Comptroller of the Currency
Administrator of National Banks

QJ Quarterly Journal

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The Value of the National Bank Charter

Office of the Comptroller of the Currency

September 2003

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Background

The Office of the Comptroller of the Currency (OCC) was established in 1863 as a bureau of the Department of the Treasury. The OCC is headed by the Comptroller, who is appointed by the President, with the advice and consent of the Senate, for a five-year term.

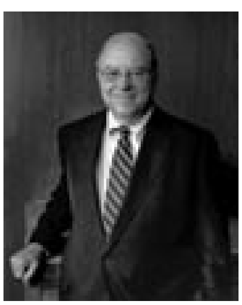
The OCC regulates national banks by its power to:

- Examine the banks;
- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure;
- Take supervisory actions against banks that do not conform to laws and regulations or that otherwise engage in unsound banking practices, including removal of officers, negotiation of agreements to change existing banking practices, and issuance of cease and desist orders; and
- Issue rules and regulations concerning banking practices and governing bank lending and investment practices and corporate structure.

The OCC divides the United States into six geographical districts, with each headed by a deputy comptroller.

The OCC is funded through assessments on the assets of national banks, and federal branches and agencies. Under the International Banking Act of 1978, the OCC regulates federal branches and agencies of foreign banks in the United States.

The Comptroller

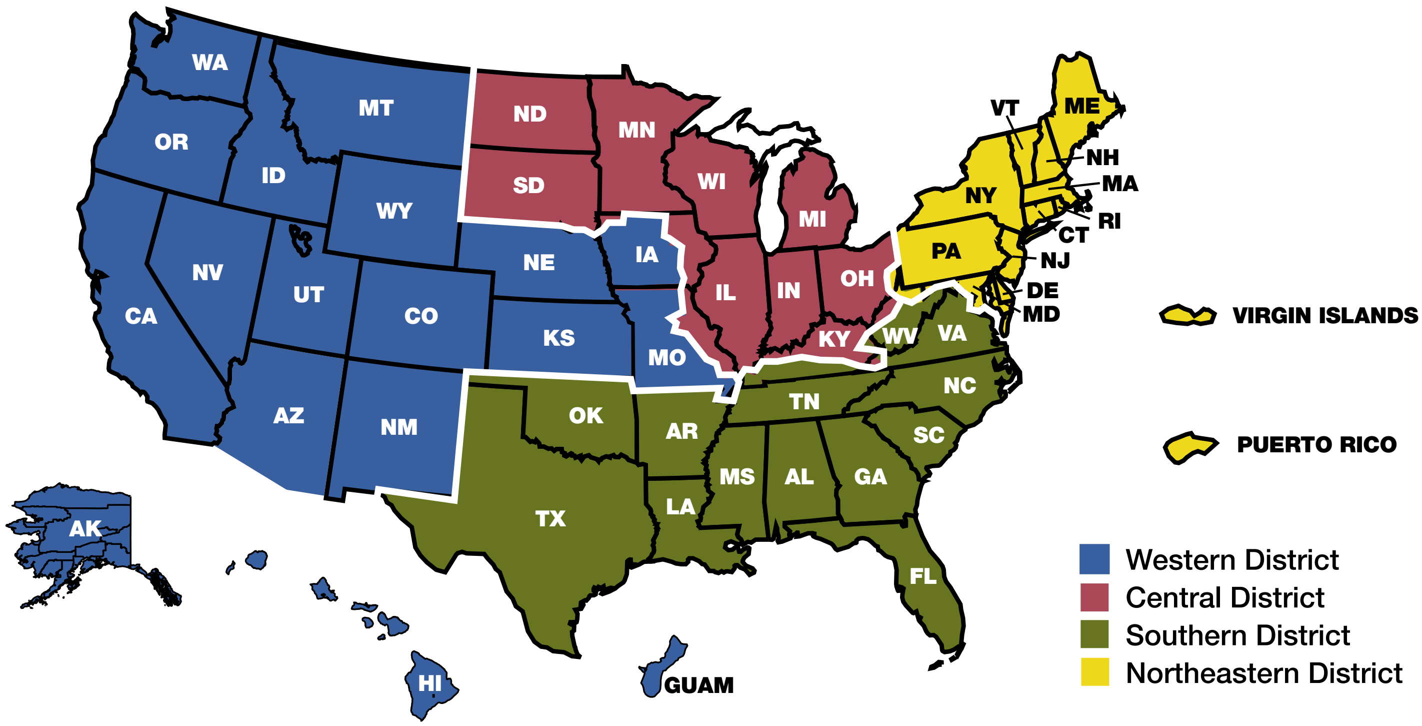


Comptroller John D. Hawke, Jr. has held office as the 28th Comptroller of the Currency since December 8, 1998, after being appointed by President Clinton during a congressional recess. He was confirmed subsequently by the U.S. Senate for a five-year term starting on October 13, 1999. Prior to his appointment Mr. Hawke served for 3½ years as Under Secretary of the Treasury for Domestic Finance. He oversaw development of policy and legislation on financial institutions, debt management, and capital markets; served as chairman of the Advanced Counterfeit Deterrence Steering Committee; and was a member of the board of the Securities Investor Protection Corporation. Before joining Treasury, he was a senior partner at the Washington, D.C., law firm of Arnold & Porter, which he joined as an associate in 1962. In 1975 he left to serve as general counsel to the Board of Governors of the Federal Reserve System, returning in 1978. At Arnold & Porter he headed the financial institutions practice. From 1987 to 1995 he was chairman of the firm.

Mr. Hawke has written extensively on the regulation of financial institutions, including Commentaries on Banking Regulation, published in 1985. From 1970 to 1987 he taught courses on federal regulation of banking at Georgetown University Law Center. He has also taught courses on bank acquisitions and serves as chairman of the Board of Advisors of the Morin Center for Banking Law Studies. In 1987 Mr. Hawke served on a committee of inquiry appointed by the Chicago Mercantile Exchange to study the role of futures markets in the October 1987 stock market crash. He was a founding member of the Shadow Financial Regulatory Committee and served on it until joining Treasury.

Mr. Hawke was graduated from Yale University in 1954 with a B.A. in English. From 1955 to 1957 he served on active duty with the U.S. Air Force. After graduating in 1960 from Columbia University School of Law, where he was editor-in-chief of the Columbia Law Review, Mr. Hawke clerked for Judge E. Barrett Prettyman on the U.S. Court of Appeals for the District of Columbia Circuit. From 1961 to 1962 he was counsel to the Select Subcommittee on Education, U.S. House of Representatives.

The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and congressional testimony, material released in the interpretive letters series, statistical data, and other information of interest to the administration of national banks. We welcome your comments and suggestions. Please send to Rebecca Miller, Senior Writer-Editor, by fax to (202) 874-5263 or by e-mail to quarterlyjournal@occ.treas.gov. Subscriptions to the new electronic *Quarterly Journal Library* CD-ROM are available for $50 a year by writing to Publications—QJ, Comptroller of the Currency, Attn: Accounts Receivable, MS 4-8, 250 E St., SW, Washington, DC 20219. The *Quarterly Journal* continues to be available on the Web at http://www.occ.treas.gov/qj/qj.htm.



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John D. Hawke, Jr.
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(Second Quarter Data)

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Condition and Performance of Commercial Banks

Summary

Banks reported favorable results once again in the second quarter of 2003. At national banks, all major income categories remained at or near record levels, as did both return on assets and return on equity. As in the first quarter, however, the biggest contributor to the increase in net income was a decrease in provisions. This is in contrast to earlier periods when rising net interest income had been the most significant factor boosting income.

Figure 1—Securities gains, lower provisioning boost net income

National banks

	Major income components (Change, $ millions)			
	2001Q2–02Q2	% Change	2002Q2–03Q2	% Change
Revenues				
Net interest income	4,185	13.7%	460	1.3%
Real gains/losses securities	50	10.4%	816	153.9%
Noninterest income	2,106	8.6%	1,500	5.6%
Expenses				
Provisioning	1,552	24.9%	-1,508	-19.4%
Noninterest expense	870	2.7%	2,728	8.2%
Net income	3,154	18.7%	1,137	8.0%

Continued strength in real estate offset weakness in several other sectors, including commercial and industrial (C&I). Net interest margins drifted lower, depressing growth in net interest income. Credit quality improved modestly at large banks. As in recent quarters, the risks for banks continue to be unemployment and high debt burdens in the consumer sector, plus continued weakness in manufacturing, financial services, and some other services.

Key Trends

As in the first quarter of 2003, all major income categories showed improvement over the same quarter of 2002, as shown in Figure 1. Net interest income rose by 1.3 percent, as declining net interest margins nearly offset an increase in loan volume. This is a change from 2002, when a surge in net interest income accounted for most of the growth in net income.

Realized gains and losses on securities rose strongly year-over-year, but gains here are strongly related to interest rates and are not expected to continue in an environment of rising interest rates. Noninterest income rose again, helped by gains in fee income from the boom in mortgages and refinancing, and the rise in market-sensitive income that accompanied favorable conditions in the stock and bond markets this spring.

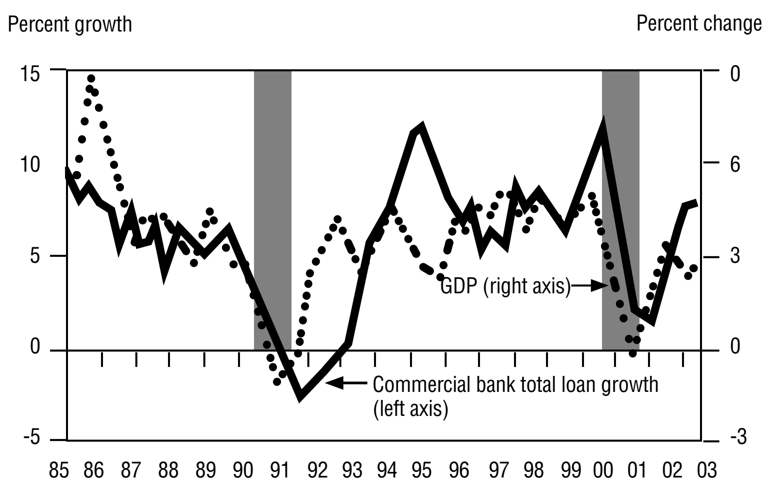
Return on equity reached 16.1 percent for the first half of 2003, slightly short of the all-time record reached in 1993. Return on assets remained just below its all-time peak, set in the third quarter of 2003.

Decreasing provisions accounted for the largest contribution to the change in net income. Most of this effect came from large banks, reflecting the expectation of improved credit quality. In contrast, in 2001 and 2002, provisions were generally increasing, reflecting the deterioration in credit quality during the recession. Noninterest expense rose, with the increase concentrated at large banks.

Net interest margins (NIMs) continued to decline at both small and large banks during the second quarter. Small-bank NIMs now stand at a 15-year low.

Loan growth, which never turned negative during the recent recession, continued apace during the second quarter. In contrast, around the time of the last recession shown in Figure 2 as the shaded area, total loans on the books of national banks fell for 10 consecutive quarters. The difference is that the earlier recession affected all sectors of the economy. This followed the normal pattern of post-war recessions, in which rising interest rates choke off home and auto sales, causing spending on housing and consumer durables to fall by 15 to 20 percent. The recession of 2001 was different: it began in the manufacturing sector, but never spread to the consumer sector. The demand for business loans fell sharply, but the mortgage and consumer sectors remained strong.

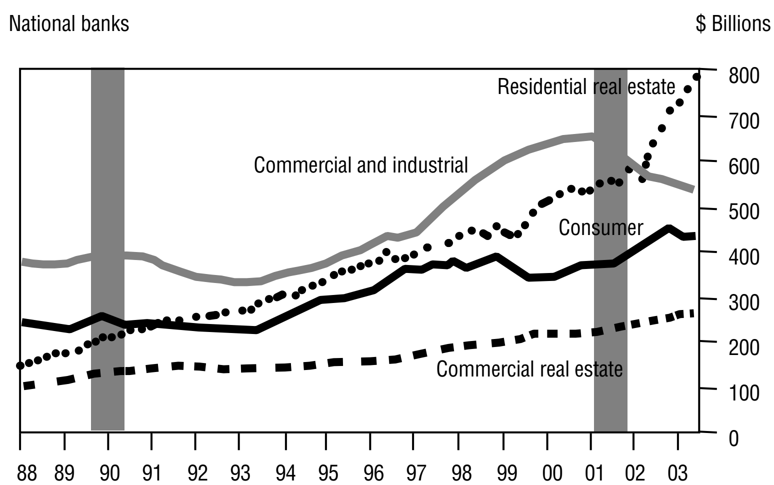
Figure 2—Loan growth continued throughout this recession



As Figure 3 shows, residential real estate lending continued to drive the aggregate numbers for loan growth. Total loans and leases rose 7.5 percent year-over-year, with residential real estate growing at over 28 percent, compared with 5.3 percent for commercial real estate loans, minus 8.1 percent for C&I loans.

Home equity lending showed particular strength, finishing the second quarter up 30 percent year-over-year. This compares with 23 percent in 2001, and 38 percent in 2002. On the other hand, credit card lending rose only 2 percent year-over-year, strengthening the impression that some homeowners are using home equity loans and cash-out refinancing to pay down credit card debt.

Figure 3—Residential real estate lending has driven loan growth

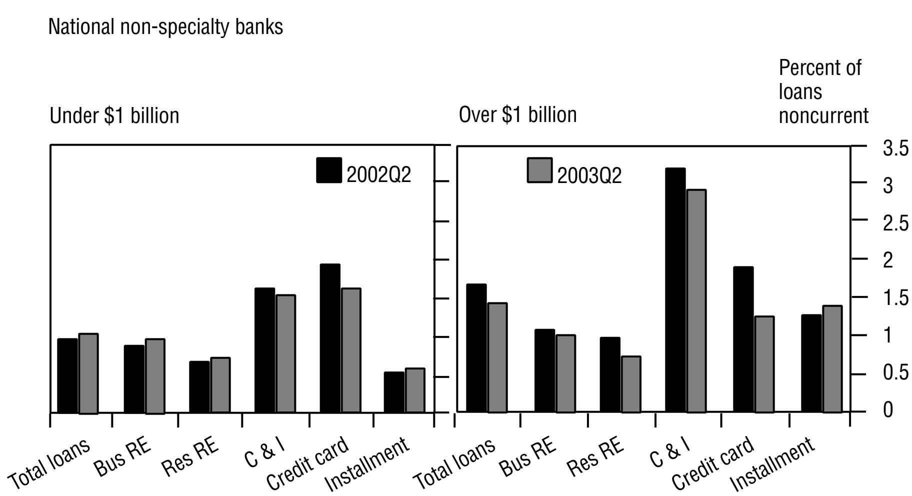


Several factors suggest that loan growth will be hard to sustain. First, higher interest rates have already taken the steam out of the boom in mortgage refinancing, with refinancing falling by half over the summer. Second, high vacancy rates are depressing new commercial real estate development. Third, corporate loan demand will likely lag the recovery. Capacity utilization rates remain at 20-year lows, discouraging investment and expansion. Further, firms have now reliquified their balance sheets, as is normal during a recession; with relatively high ratios of internally generated funds to capital needs, firms will be able to fund the first stage of new business spending by themselves. Fourth, the soft job market is expected to hold down growth in consumer loans.

Loan quality improved at large banks, with the C&I sector accounting for most of the gain (Figure 4). The noncurrent ratio for large-bank C&I loans improved for the fourth quarter in a row. C&I loans to foreign customers, however, are still deteriorating, as the noncurrent ratio has more than doubled over the last six quarters, and now stands 70 percent higher than the ratio for loans to U.S. customers.

Credit quality deteriorated slightly at community banks, with most of the slide concentrated in business real estate and residential real estate. C&I loan quality improved slightly, as it has at large banks, reflecting the modest upturn in the manufacturing sector.

Figure 4—Credit quality improves for large banks, not small



Key indicators, FDIC-insured national banks
Annual 1999–2002, year-to-date through June 30, 2003, second quarter 2002, and second quarter 2003
(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q2	Preliminary 2003Q2
Number of institutions reporting	2,365	2,231	2,138	2,077	2,048	2,105	2,048
Total employees (FTEs)	983,212	948,665	966,545	993,469	1,036,641	994,696	1,036,641
Selected income data ($)							
Net income	$42,555	$38,901	$44,220	$56,655	$30,377	$14,149	$15,286
Net interest income	114,564	115,909	125,612	141,566	70,355	34,792	35,251
Provision for loan losses	15,554	20,565	28,972	32,646	12,786	7,796	6,288
Noninterest income	92,599	96,109	99,391	109,111	55,427	26,710	28,210
Noninterest expense	125,819	128,548	131,153	136,290	70,178	33,093	35,821
Net operating income	42,380	40,152	42,990	54,508	28,694	13,645	14,353
Cash dividends declared	30,016	32,327	27,743	41,747	19,760	8,129	9,721
Net charge-offs	14,190	17,249	25,150	31,423	13,406	7,852	6,567
Selected condition data ($)							
Total assets	3,271,277	3,414,367	3,634,893	3,908,035	4,160,761	3,739,541	4,160,761
Total loans and leases	2,128,021	2,227,120	2,272,373	2,447,865	2,500,557	2,325,544	2,500,557
Reserve for losses	37,689	40,025	45,578	48,370	48,037	47,366	48,037
Securities	537,321	502,302	575,937	653,125	743,461	616,255	743,461
Other real estate owned	1,572	1,553	1,794	2,072	2,118	1,864	2,118
Noncurrent loans and leases	20,822	27,164	34,589	38,173	35,196	37,838	35,196
Total deposits	2,154,231	2,250,402	2,384,414	2,565,772	2,711,513	2,410,788	2,711,513
Domestic deposits	1,776,084	1,827,064	2,001,253	2,168,881	2,293,878	2,025,585	2,293,878
Equity capital	277,947	293,712	340,721	371,679	383,714	355,951	383,714
Off-balance-sheet derivatives	12,077,568	15,502,911	20,549,785	25,953,473	30,885,244	22,981,676	30,885,244
Performance ratios (annualized %)							
Return on equity	15.55	13.69	13.85	15.84	16.10	16.07	16.08
Return on assets	1.35	1.18	1.25	1.50	1.51	1.54	1.50
Net interest income to assets	3.63	3.50	3.56	3.76	3.50	3.78	3.46
Loss provision to assets	0.49	0.62	0.82	0.87	0.64	0.85	0.62
Net operating income to assets	1.34	1.21	1.22	1.45	1.43	1.48	1.41
Noninterest income to assets	2.94	2.90	2.82	2.90	2.76	2.90	2.76
Noninterest expense to assets	3.99	3.88	3.72	3.62	3.49	3.59	3.51
Loss provision to loans and leases	0.76	0.95	1.28	1.39	1.04	1.35	1.01
Net charge-offs to loans and leases	0.70	0.80	1.11	1.33	1.09	1.36	1.06
Loss provision to net charge-offs	109.61	119.23	115.20	103.89	95.38	99.29	95.74
Performance ratios (%)							
Percent of institutions unprofitable	7.10	6.95	7.48	6.93	5.71	6.89	6.25
Percent of institutions with earnings gains	62.11	66.61	56.83	71.26	56.84	68.69	53.71
Noninterest income to net operating revenue	44.70	45.33	44.17	43.53	44.07	43.43	44.45
Noninterest expense to net operating revenue	60.73	60.63	58.29	54.37	55.79	53.81	56.44
Condition ratios (%)							
Nonperforming assets to assets	0.70	0.86	1.02	1.06	0.92	1.09	0.92
Noncurrent loans to loans	0.98	1.22	1.52	1.56	1.41	1.63	1.41
Loss reserve to noncurrent loans	181.00	147.34	131.77	126.71	136.48	125.18	136.48
Loss reserve to loans	1.77	1.80	2.01	1.98	1.92	2.04	1.92
Equity capital to assets	8.50	8.60	9.37	9.51	9.22	9.52	9.22
Leverage ratio	7.49	7.49	7.81	7.89	7.83	8.04	7.83
Risk-based capital ratio	11.70	11.84	12.61	12.68	12.91	12.81	12.91
Net loans and leases to assets	63.90	64.06	61.26	61.40	58.94	60.92	58.94
Securities to assets	16.43	14.71	15.84	16.71	17.87	16.48	17.87
Appreciation in securities (% of par)	-2.45	-0.01	0.48	2.12	2.00	1.39	2.00
Residential mortgage assets to assets	20.60	19.60	22.54	24.72	26.09	23.19	26.09
Total deposits to assets	65.85	65.91	65.60	65.65	65.17	64.47	65.17
Core deposits to assets	47.01	45.61	48.08	48.75	48.56	47.47	48.56
Volatile liabilities to assets	34.81	35.18	31.24	30.31	30.26	30.67	30.26

Loan performance, FDIC-insured national banks
Annual 1999-2002, year-to-date through June 30, 2003, second quarter 2002, and second quarter 2003

(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q2	Preliminary 2003Q2
Percent of loans past due 30-89 days							
Total loans and leases	1.16	1.26	1.38	1.14	0.98	1.17	0.98
Loans secured by real estate (RE)	1.22	1.42	1.42	1.07	0.90	1.06	0.90
1- to 4-family residential mortgages	1.61	1.95	1.80	1.45	1.16	1.38	1.16
Home equity loans	0.77	1.07	0.98	0.62	0.48	0.58	0.48
Multifamily residential mortgages	0.69	0.59	0.75	0.40	0.55	0.43	0.55
Commercial RE loans	0.70	0.72	0.86	0.58	0.55	0.61	0.55
Construction RE loans	1.07	1.12	1.28	0.91	0.85	1.28	0.85
Commercial and industrial loans	0.71	0.71	0.95	0.76	0.79	1.08	0.79
Loans to individuals	2.36	2.40	2.39	2.16	1.78	1.96	1.78
Credit cards	2.53	2.50	2.52	2.57	2.12	2.36	2.12
Installment loans and other plans	2.24	2.31	2.65	2.08	1.76	1.88	1.76
All other loans and leases	0.50	0.58	0.84	0.56	0.47	0.63	0.47
Percent of loans noncurrent							
Total loans and leases	0.98	1.22	1.52	1.56	1.41	1.63	1.41
Loans secured by real estate (RE)	0.87	0.93	1.05	0.97	0.91	1.06	0.91
1- to 4-family residential mortgages	0.91	1.06	1.05	1.02	0.87	1.13	0.87
Home equity loans	0.32	0.41	0.42	0.33	0.28	0.35	0.28
Multifamily residential mortgages	0.43	0.55	0.49	0.44	0.49	0.45	0.49
Commercial RE loans	0.84	0.77	1.03	1.05	1.10	1.08	1.10
Construction RE loans	0.63	0.82	1.15	1.03	0.94	1.17	0.94
Commercial and industrial loans	1.11	1.66	2.44	3.00	2.81	3.07	2.81
Loans to individuals	1.52	1.46	1.58	1.61	1.47	1.49	1.47
Credit cards	2.00	1.90	2.05	2.16	1.84	1.95	1.84
Installment loans and other plans	1.16	1.06	1.41	1.30	1.37	1.28	1.37
All other loans and leases	0.40	0.85	1.18	1.10	0.94	1.04	0.94
Percent of loans charged-off, net							
Total loans and leases	0.70	0.80	1.11	1.33	1.09	1.36	1.06
Loans secured by real estate (RE)	0.10	0.12	0.26	0.19	0.16	0.17	0.16
1- to 4-family residential mortgages	0.14	0.14	0.32	0.17	0.14	0.17	0.13
Home equity loans	0.19	0.23	0.35	0.23	0.22	0.25	0.23
Multifamily residential mortgages	0.02	0.03	0.04	0.11	0.04	0.11	0.05
Commercial RE loans	0.03	0.07	0.18	0.17	0.12	0.13	0.15
Construction RE loans	0.03	0.05	0.15	0.19	0.15	0.15	0.17
Commercial and industrial loans	0.54	0.87	1.50	1.80	1.48	2.00	1.45
Loans to individuals	2.65	2.84	3.13	4.02	3.54	3.80	3.54
Credit cards	4.52	4.43	5.06	6.58	5.58	6.41	5.69
Installment loans and other plans	1.27	1.54	1.66	1.91	1.88	1.66	1.86
All other loans and leases	0.47	0.48	0.90	1.27	0.47	0.67	0.39
Loans outstanding ($)							
Total loans and leases	$2,128,021	$2,227,120	$2,272,373	$2,447,865	$2,500,557	$2,325,544	$2,500,557
Loans secured by real estate (RE)	853,141	892,140	976,137	1,139,547	1,219,212	1,025,172	1,219,212
1- to 4-family residential mortgages	433,807	443,002	472,719	573,974	619,065	483,355	619,065
Home equity loans	67,267	82,672	102,094	140,998	163,100	125,762	163,100
Multifamily residential mortgages	26,561	28,026	30,075	33,968	34,237	33,308	34,237
Commercial RE loans	214,145	221,267	236,484	253,423	260,038	246,961	260,038
Construction RE loans	71,578	76,899	91,484	95,403	97,807	92,549	97,807
Farmland loans	11,957	12,350	12,615	13,225	13,397	12,912	13,397
RE loans from foreign offices	27,825	27,923	30,668	28,556	31,567	30,324	31,567
Commercial and industrial loans	622,004	646,988	597,212	545,972	523,122	568,854	523,122
Loans to individuals	348,730	370,416	389,969	450,624	432,483	423,860	432,483
Credit cards*	147,275	176,425	166,628	209,971	187,529	191,203	187,529
Other revolving credit plans	na	na	29,258	33,243	32,404	31,403	32,404
Installment loans	201,455	193,991	194,083	207,410	212,550	201,253	212,550
All other loans and leases	306,038	319,142	310,998	314,171	328,250	310,482	328,250
Less: Unearned income	1,893	1,565	1,943	2,449	2,510	2,824	2,510

*Prior to March 2001, credit cards included "Other revolving credit plans."

Key indicators, FDIC-insured national banks by asset size
Second quarter 2002 and second quarter 2003
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2
Number of institutions reporting	988	886	944	993	131	123	42	46
Total employees (FTEs)	23,202	20,691	94,221	137,276	109,214	92,310	768,059	786,364
Selected income data ($)								
Net income	$146	$32	$781	$863	$1,696	$1,502	$11,526	$12,890
Net interest income	525	452	2,488	2,501	4,137	3,292	27,641	29,007
Provision for loan losses	37	43	203	200	623	490	6,933	5,554
Noninterest income	209	202	1,352	1,331	2,906	3,250	22,243	23,428
Noninterest expense	505	541	2,568	2,488	3,918	3,867	26,102	28,925
Net operating income	143	30	770	830	1,666	1,452	11,066	12,041
Cash dividends declared	79	79	395	393	648	682	7,007	8,566
Net charge-offs	25	23	151	153	678	423	6,998	5,968
Selected condition data ($)								
Total assets	52,347	47,871	250,305	272,334	413,921	373,078	3,022,968	3,467,478
Total loans and leases	31,289	28,109	155,753	168,025	262,466	231,760	1,876,035	2,072,664
Reserve for losses	441	402	2,233	2,424	4,570	3,722	40,122	41,489
Securities	13,035	11,862	62,762	67,937	87,040	75,163	453,418	588,500
Other real estate owned	75	80	245	306	220	215	1,325	1,517
Noncurrent loans and leases	368	365	1,521	1,700	2,444	2,250	33,505	30,881
Total deposits	43,885	40,110	202,640	220,242	268,260	242,304	1,896,003	2,208,856
Domestic deposits	43,885	40,110	202,552	219,886	265,720	239,758	1,513,428	1,794,124
Equity capital	6,094	5,537	25,733	27,865	44,463	42,953	279,661	307,359
Off-balance-sheet derivatives	24	14	1,361	4,321	36,919	22,209	23,249,262	31,213,460
Performance ratios (annualized %)								
Return on equity	9.77	2.32	12.43	12.55	15.62	14.18	16.61	16.91
Return on assets	1.13	0.27	1.26	1.28	1.65	1.61	1.55	1.52
Net interest income to assets	4.05	3.80	4.03	3.72	4.02	3.54	3.72	3.42
Loss provision to assets	0.29	0.36	0.33	0.30	0.61	0.53	0.93	0.66
Net operating income to assets	1.10	0.25	1.25	1.23	1.62	1.56	1.49	1.42
Noninterest income to assets	1.62	1.69	2.19	1.98	2.82	3.49	2.99	2.76
Noninterest expense to assets	3.90	4.55	4.16	3.70	3.80	4.15	3.51	3.41
Loss provision to loans and leases	0.48	0.61	0.53	0.48	0.95	0.85	1.48	1.08
Net charge-offs to loans and leases	0.32	0.34	0.39	0.37	1.03	0.73	1.50	1.16
Loss provision to net charge-offs	149.58	181.51	133.83	131.38	92.01	115.92	99.07	93.06
Performance ratios (%)								
Percent of institutions unprofitable	10.73	10.38	3.71	3.02	1.53	4.88	4.76	0.00
Percent of institutions with earnings gains	61.23	49.44	75.00	58.01	76.34	45.53	78.57	65.22
Nonint. income to net operating revenue	28.50	30.86	35.21	34.72	41.26	49.68	44.59	44.68
Nonint. expense to net operating revenue	68.76	82.81	66.89	64.93	55.62	59.12	52.33	55.16
Condition ratios (%)								
Nonperforming assets to assets	0.85	0.94	0.71	0.74	0.66	0.66	1.18	0.96
Noncurrent loans to loans	1.18	1.30	0.98	1.01	0.93	0.97	1.79	1.49
Loss reserve to noncurrent loans	119.78	110.27	146.77	142.61	187.00	165.40	119.75	134.35
Loss reserve to loans	1.41	1.43	1.43	1.44	1.74	1.61	2.14	2.00
Equity capital to assets	11.64	11.57	10.28	10.23	10.74	11.51	9.25	8.86
Leverage ratio	11.22	11.06	9.54	9.50	9.37	9.84	7.66	7.42
Risk-based capital ratio	18.33	18.27	15.05	15.05	15.26	16.55	12.30	12.38
Net loans and leases to assets	58.93	57.88	61.33	60.81	62.31	61.12	60.73	58.58
Securities to assets	24.90	24.78	25.07	24.95	21.03	20.15	15.00	16.97
Appreciation in securities (% of par)	1.87	2.47	1.92	2.60	2.05	3.17	1.17	1.77
Residential mortgage assets to assets	22.17	21.30	24.77	24.14	26.62	25.52	22.61	26.37
Total deposits to assets	83.83	83.79	80.96	80.87	64.81	64.95	62.72	63.70
Core deposits to assets	70.82	71.28	68.29	67.90	55.02	55.94	44.31	45.93
Volatile liabilities to assets	14.95	14.38	16.85	17.27	24.57	21.73	32.93	32.42

