Variables				1985	1986	1987	1988	
1989	1990	1991	1992	1993				
Intercept				-10.0735	-10.2933	-9.2250	-11.3179	-
8.8894	-7.2415	-8.6121	-9.0727	-9.8373				
				(0.5422)	(0.4662)	(0.4878)	(1.1054)	
(0.5168)	(0.5461)	(0.4658)	(0.4149)	(0.4302)				
Interest-Bearing				--	--	--	--	-
-	--	--	--	--				
Nonrisk Assets								
Noninterest-Bearing				--	0.0383	0.0518	--	
0.0550	0.0533	0.0427	--	--				
Nonrisk Assets					(0.0158)	(0.0201)		
(0.0223)	(0.0174)	(0.0154)						
Performing				--	--	--	--	-
-	--	--	--	--				
Risk Assets								
Loan Portfolio				-0.0002	--	--	-0.0002	-
-	-0.0003	-0.0002	-0.0001	-0.0002				
Concentration (HHI)				(0.00009)			(0.00009)	
(0.00008)	(0.00007)	(0.00005)	(0.00005)					
Total Loans plus Securities				--	--	--	--	-
-	--	--	--	--				
with >= 5 yrs Maturity								
Expense on Salaries				--	--	--	--	-
-	--	--	--	0.1650				
and Benefits								
(0.0551)								
Expense on Premises				0.4572	0.5837	--	--	-
-	--	--	--	--				
and Fixed Assets				(0.1785)	(0.1576)			
All Other Noninterest				--	--	--	--	-
-	--	--	--	--				
Expense								
Return on Earning				--	--	0.0705	0.1588	-
-	--	--	--	--				
Assets						(0.0308)	(0.0357)	
Equity Capital				--	--	--	--	-
-	--	--	--	--				
Loan-Loss Allowance				--	--	--	--	-
-	--	--	--	--				
Core Deposits				--	--	--	0.0173	-
-	--	--	--	--				
							(0.0067)	

Core Deposit Growth	--	--	--	--	--	--	--
-	--		0.0014				-
(0.0005)							
Growth in Gross Loans	--	--	--	--	--	--	--
-	--	--	--	--	--	--	-
De Novo Bank Dummy	--	--	--	--	--	--	--
-	--	1.0700	0.8955	--			-
(0.3013)	(0.3235)						
Supervisory Concern for	--	--	--	--	--	--	--
-	--	--	--	--	--	--	-
Capital Dummy							
Supervisory Concern for	--	-0.4223	--	--	-0.5878	--	--
-	--	--	--	--	--	--	-
Asset Quality Dummy				(0.1578)		(0.2320)	
Supervisory Concern for	-0.6379	--	-0.5009	--	--	--	--
-	--	-0.6182	-0.6504	-0.4867			-
Management Quality Dummy	(0.2069)		(0.1991)				
(0.1540)	(0.1549)	(0.1855)					
Supervisory Concern for	--	--	--	--	--	--	--
-	--	--	--	--	--	--	-
Earnings Dummy							
Supervisory Concern for	--	--	--	--	--	--	--
0.7987	--	--	--	--	--	--	-
Liquidity Dummy							
(0.3140)							
Log of Total Assets	0.5637	0.5141	0.4249	0.5439			
0.3890	0.3194	0.4764	0.5200	0.5730			
			(0.0385)	(0.0382)	(0.0407)	(0.0563)	
(0.0442)	(0.0420)	(0.0355)	(0.0325)	(0.0324)			
-2x Log of Likelihood	2077	2237	2060	1777			
1756	2094	2485	2798	2666			
Number of Observations	13,822	14,037	13,642	13,081			
12,715	12,395	12,024	11,659	11,272			
Pseudo R2	0.093	0.079	0.058	0.074			
0.045	0.030	0.076	0.081	0.106			
In-Sample at 4% Critical Probability							
Correct Predictions (%)							
Acquirers			32.1	26.7	17.5	19.8	
12.6	14.0	35.9	44.6	48.2			
Nonacquirers			95.2	94.4	95.9	96.1	
97.2	96.5	89.6	84.5	85.8			
Incorrect Predictions (%)							
False Acquirers or Type II Error	4.8	5.6	4.1	3.9			
2.8	3.5	10.4	15.5	14.2			
Missed Acquirers or Type I Error	67.9	73.3	82.5	80.2			
87.4	86.0	64.1	55.4	51.8			
Total Correct Predictions (%)	94.1	93.3	94.7	95.1			
96.1	95.1	88.3	83.3	84.7			
Number of Acquirers	224	240	212	182			
174	215	284	336	330			
Number of Nonacquirers	13,598	13,797	13,430	12,899			
12,541	12,180	11,740	11,323	10,943			

TABLE A-6

Model 2. - Predicting Acquirers in
Nonaffiliate Mergers

Stepwise logit estimation of the relationships between banks' year-
end financial condition
and the incidence of mergers over the succeeding
two years.
(Consolidations & FDIC-Assisted Mergers not
classified as Mergers)

Estimated Coefficients (Standard
Errors)

Explanatory Variables							
1989	1990	1991	1985 1992	1986 1993	1987	1988	
Intercept			-10.6688	-10.3840	-9.5221	-11.7955	
-8.7693	-7.2196	-8.7029	-9.2381	-9.9427			
(0.5154)	(0.5446)	(0.4657)	(0.4507)	(0.4599)	(0.4739)	(1.0940)	
			(0.4155)	(0.4316)			
Interest-Bearing			-	-	-	-	
-	-	-	-	-	-	-	
Nonrisk Assets							
Noninterest-Bearing			-	0.0352	0.0511	-	
0.0588	0.0531	0.0407	-	-			
Nonrisk Assets				(0.0158)	(0.0202)		
(0.0213)	(0.0174)	(0.0152)					
Performing			-	-	-	-	
-	-	-	-	-	-	-	
Risk Assets							
Loan Portfolio			-	-	-	-0.0002	
-	-0.0003	-0.0003	-0.0001	-0.0002			
Concentration (HHI)						(0.00009)	
(0.00008)	(0.00007)	(0.00005)	(0.00006)				
Total Loans plus Securities			-	-	-	-	
-	-	-	-	-	-	-	
with >= 5 yrs maturity							
Expense on Salaries			-	-	-	-	
-	-	-	-	-	-	-	
and Benefits							
Expense on Premises			-	0.5308	-	-	
-	-	-	-	0.1566			
and Fixed Assets				(0.1576)			
(0.0571)							
All Other Noninterest			-	-	-	-	
-	-	-	-	-	-	-	
Expense							
Return on Earning			-	-	0.0803	0.1705	
-	-	-	-	-			
Assets					(0.0294)	(0.0342)	