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Loan performance, FDIC-insured national banks by asset size
Second quarter 2002 and second quarter 2003
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2
Percent of loans past due 30-89 days								
Total loans and leases	1.35	1.40	1.11	1.02	1.09	0.97	1.18	0.97
Loans secured by real estate (RE)	1.14	1.22	0.87	0.84	0.84	0.78	1.12	0.92
1-4 family residential mortgages	1.42	1.64	1.14	1.14	0.98	1.13	1.47	1.16
Home equity loans	0.53	0.54	0.45	0.50	0.54	0.42	0.59	0.48
Multifamily residential mortgages	0.67	0.77	0.41	0.46	0.40	0.51	0.44	0.58
Commercial RE loans	0.81	0.95	0.68	0.62	0.62	0.44	0.59	0.54
Construction RE loans	1.40	1.14	0.98	0.92	1.17	0.72	1.36	0.85
Commercial and industrial loans	1.72	1.75	1.46	1.28	1.35	1.13	1.02	0.72
Loans to individuals	2.23	2.32	2.09	1.89	1.72	1.68	1.98	1.79
Credit cards	2.28	2.20	4.13	3.27	1.80	2.26	2.41	2.09
Installment loans and other plans	2.27	2.36	1.83	1.66	1.80	1.44	1.89	1.80
All other loans and leases	0.92	0.92	0.86	0.86	0.63	0.48	0.61	0.45
Percent of loans noncurrent								
Total loans and leases	1.18	1.30	0.98	1.01	0.93	0.97	1.79	1.49
Loans secured by real estate (RE)	1.03	1.16	0.81	0.88	0.76	0.87	1.14	0.91
1-4 family residential mortgages	0.87	1.01	0.70	0.79	0.71	0.92	1.26	0.87
Home equity loans	0.32	0.28	0.28	0.20	0.38	0.30	0.35	0.28
Multifamily residential mortgages	0.82	0.97	0.52	0.47	0.37	0.46	0.44	0.50
Commercial RE loans	1.12	1.20	0.94	1.04	0.88	0.95	1.16	1.15
Construction RE loans	0.85	1.28	0.85	0.73	0.94	0.81	1.29	0.99
Commercial and industrial loans	1.89	1.95	1.59	1.50	1.39	1.47	3.34	3.01
Loans to individuals	0.76	0.85	0.90	0.87	1.10	1.14	1.58	1.54
Credit cards	1.85	1.70	3.76	2.74	1.59	1.98	1.97	1.81
Installment loans and other plans	0.73	0.83	0.49	0.53	0.79	0.69	1.45	1.55
All other loans and leases	1.35	1.55	1.07	1.41	0.59	0.38	1.07	0.97
Percent of loans charged-off, net								
Total loans and leases	0.32	0.34	0.39	0.37	1.03	0.73	1.50	1.16
Loans secured by real estate (RE)	0.09	0.07	0.07	0.09	0.09	0.10	0.20	0.18
1-4 family residential mortgages	0.08	0.08	0.07	0.09	0.07	0.12	0.20	0.14
Home equity loans	0.15	-0.01	0.05	0.03	0.16	0.08	0.27	0.24
Multifamily residential mortgages	0.23	0.00	0.04	0.06	0.04	0.06	0.13	0.05
Commercial RE loans	0.11	0.08	0.07	0.13	0.11	0.08	0.16	0.18
Construction RE loans	0.11	0.12	0.06	0.06	0.07	0.18	0.18	0.19
Commercial and industrial loans	0.83	0.65	0.78	0.67	1.07	1.14	2.17	1.53
Loans to individuals	0.88	1.34	1.67	1.57	3.89	2.57	3.92	3.76
Credit cards	4.69	14.62	7.95	6.12	7.62	5.44	6.23	5.70
Installment loans and other plans	0.70	0.67	0.76	0.72	1.03	1.01	1.85	2.08
All other loans and leases	0.14	0.25	0.38	0.36	0.33	0.19	0.71	0.41
Loans outstanding ($)								
Total loans and leases	$31,289	$28,109	$155,753	$168,025	$262,466	$231,760	$1,876,035	$2,072,664
Loans secured by real estate (RE)	18,508	16,911	101,574	112,707	140,417	127,494	764,673	962,100
1-4 family residential mortgages	8,039	6,968	38,866	39,839	62,598	55,907	373,853	516,351
Home equity loans	498	479	4,740	6,071	9,989	9,081	110,535	147,469
Multifamily residential mortgages	440	434	3,764	4,340	5,468	4,703	23,636	24,761
Commercial RE loans	5,646	5,271	39,002	44,242	44,075	40,785	158,238	169,740
Construction RE loans	1,698	1,655	10,660	13,017	16,406	14,901	63,785	68,234
Farmland loans	2,187	2,104	4,539	5,198	1,759	1,655	4,426	4,439
RE loans from foreign offices	0	0	1	0	123	462	30,200	31,105
Commercial and industrial loans	5,164	4,577	27,302	27,749	49,001	39,257	487,387	451,540
Loans to individuals	3,991	3,367	17,722	18,017	50,841	41,503	351,305	369,596
Credit cards*	180	127	2,277	2,880	21,930	15,504	166,817	169,018
Other revolving credit plans	69	47	353	357	2,156	1,742	28,825	30,257
Installment loans	3,743	3,193	15,092	14,780	26,755	24,256	155,663	170,322
All other loans and leases	3,671	3,284	9,350	9,738	22,296	23,594	275,165	291,633
Less: Unearned income	45	31	194	187	89	88	2,496	2,205

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Key indicators, FDIC-insured national banks by region
Second quarter 2003
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	230	240	404	421	587	166	2,048
Total employees (FTEs)	292,229	260,260	217,053	64,983	97,219	104,897	1,036,641
Selected income data ($)							
Net income	$4,205	$3,642	$3,498	$1,071	$1,009	$1,862	$15,286
Net interest income	9,976	7,715	7,872	2,640	2,605	4,443	35,251
Provision for loan losses	2,771	502	1,363	656	186	810	6,288
Noninterest income	9,785	5,132	5,320	2,456	1,956	3,562	28,210
Noninterest expense	11,053	7,458	7,142	2,867	3,034	4,267	35,821
Net operating income	4,004	3,400	3,116	1,055	943	1,834	14,353
Cash dividends declared	3,592	2,850	1,585	720	618	355	9,721
Net charge-offs	3,094	637	1,295	638	169	735	6,567
Selected condition data ($)							
Total assets	1,097,978	1,088,816	1,025,173	228,200	297,654	422,940	4,160,761
Total loans and leases	620,341	590,215	649,798	154,344	180,321	305,537	2,500,557
Reserve for losses	16,742	8,884	11,802	3,318	2,516	4,774	48,037
Securities	212,065	202,730	196,318	29,659	65,130	37,559	743,461
Other real estate owned	193	536	765	125	329	169	2,118
Noncurrent loans and leases	13,054	6,646	9,555	1,592	1,847	2,502	35,196
Total deposits	743,666	718,416	632,148	140,764	224,565	251,953	2,711,513
Domestic deposits	471,642	652,161	577,165	135,906	223,047	233,956	2,293,878
Equity capital	105,994	92,193	85,223	25,970	28,447	45,887	383,714
Off-balance-sheet derivatives	11,749,338	16,239,708	1,854,680	7,233	84,269	950,016	30,885,244
Performance ratios (annualized %)							
Return on equity	15.99	15.90	16.57	16.64	14.32	16.55	16.08
Return on assets	1.54	1.40	1.39	1.88	1.37	1.79	1.50
Net interest income to assets	3.66	2.96	3.12	4.63	3.55	4.26	3.46
Loss provision to assets	1.02	0.19	0.54	1.15	0.25	0.78	0.62
Net operating income to assets	1.47	1.31	1.23	1.85	1.28	1.76	1.41
Noninterest income to assets	3.59	1.97	2.11	4.30	2.66	3.42	2.76
Noninterest expense to assets	4.06	2.86	2.83	5.02	4.13	4.09	3.51
Loss provision to loans and leases	1.77	0.35	0.85	1.66	0.42	1.08	1.01
Net charge-offs to loans and leases	1.98	0.44	0.81	1.61	0.38	0.98	1.06
Loss provision to net charge-offs	89.57	78.78	105.27	102.78	110.22	110.22	95.74
Performance ratios (%)							
Percent of institutions unprofitable	6.09	11.67	3.71	4.04	5.62	12.65	6.25
Percent of institutions with earnings gains	60.87	62.08	55.69	49.64	46.85	61.45	53.71
Noninterest income to net operating revenue	49.52	39.95	40.33	48.20	42.88	44.50	44.45
Noninterest expense to net operating revenue	55.93	58.05	54.14	56.25	66.53	53.31	56.44
Condition ratios (%)							
Nonperforming assets to assets	1.27	0.66	1.04	0.75	0.73	0.63	0.92
Noncurrent loans to loans	2.10	1.13	1.47	1.03	1.02	0.82	1.41
Loss reserve to noncurrent loans	128.25	133.68	123.52	208.50	136.20	190.82	136.48
Loss reserve to loans	2.70	1.51	1.82	2.15	1.40	1.56	1.92
Equity capital to assets	9.65	8.47	8.31	11.38	9.56	10.85	9.22
Leverage ratio	8.26	6.86	7.38	10.17	8.04	8.70	7.83
Risk-based capital ratio	13.28	11.60	12.58	15.67	13.46	14.29	12.91
Net loans and leases to assets	54.97	53.39	62.23	66.18	59.74	71.11	58.94
Securities to assets	19.31	18.62	19.15	13.00	21.88	8.88	17.87
Appreciation in securities (% of par)	1.73	1.82	2.01	2.85	2.43	2.99	2.00
Residential mortgage assets to assets	15.10	34.03	28.42	22.32	28.67	28.72	26.09
Total deposits to assets	67.73	65.98	61.66	61.68	75.45	59.57	65.17
Core deposits to assets	35.76	53.47	51.42	55.39	63.83	47.79	48.56
Volatile liabilities to assets	42.55	25.99	25.86	20.12	20.55	32.36	30.26

Loan performance, FDIC-insured national banks by region
Second quarter 2003
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30-89 days							
Total loans and leases	1.00	0.67	1.22	1.13	1.03	0.88	0.98
Loans secured by real estate (RE)	0.75	0.75	1.30	0.64	0.92	0.67	0.90
1- to 4-family residential mortgages	0.89	1.00	1.88	0.64	1.17	0.78	1.16
Home equity loans	0.42	0.55	0.54	0.48	0.47	0.32	0.48
Multifamily residential mortgages	0.23	0.12	0.85	0.30	1.45	0.24	0.55
Commercial RE loans	0.45	0.30	0.85	0.69	0.59	0.38	0.55
Construction RE loans	0.40	0.35	1.09	0.72	0.80	1.49	0.85
Commercial and industrial loans	0.71	0.38	1.14	1.28	1.09	0.63	0.79
Loans to individuals	1.92	1.41	1.61	1.87	1.80	1.91	1.78
Credit cards	2.12	1.43	1.94	2.01	2.28	2.30	2.12
Installment loans and other plans	2.32	1.50	1.66	1.58	1.84	1.45	1.76
All other loans and leases	0.45	0.18	0.65	0.80	0.69	0.41	0.47
Percent of loans noncurrent							
Total loans and leases	2.10	1.13	1.47	1.03	1.02	0.82	1.41
Loans secured by real estate (RE)	1.24	0.59	1.37	0.58	0.93	0.42	0.91
1- to 4-family residential mortgages	1.25	0.51	1.73	0.31	0.80	0.27	0.87
Home equity loans	0.22	0.20	0.40	0.32	0.36	0.15	0.28
Multifamily residential mortgages	0.45	0.33	0.62	0.28	0.83	0.28	0.49
Commercial RE loans	0.96	0.98	1.52	1.16	0.86	0.82	1.10
Construction RE loans	1.15	0.78	1.15	0.74	0.77	0.84	0.94
Commercial and industrial loans	3.45	3.14	2.65	1.31	1.52	1.90	2.81
Loans to individuals	2.30	0.51	0.71	1.49	0.69	1.33	1.47
Credit cards	1.91	1.10	1.60	1.74	1.56	1.87	1.84
Installment loans and other plans	4.08	0.53	0.56	0.90	0.68	0.41	1.37
All other loans and leases	1.23	0.82	0.72	1.14	1.06	0.57	0.94
Percent of loans charged-off, net							
Total loans and leases	1.98	0.44	0.81	1.61	0.38	0.98	1.06
Loans secured by real estate (RE)	0.18	0.09	0.32	0.07	0.15	0.04	0.16
1- to 4-family residential mortgages	0.07	0.09	0.31	0.04	0.15	0.01	0.13
Home equity loans	0.08	0.11	0.45	0.09	0.26	0.09	0.23
Multifamily residential mortgages	0.14	0.00	0.04	-0.02	0.09	0.09	0.05
Commercial RE loans	0.10	0.02	0.35	0.21	0.11	0.06	0.15
Construction RE loans	0.01	0.20	0.27	0.00	0.14	0.07	0.17
Commercial and industrial loans	1.76	1.35	1.50	1.01	0.80	1.22	1.45
Loans to individuals	5.02	0.90	1.95	4.36	1.08	4.13	3.54
Credit cards	5.69	3.16	5.20	5.86	5.31	5.76	5.69
Installment loans and other plans	3.99	0.89	1.25	0.50	0.90	1.15	1.86
All other loans and leases	0.55	0.13	0.44	0.35	0.10	0.35	0.39
Loans outstanding ($)							
Total loans and leases	$620,341	$590,215	$649,798	$154,344	$180,321	$305,537	$2,500,557
Loans secured by real estate (RE)	175,511	343,846	335,151	67,506	115,852	181,346	1,219,212
1- to 4-family residential mortgages	71,699	206,919	156,444	38,280	45,384	100,340	619,065
Home equity loans	30,670	35,849	54,803	4,766	11,705	25,307	163,100
Multifamily residential mortgages	3,908	7,534	13,831	1,822	2,684	4,459	34,237
Commercial RE loans	36,331	65,066	73,077	14,678	33,483	37,404	260,038
Construction RE loans	7,341	23,366	32,803	4,661	16,890	12,746	97,807
Farmland loans	520	1,855	3,702	3,299	2,932	1,089	13,397
RE loans from foreign offices	25,043	3,258	491	0	2,774	1	31,567
Commercial and industrial loans	161,644	119,096	139,483	24,039	34,352	44,509	523,122
Loans to individuals	168,283	56,412	83,650	46,952	18,916	58,270	432,483
Credit cards	100,220	433	15,214	33,437	784	37,441	187,529
Other revolving credit plans	19,916	3,025	4,847	533	637	3,445	32,404
Installment loans	48,147	52,954	63,589	12,983	17,495	17,383	212,550
All other loans and leases	116,964	70,982	91,597	15,869	11,330	21,508	328,250
Less: Unearned income	2,061	121	83	21	129	95	2,510

Key indicators, FDIC-insured commercial banks
Annual 1999-2002, year-to-date through June 30, 2003, second quarter 2002, and second quarter 2003

(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q2	Preliminary 2003Q2
Number of institutions reporting	8,580	8,316	8,080	7,888	7,833	7,967	7,833
Total employees (FTEs)	1,657,628	1,670,874	1,701,724	1,745,513	1,802,356	1,743,198	1,802,356
Selected income data ($)							
Net income	$71,507	$70,806	$73,877	$89,913	$50,395	$23,368	$25,517
Net interest income	192,149	203,964	214,919	236,856	119,164	58,628	59,948
Provision for loan losses	21,821	30,019	43,389	48,225	18,716	11,058	9,233
Noninterest income	144,403	153,166	157,507	172,013	90,414	42,751	46,114
Noninterest expense	204,220	216,119	222,673	233,073	120,727	56,933	61,670
Net operating income	71,273	72,395	71,049	85,608	47,132	22,540	23,657
Cash dividends declared	52,082	53,854	54,166	67,513	37,578	14,132	21,983
Net charge-offs	20,378	24,794	36,517	44,580	19,098	10,800	9,515
Selected condition data ($)							
Total assets	5,735,175	6,244,298	6,552,272	7,077,039	7,485,044	6,732,846	7,485,044
Total loans and leases	3,491,753	3,819,567	3,887,470	4,158,778	4,290,965	3,963,188	4,290,965
Reserve for losses	58,772	64,149	72,315	77,028	77,244	74,262	77,244
Securities	1,046,536	1,078,988	1,171,925	1,334,242	1,444,446	1,229,269	1,444,446
Other real estate owned	2,796	2,912	3,565	4,162	4,401	3,877	4,401
Noncurrent loans and leases	33,006	42,945	54,907	60,566	56,830	58,379	56,830
Total deposits	3,831,062	4,179,572	4,377,573	4,689,881	4,925,970	4,434,163	4,925,970
Domestic deposits	3,175,473	3,472,905	3,748,068	4,031,848	4,247,908	3,793,258	4,247,908
Equity capital	479,667	530,400	593,760	647,713	676,454	620,658	676,454
Off-balance-sheet derivatives	34,819,179	40,570,263	45,326,156	56,078,940	65,838,709	50,359,380	65,838,709
Performance ratios (annualized %)							
Return on equity	15.30	13.99	13.10	14.50	15.26	15.27	15.30
Return on assets	1.31	1.18	1.15	1.33	1.39	1.41	1.39
Net interest income to assets	3.51	3.41	3.35	3.51	3.29	3.54	3.27
Loss provision to assets	0.40	0.50	0.68	0.71	0.52	0.67	0.50
Net operating income to assets	1.30	1.21	1.11	1.27	1.30	1.36	1.29
Noninterest income to assets	2.64	2.56	2.46	2.55	2.50	2.58	2.52
Noninterest expense to assets	3.73	3.61	3.47	3.45	3.34	3.44	3.36
Loss provision to loans and leases	0.66	0.82	1.13	1.21	0.89	1.12	0.87
Net charge-offs to loans and leases	0.61	0.67	0.95	1.12	0.91	1.10	0.90
Loss provision to net charge-offs	107.08	121.07	118.82	108.18	98.00	102.39	97.04
Performance ratios (%)							
Percent of institutions unprofitable	7.52	7.35	8.13	6.54	5.39	6.99	5.87
Percent of institutions with earnings gains	62.82	67.32	56.29	72.77	60.13	69.98	56.56
Noninterest income to net operating revenue	42.91	42.89	42.29	42.07	43.14	42.17	43.48
Noninterest expense to net operating revenue	60.68	60.52	59.79	57.00	57.60	56.16	58.15
Condition ratios (%)							
Nonperforming assets to assets	0.63	0.74	0.92	0.94	0.84	0.96	0.84
Noncurrent loans to loans	0.95	1.12	1.41	1.46	1.32	1.47	1.32
Loss reserve to noncurrent loans	178.06	149.37	131.70	127.18	135.92	127.21	135.92
Loss reserve to loans	1.68	1.68	1.86	1.85	1.80	1.87	1.80
Equity capital to assets	8.36	8.49	9.06	9.15	9.04	9.22	9.04
Leverage ratio	7.79	7.69	7.79	7.83	7.84	8.00	7.84
Risk-based capital ratio	12.15	12.12	12.71	12.78	12.92	12.94	12.92
Net loans and leases to assets	59.86	60.14	58.23	57.68	56.30	57.76	56.30
Securities to assets	18.25	17.28	17.89	18.85	19.30	18.26	19.30
Appreciation in securities (% of par)	-2.31	0.20	0.82	2.22	2.04	1.65	2.04
Residential mortgage assets to assets	20.78	20.20	21.63	23.29	24.40	21.93	24.40
Total deposits to assets	66.80	66.93	66.81	66.27	65.81	65.86	65.81
Core deposits to assets	46.96	46.40	48.73	48.68	48.61	48.07	48.61
Volatile liabilities to assets	34.94	34.98	31.45	31.41	30.92	31.55	30.92

Loan performance, FDIC-insured commercial banks
Annual 1999-2002, year-to-date through June 30, 2003, second quarter 2002, and second quarter 2003
(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q2	Preliminary 2003Q2
Percent of loans past due 30-89 days							
Total loans and leases	1.14	1.26	1.37	1.17	1.00	1.16	1.00
Loans secured by real estate (RE)	1.09	1.26	1.31	1.08	0.90	1.03	0.90
1- to 4-family residential mortgages	1.43	1.72	1.67	1.48	1.18	1.35	1.18
Home equity loans	0.75	0.98	0.91	0.59	0.47	0.57	0.47
Multifamily residential mortgages	0.57	0.55	0.69	0.45	0.42	0.43	0.42
Commercial RE loans	0.69	0.74	0.90	0.68	0.63	0.72	0.63
Construction RE loans	0.98	1.06	1.21	0.89	0.84	1.03	0.84
Commercial and industrial loans	0.79	0.83	1.01	0.89	0.86	1.05	0.86
Loans to individuals	2.33	2.47	2.46	2.22	1.87	2.05	1.87
Credit cards	2.59	2.66	2.70	2.72	2.34	2.55	2.34
Installment loans and other plans	2.18	2.34	2.55	2.09	1.74	1.92	1.74
All other loans and leases	0.54	0.65	0.84	0.59	0.49	0.62	0.49
Percent of loans noncurrent							
Total loans and leases	0.95	1.12	1.41	1.46	1.32	1.47	1.32
Loans secured by real estate (RE)	0.79	0.81	0.96	0.89	0.85	0.95	0.85
1- to 4-family residential mortgages	0.82	0.90	0.96	0.93	0.83	1.00	0.83
Home equity loans	0.33	0.37	0.39	0.31	0.27	0.32	0.27
Multifamily residential mortgages	0.41	0.44	0.43	0.37	0.42	0.38	0.42
Commercial RE loans	0.77	0.72	0.96	0.95	0.99	0.97	0.99
Construction RE loans	0.67	0.76	1.06	0.98	0.89	1.08	0.89
Commercial and industrial loans	1.18	1.66	2.41	2.92	2.69	2.87	2.69
Loans to individuals	1.42	1.41	1.48	1.51	1.37	1.40	1.37
Credit cards	2.06	2.01	2.12	2.24	1.95	2.02	1.95
Installment loans and other plans	1.04	0.98	1.21	1.14	1.13	1.13	1.13
All other loans and leases	0.39	0.69	0.96	1.01	0.90	0.89	0.90
Percent of loans charged-off, net							
Total loans and leases	0.61	0.67	0.95	1.12	0.91	1.10	0.90
Loans secured by real estate (RE)	0.08	0.09	0.19	0.15	0.13	0.14	0.15
1- to 4-family residential mortgages	0.11	0.11	0.22	0.14	0.13	0.15	0.14
Home equity loans	0.15	0.18	0.27	0.19	0.19	0.20	0.19
Multifamily residential mortgages	0.02	0.03	0.04	0.08	0.04	0.07	0.05
Commercial RE loans	0.03	0.05	0.14	0.15	0.12	0.12	0.14
Construction RE loans	0.04	0.05	0.14	0.17	0.11	0.11	0.13
Commercial and industrial loans	0.58	0.81	1.43	1.76	1.36	1.78	1.33
Loans to individuals	2.32	2.43	2.73	3.34	3.04	3.17	3.06
Credit cards	4.46	4.39	5.12	6.38	5.80	6.29	6.03
Installment loans and other plans	1.04	1.18	1.29	1.46	1.40	1.27	1.36
All other loans and leases	0.51	0.46	0.82	1.16	0.43	0.60	0.39
Loans outstanding ($)							
Total loans and leases	$3,491,753	$3,819,567	$3,887,470	$4,158,778	$4,290,965	$3,963,188	$4,290,965
Loans secured by real estate (RE)	1,510,342	1,673,325	1,800,281	2,068,467	2,205,242	1,884,997	2,205,242
1- to 4-family residential mortgages	737,110	790,030	810,826	946,033	1,009,672	822,792	1,009,672
Home equity loans	102,339	127,694	154,157	214,665	246,265	188,583	246,265
Multifamily residential mortgages	53,168	60,406	64,131	71,936	76,666	69,371	76,666
Commercial RE loans	417,633	466,453	505,877	555,977	577,244	532,183	577,244
Construction RE loans	135,632	162,613	193,062	207,511	218,689	198,640	218,689
Farmland loans	31,902	34,096	35,532	38,065	39,708	37,016	39,708
RE loans from foreign offices	32,558	32,033	36,695	34,280	36,999	36,411	36,999
Commercial and industrial loans	969,257	1,051,992	981,059	911,861	890,880	935,419	890,880
Loans to individuals	558,520	606,716	629,434	703,780	690,407	660,032	690,407
Credit cards*	212,147	249,425	232,448	275,957	251,126	250,399	251,126
Other revolving credit plans	na	na	34,202	38,209	37,044	36,517	37,044
Installment loans	346,373	357,291	362,784	389,614	402,237	373,116	402,237
All other loans and leases	457,307	490,446	479,818	478,070	507,884	486,570	507,884
Less: Unearned income	3,673	2,912	3,122	3,400	3,448	3,830	3,448

*Prior to March 2001, credit cards included "Other revolving credit plans."

Key indicators, FDIC-insured commercial banks by asset size
Second quarter 2002 and second quarter 2003

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2
Number of institutions reporting	4,375	4,026	3,195	3,386	320	340	77	81
Total employees (FTEs)	88,883	79,949	298,767	343,671	253,376	247,022	1,102,172	1,131,714
Selected income data ($)								
Net income	$588	$451	$2,640	$2,842	$3,413	$3,683	$16,726	$18,541
Net interest income	2,191	1,957	8,422	8,450	9,028	8,648	38,987	40,893
Provision for loan losses	166	142	751	670	1,316	1,178	8,825	7,244
Noninterest income	620	625	3,105	3,258	5,494	6,434	33,533	35,797
Noninterest expense	1,899	1,856	7,149	7,281	8,182	8,607	39,702	43,925
Net operating income	579	432	2,606	2,738	3,354	3,522	16,001	16,966
Cash dividends declared	309	288	1,154	1,323	1,926	8,483	10,743	11,890
Net charge-offs	108	96	534	513	1,353	1,180	8,805	7,726
Selected condition data ($)								
Total assets	219,738	206,290	831,596	896,756	935,153	968,227	4,746,359	5,413,771
Total loans and leases	136,073	125,653	542,836	579,680	579,405	591,631	2,704,874	2,994,001
Reserve for losses	1,966	1,859	7,917	8,561	10,461	9,873	53,918	56,951
Securities	53,538	49,045	191,418	206,250	220,934	233,017	763,380	956,134
Other real estate owned	325	339	1,013	1,261	652	635	1,887	2,166
Noncurrent loans and leases	1,595	1,594	5,233	5,695	6,034	6,124	45,516	43,416
Total deposits	185,319	173,544	677,690	729,712	638,576	652,548	2,932,577	3,370,166
Domestic deposits	185,319	173,544	676,356	728,343	627,811	642,912	2,303,772	2,703,109
Equity capital	24,487	23,243	82,301	89,123	96,185	102,737	417,685	461,350
Off-balance-sheet derivatives	61	122	4,775	9,586	83,196	66,710	50,774,504	66,371,367
Performance ratios (annualized %)								
Return on equity	9.80	7.85	13.15	12.94	14.49	14.62	16.18	16.28
Return on assets	1.08	0.88	1.29	1.28	1.47	1.54	1.43	1.40
Net interest income to assets	4.03	3.83	4.11	3.82	3.90	3.62	3.34	3.09
Loss provision to assets	0.31	0.28	0.37	0.30	0.57	0.49	0.76	0.55
Net operating income to assets	1.07	0.85	1.27	1.24	1.45	1.48	1.37	1.28
Noninterest income to assets	1.14	1.22	1.51	1.47	2.37	2.70	2.88	2.71
Noninterest expense to assets	3.49	3.63	3.49	3.29	3.53	3.61	3.41	3.32
Loss provision to loans and leases	0.50	0.46	0.56	0.47	0.91	0.81	1.31	0.98
Net charge-offs to loans and leases	0.33	0.31	0.40	0.36	0.94	0.81	1.31	1.04
Loss provision to net charge-offs	152.92	147.51	140.65	130.69	97.29	99.75	100.22	93.77
Performance ratios (%)								
Percent of institutions unprofitable	10.26	8.87	2.97	2.66	3.44	3.24	2.60	2.47
Percent of institutions with earnings gains	65.53	50.32	75.59	63.11	73.44	63.82	75.32	61.73
Noninterest income to net operating revenue	22.05	24.19	26.94	27.83	37.83	42.66	46.24	46.68
Noninterest expense to net operating revenue	67.57	71.90	62.02	62.19	56.34	57.07	54.75	57.28
Condition ratios (%)								
Nonperforming assets to assets	0.88	0.94	0.76	0.78	0.72	0.70	1.04	0.87
Noncurrent loans to loans	1.17	1.27	0.96	0.98	1.04	1.04	1.68	1.45
Loss reserve to noncurrent loans	123.23	116.59	151.28	150.32	173.36	161.22	118.46	131.17
Loss reserve to loans	1.44	1.48	1.46	1.48	1.81	1.67	1.99	1.90
Equity capital to assets	11.14	11.27	9.90	9.94	10.29	10.61	8.80	8.52
Leverage ratio	10.74	10.79	9.32	9.32	9.05	9.30	7.43	7.20
Risk-based capital ratio	17.03	17.27	14.23	14.26	14.37	14.80	12.33	12.26
Net loans and leases to assets	61.03	60.01	64.32	63.69	60.84	60.08	55.85	54.25
Securities to assets	24.36	23.77	23.02	23.00	23.63	24.07	16.08	17.66
Appreciation in securities (% of par)	1.86	2.56	1.93	2.57	1.80	2.32	1.53	1.83
Residential mortgage assets to assets	21.65	21.16	23.75	23.22	26.09	26.36	20.80	24.37
Total deposits to assets	84.34	84.13	81.49	81.37	68.29	67.40	61.79	62.25
Core deposits to assets	71.30	71.41	67.98	68.05	55.42	55.34	42.06	43.31
Volatile liabilities to assets	14.79	14.36	17.54	17.27	25.66	24.36	35.94	34.99

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Loan performance, FDIC-insured commercial banks by asset size
Second quarter 2002 and second quarter 2003
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2	2002Q2	2003Q2
Percent of loans past due 30-89 days								
Total loans and leases	1.48	1.52	1.14	1.06	1.14	1.03	1.15	0.96
Loans secured by real estate (RE)	1.30	1.35	0.92	0.89	0.87	0.77	1.10	0.91
1- to 4-family residential mortgages	1.66	1.81	1.24	1.25	1.03	0.99	1.43	1.17
Home equity loans	0.75	0.69	0.52	0.52	0.55	0.44	0.57	0.47
Multifamily residential mortgages	0.66	1.06	0.45	0.40	0.46	0.37	0.40	0.42
Commercial RE loans	0.97	1.02	0.73	0.68	0.77	0.66	0.66	0.55
Construction RE loans	1.39	1.24	0.91	0.88	0.94	0.80	1.10	0.82
Commercial and industrial loans	1.80	1.81	1.38	1.31	1.35	1.23	0.93	0.70
Loans to individuals	2.43	2.53	2.22	2.05	1.97	1.97	2.03	1.81
Credit cards	2.32	2.11	5.22	4.65	2.46	2.89	2.49	2.19
Installment loans and other plans	2.48	2.59	1.92	1.78	1.81	1.53	1.90	1.74
All other loans and leases	0.97	1.01	0.98	0.81	0.69	0.59	0.57	0.44
Percent of loans noncurrent								
Total loans and leases	1.17	1.27	0.96	0.98	1.04	1.04	1.68	1.45
Loans secured by real estate (RE)	1.00	1.11	0.84	0.85	0.83	0.87	1.02	0.83
1- to 4-family residential mortgages	0.87	1.00	0.74	0.80	0.81	0.86	1.11	0.82
Home equity loans	0.30	0.34	0.28	0.26	0.33	0.29	0.32	0.27
Multifamily residential mortgages	0.65	0.91	0.48	0.47	0.28	0.47	0.38	0.36
Commercial RE loans	1.11	1.17	0.91	0.93	0.87	0.98	1.05	1.02
Construction RE loans	0.99	1.26	0.99	0.91	1.12	0.90	1.11	0.85
Commercial and industrial loans	1.84	1.88	1.44	1.45	1.75	1.75	3.29	3.05
Loans to individuals	0.93	0.98	0.83	0.92	1.01	1.00	1.56	1.49
Credit cards	1.40	1.38	3.07	3.26	1.74	1.90	2.03	1.92
Installment loans and other plans	0.94	0.98	0.58	0.64	0.65	0.52	1.35	1.34
All other loans and leases	1.31	1.47	1.26	1.33	0.80	0.68	0.85	0.88
Percent of loans charged-off, net								
Total loans and leases	0.33	0.31	0.40	0.36	0.94	0.81	1.31	1.04
Loans secured by real estate (RE)	0.10	0.08	0.08	0.10	0.13	0.14	0.17	0.17
1- to 4-family residential mortgages	0.10	0.10	0.08	0.09	0.09	0.12	0.18	0.15
Home equity loans	0.05	0.03	0.04	0.05	0.13	0.16	0.23	0.21
Multifamily residential mortgages	0.05	0.14	0.02	0.03	0.10	0.12	0.08	0.03
Commercial RE loans	0.12	0.09	0.08	0.11	0.18	0.16	0.12	0.15
Construction RE loans	0.17	0.12	0.09	0.11	0.10	0.18	0.12	0.13
Commercial and industrial loans	0.81	0.67	0.88	0.75	1.38	1.08	1.99	1.47
Loans to individuals	0.90	1.00	1.68	1.63	3.36	3.24	3.38	3.23
Credit cards	4.05	8.19	8.73	8.00	7.68	8.00	6.00	5.70
Installment loans and other plans	0.81	0.80	0.82	0.82	1.00	0.98	1.43	1.54
All other loans and leases	0.17	0.31	0.44	0.32	0.47	0.35	0.64	0.41
Loans outstanding ($)								
Total loans and leases	$136,073	$125,653	$542,836	$579,680	$579,405	$591,631	$2,704,874	$2,994,001
Loans secured by real estate (RE)	80,667	76,000	365,659	401,979	329,397	349,325	1,109,275	1,377,938
1- to 4-family residential mortgages	34,276	31,189	128,152	131,988	126,427	130,308	533,937	716,188
Home equity loans	2,366	2,318	17,225	21,027	21,862	25,089	147,130	197,830
Multifamily residential mortgages	1,858	1,728	12,975	15,277	14,795	16,080	39,743	43,581
Commercial RE loans	24,362	23,227	145,783	162,141	119,150	126,070	242,888	265,805
Construction RE loans	7,406	7,331	45,893	53,621	42,493	46,286	102,848	111,451
Farmland loans	10,399	10,206	15,596	17,894	4,175	4,429	6,845	7,179
RE loans from foreign offices	0	0	33	31	495	1,064	35,883	35,903
Commercial and industrial loans	23,085	20,958	94,517	96,315	115,807	106,288	702,009	667,319
Loans to individuals	16,362	13,985	55,086	52,581	96,120	94,927	492,464	528,914
Credit cards*	464	346	5,982	5,918	34,070	33,836	209,883	211,027
Other revolving credit plans	290	228	1,573	1,579	3,785	2,855	30,869	32,382
Installment loans	15,609	13,411	47,531	45,084	58,264	58,237	251,712	285,505
All other loans and leases	16,089	14,809	28,161	29,371	38,586	41,573	403,734	422,131
Less: Unearned income	131	98	587	567	504	482	2,609	2,301

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Key indicators, FDIC-insured commercial banks by region
Second quarter 2003
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	623	1,077	1,667	2,034	1,747	685	7,833
Total employees (FTEs)	533,755	452,621	345,484	119,400	176,804	174,292	1,802,356
Selected income data ($)							
Net income	$7,830	$5,948	$5,134	$1,626	$1,657	$3,322	$25,517
Net interest income	17,662	13,386	12,010	4,246	4,592	8,053	59,948
Provision for loan losses	3,738	1,105	1,903	804	327	1,357	9,233
Noninterest income	18,715	9,012	7,529	2,872	2,642	5,345	46,114
Noninterest expense	22,005	13,230	10,737	4,038	4,738	6,922	61,670
Net operating income	7,043	5,555	4,664	1,594	1,560	3,241	23,657
Cash dividends declared	5,037	11,536	2,499	1,008	986	917	21,983
Net charge-offs	4,061	1,277	1,741	768	275	1,392	9,515
Selected condition data ($)							
Total assets	2,540,580	1,743,204	1,539,895	394,192	505,135	762,038	7,485,044
Total loans and leases	1,188,845	1,029,243	976,793	266,669	304,954	524,460	4,290,965
Reserve for losses	27,041	15,226	16,679	5,278	4,290	8,731	77,244
Securities	498,902	333,423	308,239	64,849	121,107	117,925	1,444,446
Other real estate owned	545	1,142	1,189	368	718	438	4,401
Noncurrent loans and leases	22,623	10,376	13,248	2,807	3,193	4,582	56,830
Total deposits	1,574,886	1,165,353	1,009,537	274,645	395,207	506,343	4,925,970
Domestic deposits	1,079,437	1,085,676	935,329	269,787	393,657	484,022	4,247,908
Equity capital	217,690	152,725	130,636	43,185	48,917	83,301	676,454
Off-balance-sheet derivatives	46,366,624	16,401,803	1,959,379	10,516	86,290	1,014,098	65,838,709
Performance ratios (annualized %)							
Return on equity	14.65	15.73	15.89	15.23	13.69	16.24	15.30
Return on assets	1.26	1.41	1.35	1.66	1.33	1.77	1.39
Net interest income to assets	2.85	3.18	3.16	4.32	3.68	4.29	3.27
Loss provision to assets	0.60	0.26	0.50	0.82	0.26	0.72	0.50
Net operating income to assets	1.13	1.32	1.23	1.62	1.25	1.73	1.29
Noninterest income to assets	3.02	2.14	1.98	2.92	2.12	2.85	2.52
Noninterest expense to assets	3.55	3.14	2.82	4.11	3.80	3.69	3.36
Loss provision to loans and leases	1.27	0.44	0.79	1.20	0.43	1.06	0.87
Net charge-offs to loans and leases	1.38	0.51	0.72	1.14	0.37	1.08	0.90
Loss provision to net charge-offs	92.06	86.50	109.28	104.63	118.58	97.47	97.04
Performance ratios (%)							
Percent of institutions unprofitable	7.06	8.82	4.50	3.54	6.01	10.07	5.87
Percent of institutions with earnings gains	64.37	61.37	59.81	51.62	48.60	68.91	56.56
Noninterest income to net operating revenue	51.45	40.24	38.53	40.34	36.52	39.89	43.48
Noninterest expense to net operating revenue	60.49	59.07	54.95	56.73	65.50	51.66	58.15
Condition ratios (%)							
Nonperforming assets to assets	0.96	0.66	0.96	0.81	0.78	0.66	0.84
Noncurrent loans to loans	1.90	1.01	1.36	1.05	1.05	0.87	1.32
Loss reserve to noncurrent loans	119.52	146.73	125.89	188.00	134.37	190.55	135.92
Loss reserve to loans	2.27	1.48	1.71	1.98	1.41	1.66	1.80
Equity capital to assets	8.57	8.76	8.48	10.96	9.68	10.93	9.04
Leverage ratio	7.34	7.37	7.73	9.87	8.50	9.18	7.84
Risk-based capital ratio	12.93	11.89	12.58	14.94	14.02	14.29	12.92
Net loans and leases to assets	45.73	58.17	62.35	66.31	59.52	67.68	56.30
Securities to assets	19.64	19.13	20.02	16.45	23.98	15.47	19.30
Appreciation in securities (% of par)	1.61	2.31	2.05	2.68	2.51	2.22	2.04
Residential mortgage assets to assets	18.42	30.63	26.73	20.96	27.71	24.95	24.40
Total deposits to assets	61.99	66.85	65.56	69.67	78.24	66.45	65.81
Core deposits to assets	34.42	54.28	54.00	61.64	65.17	54.30	48.61
Volatile liabilities to assets	43.94	24.57	25.35	17.60	19.88	27.47	30.92

Loan performance, FDIC-insured commercial banks by region
Second quarter 2003
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30-89 days							
Total loans and leases	1.02	0.81	1.14	1.20	1.12	0.87	1.00
Loans secured by real estate (RE)	0.91	0.77	1.18	0.84	0.98	0.64	0.90
1- to 4-family residential mortgages	1.09	1.05	1.68	0.89	1.30	0.82	1.18
Home equity loans	0.45	0.48	0.52	0.63	0.48	0.32	0.47
Multifamily residential mortgages	0.14	0.22	0.78	0.43	0.97	0.18	0.42
Commercial RE loans	0.66	0.49	0.84	0.80	0.67	0.41	0.63
Construction RE loans	0.87	0.55	1.06	1.00	0.86	1.03	0.84
Commercial and industrial loans	0.69	0.56	1.12	1.39	1.20	0.91	0.86
Loans to individuals	1.97	1.89	1.55	2.09	1.96	1.73	1.87
Credit cards	2.30	3.44	1.97	2.34	2.16	2.09	2.34
Installment loans and other plans	1.98	1.61	1.57	1.71	2.01	1.39	1.74
All other loans and leases	0.44	0.23	0.64	0.86	0.83	0.44	0.49
Percent of loans noncurrent							
Total loans and leases	1.90	1.01	1.36	1.05	1.05	0.87	1.32
Loans secured by real estate (RE)	0.94	0.63	1.23	0.71	0.94	0.53	0.85
1- to 4-family residential mortgages	0.89	0.60	1.49	0.48	0.83	0.34	0.83
Home equity loans	0.20	0.21	0.38	0.36	0.35	0.20	0.27
Multifamily residential mortgages	0.21	0.31	0.66	0.36	0.66	0.34	0.42
Commercial RE loans	0.92	0.87	1.36	0.97	0.98	0.74	0.99
Construction RE loans	0.98	0.64	1.24	0.78	0.78	0.91	0.89
Commercial and industrial loans	3.83	2.44	2.36	1.42	1.49	1.84	2.69
Loans to individuals	2.02	0.87	0.65	1.49	0.74	1.10	1.37
Credit cards	2.10	2.08	1.60	1.90	1.48	1.69	1.95
Installment loans and other plans	2.26	0.63	0.52	0.83	0.73	0.32	1.13
All other loans and leases	1.04	0.72	0.70	1.24	1.39	0.76	0.90
Percent of loans charged-off, net							
Total loans and leases	1.38	0.51	0.72	1.14	0.37	1.08	0.90
Loans secured by real estate (RE)	0.10	0.10	0.31	0.07	0.14	0.06	0.15
1- to 4-family residential mortgages	0.05	0.10	0.35	0.06	0.16	0.02	0.14
Home equity loans	0.07	0.14	0.37	0.14	0.24	0.07	0.19
Multifamily residential mortgages	0.03	0.02	0.04	0.08	0.09	0.12	0.05
Commercial RE loans	0.07	0.08	0.31	0.11	0.10	0.11	0.14
Construction RE loans	0.06	0.11	0.24	0.01	0.15	0.09	0.13
Commercial and industrial loans	1.54	1.18	1.34	0.80	0.73	1.58	1.33
Loans to individuals	3.77	1.75	1.67	4.12	1.07	4.31	3.06
Credit cards	5.86	6.08	5.15	6.17	4.89	6.59	6.03
Installment loans and other plans	2.08	0.91	1.09	0.50	0.91	1.11	1.36
All other loans and leases	0.47	0.15	0.46	0.43	0.32	0.39	0.39
Loans outstanding ($)							
Total loans and leases	$1,188,845	$1,029,243	$976,793	$266,669	$304,954	$524,460	$4,290,965
Loans secured by real estate (RE)	418,621	620,663	523,595	135,565	199,336	307,463	2,205,242
1- to 4-family residential mortgages	206,920	305,119	223,793	60,327	75,980	137,532	1,009,672
Home equity loans	49,962	65,760	76,529	7,305	13,741	32,968	246,265
Multifamily residential mortgages	16,784	16,087	22,217	4,004	5,223	12,350	76,666
Commercial RE loans	92,716	153,806	136,646	38,409	64,790	90,877	577,244
Construction RE loans	20,899	71,331	54,303	13,028	29,565	29,563	218,689
Farmland loans	1,483	5,301	9,570	12,491	7,263	3,599	39,708
RE loans from foreign offices	29,857	3,258	536	0	2,774	573	36,999
Commercial and industrial loans	284,897	193,947	221,125	44,165	54,872	91,873	890,880
Loans to individuals	275,813	120,548	110,512	57,245	33,028	93,261	690,407
Credit cards	121,663	22,266	16,080	35,815	1,388	53,914	251,126
Other revolving credit plans	21,279	4,495	5,351	673	849	4,398	37,044
Installment loans	132,871	93,787	89,081	20,758	30,790	34,950	402,237
All other loans and leases	211,754	94,425	121,719	29,746	17,979	32,261	507,884
Less: Unearned income	2,240	340	158	52	261	398	3,448

Glossary

Data Sources

Data are from the Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (call reports) submitted by all FDIC-insured, national-chartered and state-chartered commercial banks and trust companies in the United States and its territories. Uninsured banks, savings banks, savings associations, and U.S. branches and agencies of foreign banks are excluded from these tables. All data are collected and presented based on the location of each reporting institution's main office. Reported data may include assets and liabilities located outside of the reporting institution's home state.

The data are stored on and retrieved from the OCC's Integrated Banking Information System (IBIS), which is obtained from the FDIC's Research Information System (RIS) database.

Computation Methodology

For performance ratios constructed by dividing an income statement (flow) item by a balance sheet (stock) item, the income item for the period was annualized (multiplied by the number of periods in a year) and divided by the average balance sheet item for the period (beginning-of-period amount plus end-of-period amount plus any interim periods, divided by the total number of periods). For "pooling-of-interest" mergers, prior period(s) balance sheet items of "acquired" institution(s) are included in balance sheet averages because the year-to-date income reported by the "acquirer" includes the year-to-date results of "acquired" institutions. No adjustments are made for "purchase accounting" mergers because the year-to-date income reported by the "acquirer" does not include the prior-to-merger results of "acquired" institutions.

Definitions

Commercial real estate loans—loans secured by nonfarm nonresidential properties.

Construction real estate loans—includes loans for all property types under construction, as well as loans for land acquisition and development.

Core deposits—the sum of transaction deposits plus savings deposits plus small time deposits (under $100,000).

IBIS—the OCC's Integrated Banking Information System.

Leverage ratio—Tier 1 capital divided by adjusted tangible total assets.

Loans to individuals—includes outstanding credit card balances and other secured and unsecured installment loans.

Net charge-offs to loan and lease reserve—total loans and leases charged off (removed from balance sheet because of uncollectibility), less amounts recovered on loans and leases previously charged off.

Net loans and leases to assets—total loans and leases net of the reserve for losses.

Net operating income—income excluding discretionary transactions such as gains (or losses) on the sale of investment securities and extraordinary items. Income taxes subtracted from operating income have been adjusted to exclude the portion applicable to securities gains (or losses).

Net operating revenue—the sum of net interest income plus noninterest income.

Noncurrent loans and leases—the sum of loans and leases 90 days or more past due plus loans and leases in nonaccrual status.

Nonperforming assets—the sum of noncurrent loans and leases plus noncurrent debt securities and other assets plus other real estate owned.

Number of institutions reporting—the number of institutions that actually filed a financial report.

Off-balance-sheet derivatives—the notional value of futures and forwards, swaps, and options contracts; beginning March 31, 1995, new reporting detail permits the exclusion of spot foreign exchange contracts. For March 31, 1984 through December 31, 1985, only foreign exchange futures and forwards contracts were reported; beginning March 31, 1986, interest rate swaps contracts were reported; beginning March 31, 1990, banks began to report interest rate and other futures and forwards contracts, foreign exchange and other swaps contracts, and all types of option contracts.

Other real estate owned—primarily foreclosed property. Direct and indirect investments in real estate ventures are excluded. The amount is reflected net of valuation allowances.

Percent of institutions unprofitable—the percent of institutions with negative net income for the respective period.

Percent of institutions with earnings gains—the percent of institutions that increased their net income (or decreased their losses) compared to the same period a year earlier.

Reserve for losses—the sum of the allowance for loan and lease losses plus the allocated transfer risk reserve.

Residential mortgage assets—the sum of 1- to 4-family residential mortgages plus mortgage-backed securities.

Return on assets (ROA)—net income (including gains or losses on securities and extraordinary items) as a percentage of average total assets.

Return on equity (ROE)—net income (including gains or losses on securities and extraordinary items) as a percentage of average total equity capital.

Risk-based capital ratio—total capital divided by risk-weighted assets.

Risk-weighted assets—assets adjusted for risk-based capital definitions, which include on-balance-sheet as well as off-balance-sheet items multiplied by risk weights that range from zero to 100 percent.

Securities—excludes securities held in trading accounts. Effective March 31, 1994 with the full implementation of Financial Accounting Standard (FAS) 115, securities classified by banks as "held-to-maturity" are reported at their amortized cost, and securities classified a "available-for-sale" are reported at their current fair (market) values.

Securities gains (losses)—net pre-tax realized gains (losses) on held-to-maturity and available-for-sale securities.

Total capital—the sum of Tier 1 and Tier 2 capital. Tier 1 capital consists of common equity capital plus noncumulative perpetual preferred stock plus minority interest in consolidated subsidiaries less goodwill and other ineligible intangible assets. Tier 2 capital consists of subordinated debt plus intermediate-term preferred stock plus cumulative long-term preferred stock plus a portion of a bank's allowance for loan and lease losses. The amount of eligible intangibles (including mortgage servicing rights) included in Tier 1 capital and the amount of the allowance included in Tier 2 capital are limited in accordance with supervisory capital regulations.

Volatile liabilities—the sum of large-denomination time deposits plus foreign-office deposits plus federal funds purchased plus securities sold under agreements to repurchase plus other borrowings. Beginning March 31, 1994, new reporting detail permits the exclusion of other borrowed money with original maturity of more than one year; previously, all other borrowed money was included. Also beginning March 31, 1994, the newly reported "trading liabilities less revaluation losses on assets held in trading accounts" is included.

Recent Licensing Decisions

The OCC publishes monthly, in its publication *Interpretations and Actions,* corporate decisions that represent a new or changed policy or present issues of general interest to the public or the banking industry. In addition, summaries of selected corporate decisions appear in each issue of the *Quarterly Journal.* In the fourth quarter of 2002, the following corporate decisions were of particular importance because they were precedent setting or otherwise represented issues of importance. The OCC's decision documents for these decisions may be found in *Interpretations and Actions* using the decision number at the end of each summary.

Conversions

On March 3, 2003, the OCC approved the conversion of Mellon 1st Business Bank to a national bank. The bank will retain four branches. As part of the conversion, Mellon is the first national bank to be permitted to issue zero or no par value common stock. A national bank's decision to issue zero or no par common stock may affect its ability to declare a dividend. However, the National Bank Act does not expressly require the bank to assign a par value to its common stock. Accordingly, it is permissible. [Corporate Decision No. 2003–3]

Mergers

On March 31, 2003, OCC approved the application filed by Household Bank (SB) National Association, Las Vegas, Nevada, and National Bank of the Great Lakes Elmhurst, Illinois, (NBGL) to purchase the credit card receivables of NBGL. According to a reliable source, Household ranks eleventh in the national credit card market; and NBGL is not in the top 50 credit card providers. This decision was also based on the banks' compliance with a recent amendment to the Bank Merger Act, as NBGL and Saks will enter into consent orders with the OCC before consummation, that provide for corrective actions to address Bank Secrecy Act and anti-money-laundering issues. [Corporate Decision No. 2003–7]

On March 13, 2003, the OCC approved the application filed by the City National Bank and Trust Company of Guymon, Guymon, Oklahoma, to purchase certain assets and liabilities of the Guymon, Oklahoma, branch of a nonaffiliated bank. CNB has deposits representing 27 percent of the relevant market, and would rank first and control 43 percent of total market deposits upon consummation. The newly acquired branch will remain open upon consummation and no change in community services is planned. [Corporate Decision No. 2003–5]

Change in Bank Control

On March 27, 2003 the OCC determined not to object to the Change in Bank Control notice by HSBC Holdings plc to acquire control of Household Bank (SB) National Association, Las Vegas, Nevada. Several public comments were received in connection with the filing. HSBC submitted satisfactory responses to the comments. OCC found no evidence that would cause it to object to the transaction on the basis of the comments. As part of its consideration, OCC relied upon HSBC's representation to seek non-objection from the OCC prior to transferring any receivables originated by Household Bank to any entity other than two affiliates, and affirmed that it would seek supervisory non-objection from the OCC prior to making any material changes in the business plan. Household Bank was under an Operating Agreement and Liquidity Reserve Deposit Agreement with the OCC. [Corporate Decision No. 2003–2]

Operating Subsidiaries

On March 17, 2003 the OCC approved the application filed by Bank One, National Association, Chicago, Illinois, to establish an operating subsidiary that will purchase and then sell or license data processing software that automatically collects information on corporate card use and then merge the data, generate invoices, and approve and make payments. The software processes predominantly data that is banking, financial, and economic in nature and its sale would be part of the business of banking. As part of the business of banking, the software can be sold to bank customers or licensed to large corporate credit card users. [Corporate Decision No. 2003–6]

Special Supervision and Enforcement Activities

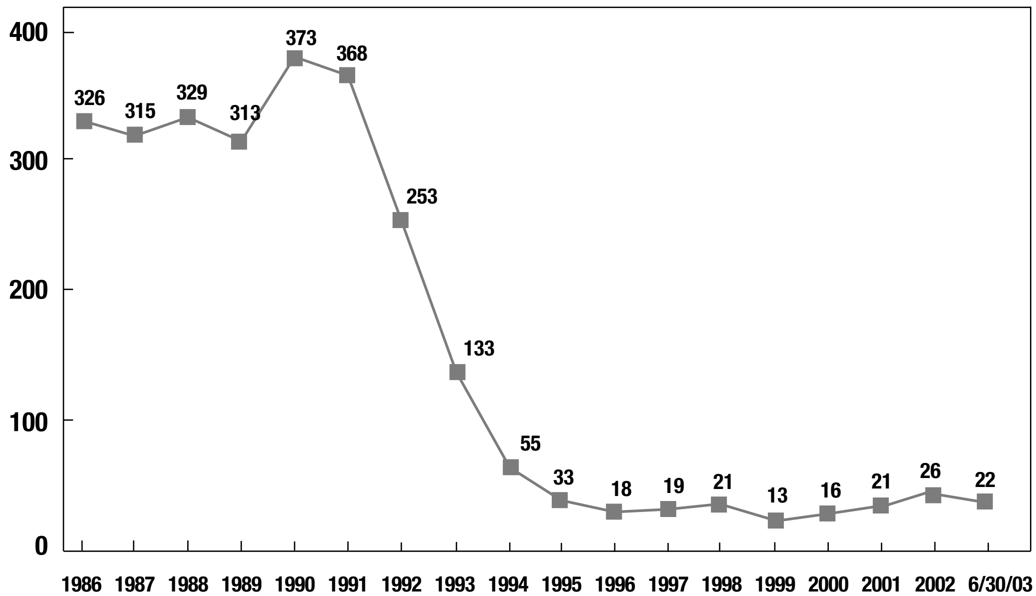
The Special Supervision division of the Mid-Size/Community Bank Supervision department supervises the resolution of critical problem banks through rehabilitation, orderly failure management, or through the forced sale, merger, or liquidation of the problem institution. The Special Supervision division monitors the supervision of nondelegated and delegated problem banks, provides training, disseminates information, and supports OCC supervisory objectives as an advisor and liaison to OCC management and field staff on emerging problem-bank and related issues.

This section includes information on problem national banks, national bank failures, and enforcement actions. Data on problem banks and bank failures is provided by the OCC's Special Supervision division and the FDIC's Department of Resolutions in Washington. Information on enforcement actions is provided by the Enforcement and Compliance division (E&C) of the law department. The latter is principally responsible for presenting and litigating administrative actions on the OCC's behalf against banks requiring special supervision.

Problem National Banks and National Bank Failures

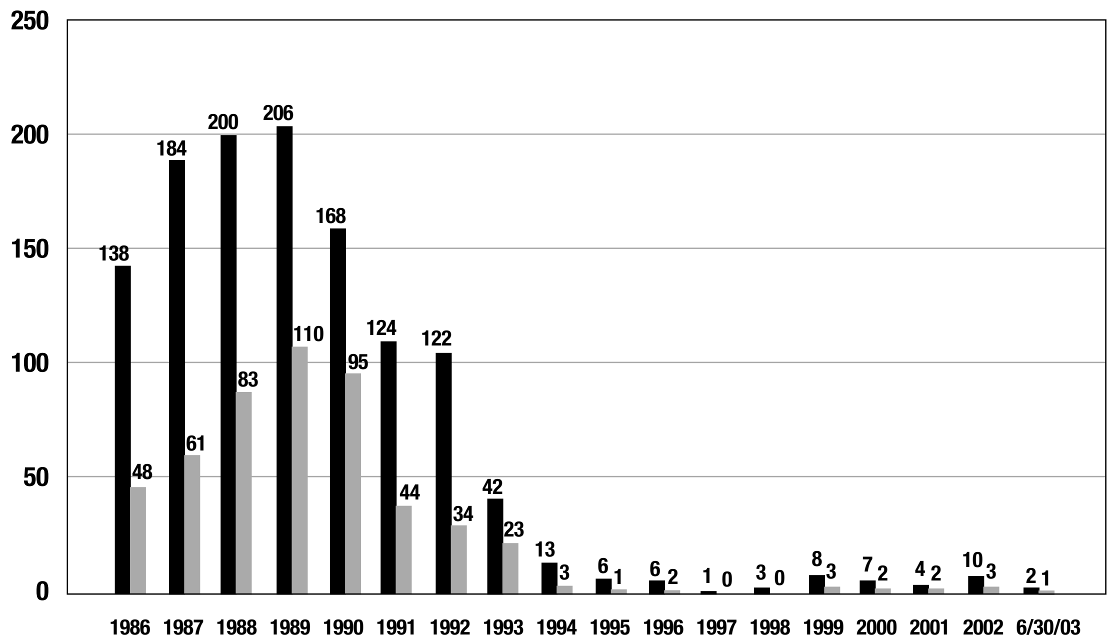
Problem banks continue to represent approximately 1 percent of the national bank population as of June 30, 2003. The volume of problem banks, those with a CAMELS rating of 4 or 5, has been relatively stable for several years. The CAMELS rating is the composite bank rating based on examiner assessment of capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. The total number of problem banks is 22 at June 30, 2003, down from 26 at December 31, 2002. One national bank failure occurred through June 30, 2003, out of two commercial bank failures.

Figure 1—Problem National Bank Historical Trend Line



Source: Special Supervision

Figure 2—Total Bank Failures Compared to OCC Failures



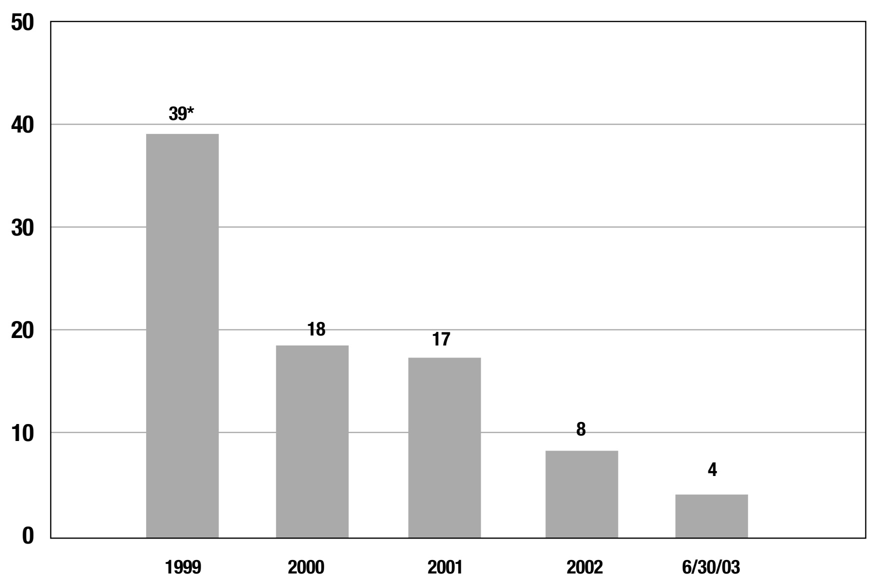
Source: Federal Deposit Insurance Corporation

Enforcement Actions

The OCC has a number of remedies with which to carry out its supervisory responsibilities. When it identifies safety and soundness or compliance problems, these remedies range from advice and moral suasion to informal and formal enforcement actions. These mechanisms are designed to achieve expeditious corrective and remedial action to return the bank to a safe and sound condition.

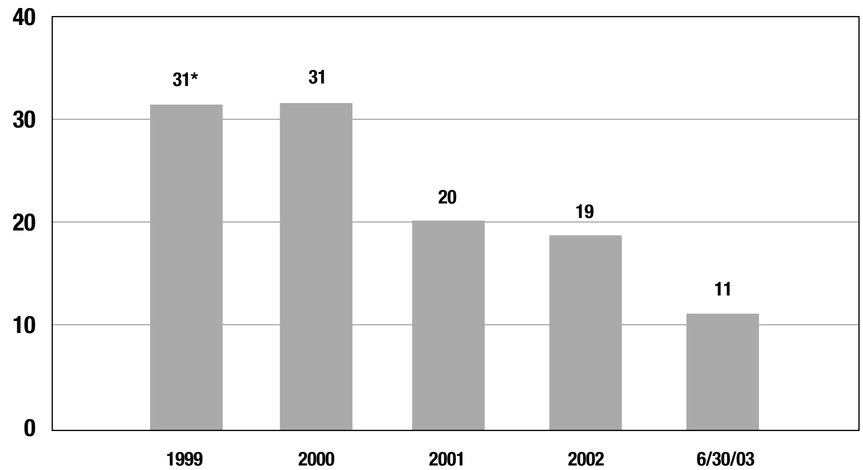
The OCC takes enforcement actions against national banks, individuals affiliated with national banks, and servicing companies that provide data processing and other services to national banks. The OCC's informal enforcement actions against banks include commitment letters and memorandums of understanding (MOUs). Informal enforcement actions are meant to handle less serious supervisory problems identified by the OCC in its supervision of national banks. Failure to honor informal enforcement actions will provide strong evidence of the need for the OCC to take formal enforcement action. The charts below show total numbers of the various types of informal enforcement actions completed by the OCC against banks in the last several years. (Year-2000–related actions taken in 1999 are noted in the figure footnotes.)

Figure 3—Commitment letters



Source: OCC Supervisory Monitoring System (SMS). Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.
*6 of which are for year-2000 problems

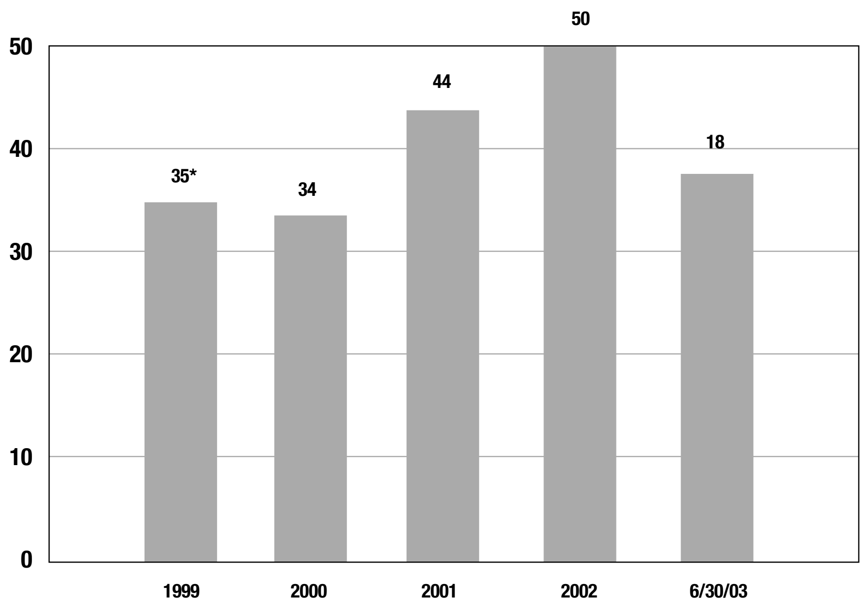
Figure 4—Memorandums of understanding



Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.
*6 of which are for year-2000 problems

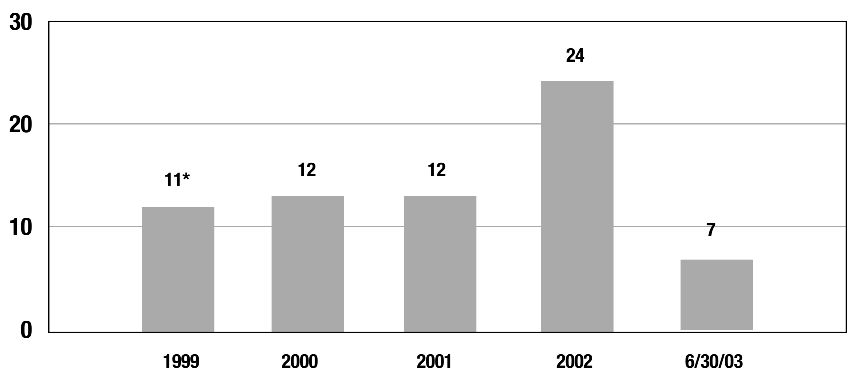
The most common types of formal enforcement actions issued by the OCC against banks over the past several years have been formal agreements and cease-and-desist orders. Formal agreements are documents signed by a national bank's board of directors and the OCC in which specific corrective and remedial measures are enumerated as necessary to return the bank to a safe and sound condition. Cease-and-desist orders (C&Ds), sometimes issued as consent orders, are similar in content to formal agreements, but may be enforced either through assessment of civil money penalties (CMPs) or by an action for injunctive relief in federal district court. The OCC may also assess CMPs against banks, and as of June 30, 2003, the OCC assessed CMPs against three banks. The OCC also issued three CMPs against national banks as of June 30, 2003.