Equity Capital	-	-	-	-	-	-
-	-	-	-	-	-	-
Loan-Loss Allowance	-	-	-	-	-	-
-	-	-0.2316	0.2168	-	-	-
(0.1053)	(0.1016)					
Core Deposits	-	-	-	-	-	0.0189
-	-	-	-	-	-	(0.0067)
Core Deposit Growth	-	-	-	-	-	-
-	-	-	-	0.0014	-	-
(0.0005)						
Growth in Gross Loans	-	-	-	-	-	-
-	-	-	-	-	-	-
De Novo Bank Dummy	-	-	-	-	-	-
-	-	1.0112	0.8820	-	-	-
(0.3014)	(0.3232)					
Log of Total Assets			0.5868	0.5173	0.4412	0.5659
0.3713	0.3177	0.4942	0.5446	0.5787		
			(0.0377)	(0.0378)	(0.0399)	(0.0556)
(0.0440)	(0.0419)	(0.0373)	(0.0345)	(0.0323)		
2x Log of Likelihood			2097	2263	2068	1785
1785	2095	2498	2813	2674		
Number of Observations			13,928	14,110	13,695	13,116
12,740	12,412	12,035	11,660	10,958		
Pseudo R2			0.086	0.076	0.055	0.070
0.039	0.035	0.071	0.076	0.103		
In-Sample at 4% Critical Probability						
Correct Predictions (%)						
Acquirers			29.9	28.1	16.5	19.2
11.4	14.0	35.2	42.0	45.8		
Nonacquirers			95.6	94.7	96.1	96.3
97.3	96.6	90.4	85.3	86.1		
Incorrect Predictions (%)						
False Acquirers or Type II Error			4.4	5.3	3.9	3.7
2.7	3.4	9.6	14.7	13.9		
Missed Acquirers or Type I Error			70.1	71.9	83.5	80.8
88.6	86.0	64.8	58.0	54.2		
Total Correct Predictions (%)			94.5	93.6	94.8	95.2
96.1	95.2	89.1	84.1	84.9		
Number of Acquirers			224	242	212	182
176	215	284	336	330		
Number of Nonacquirers			13,704	13,868	13,213	12,934
12,564	12,197	11,751	11,324	10,943		

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FDIC Banking Review

Recent Developments Affecting Depository Institutions by Benjamin B. Christopher and Valentine V. Craig

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. These joint initiatives concern capital adequacy for derivatives; interest-rate risk; retail sales of nondeposit investment products; "suspicious activity" reporting; and regulatory relief in storm-damaged areas.

Risk-Based Capital: Derivatives

The federal banking agencies the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC) amended, effective October 1, 1995, risk-based capital standards for banks and bank holding companies to implement a revision to the Basle Accord. The Accord established a risk-based capital framework for assessing capital adequacy, implemented by the U. S. banking agencies in 1989. Under this framework, off-balance-sheet transactions were incorporated into the risk-based structure by converting each item into a credit-equivalent amount that was assigned to the appropriate credit-risk category according to the obligor or counterparty, or if relevant, the guarantor or the nature of the collateral. The credit-equivalent amount of an off-balance-sheet interest-rate or exchange-rate contract was determined by adding together the current replacement cost (current exposure) of the contract and an estimate of the possible increase in the future replacement cost (potential future exposure) in view of the volatility of the current exposure of the contract. The maximum risk category for rate contracts is 50 percent.

The effects of this final rule are: a) long-dated interest-rate and exchange-rate contracts are subject to higher conversion factors and new conversion factors are set forth that specifically apply to derivative contracts related to equities, precious metals, and other commodities; b) institutions are permitted to recognize a reduction in potential future credit exposure for transactions subject to qualifying bilateral netting arrangements; and c) derivative contracts related to equities, precious metals and other commodities may be recognized in bilateral netting arrangements for risk-based capital purposes. *FR, 9/5/95, p. 46170; FIL-59-95, FDIC, 9/8/95.*

Additionally, the Bank for International Settlements, in July 1996, released a draft proposal to require derivatives dealers worldwide to record the notional and replacement cost of all derivative contracts. Public comment is due by September 30, 1996, with reporting expected to begin on December 31, 1997. *AB, July 19, 1996.*

Capital Standards For Interest-Rate Risk

The OCC, the FRB, and the FDIC issued a final rule, effective September 1, 1995, implementing the FDICIA provision requiring banking agencies to revise risk-based capital standards to take adequate account of interest-rate risk. The final rule amended capital standards to specify that the banking agencies include in their evaluations of a bank's capital adequacy an assessment of the exposure to declines in the economic value of the bank's capital due to changes in interest rates.

Subsequently, in May 1996, the three regulatory agencies approved a scaled-back approach for considering bank interest-rate risk. The agencies adopted guidelines that advised bank directors to establish interest-rate-risk limits, to appoint officials to oversee policy, and to monitor management compliance. The agencies will continue to consider interest-rate risk when setting a bank's capital requirement, but agreed to examine each bank individually rather than apply a standardized interest-rate model across-the-board. The joint policy statement on interest-rate risk became effective on June 26, 1996. *FR*, 8/2/95, pp. 39490, 39495; *AB*, 5/24/96; *FR*, 6/26/96, pp.33166; *AB*, 7/17/96.