Figure 5—Formal agreements



Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.
*2 of which are for year-2000 problems

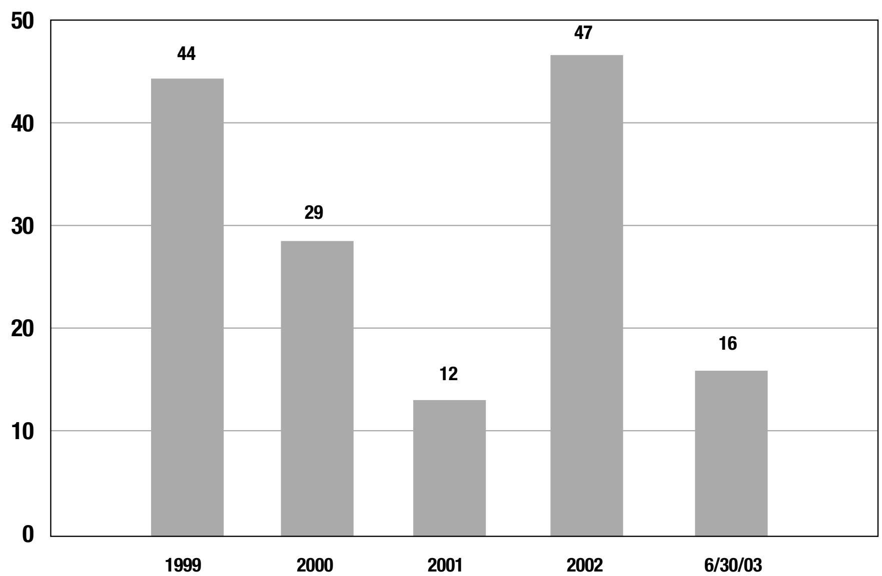
Figure 6—Cease-and-desist orders against banks



Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.
*1 of which is for year-2000 problems

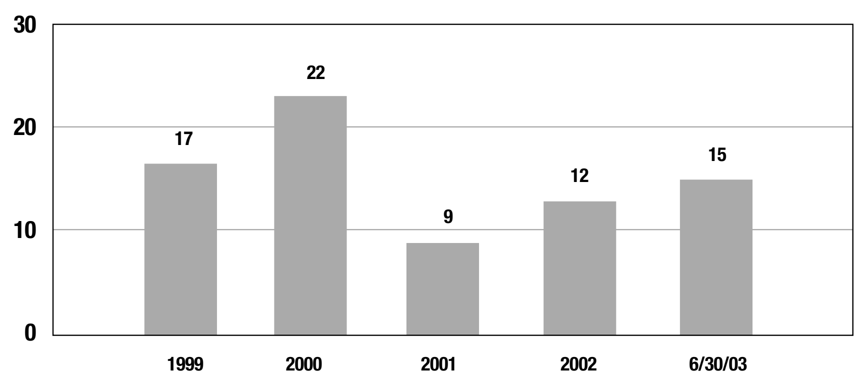
The most common enforcement actions against individuals and other institution-affiliated parties are CMPs, personal C&Ds, and removal and prohibition orders. CMPs are authorized for violations of laws, rules, regulations, formal written agreements, final orders, conditions imposed in writing, unsafe or unsound banking practices, and breaches of fiduciary duty. Personal C&Ds may be used to restrict individuals' activities, to order payment of restitution, or to require institution-affiliated parties to take other affirmative action to correct the results of past conduct. Removal and prohibition actions, which are used in the most serious cases, result in lifetime bans from the banking industry.

Figure 7—Civil money penalties against individuals



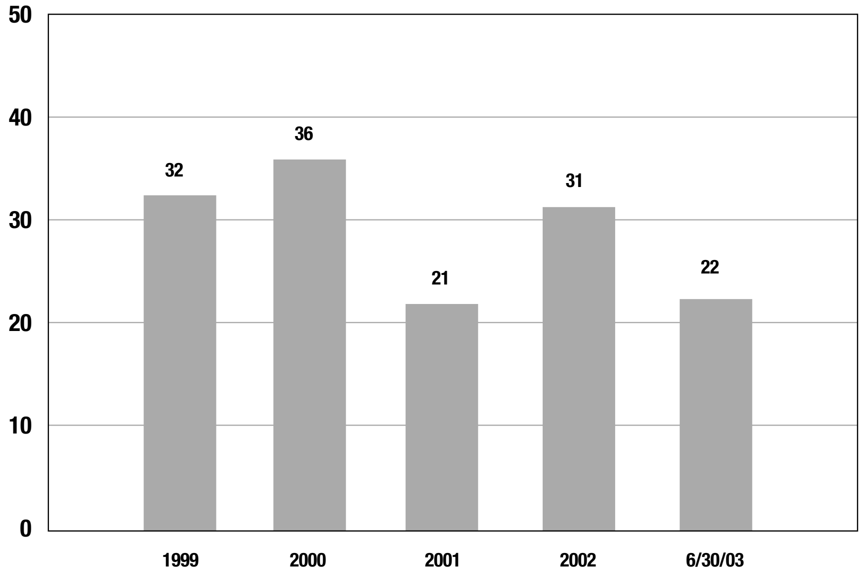
Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.

Figure 8—Cease-and-desist orders against individuals



Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised agggregates.

Figure 9—Removal and prohibition orders



Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.

Recent Enforcement Cases

Below are summaries of the significant cases completed between January 1 and June 30, 2003.

Actions Involving Payday Lending

By the end of the second quarter of 2003, all national banks with known payday lending activities through third-party vendors were ordered to exit the payday lending business. By undertaking enforcement actions against these banks, the OCC addressed safety and soundness concerns in the management of these payday loan programs, and ended significant consumer protection violations. For example, in January 2003, the OCC entered into consent orders with a bank in Texas, and its' third-party vendor, which included civil money penalties against both the bank and the vendor. OCC examiners documented that the bank and its vendor had routinely violated multiple consumer protection laws and regulations. The vendor was ordered to terminate its payday lending relationship with the bank, and to not contract with another national bank without the OCC's prior non-objection. The bank itself was also ordered to exit the payday lending business. In another matter in January 2003, the OCC entered into a consent cease-and-desist order with a bank in South Dakota. In addition to finding a variety of deceptive acts or practices and conflicts of interest within the bank, the OCC determined that the bank's oversight of its payday lending operation was weak, resulting in significant data integrity errors. The bank failed to correct deficiencies identified by bank audits. Therefore, the OCC required the bank to terminate its payday lending business through its two payday vendors.

Actions Involving Unfair or Deceptive Acts and Practices

The OCC has continued to address improper business practices of national banks that are abusive, unfair, or deceptive, thereby promoting fair treatment of bank customers and fair access to financial services for all Americans. The OCC took several enforcement actions in the first two quarters of 2003 to address such acts and practices. For example, in January, the OCC entered into a consent cease-and-desist order with a bank in South Dakota. The OCC determined that the bank's credit card programs violated section 5 of the Federal Trade Commission Act. The bank's program included a message that the card had "no annual fee," when a monthly fee was charged. Under the terms of the consent order, the OCC required the bank to establish a $6 million reserve to fund restitution payments to consumers. In another matter, in March 2003, the OCC entered into a formal agreement with a Nevada credit card bank. The bank issued private label cards that were used to finance purchases of heating and air conditioning units sold by a third-party air conditioning firm to Spanish-speaking residents in three states. Installation and operations of the units were problematic; the bank, through its third-party vendor, provided faulty disclosures; and its remediation program was further flawed. Pursuant to the formal agreement, the bank is providing restitution to affected customers.

In another matter related to a credit card bank in Oregon, in April 2003, the OCC and the credit card bank entered into a consent cease-and-desist order, settling a notice of charges and a temporary cease-and-desist order issued in March 2003. The temporary order and the consent order resulted from the bank's entering into contracts to service securitized trusts, which contracts the OCC deemed unsafe and unsound pursuant to 12 USC 1831(g). The OCC found the contracts to be unsafe and unsound because they provided for servicing fees to the bank that were significantly below industry standards and placed the bank, as the servicer, in a very disadvantageous and low priority position in the event of an early amortization, which was also contrary to industry standards applicable to similarly situated servicers. The consent order required the bank to (1) cease servicing credit card accounts upon the appointment of a successor servicer or upon the expiration of 30 days, whichever occurred first; and (2) immediately, and as long as the bank remained a servicer, withhold a servicing fee appropriate for the type of service it was performing, in accordance with a schedule of fees set forth in the consent order.

Actions Involving Insider Abuse or Breach of Duty

In other OCC actions, in January 2003, the OCC entered into consent orders with two directors of a Kentucky bank, in connection with the directors' breaches of fiduciary duty and conflicts of interest in approving loans, which resulted in substantial losses to the bank. The directors agreed to prohibitions and civil money penalties.

In April 2003, the OCC entered into personal cease-and-desist orders with three directors of a Kentucky bank in connection with the directors' unsafe and unsound practices and breaches of fiduciary duty. Each of the directors withheld financial information from the bank related to an accountholder with whom they had personal financial relationships, preventing the bank from determining whether the accountholder was engaging in suspicious activity within the meaning of the Bank Secrecy Act (BSA). The personal cease-and-desist orders require the directors to indemnify the bank for any uninsured liability the bank may incur as a result of their conduct, or, for all expenses such as reasonable legal fees that the bank incurs after recovery of any insurance proceeds as a result of defending itself from any lawsuits or other proceedings related to the account in question.

Between April and May 2003, the OCC entered into consent orders with two former officers and one former director of a failed Florida bank. The former director consented to a prohibition and a civil money penalty in connection with the OCC's allegations of unsafe and unsound practices, breaches of fiduciary duty, and violations of law related to a large loan made by the bank that appears to have been fraudulent. In addition, the two former officers both consented to personal cease-and-desist orders that limit their conduct as employees of any insured depository institution, and that require them to disclose the existence of their orders to any institution they become employed by. One of the officers also agreed to pay a civil money penalty to the OCC. Also, in May 2003, the OCC issued temporary cease-and-desist orders to three of the four individuals. The temporary orders seek to prevent the former officers and directors from dissipating their assets in anticipation of administrative proceedings seeking significant restitution and civil money penalties from the individuals. One of the temporary orders also requires one former officer and director to post a bond for approximately $1.4 million to secure his potential restitution obligation.

Actions Involving Customer Privacy

In April 2003, the OCC entered into consent orders with two former bank insiders of a Colorado bank in connection with the insiders' violation of the OCC's newly promulgated privacy regulations at 12 CFR Part 40. The OCC determined that the insiders violated the privacy regulations and engaged in unsafe or unsound practices in connection with the theft of over 2,200 electronic loan files from the bank. The consent orders included prohibitions, civil money penalties, and personal cease-and-desist orders against each insider. The personal cease-and-desist orders place restrictions on the insiders' future employment with employers other than national banks.

Actions Against Professional Firms

In May 2003, the OCC entered into formal agreements with the law firm that represented a failed bank formerly located in West Virginia, and with one of the firm's partners. The formal agreement with the law firm represents the first enforcement action of its kind taken by the OCC against a law firm acting as counsel for a national bank. The enforcement actions were the result of the law firm's and the partner's failure to inform the bank's board of directors of important information about bank management's activities and conflicts of interest involving the firm's representation of the bank and other clients. The law firm, by entering into the formal agreements, which will last for a period of three years, agreed to take certain actions with respect to the firm's representation of insured depository institutions. Specifically, the formal agreement requires the firm to comply with all federal banking laws and to ensure that firm attorneys representing insured depository institutions have sufficient experience in banking matters. The firm also agreed to correct any documents that it prepares on behalf of a banking client if the firm learns that the document omits or misstates material facts, and if it knows that the document will be, or has been, submitted to or relied upon by a federal banking agency. Furthermore, the firm agreed not to represent both an insured depository institution and any other client in the same transaction if such representations would cause a conflict of interest. In addition, the agreement provides that a firm attorney must advise the employees, officers, or directors of insured depository institution clients of their fiduciary duties to the institution. The firm also agreed to report potential misconduct by bank insiders to senior management and, if necessary, to the institution's board of directors, unless the insider takes appropriate action. By entering into the formal agreement with the OCC, the firm's partner agreed not to provide legal services to insured depository institutions. Furthermore, if the partner leaves the firm and joins an insured depository institution, another law firm, or any business that performs legal services for an insured depository institution in the next five years, he is required to provide a copy of the agreement to the new employer and notify the OCC and the FDIC of the change in employment.

Actions Involving Safety and Soundness

In May 2003, the OCC entered into a consent cease-and-desist order with a Florida bank, which was designed to prevent the recurrence, and correct the results of, the bank's already-defunct relationship with a company that served the bank as an advisor in a nationwide mortgage lending operation. Among other things, the consent order requires the bank to implement a consumer compliance program and, prior to offering any significant new product or service, perform a detailed analysis of the proposed product or service and obtain a finding of no supervisory objection from OCC. Pursuant to the consent order, the bank also agreed not to enter into or renew contracts with third parties without performing a detailed analysis of the proposed contract and to present that contract to the OCC. The order also requires the bank to conduct a file search to identify loan applicants who did not receive, or received inadequate, adverse action notices and to send complete and accurate notices to those applicants.

Actions Involving Anti–Money Laundering and Bank Secrecy Act

Also in 2003, the OCC has continued to ensure that national banks and their institution-affiliated parties comply with federal anti-money-laundering provisions. Cases in 2003 included restrictions on a bank's acceptance of cash payments on private-label credit cards, as well as improvements to BSA policies and procedures. For example, in April 2003, the OCC entered into consent cease-and-desist orders with an Illinois bank and its corporate parent, requiring the entities to adopt new policies and procedures to ensure the bank's compliance with BSA.

In February 2003, the OCC entered into a formal agreement with the federal branch of a foreign bank. The formal agreement addressed the federal branch's strategic plan, management, management information systems, credit risk controls, and its BSA, anti-money-laundering, and Office of Foreign Assets Control (OFAC) compliance.

Fast Track Enforcement Cases

The OCC continued its Fast Track Enforcement program, initiated in 1996, which ensures that bank insiders who have engaged in criminal acts in banks, but who are not being criminally prosecuted, are prohibited from working in the banking industry. As part of the Fast Track Enforcement program, E&C secured 17 consent prohibition orders against institution-affiliated parties between January 1 and June 30, 2003. Three of these orders also incorporated restitution payments to the appropriate banks for losses incurred, and two of the orders incorporated civil money penalties against the individuals. In addition, one of the orders included a personal C&D. The OCC also obtained one separate consent personal C&D. During the same period, E&C sent out notifications to 137 former bank employees, who were convicted of crimes of dishonesty, informing them that under federal law they are prohibited from working again in a federally insured depository institution.

Appeals Process

Appeal 1—Appeal of Report of Examination Conclusions

Background

A bank formally appealed the examination conclusions regarding the condition of the bank. Specifically, bank management believed the report of examination

- Overstated the adverse condition of the bank's commercial loan portfolio;
- Unduly criticized the bank's strategic planning process;
- Assigned a troubled condition designation to the bank without any reference to any standard; or benchmark against which the bank was judged; and,
- Incorrectly assessed the bank's risk profile and capital rating.

Discussion

The bank acknowledged deterioration in its commercial loan portfolio, but stated that

- The Office of the Comptroller of the Currency (OCC) Canary benchmarks reflecting the operation of its credit function were inherently conservative;
- The loan portfolio has remained well balanced between retail, real estate, commercial, and construction;
- In 1999 asset quality was rated 2; since then, asset quality has improved and capital has grown;
- Risk from unsecured credit has been steadily declining since 1996;
- The commercial loan portfolio consists of loans to locally owned and operated businesses;
- The level of non-accrual loans, past-due loans, and charge-offs has improved; and,
- The allowance for loan and lease losses (ALLL) has been adequate.

The appeal further states that the objective measures reflected an asset quality rating of 2 while subjective and harsh comments were made in the report of examination (ROE) that resulted in an assigned rating of 3.

The OCC believed that the bank's overall condition remained unsatisfactory and that the level of risk remained moderate and increasing. Subprime credit represented 150 percent of Tier 1 capital. Capital was insufficient in relation to the overall risk profile of the bank, and earnings continued to suffer because of high overhead and losses from loans and other assets. Asset quality and credit administration practices were less than satisfactory. Classified loans increased from 15 percent to 37 percent, the loan review function and account officers failed to accurately identify problem loans, and the level of retail credit accounts with low credit scores was high. Also, while some progress had been made towards complying with the formal agreement, most articles were in noncompliance.

Conclusion

The ombudsman concluded that, while the tone of the report was unduly harsh, the overall assessment and ratings assigned in the report on examination (ROE) complied with agency policy and are reasonably reflective of the bank's condition at that time. There was evidence of increased credit risk and the level of noncompliance with the formal agreement appropriately impacted the ratings, risk profile, and overall condition of the bank.

Subsequent Event

Subsequent to the appeal, the supervisory office completed a review of the first quarter 2003 financial and asset quality information submitted by the bank. The review was initiated to assess management and the board's progress in improving the bank's earnings performance and lowering its risk profile. As a result, capital, asset quality, and liquidity ratings were upgraded. Additionally, the credit risk profile was reflected as moderate with a stable direction. A complete assessment of the composite and other component ratings was not performed. The ombudsman concurred with these changes.

Appeal 2—Appeal CRA Rating and Examination Conclusions

Background

A bank formally appealed its overall Community Reinvestment Act (CRA) rating and the examination conclusions. At the most recent CRA examination, the bank's overall performance was downgraded from "outstanding" to "needs to improve." The bank asks the ombudsman to restore the "outstanding" rating and amend the conclusions of the CRA examination

During the bank's most recent CRA examination, the lending test was rated "outstanding;" the investment test was rated "outstanding," and the service test was rated "high satisfactory." However, the supervisory office concluded that the bank violated the Federal Trade Commission Act (the Act) in connection with its marketing of subprime credit cards. The marketing practices used to solicit consumers were misleading and deceptive as defined in the Act and had a material adverse impact upon the cardholders. The bank was also cited for violations of the safety and soundness standards set forth in 12 CFR part 30 appendix A. In its payday-lending program, the bank failed to identify the source of repayment and to assess the borrower's ability to repay the loan at each extension of credit.

Although the bank voluntarily discontinued its subprime lending programs and, by consent order, exited the payday-lending business, the supervisory office concluded that the egregiousness of these violations also impacted the bank's overall CRA performance, resulting in a downgrade from "outstanding" to "needs to improve."

In its appeal, the bank disagreed with the Office of the Comptroller of the Currency's (OCC's) decision to downgrade the bank's CRA performance rating based on the aforementioned violations. The bank's appeal asserts that the supervisory office misinterpreted 12 CFR 25 in applying these violations to the CRA rating. The appeal also states that the ratings assigned to the lending, investment, and service tests genuinely reflect the level of service to its local community.

Discussion and Conclusion

The ombudsman found that there were elements of the bank's CRA performance that technically supported an "outstanding" rating. However, the ombudsman agreed with the supervisory office regarding the egregiousness of the violations. Therefore, the consumer violations and the adverse impact on consumers were appropriately considered in determining the bank's overall CRA rating. The ombudsman also recognized that the bank had discontinued both programs, either voluntarily or by consent order. These actions should prevent further harm to the consumers and preclude future violations. After weighing the cumulative factors of the bank's CRA performance and corrective actions taken, the ombudsman concluded that the appropriate CRA rating was a downgrade to "satisfactory."

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Of the Comptroller of the Currency

Of the First Senior Deputy Comptroller and Chief Counsel

Of the Chief of Staff

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Consumer Bankers Association, on encouraging new efforts to meet the banking needs of the changing demographics of minority and low-income Americans, Arlington, Virginia, April 15, 2003

One doesn't need to be a macroeconomic guru to know how much reliance we have put on the consumer in the effort to get our economy on the road to a solid recovery. Accounting for two-thirds of the U.S. economy, consumer spending largely determines its fate. Over the past two years, the consumer's readiness to spend, despite rising unemployment and global unrest, has kept this recession mild and the economy afloat. If consumers continue to spend, business investment should revive and recovery should proceed. If the consumer suddenly becomes cautious, then we might be in for a much more difficult and prolonged recovery.

As we put more and more emphasis on consumers, the Consumer Bankers Association is again front and center. This is not an unfamiliar role for an organization whose members have helped so many ordinary Americans enjoy the extraordinary fruits of our industrial economy. In recent years, CBA and its members have been in the vanguard of the effort to help the industry adjust to the responsibilities and opportunities presented by the Community Reinvestment Act—an effort in which this conference has come to play a major part. And CBA has been a catalyst for industry efforts to tackle the persistent problem of financial illiteracy, helping consumers to develop the basic financial skills and obtain the information they need to make informed choices and keep them out of the clutches of the financial predators.

Now the banking industry faces a new challenge, and CBA members will once again have a critical role to play. America is changing.

Of course, change is nothing new for Americans. It's been the driver of our technological, economic, and social progress. But changes in our nation's ethnic composition have the potential to alter the banking industry profoundly—for better or worse.

There have been times in our past when demographic shifts were so massive and abrupt that they were the dominant political reality of the day. In the decade between 1841 and 1850, for example, the population of the United States grew by approximately six million. More than one third of those new Americans were immigrants, and, of that group, numbering roughly two million, half were from Ireland. The bulk of this influx settled in and around New York City, Boston, and Philadelphia, where, almost overnight, the Irish became a social and political force to be reckoned with. No one could miss their impact.

It would take far greater numbers than that to have an equivalent impact on the America of 2003. There are vastly more of us to begin with, and we are dispersed over a far wider area, than were the Americans of a century and a half ago.

But the most recent census reports tell a story that's no less dramatic—and certainly no less consequential for the banking industry. In 1990 one of every five Americans was a member of a minority group. In 2000, it was one in four. And by 2025—two decades from now—projections tell us it will be nearly two in five. Today almost 50 of the largest U.S. cities are "majority minority." The list of cities in which non-Hispanic whites went from being a majority to a minority during the 1990s includes Milwaukee, Boston, Philadelphia, and St. Louis. Nineteen other cities would have lost population during the decade if not for the growth in the Hispanic population.

But suburban and rural areas are also feeling the effects of this transformation, in largely unprecedented ways. The Hispanic populations in Mississippi and Wisconsin more than doubled during the 1990s, and some of the most dramatic growth in Asian and Hispanic populations has occurred in suburban counties where these ethnic groups had been most unfamiliar. Indeed, last year I visited community organizations in Kansas City, Kansas, at the geographic heart of the United States—where a strong influx of Hispanics had led local support organizations to devote significant attention to their interests. This is not a Kansas City that Dorothy and Toto would recognize today.

The U.S. banking industry has enjoyed tremendous success in meeting the needs of the America that we have *been.* It is no exaggeration to say that the industry's future success hinges on its ability to meet the needs of the nation we are in the process of *becoming.*

It's not just the future of the banking system that's at stake. The industry's interests and those of our economy have always been intertwined. All Americans benefit when their banks function profitably and well. By the same token, if the industry should fail to meet the challenge of the new demographics, all Americans—even those who are not bank customers today—will feel the effects. Indeed, those who are not your customers will feel those effects most of all.

To be candid about it, this is an area in which the industry has in the past had mixed success. We've noticed a certain reluctance to launch the kind of concerted outreach that developing these new markets requires. Indeed, this reluctance may stem from the recognition that cosmetic changes or targeted advertising alone won't suffice for banking organizations to make significant inroads into minority markets. It takes commitment up and down the organization, and to this point some banks have decided—shortsightedly, I believe—that the returns weren't worth the investment.

But while many banks have shown some reluctance to enter, nonbank competitors have been consolidating their foothold in minority markets. The phenomenal expansion of payday lenders, check cashers, rent-to-own operators and other such fringe providers in primarily minority communities is not only a competitive threat to U.S. commercial banks, it's a significant obstacle for members of minority groups in their bid to achieve economic security and a genuine stake in their communities.

For all that, the sheer growth of minority banking markets means that there are still plenty of opportunities to go around—and still time for financial institutions to make up for their late start in taking advantage of them.

Nowhere are the opportunities more bountiful—and the potential payoff to financial institutions, their minority customers, and economic growth more promising—than in the area of home ownership.

The housing market has been one of the few bright spots in the economy over the past several years. Rising housing sales and prices have helped offset declines in other areas, especially in the stock market, while lower interest rates and the refinancing wave have put billions of dollars back in people's pockets. Nearly one million new homes were sold in 2002—the highest number on record—and the average sales price was nearly ten percent higher than it was two years earlier. But in order to sustain this level of activity, we need to reach out to new customers in new markets.

Consider this: while the U.S. home ownership rate hit nearly 68 percent in 2000, the rates for African-Americans and Hispanics remained well below 50 percent. This gap represents approximately $600 billion-worth of home mortgages waiting to be made. And there's no end in sight: predictions are that between now and the year 2100, nearly 60 percent of all first-time homebuyers will be young minorities and immigrants.

Or consider the opportunities that are still going begging for banks to establish mutually profitable relationships with minority businesses. The fundamentals are certainly there: the entrepreneurial spirit is alive and well in many minority communities, and those who live in those communities have money to spend—more money than is usually assumed to be the case. New studies conducted in diverse cities such as New York, Houston and Washington, D.C., by Social Compact, a nonprofit coalition of corporate leaders, show that minority communities are typically undercounted, both as to size of their populations and their purchasing power. That can perpetuate a vicious cycle: merchants assume that low-income communities can't support retail investment, so they invest elsewhere; and with few local retail outlets, residents must travel to obtain goods and services, spending funds that would otherwise stay put in the community.

Businesspeople who understand the economic potential of minority communities are often frustrated by a lack of start-up and working capital and micro business financing. Surveys tell us that while three-quarters of all businesses rely on bank credit to finance growth, only two-thirds of minority-owned businesses did. The other third relied on personal debt—typically high-interest, unsecured credit card debt. Another recent study of female ethnic entrepreneurs—and women are a major source of business initiative in those communities—highlighted the greater difficulty they face in obtaining conventional financing compared to their non-minority peers—twice as difficult for African American businesswomen as for Caucasians.

Finally, it's clear that there's a demand for retail financial services in minority communities that is being met today by providers other than banks. Ten million households—nearly 10 percent of U.S. households—are unbanked, and more than 60 percent of those are minority households. African-Americans and Hispanics were *seven times* more likely *not* to have checking accounts than Caucasian respondents. And we know something about the revenues that nonbanks generate: $60 billion a year by check cashing outlets; at least $10 billion a year by payday lenders; over $3 billion a year by pawnshops; nearly $5 billion a year by rent-to-own operators. According to one estimate, the annual earnings of consumers without bank accounts amount to $500 billion. It should go without saying that numbers of this magnitude can be ignored by the banking industry only at its peril.

The people who patronize nonbank fringe providers should be *your* customers. And in some communities, where banks have demonstrated the requisite creativity and commitment to the development of these markets, they are. What are these banks doing that the rest of the industry could be doing, too? That's a question that deserves an answer, and, in the next few minutes, I'd like to share some of the lessons that can be drawn from experience and industry "best practices" in serving ethnic banking markets.

Let me begin by telling you what experience demonstrates *won't* work.—at least not in isolation. As I said at the outset, a bank's decision to make itself a felt presence in minority markets isn't a decision to be made casually. Nor is it one that a bank's marketing department is capable of executing on its own. It can't be accomplished merely by printing new brochures or running ads on Spanish-language radio, for example. Those steps can be important parts of an effective overall market-building strategy, but that strategy has to encompass a commitment throughout the company, from the very senior-most levels down to the branch management. It has to involve product development, portfolio management, community affairs, human resources, and more.

It has to reach outside the bank, as well. One of the things we've discovered is that the banks that are most successful in ethnic markets are the banks that have patiently researched the needs and characteristics of the market and developed local partnerships. One banker spent two years personally getting to know the community he was planning to target—and learning enough Spanish to enable him to communicate with his customers and employees. Other bankers have entered alliances with non-profit, community-based organizations, not only to speed the process of establishing name recognition in the community but also to provide services, such as financial literacy education, that the bank may not be equipped to deliver itself. And we know from our research and experience how crucial such training can be, especially to first-time homeowners and small business people.

Understanding the particular financial needs of ethnic communities is obviously a crucial component of any bank that hopes to succeed in them. A bank moving into such a community for the first time might assume that the same menu of product and services that works at its non-minority branches will work there. But bankers with experience in these communities have sometimes found that trying to market their whole product line may detract from effectively marketing what those customers need most. That includes, obviously, low-cost checking, deposit, and debit accounts, home mortgages, small business and consumer loans, and other products that are a normal part of most Americans' financial lives. I have long advocated that banks make wider use of technology, especially through the promotion of direct payroll deposit and the offering of electronic account access, to deliver banking services to low-income Americans at prices they can afford.

I've heard it argued that lower-income people are unfamiliar—and uncomfortable—with technology, and that they may not have personal computers in their homes. I'm afraid that at times this may reflect a rather patronizing attitude that confuses income level with intelligence. But it overlooks two important facts. First, you don't have to own a computer to be comfortable using one. Indeed, many people who spend their workdays gazing at a computer monitor choose not to have a computer at home, whether they can afford one or not. If they are permitted to use their office computer for personal purposes, they have ready access to financial services on the Internet. And even if they are not so permitted, computers are readily accessible in a variety of other locations, such as libraries and Internet cafes. When it comes to technology, you don't have to be an owner to be an accomplished user.

The second point that deserves emphasis relates yet again to the demographics of minority banking markets. Today fully 45 percent of the Hispanic population in America consists of children nine years of age and younger. Even if their parents are unfamiliar with computers, these young people—the banking customers of tomorrow—aren't. Computers are ubiquitous, and they appear everywhere kids congregate—in schools, shopping malls, and entertainment arcades. It's important to the banks that hope to serve these future customers that they're able to communicate with them technologically as well as verbally. The banking customer of the future will already be experienced at using the Internet for a wide variety of functions, and it is very likely to *expect* that he or she will be able to conduct banking transactions by computer. Over-the-counter banking will be a horse-and-buggy methodology to them.

It's also important that the menu of banking products include those that address the unique needs of minority populations. In some immigrant and minority neighborhoods, the act of transferring funds abroad is almost as common as cashing a check. Nearly $10 billion a year is wired to Mexico alone each year. And some innovative banks, recognizing this, have made low-cost wire-transfer services the centerpiece of account relationships with immigrant customers. For the customer, the savings can be substantial; for the bank, it can become the foundation of long-term, profitable relationships.

Aesthetics count, too—sometimes in ways that are not always apparent. Those of us who study such things have long wondered why people continue to patronize check-cashing establishments when there is a bank branch next door, offering the same services frequently for lower fees, or even no fees at all. And increasingly our research leads us back to intangible factors, such as bank tellers (or ATMs) that may not speak the customers' language or an unwelcoming business environment in which customers feel out-of-place.

What we do know is that the banks that have achieved some success in minority communities have typically not only staffed their teller windows and desks with employees drawn from the neighborhood, but have also tried to cultivate a look and a feel that are reassuring to those whom they'd like to see walking through their doors. Their décor reflects the culture of the local population; their business hours reflect the working schedules of their customers; they provide play areas and extra chairs in the lobby to accommodate larger families-in-waiting; the signage is multilingual.

To succeed in minority communities, in other words, banks have to work to make themselves a good fit—and good neighbors.

It's time to sum up. Change always presents challenge—and opportunity for those who are positioned to respond to it. The changing face of America will challenge us in many ways in the coming years, but if the patterns of the past hold up—as I expect they will—the primary result of the demographic changes I've been discussing will be that we're culturally and materially enriched.

Some businesses may decide that they can safely ignore these changes and carry on as before. But for a broad-based industry like banking—an industry with a statutory mandate to serve—that option does not exist. The industry's responsibilities to its multiple constituencies—employees, shareholders, existing customers—as well as its responsibilities under the law—cannot be fulfilled if it fails to respond to the needs of *all* Americans.