Retail Sales of Nondeposit Investment Products

The FDIC, the FRB, the OCC and the Office of Thrift Supervision (OTS) issued joint interpretations of their Inter-Agency Statement, released on February 15, 1994, on retail sales of mutual funds and other nondeposit investment products by federally insured financial institutions (see this Review, Winter 1995, p. 31). The interpretations give the inter-agency position regarding abbreviated disclosures and clarify instances where it is not necessary to provide disclosures.

There are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in radio broadcasts of 30 seconds or less, electronic signs, and other signs (such as banners and posters) used only as location indicators. Third-party vendors not affiliated with the depository institution need not make the Inter-Agency Statement disclosures on nondeposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution. The interpretations state that with respect to shorter logo format disclosures that can be used in visual media, such as television broadcasts, ATM screens, and signs, the text of an acceptable logo format disclosure would include the statements "Not FDIC Insured," "No Bank Guarantee," and "May Lose Value," which would be boxed, set in bold face type, and displayed conspicuously. *FIL-61-95, FDIC, 9/13/95; with "Joint Interpretations of the Inter-Agency Statement," and response letter to the American Bankers Association, 9/12/95.*

On May 5, 1996, the FDIC issued the results of a nationwide survey it funded of approximately 1,200 FDIC-insured institutions to determine their compliance with inter-agency guidelines on the sale of uninsured investment products. The survey found that banks were more likely to make required disclosures in face-to-face discussions than over the phone. Required disclosures were also found to be made more frequently by investment personnel who were members of the National Association of Securities Dealers (NASD) or employed by third-party affiliates than by investment representatives affiliated with an internal banking group. *Survey of Nondeposit Investment Sales at FDIC-Insured Institutions,*

prepared by Market Trends, 5/5/96.

Suspicious Activity Reports (SARs)

The Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury and the federal financial institutions' supervisory agencies issued new regulations requiring centralized filing with FinCEN of reports of suspicious transactions under the Bank Secrecy Act (BSA). A uniform "Suspicious Activity Report" (SAR) is to be used to report suspicious transactions and known or suspected criminal violations. Essentially the same rule was issued or is being issued by the five federal supervisory agencies for depository institutions.

The regulation raises the mandatory reporting thresholds for criminal offenses and reducing bank reporting burdens. For the reporting of known or suspected criminal activity when a bank has a substantial basis for identifying a non-insider suspect, the reporting threshold based on asset involvement is raised from the existing \$1,000 to \$5,000; where the bank has no substantial basis for identifying a suspect, the reporting threshold rises from the existing \$5,000 to \$25,000. Banks may file the referral form in several ways: they may submit an original form, a photocopy, or they may file by magnetic means, such as by computer disk. The regulatory agencies are also developing computer software to assist banks in preparing and filing the reports. *FR, 9/14/95, p. 47719; FIL-71-95, FDIC, 10/16/95; Comptroller of the Currency, News Release, OCC, NR96-12, 2/5/96.*

The designation of a single government recipient of all depository institution suspicious transaction reports is required under the Riegle Community Development and Regulatory Improvement Act of 1994. Previously, banks reported violations or suspected violations to their primary federal regulators and several law enforcement agencies using non-uniform criminal referral forms. They also filed currency transaction reports (CTRs) for transactions in currency of more than \$10,000. *FR, 9/7/95, p. 46556; BBR, 9/11, p. 377; CEO Memo 53, OTS, 3/19/96.*

Record keeping For Funds Transfers

The FRB and the Department of the Treasury jointly proposed amendments to their rules requiring enhanced Record keeping on certain wire transfers by financial institutions in accordance with the Bank Secrecy Act. The proposed amendments were made to conform the meanings of the definitions of international funds transfer to the Uniform Commercial Code.

In January, the FRB and the Department of the Treasury adopted a final rule that required each domestic financial institution involved in a wire transfer to collect and retain certain information depending upon the type of financial institution, its role in the transfer, the amount of the transfer, and the relationship of the parties to the transaction. The rule exempted wire transfers below \$3,000. The effective date was to have been January 1996, but postponements delayed the new Record keeping rules until May 1996.

FinCEN reports that electronic wire transfer systems move funds between financial institutions and handle a daily volume in excess of 500,000 transactions, moving more than \$2 trillion around the world each day. Wire transfers have provided money launderers with an efficient and secure method of transferring huge sums of money over a very short period of time. Because wire transfer

messages often are sent through several banks and wire transfer systems, launderers have been able to confuse the money trail and make it difficult for law enforcement to trace the criminal proceeds. *FR*, 1/3/95, pp. 220, 231; 8/24, pp. 44144, 44146; *Press Release, FRB*, 12/22/94; 8/18/95; *BBR*, 8/28/94, p. 330; *AB*, 3/21/96.

Bank Lending to Areas Subject to Floods

The OCC, the FRB, the FDIC, the OTS and the National Credit Union Administration (NCUA) are amending regulations regarding loans in areas having special flood hazards to implement the provisions of the National Flood Insurance Reform Act of 1994. Among the proposed amendments are new escrow requirements a lending institution that requires the escrow of taxes, property insurance premiums, fees or other charges must require the escrow of flood insurance premiums; explicit authority for lenders and servicers to "force-place" flood insurance under certain circumstances; and a requirement that lending institutions notify purchasers or lessees if the property securing the loan is located in a special flood hazard area (SFHA).

Additionally, the proposal requires each agency to assess compliance with the National Flood Insurance Program when examining the institutions it supervises, and to use a new standard form developed by the Federal Emergency Management Agency for recording whether a security property for a given loan is located in an SFHA. *FR*, 10/18/95, p. 53962; *PR-57-95, FDIC*, 9/26/95.

Federal Financial Institutions Examination Council Appraisal Regulation

The inter-agency Federal Financial Institutions Examination Council (FFIEC) is soliciting comment on how it should implement a section of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which was amended by the Riegle Community Development and Regulatory Improvement Act of 1994. The amendment added the requirements that: a) state appraiser certifying or licensing agencies are not to impose excessive fees or burdensome requirements for temporary practice; and b) the states are encouraged to develop reciprocity agreements that readily authorize appraisers who are licensed or certified in one state, and who are in good standing, to perform appraisals in other states. Since January 1, 1993, Title XI, as amended, has required all federally regulated financial institutions to use state-licensed or certified real-estate appraisers, as appropriate, to perform appraisals in federally related transactions. In response to the Title, each state, territory and the District of Columbia has established a regulatory program for certifying, licensing and supervising real-estate appraisers. *Press Release, Appraisal Subcommittee, FFIEC*, 9/8/95; *FR*, 9/12, p. 47365.

GAAP Approved For Call Reports

The FFIEC adopted the generally accepted accounting principles (GAAP) as the reporting basis for the balance sheet, income statement, and related schedules in the bank Reports of Condition and Income (Call Report), effective with the March 1997 report date. Adoption of GAAP as the reporting basis will eliminate existing differences between bank regulatory reporting standards and GAAP, among which are the accounting treatment of assets sold with recourse, futures, forwards, and option contracts. The reporting basis being adopted already is used for savings association Thrift Financial Reports and Federal Reserve bank holding

company FR Y Reports, and is consistent with the objectives of Section 307 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the federal banking agencies to develop a single form for the filing of core information by banks, savings associations, and bank holding companies.

The FFIEC believes that adopting GAAP will reduce reporting burden as well as any confusion on the part of users about differences in the reporting principles governing regulatory reports and financial statements. GAAP does not require the disclosure of all of the information needed by federal banking agencies and does not address all of the agencies' supervisory concerns, thus institutions would still have to report, in supplemental schedules and items, some information needed for supervisory and other purposes. The Council and the agencies will continue when necessary to issue specific reporting guidance that falls within the range of acceptable practice under GAAP (for example, as is currently the case for the allowance for loan and lease losses), and each agency will retain existing authority to require an institution to report a transaction in regulatory reports in accordance with the agency's interpretation of GAAP. *Press Release, FFIEC, 11/3/95.*

Mortgage Lending Reports

The FFIEC made available the reports of 1994 mortgage lending activity in metropolitan statistical areas (MSAs) for public inspection at a central depository in each MSA, and the agency headquarters. The reports, which are available almost two months earlier than last year, include individual disclosure statements and aggregate data for each MSA. They reflect the lending activity of the more than 9,800 lending institutions covered by the Home Mortgage Disclosure Act (HMDA) that reported data for 1994 to member agencies of the FFIEC and to the Department of Housing and Urban Development. The reports contain data about loan originations, loan purchases, and applications that did not result in a loan. Also, they give information about the race or national origin, gender, and annual income of the applicants or borrowers. For most loans relating to property located in MSAs, the reports identify the geographic location, usually by Census tract.

Data from the HMDA reports released in July indicated that the number of conventional home purchase loans went up 54.7 percent for blacks and 42.0 percent for Hispanics since 1993. *Press Release, FFIEC, 9/1/95.*

Proposed Revisions to CAMEL Rating System

The FFIEC proposed revisions to its Uniform Financial Institutions Rating System (commonly referred to as the CAMEL rating system) on July 9, 1996. Comments are due by September 16, 1996. The proposed changes include clarifying the component rating descriptions; addition of a sixth component to address market risk; and increased emphasis on risk management. *FIL-56-96; 7/24/96; FR, 7/18/96; p. 37472.*

Risks to Computer Systems in the New Millenium

The FFIEC issued a statement on July 12, 1996, alerting financial institutions to the need to address risks involving their computer systems as the industry enters the new century. Examiners will review each institution's 2000 plan during regular supervisory reviews. The risks arise from the programming code in existing computer systems that may cause the system to function improperly due to the

two digit year field containing "00." *FIL-50-96, 7/12/96.*

Federal Deposit Insurance Corporation Assessments

The FDIC Board of Directors voted on August 8, 1995, to reduce significantly the deposit insurance premiums paid by most banks but to keep existing assessment rates intact for savings associations. Under the new rate structure, the best-rated institutions insured by the Bank Insurance Fund (BIF) would pay four cents per \$100 of domestic deposits, down from 23 cents per \$100. The weakest institutions would continue to pay 31 cents per \$100. The FDIC announced in September 1995, that the BIF was fully recapitalized and that it would refund to banks insurance overpayments for the period of June through September. The FDIC estimated the aggregate BIF assessment refund at \$1.49 billion, plus \$19.9 million in interest. *PR-50-95, FDIC, 8/89/95; PR-54, 9/5.*

On September 26 1995, the FDIC amended its regulation on assessments to delay the regular payment date for the first quarterly payment for the first semiannual period from December 30 of the prior year to January 2 (or the first business day thereafter). At the same time, insured institutions were given the option of making the first payment on December 30 (or the prior business day). The FDIC's purpose in making these changes was to relieve certain institutions of the regulatory burden of having to make an extra assessment payment in 1995, while also affording flexibility to other institutions to make such a payment if they so desired.

The amendments approved in late September 1995, also give insured institutions the option of paying double the amount of any quarterly payment, when the payment is made on a payment date (regular or alternate) that comes before the start of the quarter to which the payment pertains on the March, June, September, and December payment dates.

The interest rate to be applied to under payments and overpayments of assessments is replaced with a new, more sensitive rate derived from the 3-month Treasury bill discount rate. Rates set under the prior standard have rapidly become obsolete in volatile interest-rate markets.

The timetable for announcing the semiannual assessment rate schedule is shortened from 45 days to 15 days prior to the invoice date. This change enables the FDIC to use the most up-to-date information available for computing assessments, thereby benefitting both the agency and the depository institutions. The rule is effective September 29, 1995, except some amendments are effective October 30, 1995. *FR, 9/29/95, p. 50400; 8/10, p. 40776; FIL-67-95, FDIC, 10/6/95.*

The FDIC Board of Directors voted on May 14, 1996, to maintain the existing assessment rates on deposits by the BIF and the SAIF for the second semiannual assessment period of 1996. Insured institutions will continue to pay annual assessment rates of from zero to \$.27 per \$100 of BIF-assessable deposits, subject to a quarterly minimum of \$500. Based upon year-end 1995 data, it is expected that these rates will result in an average annual BIF rate of approximately \$.0029 per \$100 of deposits and annual revenues of about \$72 million. The BIF reserve ratio was 1.30 percent as of December 31, 1995.