Fortunately, this is not uncharted terrain, and while there are no hard and fast rules for success in minority banking markets, we have had enough experience to have greatly improved the odds against failure. In my remarks this morning, I have tried to bring some of those lessons to light. Bankers must be receptive to innovation in product development and consumer relations. They must recognize that traditional marketing and product delivery approaches don't yield the same results in minority markets that they do in traditional ones. And they must work to develop and leverage strategic relationships with organizations that operate in the communities they seek to serve. That's particularly important in light of the distance that the industry has to make up to be truly competitive in minority communities.

The OCC will continue to take very seriously its responsibility to call the industry's attention to opportunities to serve and prosper, and to disseminate best practices to that end. The Consumer Bankers Association has long been a valued partner in that effort. We're counting on your to continue supplying the leadership that will assure the industry 's ability to meet the challenges of tomorrow—just as it has met the challenges of the past.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Exchequer Club, on the U.S. bank regulatory structure and predatory lending and preemption, Washington, D.C., April 16, 2003

Forty-three years ago, I arrived in Washington from New York City, fresh out of law school, to serve a clerkship on the U.S. Court of Appeals. Washington has been my home ever since.

Washington has obviously changed over those four decades, but one thing hasn't changed: every time someone new encounters our Byzantine structure of financial regulation, they immediately want to overhaul it. As a result, we have seen almost a score of studies, commissions, proposals, and reorganization plans put forward over the past three or four decades.

Yet, as sensible and thoughtful as these initiatives may have been, they have uniformly failed to get any traction. Just why this is so is the main topic I want to discuss with you today. And if that doesn't get your pulse racing, I want to finish up with a few comments on another current topic—predatory lending and preemption.

So let me start by posing this question: why has there been so much chatter about our bank regulatory structure?

The answer to this is obvious: the current bank regulatory structure offends all of our aesthetic and logical instincts. It's complicated; it's irrational; it probably has inefficiencies; and it takes a great deal of explaining. It's a product of historical accident, improvisation, and expediency, rather than a methodically crafted plan. It reflects the accretion of legislative enactments, each passed at a very different time—and under very different circumstances—in our history.

Given all of these criticisms over the years, it's fair to ask why we have not seen any change in the structure. It's certainly not for trying. Major efforts were put forth in the Reagan and Clinton administrations to rationalize the structure, but they never got very far off the ground. Yet in a number of foreign countries—the United Kingdom and Japan, for example—we have seen in recent years the creation of strong, independent financial supervisory agencies, with consolidated jurisdiction over financial firms. Why haven't we been as enlightened?

There are a variety of very compelling reasons, I believe.

First, the system works. While it is far from perfect, at its best it works extremely well. A variety of formal mechanisms and external pressures have caused the agencies to work quite well together. To be sure, there are examples of interagency rivalry, turf protection, and even inconsistency that arise from time to time, but on the whole the agencies have recognized the need to work together, to avoid inconsistencies, and to respect one another's jurisdictions and responsibilities. We clearly have an example of a system that doesn't work at all in theory, but works well in practice.

Moreover, studies conducted over the years by the General Accounting Office and others have repeatedly deflated the proposition that huge savings would accrue from regulatory restructuring. Instead, researchers have concluded that while there are some redundancies and extra costs associated with multiple agencies, those costs are located primarily in such back-office functions as human resources and information technology, rather than in front-line supervision, where the lion's share of agency resources are spent. Accordingly, the savings that might be realized from restructuring would likely be quite modest.

Second, there has never been a public constituency for change. Neither the banking industry itself—which has learned to cope with and take advantage of the current structure—nor advocacy or interest groups that are stakeholders in the system have mounted any case for change. And experience tells us that logic alone will generally not be enough of a catalyst for major reform legislation; a public and political constituency is almost always necessary.

But apart from these considerations, there have been, and continue to be, two major reasons why regulatory restructuring has not gained more momentum. The role of the Federal Reserve (Fed) and the FDIC (Federal Deposit Insurance Corporation) is one; the impact on state banking systems is the other. Time after time, well-meaning proposals for change have run into the intractable reality of having to deal with those concerns.

Right at the outset of any consideration of restructuring one must confront the question of what role the Federal Reserve should play in bank supervision. While the Fed's role as a supervisor was quite modest until the expansion of its bank holding-company jurisdiction in 1970, the Fed has long and successfully argued that it must have a major presence in bank supervision in order to obtain a "window" into the banking system as an adjunct to its monetary policy and payments system responsibilities. Yet countries around the world—Great Britain, Japan, and now China, chief among them—have chosen to move precisely in the opposite direction, concluding that the central bank cannot provide objective, independent bank supervision while discharging its monetary responsibilities at the same time. Who's right? More importantly, what's right for the United States? My personal view is that we have it about right as it is—although I believe very strongly that bank supervision must focus on safety and soundness concerns, and that bank supervisors should not be looked to for the conduct of macroeconomic policy.

The role of the FDIC in the supervisory framework is another perennial issue. The FDIC's role in insuring deposits and resolving failed banks has provided it with a strong argument for involving itself in the supervision of banks. But does the FDIC's legitimate interest in minimizing losses to the deposit insurance fund constitute justification for pervasive and continuous involvement in day-to-day supervision of banks that are not in the problem categories? Even more fundamentally, is the FDIC's paramount interest in minimizing losses—with the aversion to risk that interest encourages—consistent with the responsibilities of balanced supervision?

To be sure, some would resolve these conflicts by transferring all bank supervisory jurisdiction to the Fed or the FDIC. In fairness, I don't think either of those agencies has seriously suggested this. Without putting too fine a point on it, I'll just say that I do not share this view. It would probably be immodest of me to expand on that at this time.

It is obvious, I think, that the present distribution of bank supervisory authority creates some burdens for banks, not the least of which is having to contend with visitations by examiners from different agencies, frequently duplicating—or ignoring—one another's work. I believe this is a concern that needs continual attention, for if there was anything that might galvanize the industry to support restructuring, it is likely to be the annoyance and burden of such supervisory duplication.

Finally, there is the question of how any plan to rationalize bank supervision would comport with a strong dual banking system. If the federal bank supervisory agencies were consolidated into a single independent agency, as many scenarios envision, with the federal supervision of state banks being performed by the same agency that supervises national banks, charter choice might be rendered all but meaningless. Banks' ability to select the system of supervision they deemed best suited to their needs would be curtailed. Disparities in powers between state and national banks would become untenable with a single federal agency presiding over both types of institutions, and the pressure for uniformity would be very strong.

Perhaps the most significant question would be how such an agency would be funded. Today, national banks bear virtually all of the costs of their supervision, while state banks bear only about 20 percent of their supervision costs—the portion attributable to that supervision carried out by the states themselves. As we are all aware, this disparity arises because the Fed and the FDIC, with virtually bottomless pockets, subsidize the state banks they supervise by absorbing all of the costs of their federal supervision. This inequity could not possibly be perpetuated if all federal bank supervision were vested in a single independent agency that didn't have the resources of the Fed or the FDIC. Such an agency would either have to be supported by appropriations—which would be a bad idea, in my view—or it would have to assess all of the banks it supervised. Even if the agency for unified supervision were the Fed or the FDIC, it is inconceivable that the present subsidy for supervision costs could be limited to state banks. Since many supervisors of state banks—at both the state and federal levels—have a pathological fear that equalizing supervisory fees would cause massive conversions from state to national charter, it is not surprising that they have opposed regulatory consolidation.

I recognize that some may view these remarks as a ringing endorsement of maintaining the status quo. That is not my intention. I share the intellectual interest in structural rationalization that the advocates exhibit. But I think that any proposal, no matter how logical it might appear, must address the fundamental political obstacles I've been discussing before we spend a lot more time spinning our wheels over still another iteration of an idea that is showing distinct signs of age.

Now let me turn briefly to two related subjects that are stirring up a lot of comment these days: predatory lending and preemption. First, I want to state emphatically that there is no question that predatory lending is a real concern. We have ample evidence that people in many areas are being stripped of the equity in their homes by a certain subspecies—and I use that term in its most pejorative sense—of subprime lenders, overwhelmingly unregulated nonbanks. Some 20 states have undertaken initiatives to address predatory lending, either through statute or regulation. In a case that's drawn considerable attention, a Georgia statute imposes severe restrictions on so-called "high-cost" mortgage loans, requiring lenders who offer them to comply with a range of substantive and procedural requirements.

Unfortunately, the passage of these laws has led to considerable uncertainty about their applicability to national banks, which, as you know, operate under a longstanding constitutional immunity from state laws that purport to regulate the manner in which they conduct their banking business—an immunity repeatedly reaffirmed by the Supreme Court of the United States, tracing back to the mid nineteenth century. The Office of Thrift Supervision has already determined that the Georgia law is inapplicable to federally chartered savings institutions and their operating subsidiaries, and the OCC is now reviewing comments submitted in response to a request for a determination of that law's applicability to national banks.

Unfortunately, the legal disputation over preemption tends to distract us from the real question: how best to deal with the problem of predatory lending in our communities, while ensuring that adequate credit remains available on reasonable terms to mortgage customers at all income levels. The nuances of preemption theory are unlikely to mean much to borrowers who either have been burned by predatory lenders or denied credit in the first place.

I have several concerns about the across-the-board approach that has been adopted, with the best of intentions, by some states. First, it would inevitably add significant costs to banks that operate in many jurisdictions, since they would have to bear the costs and risks of complying with innumerable local laws—costs that would ultimately be reflected in the cost of credit. But even more of a concern is that such laws may actually have the effect of making credit harder to come by for those who may most need it and deserve it.

Evidence increasingly suggests this might already be happening. Fannie Mae recently announced that it would not purchase mortgage loans subject to the New York state and Georgia anti-predatory laws—a decision that will undoubtedly cause some contraction in credit availability to subprime borrowers.

Recent analysis by economists, one of whom has been on the OCC staff, of anti-predatory-lending laws in Chicago, Philadelphia, and North Carolina bears out this fear. In Chicago, a municipal law that applied primarily to banks had the effect of driving more subprime mortgage lending into the nonbank sector, which is precisely where predatory practices are most prevalent. And a Philadelphia law that applied to *all* financial services providers had the effect of reducing the availability of subprime mortgage money generally. Similarly, it appears that the North Carolina law decreased the availability of subprime credit in the state.

Subprime credit is *not* the equivalent of predatory credit. Indeed, the growth of our subprime credit market has made legitimate credit available to families that may previously not have had access to credit. Thus, any law that causes responsible lenders to exit the subprime market must be viewed as problematic.

I think that the OCC has a better approach. Rather than focusing on the features of particular loan *products,* we focus on abusive *practices*—on preventing them in the first place, attacking them out where they're found to exist, and providing restitution to those who have been victimized by them.

Our emphasis on prevention has taken the form of comprehensive guidance—the only such guidance that's been produced by *any* of the federal banking agencies—instructing national banks on how to avoid engaging in abusive or predatory practices. Rigorous, ongoing supervision and oversight by OCC examiners is designed to make certain that this guidance is followed. But when it's not, we have not hesitated to use our enforcement authority to combat unsafe, unsound, unfair, or deceptive practices. Indeed, OCC enforcement actions have resulted in refunds totaling hundreds of millions of dollars to consumers.

I believe that the OCC's approach to predatory lending not only provides an effective remedy where abusive conduct has been found, but avoids the overbroad and unintended adverse effects of one-size-fits-all laws.

Quite apart from the question whether state and local laws threaten the unintended consequences of encouraging bank lenders to exit the subprime lending market, there is the question whether such laws can constitutionally apply to national banks. Since we presently have under consideration a request for a preemption determination with respect to the Georgia law, I will not discuss that issue directly. Suffice it to say that preemption is a doctrine with almost 200 years of history and constitutional precedent behind it. It is not an issue as to which we have a broad range of discretion.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on the proposed revisions to the 1988 Basel Capital Accord ("Basel I"), Washington, D.C., June 18, 2003, with attachment

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Shelby, Senator Sarbanes, and members of the Committee, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on proposed revisions to the 1988 Capital Accord developed by the Basel Committee on Banking Supervision (Basel Committee). I welcome the efforts of the subcommittee to focus attention on these critical issues. The health of the U.S. commercial banking system is a critical element to a strong economy. Thus, it's essential that any regulatory changes that might affect the condition and competitiveness of our banking system be fully understood and carefully evaluated by the banking industry, the U.S. Congress, and the American public.

The 1988 accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards applicable to internationally active commercial banks in all of the G–10 countries, and it has been adopted by most other banking authorities around the world. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions.

By the late 1990s, it became evident that Basel I had become outdated. The increased scope and complexity of the banking activities of our largest banking institutions over the last decade, and the unintended consequences of various provisions of the regulations, severely undercut the utility of the Capital Accord. Basel I simply does not provide a meaningful measure of the risks faced by large, internationally active banks or the capital they should hold against those risks.

Consequently, over the past several years, the Basel Committee has been developing a more detailed and risk-sensitive capital adequacy framework to replace Basel I. The committee's first draft document, "Consultative Paper No. 1" (CP–1), was issued in June 1999. It laid the groundwork for the new capital adequacy framework (Basel II), but provided few details. The committee provided additional detail on the specifics of Basel II in its January 2001 issuance of "Consultative Paper No. 2" (CP–2). Although more detailed, CP–2 still left a number of key issues unaddressed and unresolved. The committee's most recent paper, "Consultative Paper No. 3" (CP–3), which I will discuss today, was issued on April 29 of this year.

As work on these consultative papers has progressed, the Basel Committee also has attempted to gauge the impact of its proposals on the required capital levels of banking institutions through a series of quantitative impact studies. In May, the committee published the results of the most recent assessment, the third quantitative impact study (QIS–3). While the committee concluded that the results were generally in line with the objectives of Basel II, the QIS–3 data still do not provide a sufficiently reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. More work in this area is clearly warranted and I will discuss this later in my testimony.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As a consequence, the U.S. banking agencies, the agencies responsible for the maintenance of capital adequacy standards for U.S. financial institutions, are faced with a daunting task. While we will work earnestly in this effort, the timeline should be seen as a means to an end, not an end in itself. As will be highlighted in my testimony, basic principles of safety and soundness demand that the banking agencies have a more complete understanding of the consequences of this proposal on the overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens before moving forward to finalize this proposal.

Our current primary focus in this effort is the development of U.S. implementing regulations and policies. As I will discuss later, the OCC and the other U.S. banking agencies will soon issue for comment proposed revisions to U.S. risk-based capital regulations to reflect the primary components of Basel II. Let me be absolutely clear about the integrity of this rulemaking process—the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not begin implementing a final Basel II framework until we have conducted whatever cost-benefit and impact analyses that are required, and fully considered all comments received during our notice and comment process—as we would with any domestic rulemaking. If we determine through this process that changes to the proposal are necessary, we will not implement proposed revisions until appropriate changes are made. We made this point quite clearly to our Basel Committee colleagues before we agreed to go forward with CP–3. Indeed, many of them will also have to go through their own internal domestic processes before they can adopt the Basel II framework.

Current Basel Proposal

The Basel Committee deserves considerable credit for its articulation of Basel II in CP–3. The proposal is still exceedingly complex, but CP–3 is a clearer presentation of inherently difficult material than its predecessors. This is an important step, since regardless of the complexity of the proposal, it is important that the industry and other interested parties have a clear understanding of the proposed accord.

The attachment to this written statement provides a summary of the substantive provisions contained in CP–3. As before, this iteration of the proposed new accord has three mutually reinforcing "pillars" that comprise the framework for assessing bank capital adequacy. The first pillar of the new accord is the minimum regulatory capital requirement. The Pillar 1 capital requirement includes a credit risk charge, measured by either a standardized approach or one of the new internal ratings–based (IRB) approaches (foundation or advanced), an operational risk charge, and a market risk charge. Again, the attached document provides a more detailed description of the various components of the Pillar 1 charge.

Pillar 2 addresses supervisory review. It is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy, and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 should also be seen as a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the committee is proposing a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the advanced IRB approach, the new accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of the building blocks of capital adequacy is greater transparency.

U.S. Implementation Actions

It is important to recognize that the Basel Accord is not self-executing in the United States. Even when adopted by the Basel Committee, Basel II will not apply to U.S. institutions unless and until the U.S. banking agencies adopt regulations to implement it. In accordance with the Administrative Procedure Act, 5 USC 551, *et seq.*, the U.S. banking agencies must publish notice and seek comment from all interested persons on any such proposal, and must fully consider those comments, before adopting a new capital regulation in final form. Obviously, the OCC and the other federal banking agencies intend to comply fully with these requirements. The importance of this rulemaking makes this comment process particularly critical to our success. Thus, we welcome this process as a means for positive contribution to this deliberative effort. We believe that the solicitation and assessment of comments is a critical step in determining the feasibility, effectiveness, and expected consequences of Basel II and related domestic capital regulations.

Next month, the U.S. banking agencies expect to jointly issue an Advance Notice of Proposed Rulemaking (ANPR) soliciting comment on proposed revisions to the existing domestic capital adequacy regulations that would implement Basel II. The ANPR will be largely based on CP–3 and will provide a description of proposed revisions to current capital regulations, while seeking comment on outstanding or contentious issues associated with the proposal. The ANPR will also request information on the cost of implementing the proposal, and will seek comment on the competitive implications in both domestic and international markets for banks of all sizes. In conjunction with the ANPR, the banking agencies will also issue for comment draft supervisory guidance articulating general supervisory expectations for banks seeking to implement Basel II–compliant methodologies for the advanced measurement approach (AMA) to operational risk and advanced IRB for corporate credits. Recognizing that CP–3 is a complex document, we understand the importance of providing U.S. banks an opportunity to review and comment on U.S. implementing documents as soon as practicable. By describing these concepts within the context of our existing regulatory and supervisory regime, the ANPR and draft guidance will provide a meaningful forum for a full discussion of Basel II.

After assessing comments generated during the ANPR process, the U.S. banking agencies will consider a complete cost analysis in accordance with applicable rulemaking requirements, including the standards of Executive Order 12866, discussed below, and will develop specific regulatory language for a joint Notice of Proposed Rulemaking (NPR). Again, the banking industry and other interested parties will have an opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

Let me now focus on two important, unique features of the U.S. regulatory capital regime that will be highlighted in the ANPR and NPR—the scope of application of Basel II and the content and structure of the proposed revisions to the capital adequacy regulations. First, the United States expects to set forth in the ANPR proposed criteria for identifying which banks in the United States will be subject to the new accord. Despite language in the 1988 Capital Accord that permitted a more limited application, U.S. banking and thrift agencies applied the Basel framework to *all* U.S. insured depository institutions. As we will highlight in the forthcoming ANPR, the U.S. agencies have determined to apply Basel II concepts more narrowly. Specifically, consistent with the focus of the Basel Capital Accord on banks that compete in the global market place, we will propose applying Basel II concepts on a mandatory basis only to large, internationally active institutions that compete on a significant global basis with other financial service providers. Other institutions will have the opportunity to voluntarily opt into the Basel framework upon application to, and approval by, their primary federal supervisor.

Preliminary analysis by the U.S. agencies suggests that under the narrow approach we are proposing, there are currently fewer than a dozen U.S. banks that would be mandatorily subject to Basel II–based regulatory capital requirements. Of course, the approach of requiring only a small population of banks to comply with Basel II will be subject to notice and comment in the ANPR and will be definitively resolved only after the U.S. rulemaking process has been completed.

Second, in developing revisions to existing capital adequacy regulations, U.S. banking agencies recognize that the revised regulation, and interagency implementation policies, need not follow the literal structure and language of Basel II. While consistent with the objectives, general principles, and core elements of the revised Basel Accord, the language, structure, and degree of detail of U.S. implementing documents may be very different from Basel II. These implementation differences are reflective of the particular statutory, regulatory, and accounting structures and practices in place in the United States. It is important to note that U.S. implementation actions do not contemplate changes to many fundamental aspects of our regulatory/supervisory process, including a focus on regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As described more fully in the attachment, the U.S. agencies will propose for notice and comment a Basel II–based regime incorporating only the advanced IRB approach for credit risk, the AMA for operational risk, and the internal models approach for market risk.

We are also very cognizant that in connection with this, or any rulemaking, existing requirements may compel preparation of detailed analysis of the costs, benefits, and other effects of our regulations, depending on threshold determinations of whether the rulemaking in question triggers the substantive requirements of particular statutes or Executive Orders. Relevant requirements are set forth in the Regulatory Flexibility Act (RFA), the Unfunded Mandates Reform Act of 1995 (UMRA), and Executive Order 12866 (EO 12866). Issuance of the ANPR will help us identify and determine costs, benefits, and other effects of the proposed rulemaking, for purposes of complying with these requirements.

Timing

As I noted early on in my testimony, the Basel Committee timeline presents a daunting task to both the U.S. banking agencies and the banking industry. While it is clearly necessary to move forward in addressing the acknowledged deficiencies in the current Basel Capital Accord, the banking agencies must better understand the full range and scale of likely consequences before finalizing any proposal. The list provided below identifies the milestones the OCC must meet under the current Basel II timeline. Each step is critical in a prudential consideration of Basel II in the United States:

- *Consideration of comments received by the Basel Committee on CP–3.* The comment period on this document concludes on July 31.

- *Finalization, issuance, and consideration of comments on the U.S. ANPR.* Based on current estimates, the notice and comment period will run from July to October.

- *Finalization, issuance, and consideration of comments on supervisory guidance on corporate IRB and AMA methodologies.* Based on current estimates, the notice and comment period will run from July to October.

- *Development, issuance, and consideration of comments on supervisory guidance on other substantive aspects of Basel II–based regulations, especially including retail IRB.* Based on current estimates, the agencies hope to commence solicitation of comment on this guidance by year-end 2003.

- *Participation in the Basel Committee's consideration of Basel II.* Under the current timeline, the committee is to consider approval of Basel II in December of this year.

- *Development, issuance, and analysis of results of additional agency efforts to evaluate the prospective effects of Basel II implementation.* EO 12866 may compel the OCC and OTS to undertake such analysis prior to the issuance of a Notice of Proposed Rulemaking (NPR). Even without regard to this requirement, however, it is essential that we have a reliable estimate of the impact of Basel II on the capital and competitive position of U.S. banks.

- *Development, issuance, and consideration of comments on the U.S. NPR.* This document would only be issued after the Basel Committee finalizes its consideration of Basel II. If the existing timeline is maintained, solicitation of comment on the NPR would commence no earlier that the first quarter of 2004.

- *Development and issuance of a U.S. final rule and supervisory guidance.* Again, assuming the present timeline is maintained, our best estimate for the issue date of a final rule implementing Basel II is the third or fourth quarter of 2004.

- *Completion of all necessary supervision-related steps to implement Basel II–based regulations in advance of the presently proposed December 2006 effective date.* Most significantly, the agencies need to determine whether each bank subject to Basel II–based regulations has appropriate systems and procedures in place to qualify for using the A–IRB and AMA.

Status of Basel Proposal—Outstanding Issues

In commencing an objective assessment of the status of Basel II, it is important to reiterate and reaffirm the commendable work of the Basel Committee, and in particular, the strong and intelligent leadership of its former chairman, William McDonough. The OCC firmly supports the objectives of Basel II. These objectives constitute a sound conceptual basis for the development of a new regulatory capital regime and should continue to serve as a useful benchmark to gauge our progress in this effort. Nonetheless, much of that conceptual basis has not been tested in practice in any manner approaching the magnitude of Basel II. We continue to be concerned about the potential for unintended or unanticipated consequences of the Basel II proposals.

Implementation Challenges

At its foundation, the Basel II proposals permit qualifying institutions to calculate their minimum risk-based capital requirements by reference to their own internal systems and methodologies.

While it is the hallmark of Basel II, a greater alignment of internal risk assessment with minimum regulatory capital derived through internal models represents a radical departure from our existing regulatory capital framework. As we will highlight in the ANPR and accompanying guidance, this reliance on internal risk assessment systems mandates changes in the way we structure our capital regulations and, in certain important respects, how we conduct our supervisory activities. The fundamental question for the banking agencies in assessing Basel II is the issue the OCC has previously identified—whether the regime will work in practice, as well as theory, as the basis for a regulatory capital regime.

For bank supervisors and other external stakeholders to be in a position to rely on a bank's internal process in the establishment of regulatory capital requirements, there must be a high degree of confidence that regulators can establish and enforce appropriate risk measurement and management standards consistently across the banks subject to a Basel II–based regime. The challenge for supervisors is to create a verifiably accurate system that appropriately balances the need for flexibility, to promote continued improvement in risk management practices, with the need for objective standards, to ensure consistency in application across institutions and supervisors, both foreign and domestic.

The capital rule we implement must respect the evolutionary nature of risk management. As regulators, we must acknowledge that we are still in the relatively early days of model-based credit and operational risk measurement and management, and we must recognize the inevitability of further innovation and improvements in this area. This respect for the evolutionary nature of this discipline must then be reconciled with the need for objective standards to ensure consistency in application. Much of the detail and complexity within Basel II derives from the need to establish more objective expectations for bank rating systems, control mechanisms, audit processes, data systems, and other internal determinations of risk by individual banks. In many cases, this has led to the establishment of supervisory standards in areas previously left to management discretion or supervisory judgment.

Not surprisingly, the regulatory community has struggled with the establishment of these standards. Failing to achieve the proper balance for these often conflicting objectives while moving forward with the radically different Basel II–based regime can have dramatic consequences. If our regulation and supervisory process is overly flexible, bank internal calculations of capital adequacy may prove insufficient, non-comparable, or both. If we err on the other extreme, we establish an excessively prescriptive supervisory regime that stifles innovation, imposes undue regulatory burden, and inappropriately narrows the role of judgment.

This need to carefully balance dramatically opposed objectives, together with the significant uncertainties that still exist about the practical feasibility of these proposed changes to the Capital Accord, raise doubts about the achievability of the time frame established by the Basel Committee.

Competitive Equality

A stated goal of the Basel Committee in developing Basel II was that "the Accord should continue to enhance competitive equality." Realistically, we are not yet in a position to assess definitively the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. There are risks that Basel II may create or exacerbate relative advantages between domestic banks and foreign banks; between banks and nonbanks; and between large domestic banks and mid-size/small domestic banks. It is imperative that the U.S. banking agencies remain sensitive to these concerns and assess, to the extent possible, any unintended consequences resulting from the implementation of Basel II.

One of the primary objectives of the Basel Committee itself is the reduction of gaps and differences in international supervisory coverage by national supervisory agencies, especially as it relates to large internationally active banks that compete on a significant global basis with other financial service providers. This principle of competitive equality and a level playing field for international banks is an admirable one, and an appropriate goal of the committee's efforts. Yet, the very complexity of the rules themselves calls this objective into question. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an evenhanded way across such a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 to 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in assessing the banks' operations and judging the banks' compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to a comparably sized institution, or may examine such an institution thoroughly only every five years, or may put heavy reliance on the oversight of outside auditors.[1]

It's fair to ask, I think, in which type of supervisory regime detailed, prescriptive capital rules are more likely to be robustly and reliably enforced. The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedrock principle of Basel II. Can we really achieve competitive equality *without* addressing disparities in supervision, particularly when we are operating on the assumption that the complex new rules we're writing will be applied in an evenhanded way throughout the world?

Another principle source of competition for many banks is not other insured depository institutions, but nonbanks. This situation is especially pronounced in businesses such as asset management and payments processing. As you are aware, however, regulations implementing Basel II–based concepts in the United States will apply only to insured depository institutions and their holding companies. While differences in regulatory requirements for banks and nonbanks exist today, many institutions have voiced concern that implementation of Basel II may unduly exacer-

[1] See Daniel E. Nolle, "Bank Supervision in the U.S. and the G–10: Implications for Basel II," *RMA Journal,* June 2003.

bate the current differences. These concerns have been mainly focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Finally, there is concern about the potential effect of Basel II on the competitive balance between large and small banks. As implemented in the United States, Basel II would result in a bifurcated regulatory capital regime, with large banks subject to Basel II–based requirements and small and mid-sized banks subject to the current capital regime. This structure is premised on the belief that, to the extent possible, regulations should reflect the size, structure, complexity, and risk profile of banking institutions. The Basel II framework was developed to address the unique risks of large, internationally active institutions. Mandatory application of such a framework to small banks, with its associated costs, was deemed inappropriate. In fact, the banking agencies sought comment from the banking industry, especially smaller institutions, on the development of a simplified capital framework specifically for non-complex institutions.[2] Industry comments were overwhelmingly negative on the proposal—most institutions felt that the cost of adopting a new regulatory capital regime outweighed any potential benefits. Accordingly, the banking agencies tabled the proposal.

With that said, the banking agencies need to continue to assess the competitive effects of a bifurcated regulatory capital regime, and it is one of the areas on which we will seek guidance in our ANPR. There are several concerns in this regard. First, banks using a Basel II–based regime may have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with smaller banks for both assets and liabilities. To be sure, banks subject to the new Basel II requirements will incur very significant systems and compliance costs in preparing for the new regime. These concerns are discussed in more detail in the “Calibration” section below. Moreover, banks using a Basel II–based regime may have significantly higher or lower marginal regulatory capital charges than non-Basel banks for some types of loan products, resulting in potential pricing differentials. While Basel II might enable larger banks to compete more effectively for high-quality credits, it could also result in larger concentrations of lower quality credits in smaller institutions. Finally, the potential implications on industry consolidation are simply not known. The banking agencies must continue to assess this situation and, if warranted, take steps to mitigate adverse effects on the competitive balance between large and small banks. We would be seriously concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the United States.

Calibration

The first objective of the Basel Committee in embarking on the Basel II effort was to calibrate minimum capital requirements to bring about a level of capital in the industry that, on average, is

[2] See Advance Notice of Proposed Rulemaking, “Simplified Capital Framework for Non-Complex Institutions,” 65 FR 66193 (November 3, 2000).

approximately equal to the global requirements of the present Basel Accord. That calibration was to be designed to provide an incentive to banks to develop and maintain sophisticated and risk-sensitive internal ratings–based systems.

In order to gauge its success in meeting that objective, the Basel Committee attempted to measure the impact of its proposals on the required capital levels of banking institutions through several quantitative impact studies. On May 5, 2003, the committee published an overview of the results of its most recent assessment, the third quantitative impact study (QIS–3). On the basis of QIS–3 results, the committee concluded that the aggregate results were generally in line with the objectives established for Basel II.

Unfortunately, the QIS–3 data do not provide a reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. Banks encountered several practical impediments to providing accurate estimates of the effect of the proposals on their measured ratios; thus, the estimated risk-based capital ratios were subject to a substantial margin of error. For example, in many cases, existing bank systems were not able to produce the data requirements necessary for inputs required by the new accord. In some areas, the QIS–3 instructions were not sufficiently clear or were misinterpreted, and in other cases, the proposals were still in flux as banks were completing the survey. Most important, QIS–3 was completed without the rigorous supervisory validation and oversight that would occur when the proposal actually takes effect.

A key concern is that focusing on the overall results of the QIS–3 exercise masks the wide dispersion of results for individual institutions. In the United States, measured against current risk-weighted assets, the use of advanced approaches yielded results that ranged from a decrease in regulatory capital requirements of 36 percent to an increase of 43 percent. Similarly broad dispersions are found in a great many of the underlying components that make up the total capital requirement. While some dispersion of results in a truly more risk-sensitive framework would be expected, we are not convinced that the wide ranges indicated by QIS–3 can be explained by relative differences in risk among institutions; it appears that comparability of QIS–3 results among different institutions may be severely lacking.

Finally, the quantitative studies that have been done to date have been based on unilateral inputs from the participating banks. We and other supervisors have had only very limited ability to review the veracity of the results. I want to be clear that we have no reason to believe that U.S. banks did not make every effort to provide results as accurate as possible given the constraints they were operating under. Nonetheless, it is certainly conceivable—I would say highly likely—that the results might change significantly, and not necessarily in any particular direction, when all the intricacies of real-world implementation come into play. It seems fair to assume that banks will have fewer incentives to take conservative stances and greater incentives to exploit any loopholes or gray areas in the final rules; the extent to which these effects might be offset (or exceeded by) greater supervisory oversight is unknown.