Institutions insured by the Savings Association Insurance Fund (SAIF) will

continue paying premiums on a risk-related basis of between \$.23 per \$100 to \$.31 per \$100 of assessable deposits. It is expected that these rates will result in an average annual SAIF rate of approximately \$.234 per \$100 in assessable deposits. SAIF-insured institutions will continue to pay higher rates than BIF-insured banks because the SAIF remains seriously undercapitalized. At December 31, 1995, the SAIF had reserves of approximately \$3.4 billion and is not expected to reach the minimum reserve level of 1.25 percent until the year 2002, given the current circumstances and reasonably optimistic assumptions. *PR-70-95, FDIC, 11/14/95; FIL-40-96, 6/11/96.*

Thrifts Allowed to Transfer Deposits to Affiliates

The FDIC has decided that thrifts may transfer deposits to newly chartered bank affiliates, if the deposit shift is initiated by the depositor. This decision will allow thrifts to take advantage of cheaper deposit insurance available to banks. The FDIC ruling is expected to accelerate the outflow of funds from the thrift industry, thereby reducing the FICO payment base. *WSJ, 7/3/96.*

Assessments For Oakar Institutions

On July 3, 1996, the FDIC proposed to amend its assessment regulations regarding the so-called Oakar institutions institutions that belong to one insurance fund, but hold deposits that are treated as insured by another insurance fund. The changes would affect particularly calculations of the Adjusted Attributable Deposit Amount (AADA). The AADA is used to determine the allocation of an Oakar institution's deposits between the BIF and the SAIF.

The proposed amendments are intended to eliminate anomalies in the assessment of these institutions' deposits. One amendment would change the AADA adjustment for an institution's overall deposit growth. The FDIC has found that the current treatment of deposit sales for Oakar institutions has resulted in an increase in the total amount of primary fund deposits reported and assessed and a decrease in the total amount of secondary fund deposits reported. The proposed rule would correct this anomaly for all deposit sale transactions occurring after June 30, 1996; and would adjust the AADA for growth or shrinkage on a quarterly basis. The FDIC is also proposing to eliminate the requirement that Oakar institutions submit growth worksheets to adjust the AADAs. Finally, public comment is requested on two options for allocating funds to the BIF or the SAIF at the time of deposit sales. One option would treat deposit sales by Oakar institutions as sales of primary fund deposits only (unless the deposits sold exceeded the amount of primary fund deposits available); the second alternative would treat the deposits as a pro rata blend of the institutions' primary and secondary fund deposits. *FIL-54-96, 7/19/96; FR,3/3/96, p. 34751.*

BIF and SAIF First-Quarter 1996 Financial Highlights

The BIF earned \$295 million in net income in the first quarter of 1996, significantly below the \$1.3 billion earned the same period a year earlier. The decrease is primarily due to the reduction in premium rates. The fund's estimated liability for anticipated failures decreased to \$240 million from \$279 million at year-end 1995. The fund balance at the end of the quarter was \$25.748 billion. One BIF-insured bank failed during the quarter. The SAIF earned \$292 million in net income in the first quarter of 1996, \$13 million more than it earned in the same quarter a year earlier. Net assessment revenue came to \$251 million through the first quarter of

1996 after payments of \$393 million to service Financing Corporation (FICO) obligations. The fund balance at the end of the quarter rose to \$3.650 billion. *Federal Deposit Insurance Corporation, First-Quarter 1996 Financial Results, Bank Insurance Fund, 3/31/96.*

Capital Maintenance

The FDIC adopted an interim rule and requested comments to implement Section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994 which provides that a qualifying insured depository institution that transfers small-business loans and leases on personal property with recourse need include only the amount of retained recourse in its risk-weighted assets when calculating its capital ratios if certain conditions are met. The transaction must be treated as a sale under GAAP; and the transferring institution must establish a non-capital reserve sufficient to meet the reasonably estimated liability under the recourse arrangements. A qualifying institution is one that is well-capitalized or, with the approval of the appropriate federal banking agency, adequately capitalized. For these institutions, the rule, which is effective August 31, 1995, will result in lower capital requirements for affected loans and leases. *PR-52-95, FDIC, 8/25/95; FR, 8/31, p. 45606; p. 45612 (FRB notice); p. 45618 (OTS notice).*

Final Rules on Golden Parachutes, Internal Audits and Foreign Bank Deposits

The FDIC issued a final rule, effective April 1, 1996, prohibiting with certain exceptions golden parachute payments to executives of troubled holding companies, banks and thrifts. Exceptions to the prohibition include payments to qualified pension and retirement plans. The rule provides guidance on what constitutes legitimate payments. The new rule also limits holding companies or FDIC-insured institutions from paying the legal expenses or liabilities of their employees or directors who are subject to enforcement proceedings. *PR-8-96, FDIC, 2/6/96; BBR, 2/12/96, pp. 205-206.*

Court Supports Agency on Cross-Guaranty

The U.S. Court of Appeals for the Second Circuit upheld the FDIC's power, granted to the agency by FIRREA in 1989, to charge losses from a bank failure to another bank in the same corporate organization (Meriden Trust and Safe Deposit Co. v. FDIC). It rejected claims that such action amounts to an unconstitutional taking under the Fifth Amendment. In 1994, a federal claims court judge held that the agency's use of the cross-guaranty power might be a violation of the takings clause (Branch v. U.S.). *BBR, 8/14/95, p. 308.*

On July 24, 1996, First Coastal Corporation of Westbrook, Maine, paid the FDIC \$9.75 million to settle a cross-guaranty assessment levied against its subsidiary, Coastal Savings Bank of Portland, Maine, in 1993. *FDIC, PR-55-96. 7/24/96.*

Court Rules Government Breached Contracts With Savings-and-Loan Associations

On July 1, 1996, the U. S. Supreme Court ruled in the United States v. Winstar Corp., No 95-865, that Congress erred in changing industry accounting rules concerning supervisory goodwill in 1989. The plaintiffs were Glendale Federal Bank of California, and two since-closed thrift companies, Statesman Savings

Holding Corporation and Winstar Corporation, who acquired weak savings institutions at the government's behest in the 1980s and in return were given assurances that the supervisory goodwill created in the transactions could be counted as capital and written off over time. The regulators subsequently refused to honor the agreements that they claimed were repudiated under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

The Federal Circuit Court of Appeals had previously ruled that the government violated contracts with the three plaintiffs. In this most recent ruling, the U.S. Supreme Court concluded that "it would have been madness" for the institutions to have taken over the weak institutions if they had known that the government could cancel the current accounting "gimmicks" at its will. The Court ruled that the government was liable for damages, and sent the case back to a lower court to determine those amounts. Breach-of-contract suits have been filed by at least one hundred thrifts. *BBR*, 9/11/95, p. 403; *AB*, 8/31, p. 1, *AB*, 7/26/96, *WSJ*, 7/2/96, *NYT*, 7/2/96.

Subsequent to the Supreme Court ruling, the FDIC took steps to appear as plaintiff in two cases involving supervisory goodwill pending in the U.S. Court of Federal Claims, and is investigating other cases with possible goodwill claims to determine whether it will become a plaintiff. In these cases, the FDIC is acting as a receiver for the failed institutions. *FDIC*, *PR-56-96*, 7/24/96, *AB*, 7/26/96.

D'Oench Duhme Doctrine Rulings

The U.S. Court of Appeals for the District of Columbia ruled in August 1995, that the FDIC might use the D'Oench Duhme doctrine to void secret agreements that would cause a loss in a failed bank's assets, but could not use it as a protection against fraud claims. In this case, an investor in a bankrupt Florida resort sued the developers and Southeastern Bank, charging that the bank secretly controlled the development and was responsible for fraudulent statements about the project's financial condition.

In another recent case, the U. S. Court of Appeals for Atlanta found that Congress did not eliminate the D'Oench Duhme doctrine in passing the thrift bailout law in 1989. In this case, the 11th Circuit Court concurred with a May 1996, FDIC ruling that the D'Oench Duhme doctrine prevented a car dealership from suing for breach of contract against Southeast Bank of Florida.

The D'Oench Duhme doctrine began with a 1942 Supreme Court decision and legislation enacted in 1950. It required that the FDIC recognize only written agreements by banks that subsequently fail and was intended to force bankers to put agreements in writing so that examiners could more accurately evaluate an institution's financial condition. *AB*, 8/9/95, p. 2; 5/31/96, p. 2.

Court Rules Examination Reports Accessible During Discovery

The U.S. Court of Appeals for the Sixth Circuit, rejecting an attempt by Bankers Trust Company to shield its examination results, ruled that parties to a lawsuit can seek examination reports from banks during the discovery process. As a result of the decision, which affects banks in Ohio, Michigan, Kentucky and Tennessee, a litigant can ask the bank for a report directly, and if refused can ask the trial judge to order the bank to comply. The judge must first give the regulator a chance to object. Previously, a litigant's request for an examination report had to be made

through the bank's regulator, and if refused, which usually occurred in respect to the examiner's subjective comments, the plaintiff could seek compliance through the court. *AB, 8/10/95, p. 3.*

Improvement in Real-Estate Markets Reported

The FDIC's July 1996 Survey of Real Estate Trends reported continued improvements in both commercial and residential real-estate markets during the second quarter of 1996. The latest results represented the second consecutive quarter of reported improvements and were the most positive in over a year.

The quarterly survey asks field personnel from all federal bank and thrift regulatory agencies about developments during the prior three months in their local real-estate markets. The survey reflected positive trends in market activity in many areas of the nation, with the Northeast and the West reporting the most gains. The proportion of respondents seeing better market conditions in the South and the Midwest remained the same or declined following reports in April of significant progress.

The national composite index, summarizing assessments of real-estate markets, edged up to 68 in July from 67 in April. Values above 50 indicate that more examiners and asset managers at federal bank and thrift regulatory agencies thought conditions were improving than declining. The July report represents the second consecutive increase in the summary index from its recent low of 60 in January. Although the gains reported in the last three months were not as strong as those observed in the February-April period, the July composite index is the highest reading in two years.

Survey respondents reported continued confidence in the residential markets. Forty-five percent observed better conditions in their local housing markets the same proportion reported previously. However, those noting worsening conditions in July fell to eight percent. The national summary index for residential markets inched up to 69 from 68 in April, with a substantial boost from gains in the West, where 66 percent of the respondents reported better housing conditions, up from 54 in April.

Overall assessments of commercial real-estate trends continued to be positive as well. An increasing proportion of survey participants observed improving conditions (38 percent) while reports of worsening conditions were very few (one percent). As a result, the composite index for commercial markets rose to 68 in July from 66 in April. *Survey of Real Estate Trends, July 1996.*

Online Press Release Service Via Internet

The FDIC has established an online subscription service that allows subscribers to receive over the Internet and World Wide Web press releases and copies of key Congressional testimony and major speeches by agency officials. The new service will send the material directly to subscribers via e-mail. Released materials will continue to be available via fax modem, postal service mail and from information racks in FDIC buildings. *PR-59-95, FDIC, 10/4.*

Disclosure of Information

The FDIC revised the procedures used by the public in requesting records under the Freedom of Information Act (FOIA) and the Freedom of Information Reform Act (FOIRA). Among its provisions, the final rule sets forth the conditions under which exempt records may be disclosed to third parties, including such conditions as are necessary to protect the confidentiality of the records. The rule contains procedures by which the agency would charge appropriate fees as required under FOIRA and guidelines established by the Office of Management and Budget. The FOIRA significantly amended the fee provisions of FOIA by establishing classes of FOIA requesters and a framework under which fees could be charged to the individual categories of requesters. *FR*, 7/6/95, p. 35148; 11/30, p. 61465.