Notwithstanding the significant uncertainties noted above, it presently appears that the required capital levels of some U.S. institutions could drop significantly, even taking into account the temporary minimum floor capital requirements, discussed in the attachment. The OCC does not believe that some reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an adverse feature of Basel II. Such a result is only acceptable, however, if the reduction is based on a regulatory capital regime that appropriately reflects the degree of risk in that bank's positions and activities. Given the fact that relevant bank systems and procedures are still in development, the OCC is not yet in a position to make that determination as it relates to Basel II. As such, the OCC is not yet comfortable allowing national banks to materially lower their current capital levels simply on the basis of the output of the currently proposed Basel II framework.

The OCC expects that an additional quantitative study will be necessary after the Basel Committee's work on Basel II is completed. Ideally, this should take the form of another global study by the Basel Committee itself—*i.e.,* a QIS–4. However, even if the Basel Committee does not undertake such a study, I believe that it is absolutely essential that the U.S. agencies do so prior to the adoption of final implementing regulations. I strongly believe that we cannot responsibly adopt final rules implementing Basel II until we have not only determined with a high degree of reliability what the impact will be on the capital of our banks, but we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States.

Conclusion

As I have indicated, the OCC firmly supports the objectives of Basel II—a more risk-sensitive and accurate capital regime. However, in light of the issues that been identified with the current iteration of Basel II, the U.S. banking agencies must now determine how best to proceed on this critically important issue. I believe the following are essential elements in the agencies' consideration of Basel II implementation within the United States.

First, the agencies need to move forward with the solicitation of comments on a Basel II–related ANPR and associated guidance. That is the most effective mechanism to a have full and complete consideration of the proposal from all interested parties. The solicitation of comments on a proposed regulatory and supervisory structure for Basel II implementation will also permit supervisors to tangibly assess the feasibility of the proposal.

Second, the agencies need to undertake additional steps to evaluate the costs, benefits, and other effects of the proposal before moving forward with any final regulatory action. Frankly, we simply need additional information to reasonably address the numerous issues, concerns, and uncertainties associated with Basel II implementation. We must better understand the likely consequences of this proposal on overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens. In determining the appropriate additional steps, the agencies should consider the obligations imposed under EO 12866, the other statutory requirements for consideration of costs and impact, lessons learned from QIS–3, and perhaps, a U.S. version of QIS–4.

Third, as I have consistently reiterated, if we determine through this process that changes to the Basel II proposal are necessary, the U.S. agencies must pursue those changes, both domestically and in the Basel Committee. In this regard, the U.S. agencies should not foreclose consideration of alternative proposals that address the acknowledged deficiencies of the 1988 Accord but that do not constitute such a radical departure from our existing regulatory capital framework.

Fourth, the overarching consideration for supervisors in moving forward on Basel II is the need to act in accordance with our primary mission—to ensure the continued maintenance of a robust and safe and sound banking system. We need to "incent" banks to continue to better measure and manage the full panoply of risks they face and to make use of new and evolving risk management practices. We must also ensure that prudential consideration of safety and soundness principles remain paramount.

As I said in the beginning of my statement, the OCC, the agency to which Congress has committed the authority to define capital requirements for national banks, will not sign off on implementation of a final Basel II framework until we have fully considered all comments received during our notice and comment process. Given the importance of this proposal, the significant issues that remain unresolved, and the prospect that whatever emerges from this process is likely to govern the financial landscape for years to come, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee in both theory as well as practice.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

Attachment

Summary of Basel II: The Proposed New Accord

Office of the Comptroller of the Currency

The Basel Committee (the committee) has been developing the new accord over the past five years. During that time, three full-scale consultative papers (June 1999, January 2001, and April 2003) and numerous working papers supporting various elements of the new accord have been released to the industry for comment. This summary is intended to convey a general idea of the structure and substance of the proposed new accord, and does not attempt to provide a complete analysis. It is based on the most recent publications from the Basel Committee, notably the New Basel Capital Accord (Consultative Document), which is out for comment until July 31; the document can be found on the committee's Web site at http://www.bis.org/bcbs/index.htm.

The new accord will include menus of approaches for measuring the capital required for credit risk, market risk, and operational risk. For credit risk and operational risk, each of the proposed approaches is described briefly below; capital charges for market risk are unchanged in the new accord and are not discussed here. Some of the approaches described are unlikely to be implemented in the United States and have been noted as such. Moreover, based on preliminary analysis by the U.S. agencies, currently there are less than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. While other banks would be permitted to opt in to the Basel rules (subject to meeting prudential qualification requirements), the U.S. capital rules will remain in place for the vast majority of U.S. banks that either are not required to or do not opt to apply the Basel II framework. Of course, any issues regarding U.S. implementation of the new accord will be definitively resolved only after the U.S. rulemaking process has been completed.

The current structure of the accord has been influenced by the results of several quantitative impact studies (QIS), the most recent of which was completed in December 2002. Approximately 20 U.S. banks participated in the QIS exercise in December and the results have been factored into the most recent version of the accord. Changes were made in several areas including the treatment of retail credits, specialized lending, securitization, and operational risk.

General Structure of the Proposed New Accord

The new accord has three mutually reinforcing "pillars" that make up the framework for assessing capital adequacy in a bank. The first pillar of the new accord is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market, and operational risk. The new accord offers a series of options for calculating credit and operational risk. Market risk will remain unchanged from a 1996 amendment to the accord. The new options for credit and operational risk were designed to be available to a wide range of banks, from relatively simple to very complex. For credit risk, the Pillar 1 capital requirement includes both the standardized approach, updated since the 1988 accord, and the new internal ratings–based (IRB) approaches (foundation and advanced). Pillar 1 has been the focal point of much of the discussion and comment from the industry on the new accord.

Pillar 2 covers supervisory review and banks' obligation to hold sufficient capital vis-à-vis their risk profile. The pillar is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy. It provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 is also a way to focus supervisors on other means of addressing risks in bank's portfolio, such as improving risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the new accord proposes a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies for market and operational risk, the new accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar has been subject to numerous changes as the committee has worked to balance the need for robust disclosure with a recognition of the proprietary and confidential nature of some of the information.

Capital for Credit Risk

Under Basel II, banks must select one of three approaches to determine their capital for credit risk. The three approaches, from simplest to most complex are: the standardized approach, the foundation IRB, and the advanced IRB.

Standardized Approach

The 1988 accord introduced the standardized risk-bucketing approach for setting the minimum regulatory capital requirement, which is still used in the United States today. The approach has been subject to criticism that it lacks sufficient risk sensitivity. The revised standardized approach under Basel II enhances the 1988 accord by providing greater, though still limited, risk sensitivity.

Key changes to create a more risk-sensitive framework include the refinement and addition of risk buckets, the introduction of external credit ratings, and a wider recognition of credit risk mitigation techniques. Risk weights are still determined by category of the borrower—sovereign, bank, or corporate—but within each of these categories changes have been made to make the capital more reflective of the riskiness of the asset category. For example, the risk weight on mortgage loans has decreased from 50 percent to 35 percent and the risk weight on certain retail credits has moved from 100 percent to 75 percent. Risk weights for externally rated corporate credits, currently 100 percent, will range from 20 percent to 150 percent. Sovereign risk weights are no longer dependent upon whether a country is a member of the Organization for Economic Cooperation and Development (OECD), but rather on the external rating identified for the country.

The standardized approach is not likely to be implemented in the United States. U.S. supervisors believe that credit risk measured under the standardized approach of Basel II would generally not be appreciably different than that measured under current rules for most U.S. banks, and the marginal changes in capital requirements would not justify the cost of implementation.

Internal Ratings–Based Approach (Foundation and Advanced)

The IRB approach represents a fundamental shift in the committee's thinking on regulatory capital. It builds on internal credit risk rating practices used by some institutions to estimate the amount of capital they believe necessary to support their economic risks. In recent years, as a result of technological and financial innovations and the growth of the securities markets, leading banking institutions throughout the world have improved their measurement and management of credit risks. These developments have encouraged the supervisory authorities to devote greater attention to introducing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of eligibility standards or “qualifying criteria” in order to use the IRB approach. Because the requirements include both qualitative and quantitative measures, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by both the type of exposure and whether the bank intends to use the simpler foundation IRB framework or the more advanced IRB framework. The requirements are extensive and cover a number of different areas, including rating system design, risk rating system operations, corporate governance, and validation of internal estimates. A brief sample of actual criteria include:

- The board of directors and senior management have a responsibility to oversee all material aspects of the IRB framework, including rating and probability of default (PD) estimation processes, frequency, and content of risk-rating management reports, documentation of risk-rating determinations, and evaluation of control functions.

- A one-year PD estimate for each grade must be provided as a minimum input.

- Banks must collect and store historical data on borrower defaults, rating decisions, rating histories, rating migration, information used to assign ratings, PD estimate histories, key borrower characteristics, and facility information.

As mentioned above, the requirements that a bank must meet are partially dependent upon which of the two IRB approaches a bank will use. The first methodology, called the foundation approach, requires fewer direct inputs by banks and provides several supervisory parameters that, in many cases, carry over from those proposed for the standardized approach. For a variety of reasons, the United States does not plan to introduce the foundation approach in its regulations. The second approach, the advanced IRB approach, allows banks much greater use of their internal assessments in calculating the regulatory capital requirements. This flexibility is subject to the constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equality among banks worldwide.

There are four key inputs that are needed under IRB, for both the foundation and advanced approaches. The first element is the PD of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second input is the estimate of loss severity, known as the loss given default (LGD). The final two elements are the amount at risk in the event of default or exposure at default (EAD) and the facility’s remaining maturity (M). LGD, EAD, and M are provided by supervisors in the foundation approach, but must be provided by banks operating under the advanced approach (subject to supervisory review and validation). For each exposure, the risk weight is a function of PD, LGD, and EAD.

The IRB approach envisions internal rating systems that are two-dimensional. One dimension focuses on the borrower's financial capacity and PD estimates that quantify the likelihood of default by the borrower, independent of the structure of the facility. The other dimension takes into account transaction-specific factors such as terms, structure, and collateral. These characteristics would determine the second dimension, i.e., the LGD. Implicit in this treatment is the assumption that when a borrower defaults on one obligation, it will generally default on all its obligations. (This assumption is relaxed with the IRB treatment of retail portfolios.)

Calculating the capital charge under the IRB approach involves several steps. The first of these steps is the breakdown of the bank's portfolio into five categories: corporate (including commercial real estate), retail, bank, sovereign, and equity. The IRB rules differ to varying degrees across these portfolios. As a result, the IRB capital charge is calculated by category, with the PD, LGD, and EAD inputs potentially differing across these categories. Supervisory approval is needed before banks can use the IRB approach for any of the five categories. The minimum requirements described above were written to apply across these five types of exposures.

Another important step is the determination by the bank of the PDs for its loan grading categories. The PD of an exposure is the one-year PD associated with the borrower grade, subject to a floor of 0.03 percent (excluding sovereigns). The determination of PDs for borrowers supported by guarantees or credit derivatives is more complex. Banks under the advanced approach would use their internal assessments of the degree of risk transfer within supervisory-defined parameters, while those under the foundation approach would use the framework set forth in the new credit-risk mitigation provisions. Overall, the PD must be "grounded in historical experience and empirical evidence," while being "forward looking" and "conservative." A reference definition of default has been developed for use in PD estimation and internal data collection of realized defaults.

Once the PD has been established, banks must then establish the dimensions of LGD based on collateral and M. Under the foundation approach, M is assumed to be 2.5 years. There are several options that may be selected for the advanced approach, but in general, M is defined as the greater of one year or the remaining effective maturity in years.

After the bank determines the PDs and LGDs for all applicable exposures, these combinations can be mapped into regulatory risk weights. The risk weights, which are calibrated to include coverage for both expected and unexpected losses, are expressed as a continuous function. The minimum capital charge is then determined by multiplying the risk weight by the amount expected to be outstanding at the time of default (EAD), and by 8 percent.

A final step in this process involves the ongoing review by the supervisors of the systems used to develop the IRB capital charge. Periodically, supervisors will need to validate these systems and review the internal controls that provide the foundation for the IRB approach. In addition, supervisors will also have to consider, under Pillar 2, whether the amount of capital generated by the IRB approach is commensurate with the bank's risk profile.

Implementation of the IRB Approach

In addition to the requirement that a bank meet the qualifying or eligibility criteria, the new accord requires that banks using the IRB approach run parallel systems for one year before implementation. This means that a bank planning to implement the IRB approach in December 2006 will actually have to begin calculating results as of December 2005, while continuing to run its current systems.

Adjustments to the Capital Charge for Credit Risk

There are additional considerations that banks may have to factor in when determining the capital charge for credit risk. These additional considerations will further adjust required capital, outside of the requirements of the different approaches to credit risk. The two primary adjustments that might be made to the credit risk charge are for credit risk mitigation and asset securitization.

Credit Risk Mitigation

The new accord provides a measure of capital relief for certain qualifying risk-mitigating techniques used by banks. However, it is important to note that most of the credit risk mitigation proposals in the new accord are only directly relevant to the standardized or foundation IRB approaches, which are not likely to be used in the United States. In the advanced IRB approach, credit risk mitigation must meet certain qualitative requirements, such as legal certainty. In addition, specific proposals related to maturity mismatches and backtesting requirements of certain model results are applicable to the advanced IRB approach. Otherwise, it is assumed that any credit risk mitigation efforts will be factored into the PDs and LGDs assigned by the bank.

With that caveat in mind, the section on credit risk mitigation in the new accord attempts to provide rough approximations of the risk reduction attributable to various forms of collateralized credit exposures, guarantees, credit derivatives, and on-balance-sheet netting arrangements. The committee has proposed a conceptual approach to these risk mitigation techniques that, while recognizing their risk reduction benefits, attempts to capture the additional risks posed by such transactions.

The credit risk mitigation proposal provides both a simple and a comprehensive approach to dealing with collateral. The proposal expands the range of eligible collateral from that recognized in Basel I. It also discusses the appropriate treatment for maturity mismatches between the credit risk mitigant and the underlying credit exposure. The proposal introduces haircuts, which the bank may estimate, to cover the market price and foreign exchange volatility that may be inherent in collateral. The proposal allows banks to greatly reduce the capital requirements for exposures with large amounts of high quality collateral. There are strict quantitative and qualitative factors that must be met in order for a bank to be permitted to use its own haircut estimates. The proposal encourages the use of credit-risk mitigation by expanding the type of collateral, guarantors, and transaction structures that are recognized for capital reduction. Different types of credit risk mitigation techniques pose different levels of additional risk; the proposal incorporates flexibility that recognizes these differences and adjusts the capital treatment accordingly.

Asset Securitization

Asset securitization is clearly an important issue in the United States, as the securitization market is significantly greater than the securitization market of any other Basel-member country. The committee believes that it is important to construct a more comprehensive framework to better reflect the risks inherent in the many forms of asset securitizations, including traditional and synthetic forms.

The securitization framework in the new Basel accord applies generally when there is a transaction that involves the stratification, or tranching, of credit risk. The committee has developed securitization approaches for both standardized and IRB banks. The level of complexity is significantly higher for IRB banks. The framework tries to focus on the economic substance of the transaction, rather than its legal form.

Under the proposal for the treatment of securitizations by standardized banks, the capital charge is generally determined by multiplying the amount of the securitization exposure by the risk weight mapped to the long- and short-term rating categories. Off-balance-sheet exposures are subject to a conversion factor before the appropriate risk weight is applied. The proposal does allow for some recognition of credit risk mitigants provided on securitization exposures, but that recognition is permitted only when the bank meets a series of stringent criteria.

Banks that adopt the IRB approach for credit risk are generally required to use one of two methods for determining capital requirements for securitization exposures. One method is the supervisory formula approach (SFA), under which capital is calculated through the use of five bank-supplied inputs: 1) the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); 2) the tranche's credit enhancement level and 3) thickness; 4) the pool's effective number of loans; and 5) the pool's exposure-weighted average loss given default (LGD). The second method is known as the ratings-based approach (RBA). Under this approach, capital is determined by multiplying the amount of the exposure by the appropriate asset-backed security risk weights, which depend on external rating grades, short- or long-term. Granularity of the pool and the level of seniority of the position are also considered.

The securitization proposal is one of the newest pieces of the accord and its potential impact on the industry is still being assessed. In the December 2002 QIS exercise, banks were asked for the first time to provide data on the relative impact of the proposals. The QIS results did not provide entirely reliable results. However, the committee has responded to some of the concerns raised during the QIS process by making changes to the securitization framework. One key change was the introduction of a simpler approach for liquidity facilities.

Operational Risk

One of the most significant changes in the new accord is the proposal for an operational risk charge. It is expected to represent, on average, 10–15 percent of the total minimum regulatory capital charge. The framework is based upon the following operational risk definition: the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This includes legal risk, but excludes strategic and reputational risks.

The committee has proposed three approaches to calculate the operational risk charge, which represent a continuum of increasing sophistication and risk sensitivity. The basic indicator approach (BIA) is the simplest of the three approaches; the capital charge is determined by taking an alpha factor decided by the committee and multiplying it by an indicator, gross income. The next approach is known as the standardized approach and is similar to the BIA, but breaks out gross income into business lines. The committee has introduced an Alternative Standardized Approach to address some of the concerns raised by the results of the December 2002 QIS exercise; this is not a separate approach, but rather a modification to the Standardized Approach. Because there is no compelling link between these measures and the level of operational risk, the United States does not plan to utilize the BIA or the Standardized Approach (including the Alternative Standardized Approach) to determine the capital charge for operational risk.

The committee has made the most significant changes to the advanced approach since it was originally introduced in January 2001. At that time, the committee envisaged a single, very prescriptive advanced approach for operational risk, similar to credit risk. However, after numerous comments from the industry, the committee made substantive changes in the proposal to reflect the evolutionary nature of the operational risk framework. The committee recognized that, unlike credit risk, there are very little data and no internal systems specifically designed to target operational risk; instead, banks and supervisors rely primarily on internal controls to deal with a myriad of banking risks that cannot be as readily quantified as credit and market risks.

The committee considered the comments and analyzed the state of the art of operational risk and developed what is known as the advanced measurement approaches (AMA). Rather than prescribing one methodology, the AMA will allow banks the option of designing the operational risk measurement framework that best suits their institution, subject to some broad criteria. The criteria will be the key to achieving a certain level of consistency and comparability among institutions, as well as providing a margin of comfort to supervisors who must assess these differing systems. The criteria currently identified in the new accord include the need for internal and external data, scenario analysis, and consideration of business environment and internal control factors. Banks may also, under the AMA, consider the impact of risk mitigation (such as insurance), again subject to certain criteria set to ensure that the risk mitigants act as an effective capital-replacement tool.

Temporary Capital Floors

Two floors have been established for the Basel II framework. In the first year of implementation, an institution's required minimum level of regulatory risk-based capital cannot be less than 90 percent of the minimum level of capital that would be required under the agencies' general risk-based capital rules. In the following year, an institution's minimum level of regulatory risk-based capital cannot be less than 80 percent of the minimum amount required under the agencies' general risk-based capital rules.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the Subcommittee on Financial Institutions and Consumer Credit, of the U.S. House of Representatives Committee on Financial Services, on the proposed revisions to the 1988 Basel Capital Accord ("Basel I"), Washington, D.C., June 19, 2003, with attachment

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Bachus, Congressman Sanders, and members of the subcommittee, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on proposed revisions to the 1988 Capital Accord developed by the Basel Committee on Banking Supervision (Basel Committee). I welcome the efforts of the subcommittee to focus attention on these critical issues. The health of the U.S. commercial banking system is a critical element to a strong economy. Thus, it's essential that any regulatory changes that might affect the condition and competitiveness of our banking system be fully understood and carefully evaluated by the banking industry, the U.S. Congress, and the American public.

The 1988 Accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards applicable to internationally active commercial banks in all of the G–10 countries, and it has been adopted by most other banking authorities around the world. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions.

By the late 1990s, it became evident that Basel I had become outdated. The increased scope and complexity of the banking activities of our largest banking institutions over the last decade, and the unintended consequences of various provisions of the regulations, severely undercut the utility of the Capital Accord. Basel I simply does not provide a meaningful measure of the risks faced by large, internationally active banks or the capital they should hold against those risks.

Consequently, over the past several years, the Basel Committee has been developing a more detailed and risk-sensitive capital adequacy framework to replace Basel I. The committee's first draft document, "Consultative Paper No. 1" (CP–1), was issued in June 1999. It laid the groundwork for the new capital adequacy framework (Basel II), but provided few details. The committee provided additional detail on the specifics of Basel II in its January 2001 issuance of "Consultative Paper No. 2" (CP–2). Although more detailed, CP–2 still left a number of key issues unaddressed and unresolved. The committee's most recent paper, "Consultative Paper No. 3" (CP–3), which I will discuss today, was issued on April 29 of this year.

As work on these consultative papers has progressed, the Basel Committee also has attempted to gauge the impact of its proposals on the required capital levels of banking institutions through a series of quantitative impact studies. In May, the committee published the results of the most recent assessment, the third quantitative impact study (QIS–3). While the committee concluded that the results were generally in line with the objectives of Basel II, the QIS–3 data still do not provide a sufficiently reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. More work in this area is clearly warranted and I will discuss this later in my testimony.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As a consequence, the U.S. banking agencies, the agencies responsible for the maintenance of capital adequacy standards for U.S. financial institutions, are faced with a daunting task. While we will work earnestly in this effort, the timeline should be seen as a means to an end, not an end in itself. As will be highlighted in my testimony, basic principles of safety and soundness demand that the banking agencies have a more complete understanding of the consequences of this proposal on the overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens before moving forward to finalize this proposal.

Our current primary focus in this effort is the development of U.S. implementing regulations and policies. As I will discuss later, the OCC and the other U.S. banking agencies will soon issue for comment proposed revisions to U.S. risk-based capital regulations to reflect the primary components of Basel II. Let me be absolutely clear about the integrity of this rulemaking process—the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not begin implementing a final Basel II framework until we have conducted whatever cost-benefit and impact analyses that are required, and fully considered all comments received during our notice and comment process—as we would with any domestic rulemaking. If we determine through this process that changes to the proposal are necessary, we will not implement proposed revisions until appropriate changes are made. We made this point quite clearly to our Basel Committee colleagues before we agreed to go forward with CP–3. Indeed, many of them will also have to go through their own internal domestic processes before they can adopt the Basel II framework.

Current Basel Proposal

The Basel Committee deserves considerable credit for its articulation of Basel II in CP–3. The proposal is still exceedingly complex, but CP–3 is a clearer presentation of inherently difficult material than its predecessors. This is an important step, since regardless of the complexity of the proposal, it is important that the industry and other interested parties have a clear understanding of the proposed accord.

The attachment to this written statement provides a summary of the substantive provisions contained in CP–3. As before, this iteration of the proposed new accord has three mutually reinforcing "pillars" that comprise the framework for assessing bank capital adequacy. The first pillar of the new accord is the minimum regulatory capital requirement. The Pillar 1 capital requirement includes a credit risk charge, measured by either a standardized approach or one of the new internal ratings–based (IRB) approaches (foundation or advanced), an operational risk charge, and a market risk charge. Again, the attached document provides a more detailed description of the various components of the Pillar 1 charge.

Pillar 2 addresses supervisory review. It is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy, and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 should also be seen as a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the committee is proposing a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the advanced IRB approach, the new accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of the building blocks of capital adequacy is greater transparency.

U.S. Implementation Actions

It is important to recognize that the Basel Accord is not self-executing in the United States. Even when adopted by the Basel Committee, Basel II will not apply to U.S. institutions unless and until the U.S. banking agencies adopt regulations to implement it. In accordance with the Administrative Procedure Act, 5 USC 551, *et seq.*, the U.S. banking agencies must publish notice and seek comment from all interested persons on any such proposal, and must fully consider those comments, before adopting a new capital regulation in final form. Obviously, the OCC and the other federal banking agencies intend to comply fully with these requirements. The importance of this rulemaking makes this comment process particularly critical to our success. Thus, we welcome this process as a means for positive contribution to this deliberative effort. We believe that the solicitation and assessment of comments is a critical step in determining the feasibility, effectiveness, and expected consequences of Basel II and related domestic capital regulations.

Next month, the U.S. banking agencies expect to jointly issue an Advance Notice of Proposed Rulemaking (ANPR) soliciting comment on proposed revisions to the existing domestic capital adequacy regulations that would implement Basel II. The ANPR will be largely based on CP–3 and will provide a description of proposed revisions to current capital regulations, while seeking comment on outstanding or contentious issues associated with the proposal. The ANPR will also request information on the cost of implementing the proposal, and will seek comment on the competitive implications in both domestic and international markets for banks of all sizes. In conjunction with the ANPR, the banking agencies will also issue for comment draft supervisory guidance articulating general supervisory expectations for banks seeking to implement Basel II–compliant methodologies for the advanced measurement approach (AMA) to operational risk and advanced IRB for corporate credits. Recognizing that CP–3 is a complex document, we understand the importance of providing U.S. banks an opportunity to review and comment on U.S. implementing documents as soon as practicable. By describing these concepts within the context of our existing regulatory and supervisory regime, the ANPR and draft guidance will provide a meaningful forum for a full discussion of Basel II.

After assessing comments generated during the ANPR process, the U.S. banking agencies will consider a complete cost analysis in accordance with applicable rulemaking requirements, including the standards of Executive Order 12866, discussed below, and will develop specific regulatory language for a joint Notice of Proposed Rulemaking (NPR). Again, the banking industry and other interested parties will have an opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

Let me now focus on two important, unique features of the U.S. regulatory capital regime that will be highlighted in the ANPR and NPR—the scope of application of Basel II and the content and structure of the proposed revisions to the capital adequacy regulations. First, the United States expects to set forth in the ANPR proposed criteria for identifying which banks in the United States will be subject to the new accord. Despite language in the 1988 Capital Accord that permitted a more limited application, U.S. banking and thrift agencies applied the Basel framework to *all* U.S. insured depository institutions. As we will highlight in the forthcoming ANPR, the U.S. agencies have determined to apply Basel II concepts more narrowly. Specifically, consistent with the focus of the Basel Capital Accord on banks that compete in the global market place, we will propose applying Basel II concepts on a mandatory basis only to large, internationally active institutions that compete on a significant global basis with other financial service providers. Other institutions will have the opportunity to voluntarily opt into the Basel framework upon application to, and approval by, their primary federal supervisor.

Preliminary analysis by the U.S. agencies suggests that under the narrow approach we are proposing, there are currently fewer than a dozen U.S. banks that would be mandatorily subject to Basel II–based regulatory capital requirements. Of course, the approach of requiring only a small population of banks to comply with Basel II will be subject to notice and comment in the ANPR and will be definitively resolved only after the U.S. rulemaking process has been completed.

Second, in developing revisions to existing capital adequacy regulations, U.S. banking agencies recognize that the revised regulation, and interagency implementation policies, need not follow the literal structure and language of Basel II. While consistent with the objectives, general principles, and core elements of the revised Basel Accord, the language, structure, and degree of detail of U.S. implementing documents may be very different from Basel II. These implementation differences are reflective of the particular statutory, regulatory, and accounting structures and practices in place in the United States. It is important to note that U.S. implementation actions do not contemplate changes to many fundamental aspects of our regulatory/supervisory process, including a focus on regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As described more fully in the attachment, the U.S. agencies will propose for notice and comment a Basel II–based regime incorporating only the advanced IRB approach for credit risk, the AMA for operational risk, and the internal models approach for market risk.

We are also very cognizant that in connection with this, or any rulemaking, existing requirements may compel preparation of detailed analysis of the costs, benefits, and other effects of our regulations, depending on threshold determinations of whether the rulemaking in question triggers the substantive requirements of particular statutes or Executive Orders. Relevant requirements are set forth in the Regulatory Flexibility Act (RFA), the Unfunded Mandates Reform Act of 1995 (UMRA), and Executive Order 12866 (EO 12866). Issuance of the ANPR will help us identify and determine costs, benefits, and other effects of the proposed rulemaking, for purposes of complying with these requirements.

Timing

As I noted early on in my testimony, the Basel Committee timeline presents a daunting task to both the U.S. banking agencies and the banking industry. While it is clearly necessary to move forward in addressing the acknowledged deficiencies in the current Basel Capital Accord, the banking agencies must better understand the full range and scale of likely consequences before finalizing any proposal. The list provided below identifies the milestones the OCC must meet under the current Basel II timeline. Each step is critical in a prudential consideration of Basel II in the United States:

- *Consideration of comments received by the Basel Committee on CP–3.* The comment period on this document concludes on July 31.

- *Finalization, issuance, and consideration of comments on the U.S. ANPR.* Based on current estimates, the notice and comment period will run from July to October.

- *Finalization, issuance, and consideration of comments on supervisory guidance on corporate IRB and AMA methodologies.* Based on current estimates, the notice and comment period will run from July to October.

- *Development, issuance, and consideration of comments on supervisory guidance on other substantive aspects of Basel II–based regulations, especially including retail IRB.* Based on current estimates, the agencies hope to commence solicitation of comment on this guidance by year-end 2003.

- *Participation in the Basel Committee's consideration of Basel II.* Under the current timeline, the committee is to consider approval of Basel II in December of this year.

- *Development, issuance, and analysis of results of additional agency efforts to evaluate the prospective effects of Basel II implementation.* EO 12866 may compel the OCC and OTS to undertake such analysis prior to the issuance of a Notice of Proposed Rulemaking (NPR). Even without regard to this requirement, however, it is essential that we have a reliable estimate of the impact of Basel II on the capital and competitive position of U.S. banks.

- *Development, issuance, and consideration of comments on the U.S. NPR.* This document would only be issued after the Basel Committee finalizes its consideration of Basel II. If the existing timeline is maintained, solicitation of comment on the NPR would commence no earlier that the first quarter of 2004.

- *Development and issuance of a U.S. final rule and supervisory guidance.* Again, assuming the present timeline is maintained, our best estimate for the issue date of a final rule implementing Basel II is the third or fourth quarter of 2004.

- *Completion of all necessary supervision-related steps to implement Basel II–based regulations in advance of the presently proposed December 2006 effective date.* Most significantly, the agencies need to determine whether each bank subject to Basel II–based regulations has appropriate systems and procedures in place to qualify for using the A–IRB and AMA.

H.R. 2043

Mr. Chairman, you and some of your colleagues have introduced H.R. 2043, a bill that would establish an interagency committee, the United States Financial Policy Committee (USFPC). The USFPC would be chaired by the Secretary of the Treasury, and its other members would be the Comptroller of the Currency, and the chairmen of the Federal Reserve Board and the FDIC. Broadly speaking, the purpose of this committee would be to develop uniform U.S. positions on issues before the Basel Committee and require the banking agencies, in consultation with the Secretary of the Treasury, to evaluate the impact of the proposed accord, taking into account certain specific factors, including the costs associated with implementation of the accord and its competitive effects. In cases where a uniform position could not be reached, the position of the Secretary of the Treasury would be determinative.

Mr. Chairman, we understand—and we share—your desire to make sure that the banking agencies adopt a uniform approach and that the impact of Basel II is well understood before it is adopted. However, we do not believe legislation is needed to compel that result. As I have already discussed, the next key step in the United States is the rulemaking process. That process is subject to requirements, including those contained in the statutes and the executive order that I mentioned earlier, that we believe will address the key concerns underlying the proposed legislation.

In this regard it is important to note that the rulemaking process is already an interagency process involving all the banking agencies in joint rulemaking. While we have not all agreed on every issue, the interagency approach has been very collaborative, and I am confident we will be able to work out any remaining differences in pursuit of our mutual objective.

As noted earlier, we are under an obligation to consider the costs and competitive effects of proposals like Basel II. This evaluation of the impact of Basel II involves factors similar to that proposed under H.R. 2043. Specifically, EO 12866 requires the OCC and OTS to provide specific information to OMB's Office of Information and Regulatory Affairs (OIRA), including an assessment of the costs and benefits of the regulatory action, if the agency or OIRA determines that a proposed regulation is a "significant regulatory action." A "significant regulatory action" is defined to include a rule that may have an annual effect on the economy of $100 million or more, or have a material adverse effect on the economy, a sector of the economy, productivity, jobs, or several other factors. The RFA [Regulatory Flexibility Act] requires an agency to consider whether a rule will have a "significant economic impact" on a "substantial number" of small businesses, including, of course, small banks. The UMRA [Unfunded Mandates Reform Act of 1995] requires an agency to prepare a written statement if a proposed or final rule includes a "federal mandate," that is, a federally imposed requirement that may, among other things, result in private sector expenditures for compliance of $100 million or more in any one year. If a written statement is required under the UMRA, it would include a qualitative and quantitative assessment of the anticipated costs and benefits of the federal mandate and, to the extent feasible, estimates of its effect on the international competitiveness of U.S. goods and services.