New FDIC Board Member

Former Mississippi Banking Commissioner Joseph H. Neely was sworn in as a member of the five-person FDIC Board on January 29, 1996. As Mississippi's Banking Commissioner, a position he occupied since 1992, Mr. Neely served as the primary regulator and supervisor of state-chartered banking and thrift institutions. He was also responsible for supervising state-chartered credit unions and consumer finance companies. Additionally, Mr. Neely served on the faculty of the Mississippi School of Banking from 1993 to 1995. *PR-6-96, FDIC*, 1/29/96.

Stored-Value Cards

On July 16, 1996, the FDIC issued an opinion on whether federal deposit insurance applied to stored-value cards. Stored-value cards look like a credit card or ATM card and store electronic value on either a magnetic stripe or a computer chip, and can be used to pay for purchases. The FDIC concluded that in most cases stored-value cards are not protected by deposit insurance. However, if the funds represented by the card were maintained in the customer's own account, rather than a single pool, deposit insurance would apply. The FDIC scheduled a hearing for September 12, 1996, on stored-value cards, Internet banking and other electronic payment systems. *FDIC PR-52-96, 7/16/96; PR-53-96, 7/16/96.*

FDIC Review of Regulations

The FDIC is conducting a systematic review of its regulations and policies to identify and revise regulations that might be inefficient, cause unnecessary burden, or contain outmoded, duplicative or inconsistent provisions. In one action, the FDIC issued an inter-agency proposal to remove inconsistencies in the way regulators assign risk-based capital requirements to certain loans and other collateralized transactions. The agency also proposed that publicly traded FDIC-supervised banks use Securities and Exchange Commission (SEC) rules for registration of securities and reporting instead of separate but similar FDIC rules. Final action was also taken eliminating outmoded policies on the submission of quarterly Reports of Condition and Income and the advertising of Negotiable Order of Withdrawal (NOW) accounts. *FDIC, PR-44-96, 6/17/96; FIL-48-96, 7/12/96; FR, 7/3/96, p. 34814.*

Resolution Trust Corporation Thrift Depositor Protection Oversight Board Will Continue

The Thrift Depositor Protection Oversight Board (TDPOB) continues in operation following termination of the Resolution Trust Corporation (RTC) on December 31,

1995. It is responsible for preparing final reports on the resolution of the thrift crisis and for overseeing the Resolution Funding Corporation, which between 1989 and 1991 issued long-term bonds to finance the resolution. The Board's membership will be reduced to three the Secretary of the Treasury, Chairman of the Federal Reserve Board, and Secretary of the Department of Housing and Urban Development. *AB*, 12/6/95, p. 2.

Last RTC Auction

At its eighth and final national auction, the RTC sold performing and nonperforming loans with a book value of \$577 million. It recovered \$404 million on the sale, approximately 70 percent of book value. The three-day auction was held in Kansas City beginning December 13, 1995. *National Mortgage News*, 1/2/96, pg. 3.

Final Cost of Thrift Bailout

The GAO reported that the thrift cleanup cost the taxpayer \$160.1 billion in direct costs or \$480.9 billion, if interest costs are included. Direct costs consist of \$87.9 billion spent by the RTC; \$64.7 billion spent by the FSLIC; and \$7.5 billion in tax breaks to acquirers of ailing institutions. Interest costs consist of \$111.8 billion of interest expenses on two bond issues, and \$209 billion in interest computed on Congressional appropriations. Interest costs are not generally counted in government allocations. *The New York Times*, 7/13/96; *WSJ*, 7/15/96; *The Washington Post*, 7/13/96.

Federal Reserve Board Derivatives Transaction Standards

The Federal Reserve Bank of New York and five securities industry groups released final transaction standards for derivatives market participants. The standards cover such issues as the definition of a participant, a client's reliance on a dealer's advice, confidentiality, valuation, distribution of the standards, information, and disputes, but do not include any provision for dealers to determine a client's suitability for a particular transaction. *BBR*, 8/28/95, p. 329.

International Operations of Banks

The FRB proposed to amend its Regulation K to provide additional general consent authority for de novo investments in foreign countries by U.S. banking organizations that are strongly capitalized and well-managed. Banks meeting these requirements would be permitted to make certain investments without the need for prior approval or review. In order to strike a reasonable balance between reduced regulatory burden and continued FRB oversight, limits would be imposed on the total amount of general consent investments that may be made in a year. In addition, certain investments or activities would not be eligible for the expanded authority. Investors making use of the expanded authority would be required to provide the FRB with a post-investment notice. The Board's proposal is part of an overall review of the regulation. *FR*, 9/25/95, p. 49350; *Press Release, FRB*, 9/22.

Proposed Amendments to Leasing Regulation

The FRB proposed amendments to its Regulation M, implementing the Consumer Leasing Act, which was enacted into law in 1976 as an amendment to the Truth in

Lending Act (TILA). Generally, the CLA applies to consumer leases of personal property such as automobiles and furniture involving \$25,000 or less, and a term of more than four months. Among the disclosures required of lessors are the amount of the initial charges to be paid, a payment schedule, the responsibilities for maintaining the leased property, and the liability for terminating a lease early. Among the proposed amendments are: additional disclosure requirements about early termination charges; disclosure of the gross costs of leases, the residual value, and the estimated lease charge; and, pursuant to a statutory change, new advertising provisions for radio and television.

The Board also proposed changes to the official staff commentary on Regulation M. *Press Release, FRB, 9/13/95; FR, 9/20, pp. 48752, 48769; BBR, 9/18, p. 438.*

Investment Advisory Powers Expanded

The FRB granted authority for Credit Suisse of Zurich to provide discretionary portfolio management services for futures and options on nonfinancial commodities. The service, to be provided through a New York-based subsidiary, will be limited to institutional customers who specifically request it. The FRB said the approved activity is similar to other investment advisory services that bank holding company affiliates provide. *AB, 7/7/95, p.2.*

Banks Permitted to Purchase Education Finance Firm

The FRB granted approval for four North Carolina-based bank holding companies to purchase the shares of a company that will provide services to North Carolina and other state governments in programs to assist parents in financing higher education for their children. Among the firm's activities will be developing and managing an education savings and loan plan, designing and providing software, providing marketing materials, and training state employees. *BBR, 10/2/95, p. 532.*

Changes in Fedwire Access Policy

The FRB has modified its Fedwire third-party access policy to clarify its applicability and to reduce the administrative burden of several provisions. Some depository institutions have entered into arrangements under which a third party provides operating facilities for their Fedwire services; under such arrangements, the third party's actions may result in a debit to the institution's reserve or clearing account at a Federal Reserve Bank. The policy provides important safeguards to both depository institutions participating in third-party access arrangements and to the Reserve Banks. Among other things, the policy requires depository institutions to impose prudent controls over Fedwire funds transfers and book-entry securities transfers initiated, received, or otherwise processed on their behalf by a third-party service provider. These policy modifications are on an interim basis pending the completion of a broader review of supervisory policies that should be applicable to outsourcing arrangements. The changes become effective August 10, 1995; existing Fedwire third-party arrangements should be in compliance by March 1, 1996. *Press Release, FRB, 8/10/95.*

Access to Automated Clearing House Service

The FRB is requesting comment on the benefits and costs of adopting a policy to control access to the Federal Reserve Banks' automated clearing house (ACH)

service by entities other than the depository institution whose Federal Reserve account will be debited. The controls would apply to ACH credit transactions sent by third-party processors (service providers) and respondent depository institutions directly to a Reserve Bank or a private ACH operator that exchanges transactions with a Federal Reserve Bank. Controlling access to the ACH service will help to ensure the safety and soundness of the ACH system.

The FRB is requesting comment on the specific provisions of the proposed policy and the cost and operational impact of providing risk-monitoring capabilities for controlling access to the Federal Reserve Banks' ACH service. The risk-monitoring capabilities are intended to permit the depository institutions that are responsible for funding ACH credit transactions to control the potential credit risk and reduce the risk of fraud created by their customers and respondent depository institutions. The proposed policy provisions and monitoring alternatives do not cover ACH debit transactions. *Press Release, FRB, 8/10/95; FR, 8/15, p. 42413.*

Survey of Consumer Finances

The FRB is sponsoring a statistical study of household finances that will provide information on the economic condition of a broad array of American families. The study, which is undertaken every three years, is being conducted by the National Opinion Research Center at the University of Chicago through November 1995. Participants in the study are chosen at random using a scientific sampling procedure in 100 areas across the U.S. Participation is voluntary. Summary results will be published in the Federal Reserve Bulletin. *Press Release, FRB, 8/7/95.*

Mortgage Loan Software Program

The FRB announced the availability, free of charge, to member banks of a computer software program designed to serve as an analytic tool for financial institutions in offering affordable mortgage loans to low- and moderate-income applicants. The software program, entitled "Partners" can determine within seconds if potential home buyers can qualify, mathematically, for a home purchase loan, given the underwriting criteria and financial information provided. In addition to determining loan eligibility, "Partners" offers loan amortization schedules, equity build-up calculations, and secondary market analysis. The program also can be utilized by community groups, government agencies, and other community development practitioners who offer home purchase loans. *Press Release, FRB, 10/19/95.*

Regulatory Review Timetable

The FRB published a schedule for review of its major regulations, policy statements, and regulatory guidances as required under Section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994. Section 303 requires that each federal banking agency review its regulations and written policies to accomplish certain goals. These goals are to streamline and modify regulations and policies to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability; to remove inconsistencies and outmoded and duplicative requirements; and to work jointly with the other federal banking agencies to make uniform all regulations and guidelines

implementing common statutory or supervisory policies.

The FRB noted that it has undertaken over 20 separate measures since the passage of Section 303 to reduce the burden and simplify regulations, written policies and procedures. Additionally, several proposals were out for comment which will further these efforts. *FR*, 10/16/95, p. 53546.

Federal Reserve Board Appointments

President Clinton reappointed Federal Reserve Chairman Alan Greenspan to his third four-year term as Federal Reserve Board Chairman. White House Budget Director Alice M. Rivlin and Washington University professor Laurence H. Meyer were also nominated to fill the two remaining vacancies on the Board. John P. LaWare left the Board in April of 1995 and Alan Blinder in January of this year. All three individuals are economists. *BBR*, 2/26/96, p. 291; *AB*, 2/26/96, p 1-2.

Office of the Comptroller of the Currency "Supervision by Risk" Program

The OCC is expanding, enhancing and standardizing the way examiners evaluate risk in national banks. The agency has defined nine specific categories of risk it will use in assessing risks in bank activities. The program focuses on evaluating the quantity of risk exposure in an institution and determining the quality of the risk-management systems in place to control that risk. The nine definitions, among which are credit risk, interest-rate risk, liquidity risk, and price risk, will enable the agency to treat the same risks consistently in all banks and across various products and activities, and they clarify for bankers the kinds of risk the OCC will be assessing in their institutions. Risk profiles prepared for each bank will help focus examiner attention on the most serious concerns within a bank and direct the agency's resources to institutions where the need is greatest. *News Release, OCC, 9/26/95.*

Examiner Guidance on Establishing Reserves

The OCC released a new Comptroller's Handbook section "Allowance For Loan and Lease Losses" (ALLL). This new section replaces the ALLL examination section that has been in effect since 1992. It requires no changes in basic examination objectives and procedures but consolidates a number of ALLL-related materials and identifies specific categories of risk. *NR 96-75, OCC, 6/19/96.*

Bank Examiner Guidance on Futures Brokerage

The OCC issued to its examiners guidance on derivatives that is applicable to subsidiaries that operate as futures commission merchants (FCM) registered with the Commodity Futures Trading Commission. Among the several elements of the guidance are: a) FCMs are expected to have a risk control unit that is separate from the unit that trades in derivatives futures; b) the independent risk control unit is to report to executive management, the bank's board of directors or a designated management committee, and is to communicate findings periodically to senior management and the bank's board; and c) capital to support risk exposures of the futures brokerage subsidiary should reflect the level and complexity of the risk and not be limited to meeting regulatory requirements. An FCM's compliance program should include at least one designated compliance officer, and include also standards for disclosure of risk to customers, and a plan