Status of Basel Proposal—Outstanding Issues

In commencing an objective assessment of the status of Basel II, it is important to reiterate and reaffirm the commendable work of the Basel Committee, and in particular, the strong and intelligent leadership of its former chairman, William McDonough. The OCC firmly supports the objectives of Basel II. These objectives constitute a sound conceptual basis for the development of a new regulatory capital regime and should continue to serve as a useful benchmark to gauge our progress in this effort. Nonetheless, much of that conceptual basis has not been tested in practice in any manner approaching the magnitude of Basel II. We continue to be concerned about the potential for unintended or unanticipated consequences of the Basel II proposals.

Implementation Challenges

At its foundation, the Basel II proposals permit qualifying institutions to calculate their minimum risk-based capital requirements by reference to their own internal systems and methodologies.

While it is the hallmark of Basel II, a greater alignment of internal risk assessment with minimum regulatory capital derived through internal models represents a radical departure from our existing regulatory capital framework. As we will highlight in the ANPR and accompanying guidance, this reliance on internal risk assessment systems mandates changes in the way we structure our capital regulations and, in certain important respects, how we conduct our supervisory activities. The fundamental question for the banking agencies in assessing Basel II is the issue the OCC has previously identified—whether the regime will work in practice, as well as theory, as the basis for a regulatory capital regime.

For bank supervisors and other external stakeholders to be in a position to rely on a bank's internal process in the establishment of regulatory capital requirements, there must be a high degree of confidence that regulators can establish and enforce appropriate risk measurement and management standards consistently across the banks subject to a Basel II–based regime. The challenge for supervisors is to create a verifiably accurate system that appropriately balances the need for flexibility, to promote continued improvement in risk management practices, with the need for objective standards, to ensure consistency in application across institutions and supervisors, both foreign and domestic.

The capital rule we implement must respect the evolutionary nature of risk management. As regulators, we must acknowledge that we are still in the relatively early days of model-based credit and operational risk measurement and management, and we must recognize the inevitability of further innovation and improvements in this area. This respect for the evolutionary nature of this discipline must then be reconciled with the need for objective standards to ensure consistency in application. Much of the detail and complexity within Basel II derives from the need to establish more objective expectations for bank rating systems, control mechanisms, audit processes, data systems, and other internal determinations of risk by individual banks. In many cases, this has led to the establishment of supervisory standards in areas previously left to management discretion or supervisory judgment.

Not surprisingly, the regulatory community has struggled with the establishment of these standards. Failing to achieve the proper balance for these often conflicting objectives while moving forward with the radically different Basel II–based regime can have dramatic consequences. If our regulation and supervisory process is overly flexible, bank internal calculations of capital adequacy may prove insufficient, non-comparable, or both. If we err on the other extreme, we establish an excessively prescriptive supervisory regime that stifles innovation, imposes undue regulatory burden, and inappropriately narrows the role of judgment.

This need to carefully balance dramatically opposed objectives, together with the significant uncertainties that still exist about the practical feasibility of these proposed changes to the Capital Accord, raise doubts about the achievability of the time frame established by the Basel Committee.

Competitive Equality

A stated goal of the Basel Committee in developing Basel II was that "the Accord should continue to enhance competitive equality." Realistically, we are not yet in a position to assess definitively the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. There are risks that Basel II may create or exacerbate relative advantages between domestic banks and foreign banks; between banks and nonbanks; and between large domestic banks and mid-size/small domestic banks. It is imperative that the U.S. banking agencies remain sensitive to these concerns and assess, to the extent possible, any unintended consequences resulting from the implementation of Basel II.

One of the primary objectives of the Basel Committee itself is the reduction of gaps and differences in international supervisory coverage by national supervisory agencies, especially as it relates to large internationally active banks that compete on a significant global basis with other financial service providers. This principle of competitive equality and a level playing field for international banks is an admirable one, and an appropriate goal of the committee's efforts. Yet, the very complexity of the rules themselves calls this objective into question. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an evenhanded way across such a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 to 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in assessing the banks' operations and judging the banks' compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to a comparably sized institution, or may examine such an institution thoroughly only every five years, or may put heavy reliance on the oversight of outside auditors.[1]

It's fair to ask, I think, in which type of supervisory regime detailed, prescriptive capital rules are more likely to be robustly and reliably enforced. The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedrock principle of Basel II. Can we really achieve competitive equality *without* addressing disparities in supervision, particularly when we are operating on the assumption that the complex new rules we're writing will be applied in an evenhanded way throughout the world?

Another principle source of competition for many banks is not other insured depository institutions, but nonbanks. This situation is especially pronounced in businesses such as asset management and payments processing. As you are aware, however, regulations implementing Basel II–based concepts in the United States will apply only to insured depository institutions and their holding companies. While differences in regulatory requirements for banks and nonbanks exist today, many institutions have voiced concern that implementation of Basel II may unduly exacer-

[1] See Daniel E. Nolle, "Bank Supervision in the U.S. and the G–10: Implications for Basel II," *RMA Journal,* June 2003.

bate the current differences. These concerns have been mainly focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Finally, there is concern about the potential effect of Basel II on the competitive balance between large and small banks. As implemented in the United States, Basel II would result in a bifurcated regulatory capital regime, with large banks subject to Basel II–based requirements and small and mid-sized banks subject to the current capital regime. This structure is premised on the belief that, to the extent possible, regulations should reflect the size, structure, complexity, and risk profile of banking institutions. The Basel II framework was developed to address the unique risks of large, internationally active institutions. Mandatory application of such a framework to small banks, with its associated costs, was deemed inappropriate. In fact, the banking agencies sought comment from the banking industry, especially smaller institutions, on the development of a simplified capital framework specifically for non-complex institutions.[2] Industry comments were overwhelmingly negative on the proposal—most institutions felt that the cost of adopting a new regulatory capital regime outweighed any potential benefits. Accordingly, the banking agencies tabled the proposal.

With that said, the banking agencies need to continue to assess the competitive effects of a bifurcated regulatory capital regime, and it is one of the areas on which we will seek guidance in our ANPR. There are several concerns in this regard. First, banks using a Basel II–based regime may have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with smaller banks for both assets and liabilities. To be sure, banks subject to the new Basel II requirements will incur very significant systems and compliance costs in preparing for the new regime. These concerns are discussed in more detail in the "Calibration" section below. Moreover, banks using a Basel II–based regime may have significantly higher or lower marginal regulatory capital charges than non-Basel banks for some types of loan products, resulting in potential pricing differentials. While Basel II might enable larger banks to compete more effectively for high-quality credits, it could also result in larger concentrations of lower quality credits in smaller institutions. Finally, the potential implications on industry consolidation are simply not known. The banking agencies must continue to assess this situation and, if warranted, take steps to mitigate adverse effects on the competitive balance between large and small banks. We would be seriously concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the United States.

Calibration

The first objective of the Basel Committee in embarking on the Basel II effort was to calibrate minimum capital requirements to bring about a level of capital in the industry that, on average, is

[2] See Advance Notice of Proposed Rulemaking, "Simplified Capital Framework for Non-Complex Institutions," 65 FR 66193 (November 3, 2000).

approximately equal to the global requirements of the present Basel Accord. That calibration was to be designed to provide an incentive to banks to develop and maintain sophisticated and risk-sensitive internal ratings–based systems.

In order to gauge its success in meeting that objective, the Basel Committee attempted to measure the impact of its proposals on the required capital levels of banking institutions through several quantitative impact studies. On May 5, 2003, the committee published an overview of the results of its most recent assessment, the third quantitative impact study (QIS–3). On the basis of QIS–3 results, the committee concluded that the aggregate results were generally in line with the objectives established for Basel II.

Unfortunately, the QIS–3 data do not provide a reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. Banks encountered several practical impediments to providing accurate estimates of the effect of the proposals on their measured ratios; thus, the estimated risk-based capital ratios were subject to a substantial margin of error. For example, in many cases, existing bank systems were not able to produce the data requirements necessary for inputs required by the new accord. In some areas, the QIS–3 instructions were not sufficiently clear or were misinterpreted, and in other cases, the proposals were still in flux as banks were completing the survey. Most important, QIS–3 was completed without the rigorous supervisory validation and oversight that would occur when the proposal actually takes effect.

A key concern is that focusing on the overall results of the QIS–3 exercise masks the wide dispersion of results for individual institutions. In the United States, measured against current risk-weighted assets, the use of advanced approaches yielded results that ranged from a decrease in regulatory capital requirements of 36 percent to an increase of 43 percent. Similarly broad dispersions are found in a great many of the underlying components that make up the total capital requirement. While some dispersion of results in a truly more risk-sensitive framework would be expected, we are not convinced that the wide ranges indicated by QIS–3 can be explained by relative differences in risk among institutions; it appears that comparability of QIS–3 results among different institutions may be severely lacking.

Finally, the quantitative studies that have been done to date have been based on unilateral inputs from the participating banks. We and other supervisors have had only very limited ability to review the veracity of the results. I want to be clear that we have no reason to believe that U.S. banks did not make every effort to provide results as accurate as possible given the constraints they were operating under. Nonetheless, it is certainly conceivable—I would say highly likely—that the results might change significantly, and not necessarily in any particular direction, when all the intricacies of real-world implementation come into play. It seems fair to assume that banks will have fewer incentives to take conservative stances and greater incentives to exploit any loopholes or gray areas in the final rules; the extent to which these effects might be offset (or exceeded by) greater supervisory oversight is unknown.

Notwithstanding the significant uncertainties noted above, it presently appears that the required capital levels of some U.S. institutions could drop significantly, even taking into account the temporary minimum floor capital requirements, discussed in the attachment. The OCC does not believe that some reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an adverse feature of Basel II. Such a result is only acceptable, however, if the reduction is based on a regulatory capital regime that appropriately reflects the degree of risk in that bank's positions and activities. Given the fact that relevant bank systems and procedures are still in development, the OCC is not yet in a position to make that determination as it relates to Basel II. As such, the OCC is not yet comfortable allowing national banks to materially lower their current capital levels simply on the basis of the output of the currently proposed Basel II framework.

The OCC expects that an additional quantitative study will be necessary after the Basel Committee's work on Basel II is completed. Ideally, this should take the form of another global study by the Basel Committee itself—*i.e.,* a QIS–4. However, even if the Basel Committee does not undertake such a study, I believe that it is absolutely essential that the U.S. agencies do so prior to the adoption of final implementing regulations. I strongly believe that we cannot responsibly adopt final rules implementing Basel II until we have not only determined with a high degree of reliability what the impact will be on the capital of our banks, but we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States.

Conclusion

As I have indicated, the OCC firmly supports the objectives of Basel II—a more risk-sensitive and accurate capital regime. However, in light of the issues that been identified with the current iteration of Basel II, the U.S. banking agencies must now determine how best to proceed on this critically important issue. I believe the following are essential elements in the agencies' consideration of Basel II implementation within the United States.

First, the agencies need to move forward with the solicitation of comments on a Basel II–related ANPR and associated guidance. That is the most effective mechanism to a have full and complete consideration of the proposal from all interested parties. The solicitation of comments on a proposed regulatory and supervisory structure for Basel II implementation will also permit supervisors to tangibly assess the feasibility of the proposal.

Second, the agencies need to undertake additional steps to evaluate the costs, benefits, and other effects of the proposal before moving forward with any final regulatory action. Frankly, we simply need additional information to reasonably address the numerous issues, concerns, and uncertainties associated with Basel II implementation. We must better understand the likely consequences of this proposal on overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens. In determining the appropriate additional steps, the agencies should consider the obligations imposed under EO 12866, the other statutory requirements for consideration of costs and impact, lessons learned from QIS–3, and perhaps, a U.S. version of QIS–4.

Third, as I have consistently reiterated, if we determine through this process that changes to the Basel II proposal are necessary, the U.S. agencies must pursue those changes, both domestically and in the Basel Committee. In this regard, the U.S. agencies should not foreclose consideration of alternative proposals that address the acknowledged deficiencies of the 1988 Accord but that do not constitute such a radical departure from our existing regulatory capital framework.

Fourth, the overarching consideration for supervisors in moving forward on Basel II is the need to act in accordance with our primary mission—to ensure the continued maintenance of a robust and safe and sound banking system. We need to "incent" banks to continue to better measure and manage the full panoply of risks they face and to make use of new and evolving risk management practices. We must also ensure that prudential consideration of safety and soundness principles remain paramount.

As I said in the beginning of my statement, the OCC, the agency to which Congress has committed the authority to define capital requirements for national banks, will not sign off on implementation of a final Basel II framework until we have fully considered all comments received during our notice and comment process. Given the importance of this proposal, the significant issues that remain unresolved, and the prospect that whatever emerges from this process is likely to govern the financial landscape for years to come, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee in both theory as well as practice.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

Attachment

Summary of Basel II: The Proposed New Accord

Office of the Comptroller of the Currency

The Basel Committee (the committee) has been developing the new accord over the past five years. During that time, three full-scale consultative papers (June 1999, January 2001, and April 2003) and numerous working papers supporting various elements of the new accord have been released to the industry for comment. This summary is intended to convey a general idea of the structure and substance of the proposed new accord, and does not attempt to provide a complete analysis. It is based on the most recent publications from the Basel Committee, notably the New Basel Capital Accord (Consultative Document), which is out for comment until July 31; the document can be found on the committee's Web site at http://www.bis.org/bcbs/index.htm.

The new accord will include menus of approaches for measuring the capital required for credit risk, market risk, and operational risk. For credit risk and operational risk, each of the proposed approaches is described briefly below; capital charges for market risk are unchanged in the new accord and are not discussed here. Some of the approaches described are unlikely to be implemented in the United States and have been noted as such. Moreover, based on preliminary analysis by the U.S. agencies, currently there are less than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. While other banks would be permitted to opt in to the Basel rules (subject to meeting prudential qualification requirements), the U.S. capital rules will remain in place for the vast majority of U.S. banks that either are not required to or do not opt to apply the Basel II framework. Of course, any issues regarding U.S. implementation of the new accord will be definitively resolved only after the U.S. rulemaking process has been completed.

The current structure of the accord has been influenced by the results of several quantitative impact studies (QIS), the most recent of which was completed in December 2002. Approximately 20 U.S. banks participated in the QIS exercise in December and the results have been factored into the most recent version of the accord. Changes were made in several areas including the treatment of retail credits, specialized lending, securitization, and operational risk.

General Structure of the Proposed New Accord

The new accord has three mutually reinforcing "pillars" that make up the framework for assessing capital adequacy in a bank. The first pillar of the new accord is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market, and operational risk. The new accord offers a series of options for calculating credit and operational risk. Market risk will remain unchanged from a 1996 amendment to the accord. The new options for credit and operational risk were designed to be available to a wide range of banks, from relatively simple to very complex. For credit risk, the Pillar 1 capital requirement includes both the standardized approach, updated since the 1988 accord, and the new internal ratings-based (IRB) approaches (foundation and advanced). Pillar 1 has been the focal point of much of the discussion and comment from the industry on the new accord.

Pillar 2 covers supervisory review and banks' obligation to hold sufficient capital vis-à-vis their risk profile. The pillar is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy. It provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 is also a way to focus supervisors on other means of addressing risks in bank's portfolio, such as improving risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the new accord proposes a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies for market and operational risk, the new accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar has been subject to numerous changes as the committee has worked to balance the need for robust disclosure with a recognition of the proprietary and confidential nature of some of the information.

Capital for Credit Risk

Under Basel II, banks must select one of three approaches to determine their capital for credit risk. The three approaches, from simplest to most complex are: the standardized approach, the foundation IRB, and the advanced IRB.

Standardized Approach

The 1988 accord introduced the standardized risk-bucketing approach for setting the minimum regulatory capital requirement, which is still used in the United States today. The approach has been subject to criticism that it lacks sufficient risk sensitivity. The revised standardized approach under Basel II enhances the 1988 accord by providing greater, though still limited, risk sensitivity.

Key changes to create a more risk-sensitive framework include the refinement and addition of risk buckets, the introduction of external credit ratings, and a wider recognition of credit risk mitigation techniques. Risk weights are still determined by category of the borrower—sovereign, bank, or corporate—but within each of these categories changes have been made to make the capital more reflective of the riskiness of the asset category. For example, the risk weight on mortgage loans has decreased from 50 percent to 35 percent and the risk weight on certain retail credits has moved from 100 percent to 75 percent. Risk weights for externally rated corporate credits, currently 100 percent, will range from 20 percent to 150 percent. Sovereign risk weights are no longer dependent upon whether a country is a member of the Organization for Economic Cooperation and Development (OECD), but rather on the external rating identified for the country.

The standardized approach is not likely to be implemented in the United States. U.S. supervisors believe that credit risk measured under the standardized approach of Basel II would generally not be appreciably different than that measured under current rules for most U.S. banks, and the marginal changes in capital requirements would not justify the cost of implementation.

Internal Ratings-Based Approach (Foundation and Advanced)

The IRB approach represents a fundamental shift in the committee's thinking on regulatory capital. It builds on internal credit risk rating practices used by some institutions to estimate the amount of capital they believe necessary to support their economic risks. In recent years, as a result of technological and financial innovations and the growth of the securities markets, leading banking institutions throughout the world have improved their measurement and management of credit risks. These developments have encouraged the supervisory authorities to devote greater attention to introducing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of eligibility standards or "qualifying criteria" in order to use the IRB approach. Because the requirements include both qualitative and quantitative measures, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by both the type of exposure and whether the bank intends to use the simpler foundation IRB framework or the more advanced IRB framework. The requirements are extensive and cover a number of different areas, including rating system design, risk rating system operations, corporate governance, and validation of internal estimates. A brief sample of actual criteria include:

- The board of directors and senior management have a responsibility to oversee all material aspects of the IRB framework, including rating and probability of default (PD) estimation processes, frequency, and content of risk-rating management reports, documentation of risk-rating determinations, and evaluation of control functions.

- A one-year PD estimate for each grade must be provided as a minimum input.

- Banks must collect and store historical data on borrower defaults, rating decisions, rating histories, rating migration, information used to assign ratings, PD estimate histories, key borrower characteristics, and facility information.

As mentioned above, the requirements that a bank must meet are partially dependent upon which of the two IRB approaches a bank will use. The first methodology, called the foundation approach, requires fewer direct inputs by banks and provides several supervisory parameters that, in many cases, carry over from those proposed for the standardized approach. For a variety of reasons, the United States does not plan to introduce the foundation approach in its regulations. The second approach, the advanced IRB approach, allows banks much greater use of their internal assessments in calculating the regulatory capital requirements. This flexibility is subject to the constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equality among banks worldwide.

There are four key inputs that are needed under IRB, for both the foundation and advanced approaches. The first element is the PD of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second input is the estimate of loss severity, known as the loss given default (LGD). The final two elements are the amount at risk in the event of default or exposure at default (EAD) and the facility's remaining maturity (M). LGD, EAD, and M are provided by supervisors in the foundation approach, but must be provided by banks operating under the advanced approach (subject to supervisory review and validation). For each exposure, the risk weight is a function of PD, LGD, and EAD.

The IRB approach envisions internal rating systems that are two-dimensional. One dimension focuses on the borrower's financial capacity and PD estimates that quantify the likelihood of default by the borrower, independent of the structure of the facility. The other dimension takes into account transaction-specific factors such as terms, structure, and collateral. These characteristics would determine the second dimension, i.e., the LGD. Implicit in this treatment is the assumption that when a borrower defaults on one obligation, it will generally default on all its obligations. (This assumption is relaxed with the IRB treatment of retail portfolios.)

Calculating the capital charge under the IRB approach involves several steps. The first of these steps is the breakdown of the bank's portfolio into five categories: corporate (including commercial real estate), retail, bank, sovereign, and equity. The IRB rules differ to varying degrees across these portfolios. As a result, the IRB capital charge is calculated by category, with the PD, LGD, and EAD inputs potentially differing across these categories. Supervisory approval is needed before banks can use the IRB approach for any of the five categories. The minimum requirements described above were written to apply across these five types of exposures.

Another important step is the determination by the bank of the PDs for its loan grading categories. The PD of an exposure is the one-year PD associated with the borrower grade, subject to a floor of 0.03 percent (excluding sovereigns). The determination of PDs for borrowers supported by guarantees or credit derivatives is more complex. Banks under the advanced approach would use their internal assessments of the degree of risk transfer within supervisory-defined parameters, while those under the foundation approach would use the framework set forth in the new credit-risk mitigation provisions. Overall, the PD must be "grounded in historical experience and empirical evidence," while being "forward looking" and "conservative." A reference definition of default has been developed for use in PD estimation and internal data collection of realized defaults.

Once the PD has been established, banks must then establish the dimensions of LGD based on collateral and M. Under the foundation approach, M is assumed to be 2.5 years. There are several options that may be selected for the advanced approach, but in general, M is defined as the greater of one year or the remaining effective maturity in years.

After the bank determines the PDs and LGDs for all applicable exposures, these combinations can be mapped into regulatory risk weights. The risk weights, which are calibrated to include coverage for both expected and unexpected losses, are expressed as a continuous function. The minimum capital charge is then determined by multiplying the risk weight by the amount expected to be outstanding at the time of default (EAD), and by 8 percent.

A final step in this process involves the ongoing review by the supervisors of the systems used to develop the IRB capital charge. Periodically, supervisors will need to validate these systems and review the internal controls that provide the foundation for the IRB approach. In addition, supervisors will also have to consider, under Pillar 2, whether the amount of capital generated by the IRB approach is commensurate with the bank's risk profile.

Implementation of the IRB Approach

In addition to the requirement that a bank meet the qualifying or eligibility criteria, the new accord requires that banks using the IRB approach run parallel systems for one year before implementation. This means that a bank planning to implement the IRB approach in December 2006 will actually have to begin calculating results as of December 2005, while continuing to run its current systems.

Adjustments to the Capital Charge for Credit Risk

There are additional considerations that banks may have to factor in when determining the capital charge for credit risk. These additional considerations will further adjust required capital, outside of the requirements of the different approaches to credit risk. The two primary adjustments that might be made to the credit risk charge are for credit risk mitigation and asset securitization.

Credit Risk Mitigation

The new accord provides a measure of capital relief for certain qualifying risk-mitigating techniques used by banks. However, it is important to note that most of the credit risk mitigation proposals in the new accord are only directly relevant to the standardized or foundation IRB approaches, which are not likely to be used in the United States. In the advanced IRB approach, credit risk mitigation must meet certain qualitative requirements, such as legal certainty. In addition, specific proposals related to maturity mismatches and backtesting requirements of certain model results are applicable to the advanced IRB approach. Otherwise, it is assumed that any credit risk mitigation efforts will be factored into the PDs and LGDs assigned by the bank.

With that caveat in mind, the section on credit risk mitigation in the new accord attempts to provide rough approximations of the risk reduction attributable to various forms of collateralized credit exposures, guarantees, credit derivatives, and on-balance-sheet netting arrangements. The committee has proposed a conceptual approach to these risk mitigation techniques that, while recognizing their risk reduction benefits, attempts to capture the additional risks posed by such transactions.

The credit risk mitigation proposal provides both a simple and a comprehensive approach to dealing with collateral. The proposal expands the range of eligible collateral from that recognized in Basel I. It also discusses the appropriate treatment for maturity mismatches between the credit risk mitigant and the underlying credit exposure. The proposal introduces haircuts, which the bank may estimate, to cover the market price and foreign exchange volatility that may be inherent in collateral. The proposal allows banks to greatly reduce the capital requirements for exposures with large amounts of high quality collateral. There are strict quantitative and qualitative factors that must be met in order for a bank to be permitted to use its own haircut estimates. The proposal encourages the use of credit-risk mitigation by expanding the type of collateral, guarantors, and transaction structures that are recognized for capital reduction. Different types of credit risk mitigation techniques pose different levels of additional risk; the proposal incorporates flexibility that recognizes these differences and adjusts the capital treatment accordingly.

Asset Securitization

Asset securitization is clearly an important issue in the United States, as the securitization market is significantly greater than the securitization market of any other Basel-member country. The committee believes that it is important to construct a more comprehensive framework to better reflect the risks inherent in the many forms of asset securitizations, including traditional and synthetic forms.

The securitization framework in the new Basel accord applies generally when there is a transaction that involves the stratification, or tranching, of credit risk. The committee has developed securitization approaches for both standardized and IRB banks. The level of complexity is significantly higher for IRB banks. The framework tries to focus on the economic substance of the transaction, rather than its legal form.

Under the proposal for the treatment of securitizations by standardized banks, the capital charge is generally determined by multiplying the amount of the securitization exposure by the risk weight mapped to the long- and short-term rating categories. Off-balance-sheet exposures are subject to a conversion factor before the appropriate risk weight is applied. The proposal does allow for some recognition of credit risk mitigants provided on securitization exposures, but that recognition is permitted only when the bank meets a series of stringent criteria.

Banks that adopt the IRB approach for credit risk are generally required to use one of two methods for determining capital requirements for securitization exposures. One method is the supervisory formula approach (SFA), under which capital is calculated through the use of five bank-supplied inputs: 1) the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); 2) the tranche's credit enhancement level and 3) thickness; 4) the pool's effective number of loans; and 5) the pool's exposure-weighted average loss given default (LGD). The second method is known as the ratings-based approach (RBA). Under this approach, capital is determined by multiplying the amount of the exposure by the appropriate asset-backed security risk weights, which depend on external rating grades, short- or long-term. Granularity of the pool and the level of seniority of the position are also considered.

The securitization proposal is one of the newest pieces of the accord and its potential impact on the industry is still being assessed. In the December 2002 QIS exercise, banks were asked for the first time to provide data on the relative impact of the proposals. The QIS results did not provide entirely reliable results. However, the committee has responded to some of the concerns raised during the QIS process by making changes to the securitization framework. One key change was the introduction of a simpler approach for liquidity facilities.

Operational Risk

One of the most significant changes in the new accord is the proposal for an operational risk charge. It is expected to represent, on average, 10–15 percent of the total minimum regulatory capital charge. The framework is based upon the following operational risk definition: the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This includes legal risk, but excludes strategic and reputational risks.

The committee has proposed three approaches to calculate the operational risk charge, which represent a continuum of increasing sophistication and risk sensitivity. The basic indicator approach (BIA) is the simplest of the three approaches; the capital charge is determined by taking an alpha factor decided by the committee and multiplying it by an indicator, gross income. The next approach is known as the standardized approach and is similar to the BIA, but breaks out gross income into business lines. The committee has introduced an Alternative Standardized Approach to address some of the concerns raised by the results of the December 2002 QIS exercise; this is not a separate approach, but rather a modification to the Standardized Approach. Because there is no compelling link between these measures and the level of operational risk, the United States does not plan to utilize the BIA or the Standardized Approach (including the Alternative Standardized Approach) to determine the capital charge for operational risk.

The committee has made the most significant changes to the advanced approach since it was originally introduced in January 2001. At that time, the committee envisaged a single, very prescriptive advanced approach for operational risk, similar to credit risk. However, after numerous comments from the industry, the committee made substantive changes in the proposal to reflect the evolutionary nature of the operational risk framework. The committee recognized that, unlike credit risk, there are very little data and no internal systems specifically designed to target operational risk; instead, banks and supervisors rely primarily on internal controls to deal with a myriad of banking risks that cannot be as readily quantified as credit and market risks.

The committee considered the comments and analyzed the state of the art of operational risk and developed what is known as the advanced measurement approaches (AMA). Rather than prescribing one methodology, the AMA will allow banks the option of designing the operational risk measurement framework that best suits their institution, subject to some broad criteria. The criteria will be the key to achieving a certain level of consistency and comparability among institutions, as well as providing a margin of comfort to supervisors who must assess these differing systems. The criteria currently identified in the new accord include the need for internal and external data, scenario analysis, and consideration of business environment and internal control factors. Banks may also, under the AMA, consider the impact of risk mitigation (such as insurance), again subject to certain criteria set to ensure that the risk mitigants act as an effective capital-replacement tool.

Temporary Capital Floors

Two floors have been established for the Basel II framework. In the first year of implementation, an institution's required minimum level of regulatory risk-based capital cannot be less than 90 percent of the minimum level of capital that would be required under the agencies' general risk-based capital rules. In the following year, an institution's minimum level of regulatory risk-based capital cannot be less than 80 percent of the minimum amount required under the agencies' general risk-based capital rules.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the OCC Alumni Association, on an historical perspective on current issues facing the national banking system, Washington, D.C., May 14, 2003

It is remarkable how many of the significant issues facing the OCC and national banks today have their roots—and their answers—in fundamental characteristics of the national bank charter and the original design of the national banking system. So, I thought, what could be a better topic for remarks to a group of OCC alumni? I'm going to talk about three of those issues today:

- What activities may national banks conduct as part of, or incidental to, the "business of banking"?
- To what extent do national banks operate under uniform national standards and when do state laws apply to their activities?
- And, if a state law applies to a national bank, who enforces it?

Earlier this year, I prepared a paper on "The OCC, the National Bank Charter, and Current Issues Facing the National Banking System,"[1] which described the origins of banking in the United States and the circumstances leading up to the creation of the national banking system and establishment of the Office of the Comptroller of the Currency (OCC) in 1863. I believe that Bob Serino has provided many of you with a copy of that paper as your "homework" assignment in preparation for today's lunch, and it goes into considerably more detail than I will confront you with as a luncheon speaker. As the paper recounts, the Civil War did, in fact, provide the catalyst for establishing a new system of national banks that were capitalized in a manner that aided the federal government in financing the Civil War. That financing role occurred because new national banks, upon being chartered by the Comptroller, were required to use a portion of their paid-in capital to purchase U.S. Treasury securities. The money received by the Treasury, in turn, was used to fund the Union efforts in the war.

But the design of the national banking system evidences creation of more than just a financing arm for the government's war effort. In an extraordinary step for the time, President Lincoln sought an entirely new system of federally chartered, but privately owned enterprises, whose powers and responsibilities were established under federal law, whose duration could be perpetual, and which were made subject to uniform federal supervision by a new federal regulator. The Treasury securities that new national banks were required to buy were pledged as backing for a new species of circulating notes issued by the banks with the Comptroller's approval. With capital

[1] "The OCC, the National Bank Charter, and Current Issues Facing the National Banking System," presented to the Financial Services Regulatory Conference, March 17, 2003, Washington, D.C. [Available in the *Quarterly Journal,* Vol. 22, No. 2 (June 2003) and on the Web at http://www.occ.treas.gov/QJ/QJ.htm/QJ22-2/3-SpeechesTestimony.pdf.]

in the form of government securities, these circulating notes were designed to be a new national currency that would hold a stable value and could be used, reliably, across the nation.

Thus, from the very outset, national banks were unique federal enterprises. It was envisioned that they would be located throughout the country, and that wherever located, they would exercise a uniform set of federal powers, under federal standards of operation, and federally mandated capitalization, with a federal supervisor overseeing all of the foregoing. Regardless of their short-term role in Civil War finance, this was a system of financial institutions designed to far outlast the aftermath of the war, with attributes that would enable them to play a powerful and evolving role in the national economy.

A vital attribute of national banks' ability to play this role was how their powers were—and, perhaps as importantly, were not—defined.

The Powers of National Banks —What is the "Business of Banking?"

The centerpiece for powers of national banks is language set forth at 12 USC 24 (Seventh), which provides that national banks are authorized to exercise "all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes. . . ."

It is stunning, but it was deliberate, that this central source of national bank powers is contained in just these 53 words. Congress modeled this authority on the bank charter authorized by the New York Free Banking Act; a type of charter that the New York courts explicitly had found to possess flexible and adaptive powers. Shortly before enactment of the National Bank Act, in a case called *Curtis* v. *Leavitt,* the New York Court of Appeals described the dynamic nature of the New York bank charter, stating that "[t]he implied powers [of a bank] exist by virtue of the grant [to do the banking business] and are not enumerated and defined; because no human sagacity can foresee what implied powers may in the progress of time, the discovery and perfection of better methods of business, and the ever-varying attitude of human relations, be required to give effect to the express powers."[2]

According to the court, the specifications of certain permissible banking activities in the New York banking laws, (and subsequently copied into the National Bank Act), were "eminently useful," but "not indispensable." Put more directly, banks' permissible activities were not limited to just the activities listed in the statute. Based on this lineage, in determining what activities are permissible for national banks, the OCC typically looks to both the literal language and the

[2] *Curtis* v. *Leavitt,* 15 N.Y. 9 (1857).

objectives of the act, approaching the statute, as one commentator picturesquely put it, as "an architect's drawing and not a set of specifications."[3] The result is that, in effect, the content of the powers of national banks has been continually under construction under the careful administration of the OCC for 140 years. In this role, the OCC consistently has viewed the powers of the national bank charter as fundamentally evolutionary, capable of developing and adjusting as needed to support the changing financial and economic needs of the nation and bank customers of all types.

Any doubt concerning the validity of this approach was settled with the Supreme Court's decision in *NationsBank* v. *Variable Annuity Life Insurance Co. (VALIC)* in which the court expressly held that the "business of banking" is not limited to the enumerated powers in 24 (Seventh) and that the Comptroller has discretion, within reason, to authorize activities beyond those specifically enumerated in the statute.[4] In the same decision, the court also reiterated a previous admonition that the Comptroller's determinations regarding the scope of permissible national bank activities pursuant to this authority should be accorded great deference, stating emphatically that "it is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws."[5]

The OCC makes its decisions concerning the content and boundaries of permissible national bank activities carefully and systematically, using a framework of analyses that looks both to the vitality of the national bank charter in the environment in which it is then operating, and the safety and soundness considerations associated with the proposed new activity. For example, in determining whether an activity is part of the business of banking, the OCC considers whether the activity is a contemporary functional equivalent or logical outgrowth of a recognized permissible banking function, whether the activity benefits customers and/or strengthens the bank, and whether the risks of the activity are similar to the type of risks already assumed by banks. In evaluating whether an activity is "incidental" to banking, the OCC will look to whether the activity facilitates the operation of the bank as a business enterprise, whether it enhances the efficiency and quality of the content or delivery of banking services or products, and whether it optimizes the use and value of a bank's facilities and competencies, or enables the bank to avoid economic waste in its banking franchise.

A glance at recent installments of the OCC's *Interpretations and Actions* publication reflects how these progressive standards have enabled national banks of all sizes to engage in new activities that contribute importantly to their ability to remain competitive and serve changing needs of their customers—new technology-based products and services, new types of advisory and con-

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[3] Harfield, "The National Bank Act and Foreign Trade Practices," 61 Harv. L. Rev. 782 (1948).

[4] *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.,* 513 U.S. 251 (1995).

[5] *Clarke* v. *Securities Industry Assn.,* 479 U.S. 388, 403–404 (1987) (quoting *Investment Company Institute* v. *Camp,* 401 U.S. 617, 626–627.

sulting services, and new risk mitigation and risk management techniques for themselves and their customers, are just a few examples. Indeed, one reason for national banks' strength and strong earnings in current, less-than-ideal economic conditions is the diversification of their earnings that has resulted from decisions by the OCC to recognize new types of activities and new risk management techniques as part of the dynamic and evolving nature of the business of banking.

Preemption

Preemption, in the context of national banks, is an often misunderstood and mischaracterized question. Fundamentally, national bank preemption issues raise the same question: to what extent are national banks, as federally created and federally supervised enterprises able to operate under *federal standards?* Individual skirmishes concerning displacement of particular state laws miss the key point: preemption is a means by which national banks are enabled to operate under the uniform national standards that Congress intended from the very outset of the national banking system. Resistance to preemption is essentially resistance to the uniform standards inherent in a national system.

While the subject of preemption may not be popular in some quarters, principles of preemption flow directly from the Supremacy Clause of the United States Constitution,[6] which provides that federal law prevails over any conflicting state law, and has long been recognized with respect to authority granted national banks under the National Bank Act. An extensive body of judicial precedent has developed over the 140 years of existence of the national banking system, explaining and defining the standards of federal preemption of state laws as applied to national banks.[7]

[6] U.S. Const. Art. VI, cl. 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

[7] *See, e.g., Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 U.S. 25, 26, 32, 33 (1996) ("grants of both enumerated and incidental 'powers' to national banks [are] grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States may not "prevent or significantly interfere with the national bank's exercise of its powers."); *Franklin National Bank,* 347 U.S. at 378–379 (1954) (federal law preempts state law when there is a conflict between the two; "The compact between the states creating the Federal Government resolves them as a matter of supremacy. However wise or needful [the state's] policy, . . . it must give way to contrary federal policy."); *Anderson National Bank* v. *Luckett,* 321 U.S. 233, 248, 252 (1944) (state law may not "infringe the national banking laws or impose an undue burden on the performance of the banks' functions" or "unlawful[ly] encroac[h] on the rights and privileges of national banks"); *First National Bank* v. *Missouri,* 263 U.S. 640, 656 (1924) (federal law preempts state laws that "interfere with the purposes of [national banks'] creation, tend to impair or destroy their efficiency as federal agencies or conflict with the paramount law of the United States."); *First National Bank of San Jose* v. *California,* 262 U.S. 366, 368–369 (1923) ("[National banks] are instrumentalities of the federal government. * * * [A]ny attempt by a state to define their duties or control the conduct of their affairs is void, whenever it conflicts with the laws of the United Sates or frustrates the purposes of the national legislation, or impairs the efficiency of the bank to discharge the duties for which it was created."); *McClellan* v. *Chipman,* 164 U.S. 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destro[y] or hampe[r]" national bank functions); *First National Bank of Louisville* v. *Commonwealth of Kentucky,* 76 U.S. (9 Wall.) 353, 362–63 (1870)

Together, the uniformity of powers and operating standards that result from federal preemption, coupled with the OCC's exclusive visitorial authority, which I will discuss in a moment, are defining characteristics of the national bank charter. Together, they constitute essential distinctions between the national banking system and the system of state-chartered and state-regulated banks that comprise the other half of our "dual banking system."

Ironically, many opponents of preemption are also fervent defenders of the "dual banking system." I have to confess to being perplexed when I hear state authorities on the one hand embracing as sacrosanct the "dual banking system," while at the same time criticizing national banks for taking advantage of the very characteristics of the national bank charter that distinguish national and state banks and make the system "dual." Similarly, the dual banking system is sometimes praised because of the *variety* of activities that may be allowed in different states, and for that reason the state banking component of the dual banking system is touted by its supporters as providing laboratories for innovation. It should be noted, however, that the attribute of the state system that is being extolled is the potential state-by-state *diversity* of standards applicable to state banks. That's fine. But it makes no sense then to criticize the other half of the dual banking system—national banks—for seeking uniform, *national* standards of operation, consistent with the *national* character of their charter.

Preemption is simply the legal theory that enables national banks to operate nationwide, under the uniform national standards, subject to the oversight of a federal regulator, just as Congress originally intended. As the Supreme Court noted in 1939, in *Deitrick, Receiver* v. *Greaney,*[8] "[t]he National Bank Act constitutes 'by itself a complete system for the establishment and government of National Banks.'" In a much earlier case, decided in 1896, the Supreme Court stated that "[n]ational banks are instrumentalities of the federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States. It follows that an attempt, by a State, to define their duties or control the conduct of their affairs is absolutely void, wherever such attempted exercise of authority expressly conflicts with the laws of the United States, and either frustrates the purpose of the national legislation or impairs the efficiency of these agencies of the Federal government to discharge the duties, for the performance of which they were created."[9]

This independence from state direction and control both recognizes the essential federal character of national banks and protects them from conflicting local laws that may undermine the uniform, nationwide character of the national banking system. Indeed, the Supreme Court consistently has held that subjecting national banks' exercise of their federally authorized powers to state regula-

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(national banks subject to state law that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the federal] Government"); *Association of Banks in Insurance, Inc.* v. *Duryee,* 270 F.3d 397, 403–404 (6th Cir. 2001) ("The Supremacy Clause 'invalidates state laws that "interfere with, or are contrary to," federal law.' * * * A state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach th[at] goal.") (citations omitted).

[8] 309 U.S. 190, 194 (1939).

[9] *Davis* v. *Elmira Savings Bank,* 161 U.S. 275, 283 (1896).

tion or supervision would be inconsistent with the system that Congress designed.[10] The court also has recognized that because national banks are federal creations, state law aimed at regulating national banks and their activities applies to national banks only when Congress directs that result,[11] and, as the court said in 1875, "the States can exercise no control over them, nor in any wise affect their operation, except in so far as Congress may see proper to permit."[12]

The court's decisions also have agreed that Congress was concerned not just with the application of certain states' laws to individual national banks but also with the application of *multiple* states' standards, which would undermine the uniform, national character of the powers of national banks throughout the system. This point was highlighted by the Supreme Court in 1891, in *Talbott* v. *Silver Bow County Commissioners* when the court stressed that the "entire body of the Statute respecting national banks emphasize that which the character of the system implies—an intent to create a national banking system co-extensive with the territorial limits of the United States, and with uniform operation within those limits. . . ."[13] A similar point was made by the court 100 years ago, in 1903, in *Easton* v. *Iowa,* which stressed that the national banking system was "a system extending throughout the country, and independent, so far as the powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States."[14]

This federal character has consistently informed the decisions of the Supreme Court when the court has considered whether particular state laws apply to national banks. In a recent instance in which the Supreme Court had occasion to review the federal constitutional foundations of the national banking system, the court concluded that, because of the federal status and purpose of national banks, national bank powers are not normally limited by state law.[15]

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[10] *See, e.g., Marquette Nat. Bank of Minneapolis,* 439 U.S. at 314–315 ("Congress intended to facilitate a 'national banking system.'"); *First National Bank of San Jose,* 262 U.S. 366, 369 (1923) (national banks are instrumentalities of the federal government; "any attempt by a State to define their duties or control the conduct of their affairs is void, whenever it conflicts with the laws of the United States or frustrates the purpose of national legislation or impairs the efficiency of the bank to discharge the duties for which it was created.").

[11] Of course, Congress may specifically require the application of state law to national banks for certain purposes. *See, e.g.,* 12 USC 92a(a) (the extent of a national bank's fiduciary powers is determined by reference to the law of the state where the national bank is located). Congress may also, more generally, establish standards that govern when state law will apply to national banks' activities. *See, e.g.,* 15 USC 6701 (codification of section 104 of the Gramm–Leach–Bliley Act, which establishes standards for determining the applicability of state law to different types of activities conducted by national banks, other insured depository institutions, and their affiliates). In such cases, the OCC applies the law or the standards that Congress has required or established.

[12] *Farmers' & Mechanics' National Bank* v. *Dearing,* 91 U.S. 29, 33–34 (1875).

[13] *Talbott* v. *Silver Bow County Commissioners,* 139 U.S. 438, 443 (1891).

[14] *Easton* v. *Iowa,* 188 U.S. 220, 229, 231–232 (1903)(emphasis added).

[15] *Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 U.S. 25, 32 (1996) (the history of the legal concept of national bank powers "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law").

Visitorial Powers

Closely related to preemption, the OCC's authority to regulate, supervise, and examine national banks is extensive, and in many respects, exclusive. This authority, referred to in old English common law terminology as "visitorial powers," has recently given rise to issues with state authorities on several fronts, including whether the scope of the OCC's exclusive visitorial powers applies to national bank operating subsidiaries. Under OCC regulations, national bank operating subsidiaries conduct their activities pursuant to the same authorization, terms, and conditions that apply to the conduct of those activities by their parent national bank, and are subject to state law only to the extent of their parent bank. Recent state efforts to examine and regulate mortgage lending "op subs" of national banks has led to litigation on this point that is currently ongoing in California. I am happy to report that, just last week, the federal district court in California upheld our regulations on this point and agreed with our position that the OCC has exclusive visitorial authority over national bank operating subsidiaries to the same extent as it has that authority over their parent national bank.

As has recently been the case in California, some state authorities have balked at recognizing the scope of the OCC's exclusive visitorial powers. Suggestions have been offered that the OCC's visitorial powers contain an unwritten distinction between safety and soundness and consumer protection laws and that the OCC's exclusive visitorial authority should be read as limited to safety and soundness issues. Even more remarkably, others have suggested that the ability of *states* to regulate *national banks* is a fundamental tenet of the dual banking system.

These suggestions lack support, and the latter assertion, in particular, has things utterly backward. Differences in national and state bank powers and in supervision and regulation of national and state banks are not inconsistent with the dual banking system; they are the defining characteristics of it. To the extent that state authorities resist or try to blur those distinctions, their actions, not the

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[16] Representative Samuel Hooper, who reported the bill to the House, stated in support of the legislation that one of its purposes was "to render the law [Currency Act] so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters." Cong. Globe, 38th Cong. 1st Sess. 1256 (March 23, 1864). While he did not believe that the legislation was necessarily harmful to the state bank system, he did "look upon the system of State banks as having outlived its usefulness. . . ." *Id.* Opponents of the legislation believed that it was intended to "take from the States . . . all authority whatsoever over their own State banks, and to vest that authority . . . in Washington. . . ." Cong. Globe, 38th Cong., 1st Sess. 1267 (March 24, 1864) (statement of Rep. Brooks). Rep. Brooks made that statement to support the idea that the legislation was intended to transfer control over banking from the states to the federal government. Given that the legislation's objective was to replace state banks with national banks, its passage would, in Rep. Brooks' opinion, mean that there would be no state banks left over which the states would have authority. Thus, by observing that the legislation was intended to take authority over state banks from the states, Rep. Brooks was not suggesting that the federal government would have authority over state banks; rather, he was explaining the bill in a context that assumed the demise of state banks. Rep. Pruyn opposed the bill stating that the legislation would "be the greatest blow yet inflicted upon the States. . . ." Cong. Globe, 38th Cong., 1st Sess. 1271 (March 24, 1864). See also John Wilson Million, "The Debate on the National Bank Act of 1863," 2 *Journal of Political Economy* 251, 267 (1893–94) regarding the Currency Act. ("Nothing can be more obvious from the debates than that the national system was to supersede the system of state banks.")

actions of the OCC, dilute the character of the dual banking system. Familiarity with a little bit of history helps a lot to understand this point in the context of the issue of visitorial powers.

At the beginning of the national banking system, both proponents and opponents of the new system expected that it would supersede the existing system of state banks.[16] Given this anticipated impact on *state* banks and the resulting diminution of control by the states over banking in general,[17] proponents of the national banking system were concerned that states would attempt to undermine it. Remarks of Senator Sumner in 1864, the first year of the national banking system, addressing the prospect of state taxation of national banks, illustrate the sentiment of many legislators of the time. He said, "[c]learly, the bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions."[18]

The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with this need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and vested responsibility to carry it out in the newly created OCC. Congress granted the OCC the broad authority "to make a thorough examination of all the affairs of [a national] bank,"[19] and solidified this federal supervisory authority by vesting the OCC with exclusive "visitorial" powers over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protected national banks from potential state hostility by establishing that the authority to examine national banks is vested *only* in the OCC, unless otherwise provided by federal law.[20]

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[17] *See, e.g., Tiffany* v. *National Bank of the State of Missouri,* 85 U.S. 409, 412–413 (1874) ("It cannot be doubted, in view of the purpose of Congress in providing for the organization of national banking associations, that it was intended to give them a firm footing in the different states where they might be located. It was expected they would come into competition with state banks, and it was intended to give them at least equal advantages in such competition. . . . National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks."). *See also* B. Hammond, *Banks and Politics in America from the Revolution to the Civil War,* 725–34 (1957); P. Studenski & H. Krooss, *Financial History of the United States,* 155 (1st ed. 1952).

[18] Cong. Globe, 38th Cong., 1st Sess., at 1893 (April 27, 1864). *See also Anderson* v. *H&R Block,* __ F.3d __, 2002 U.S. App. LEXIS 5978, at 15–16 (No. 01–11863, April 3, 2002) ("congressional debates amply demonstrate Congress's desire to protect national banks from state legislation").

[19] Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, codified at 12 USC 481.

[20] Writing shortly after the Currency Act and National Bank Act were enacted, then–Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that "Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments. . . ." Cong. Globe, 39th Cong., 1st Sess., Misc. Doc. No. 100, at 2 (April 23, 1866).

Courts have consistently recognized the distinct status of the national banking system and the limits placed on state involvement in national bank supervision and regulation by the National Bank Act. For example, in *Guthrie* v. *Harkness,*[21] the Supreme Court stated that

> Congress had in mind, in passing this section [section 484] that in other sections of the law it had made full and complete provision for investigation by the Comptroller of the Currency and examiners appointed by him, and, authorizing the appointment of a receiver, to take possession of the business with a view to winding up the affairs of the bank. It was the intention that this statute should contain a full code of provisions upon the subject, and that no state law or enactment should undertake to exercise the right of visitation over a national corporation. Except in so far as such corporation was liable to control in the courts of justice, this act was to be the full measure of visitorial power.[22]

The Supreme Court also has recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the Currency Act could develop and flourish. As the court stated in *Easton* v. *Iowa,*[23] the National Bank Act "has in view the erection of a system extending throughout the country, and independent, so far as the powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States. * * * If [the states] had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities."[24]

The court in *Farmers' and Mechanics' Bank,* similarly found that "States can exercise no control over [national banks] nor in any wise affect their operation, except in so far as Congress may see proper to permit." Any thing beyond this is "an abuse, because it is the usurpation of power which a single State cannot give."[25]

Consistent with the need for a uniform system of laws and uniform supervision that would foster the nationwide banking system, courts have interpreted the OCC's visitorial powers expansively.

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[21] 199 U.S. 148 (1905).

[22] *Id.* at 159.

[23] 188 U.S. 220 (1903).

[24] *Id.* at 229, 231–232 (emphasis added); *see also Marquette National Bank* v. *First of Omaha Service Corp.,* 439 U.S. 299, 314–315 (1978) ("Close examination of the National Bank Act of 1864, its legislative history, and its historical context makes clear that, . . . Congress intended to facilitate . . . a 'national banking system'." (citation omitted)); *Franklin National Bank of Franklin Square* v. *New York,* 347 U.S. 373, 375 (1954) ("The United States has set up a system of national banks as Federal instrumentalities to perform various functions such as providing circulating medium and government credit, as well as financing commerce and acting as private depositories."); *Davis* v. *Elmira Savings Bank,* 161 U.S. 275, 283 (1896) ("National banks are instrumentalities of the Federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States").

[25] *Farmers' and Mechanics' National Bank* v. *Dearing,* 91 U.S. 29, 34 (1875).

The Supreme Court in *Guthrie* noted that the term "visitorial" as used in section 484 derives from English common law, which used the term "visitation" to refer to the act of a superintending officer who visits a corporation to examine its manner of conducting business and enforce observance of the laws and regulations (citing *First National Bank of Youngstown* v. *Hughes*[26]).[27] "Visitors" of corporations "have power to keep them within the legitimate sphere of their operations, and to correct all abuses of authority, and to nullify all irregular proceedings." The *Guthrie* court also specifically noted that visitorial powers include bringing "judicial proceedings" against a corporation to enforce compliance with applicable law.[28] Thus, section 484 establishes the OCC as the exclusive regulator of the business of national banks, except where otherwise provided by federal law.

Congress affirmed the OCC's exclusive visitorial powers recently with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 (Riegle–Neal).[29] Although Riegle–Neal clarifies that interstate branches of national banks are subject to specified types of laws of a "host" state in which the bank has an interstate branch to the same extent as a bank based in that state, potentially including consumer protection laws—except when federal law preempts the application of such state laws to national banks—the statute then makes crystal clear that even where the state law is applicable, authority to enforce the law is vested in the OCC.[30]

While all this means that the national banking system and the state banking system are distinct—indeed the differences that I've discussed are at the very heart of the "dual" character of the dual banking system that we highly value today—the distinct character of the national banking system definitely does *not* mean that national banks operate with lesser standards or less rigorous oversight than generally applicable to state banks. While state laws and the resources of state supervisors necessarily will vary state-by-state, national banks are subject to rigorous standards and systemic supervision, administered from the federal level, that applies uniformly to their business, wherever and in whatever form, they conduct it.

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[26] 6 F. 737, 740 (6th Cir. 1881), *appeal dismissed,* 106 U.S. 523 (1883).

[27] *Guthrie,* 199 U.S. at 158. *See also Peoples Bank v. Williams,* 449 F. Supp. 254, 259 (W. D. Va. 1978) (visitorial powers involve the exercise of the right of inspection, superintendence, direction, or regulation over a bank's affairs).

[28] Enforcement through judicial proceedings was the most common—and perhaps exclusive—means of exercising the visitorial power to enforce compliance with applicable law at the time section 484 was enacted into law. Administrative actions were not widely used until well into the 20th century. Thus, by vesting the OCC with exclusive visitorial power, section 484 vests the OCC with the exclusive authority to enforce, whether through judicial or administrative proceedings.

[29] Pub. L. 103–328, 108 Stat. 2338 (September 29, 1994).

[30] *See* 12 USC 36(f)(1)(B) ("The provisions of any State law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency.").

We are recognized for our "sophisticated credit examination and risk management capabilities" by leaders in the banking industry,[31] and we have taken a leadership role in ensuring that the business practices of national banks are of the highest caliber. We not only have a progressive approach to bank powers to enable national banks to better serve their customers through new products and services and new technology, we also have taken a pioneering position to ensure national bank customers are treated fairly by using our cease-and-desist powers to prevent unfair or deceptive practices. National bank customers, as well as national banks themselves, are the beneficiaries of our regulatory and supervisory efforts.

We recognize that the OCC bears a heavy responsibility as administrator of the national banking system. The national banking system portion of the dual banking system is designed and premised on the OCC carrying out *multiple* responsibilities that trace to the agency's origins: ensuring the safety and soundness of national banks' operations, overseeing the standards by which national banks operate, and assuring that national banks are playing an appropriate role in the national economy. In this mix, the safety and soundness of national banks is of obvious importance, but so too is the fairness and integrity national banks display in conducting their business. As Judge Posner of the Seventh Circuit observed in *Central National Bank of Mattoon* v. *U.S. Dept. of the Treasury,* "[national] banks are [the Comptroller's] wards, and his only wards; if they fail in droves, he will be blamed."[32] And so too will the Comptroller's office be criticized if national banks fail to conduct their operations fairly and with integrity. And so, too, will the OCC be blamed if national banks fail to provide products and services that support a healthy, stable, and growing economy.

Conclusion

This journey from the roots of the national banking system, to the present-day issues we face at the OCC, provides context and the foundation for how we face those issues—and the future. The national banking system is a unique asset of the U.S. financial system and valuable pillar of our national economy. At the OCC, our responsibilities for overseeing the system are, in fact, multi-dimensional. As Carter Golembe put it in one of his famous commentaries—"to assure that national banks are safe and sound, competitive and profitable, and capable of serving in the best possible manner the banking needs of their customers."

Thank you very much.

[31] Kenneth Lewis, Chairman and Chief Executive Officer, Bank of America, "Regulatory Reform for the American People," presented to the FDIC Symposium on The Future of Financial Regulation, March 13, 2003.

[32] 912 F 2.2d 897, 905 (7th Cir. 1990).

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the Risk Management Association's Retail Risk Management Conference, on regulatory concerns about certain retail banking practices, Chicago, June 3, 2003

I am sure all your speakers begin their remarks by telling you how happy they are to be addressing you. I am no different in that respect, but I am particularly sincere in saying that, because this speech provides an opportunity to knit together several important subjects in the retail banking arena: the significance of the retail banking business today and some particular concerns we have with how it is being conducted; how those concerns interact with broader supervisory and regulatory policy perspectives of the OCC; and thoughts on potential consequences for the industry of the convergence of questionable retail banking practices with our supervisory and policy concerns and objectives.

We are talking about an enormously important segment of the banking business today. The consumer accounts for no less than two-thirds of all U.S. economic activity, and it's widely agreed that the extent to which consumer confidence bounces back—as it appears to be doing—after its recent decline, will go far in determining the magnitude and duration of the economy's recovery.

Consumer attitudes and behavior are also of profound importance to the banking system—and always have been. But consumer behavior now affects the financial services industry more directly than ever before. During the past two decades, the growth in loans to individuals—and the declining prominence of commercial and industrial loans—have been perhaps the most dramatic of the many changes that have occurred in bank portfolios. At the same time, banks have grown increasingly reliant on noninterest income, derived increasingly from their retail customers. In 1983, banks earned nearly $9 in interest income for every dollar of noninterest income. In 2001, the ratio was down to less than three to one.

So while unemployment rates, wage growth, housing prices, household debt burden, and other consumer-related measures have always been full of meaning for banks, they have never had a more immediate bearing on the industry's bottom line than they do today.

Given this reliance, one might assume that banks would be bending over backwards to cultivate and retain their retail customers. Indeed, some are—and the effort is usually well rewarded. But we have observed too many banks engaging in retail banking practices that are hard to defend, either from consumer protection or safety and soundness perspectives. Bankers who invent new fees to impose on consumer transactions, or who arbitrarily raise their existing fees, or who engage in fine-print sleight-of-hand about how those fees are calculated and applied, risk alienating customers and driving them into the arms of nonbank competitors.

The loss of retail customers *en masse* would be a serious blow to any business that depends upon them as much as depository institutions do today. But taking those customers for granted—or being insensitive to *their* needs and interests—presents additional risks to the industry. When retail customer practices by some institutions are abusive, unsavory, unfair, deceptive or unsafe, and unsound, those practices may provoke a legislative response—or a reaction from bank regulators—that will affect all the institutions engaged in that line of business. The result might be a loss of flexibility by all, and costly new burdens on an entire banking sector. And, in the broadest sense, consumer-unfriendly banking practices are counterproductive to the country's economic recovery.

I know that last point might strike some as a stretch. But when we were checking the latest report on consumer attitudes from the University of Michigan, we happened upon another report prepared by researchers at the same institution, which concluded that customer satisfaction was *the* most important leading indicator of consumer spending—more important than income changes and consumer confidence *combined.*

Think about that for a moment. If these researchers are right, then the *quality* of the interaction between consumers and merchants does more to determine whether that consumer keeps coming back for more—and continues to do his or her part to fuel the economy—than anything else. In other words, it appears that for a significant percentage of the American public, unpleasant, unproductive, or disillusioning retail experiences can have a chilling effect on future spending—depriving the economy of the stimulus from which it would otherwise benefit.

These macroeconomic considerations buttress the case for vigorous supervision of retail banking activities—for the benefit of banks *and* their customers—and for prompt and decisive supervisory intervention when we find patterns of conduct incompatible with safety and soundness, as well as with the letter and the spirit of consumer protection laws.

Unfortunately, questionable practices are not rare—especially in the credit card business, which generates more customer complaints than any other retail banking activity. That's been the case since the OCC began collecting and tabulating customer complaints relating to national banks in the late 1990s. But consumers with credit-card–related complaints have become more vociferous—and the issues they raise more serious—over the past several years.

Certainly the OCC has taken these complaints seriously—and has acted vigorously to combat the abuses that we discover. In 2000, we investigated charges that Providian National Bank was engaging in unfair and deceptive credit card marketing practices—practices that affected literally hundreds of thousands of customers. To resolve that dispute, Providian entered into a consent decree that not only assured that the practices we cited would come to a halt, but also provided hundreds of millions of dollars in restitution to customers who had suffered harm. In the last half of 2001, we arrived at similar consent decrees with two other national banks found to have engaged in "unfair and deceptive" practices in their credit card operations. And a fourth national bank whose business was predominantly credit-card–related was closed early in 2002 after its unsafe and unsound practices depleted its capital.

These actions, I think, demonstrated our strong commitment to protecting consumers, to upholding the reputation, as well as the safety and soundness of the national banking system, and to safeguarding the public interest. Yet, as already noted, there was continuing and growing evidence—reported both by consumers and our examiners—that the problems that I've just mentioned—and the practices that gave rise to them—were becoming sufficiently pervasive industry-wide to warrant a more comprehensive and systematic response.

That's why the OCC, along with the Federal Reserve, FDIC, and OTS, last year began to develop guidance focusing on account management practices for credit card lending—issues with safety and soundness as well as consumer protection implications. And this past January, the agencies issued new guidance intended to address those problems. The guidance is significant both for what it says, and because the agencies had to issue it in the first place. I'll talk about each of these points in turn.

The guidance aimed "to ensure that financial institutions conduct credit card lending in a safe and sound manner by establishing sound account management, risk management, and loss allowance practices." And it spelled out our specific expectations in each area of concern: credit line management, overlimit practices, minimum payments and negative amortization, workout and forbearance practices, and income recognition and loss allowance practices.

Our concern about **credit line management** stemmed from the growing number of card issuers extending and expanding credit without sufficient consideration of the cardholders' ability to repay. In some cases, having established a profitable relationship with a borrower, lenders have gone on to increase credit lines or to issue additional cards, including store-specific private label cards and affinity relationships cards, without considering how such extensions might affect that relationship or overextend the borrower's financial capabilities. It's not unheard of for institutions to offer additional cards even to borrowers who have *already* started to experience repayment problems.

The interagency guidance makes clear that lenders must manage credit line assignments and increases responsibly, using proven credit criteria. We expect institutions to test, analyze, and document line-assignment and line-increase criteria, and to establish and strengthen internal controls capable of determining the impact of additional credit lines on repayment capability.

Overlimit practices have been another matter of concern. We have found that account management practices that don't control the authorization or provide for timely repayment of overlimit amounts may significantly increase the credit risk profile of the portfolio—especially in the case of subprime accounts, where liberal overlimit tolerances and inadequate repayment requirements can magnify the high risk exposure to the lender.

The guidance stresses the importance of careful management of overlimit accounts, to ensure that bankers are able to identify, measure, manage, and control the risks associated with them. It puts banks on notice to restrict over limit accounts, particularly those that are subprime, and to subject them to appropriate policies and controls.

As regulators, we understand the competitive pressures under which banks operate today. And we understand why banks might see it as advantageous to adopt policies designed to maintain outstanding balances. But some institutions have crossed an important line: they've reduced minimum payment-due amounts on their cards to the point that they fall short of covering all finance charges and fees assessed during the billing period, so that the outstanding balance continues to grow through negative amortization. At the very least, minimum payments set at that level make very little progress in reducing the amount owed.

But such **minimum payment and negative amortization** practices also cross a regulatory line, as our guidance makes explicit. First, reduced minimum payments may have the effect (if not the intent) of masking declining credit quality and borrower impairment. Second, they dig borrowers into an ever deeper hole, requiring increasingly more difficult measures if borrowers are ever to pay their way out of debt.

For those reasons, we expect financial institutions to require minimum payments that will amortize the current balance over a reasonable period of time. Low minimum payments, especially when they result in negative amortization, are not consistent with the principle that consumer loans should be repaid within a reasonable period of time. As the guidance states, negative amortization, inappropriate fees, and other practices can compound or protract consumer debt and disguise portfolio performance. These practices raise safety and soundness concerns and are subject to examiner criticism.

Although it's only been in effect for several months, the guidance has already produced several positive results. It's promoted a greater understanding of the credit risk inherent in overlimit accounts, and has led to a strengthening of overlimit practices. It has generated a useful dialogue with the industry on the adequacy of minimum payments; some institutions that had inordinately reduced their minimums are in the process of raising minimum payments back in line with the industry. It has encouraged the adoption of improved income recognition and loss allowance practices, particularly for uncollectible accrued interest and fees.

But, as important as the content of the guidance is the fact that the guidance had to be issued in the first place. Allow me to elaborate on some lessons to be learned from this development.

At the OCC, we support the ability of national banks to conduct the banking business authorized under their federal charter, including the products they are allowed to offer and the fees they are allowed to charge for them. This assuredly does not mean, however, that we will tolerate abusive or sly consumer banking practices by national banks. We expect national banks to treat their customers fairly and to exhibit the highest standards of integrity in all their business operations. Given the importance of consumer banking business these days, this should be a business imperative. But, where banks fail to do so, we have, and we will take action.

In general, our approach has been to address particular *practices* by particular national banks. Typically, we have tackled unfair, deceptive, unsafe, or unsound practices on an institution-specific basis. We recognize that differences in conduct require different sanctions and solutions, and that, on the other hand, different banks could have different, but nevertheless appropriate ways of dealing with a particular consumer issue. Our system of comprehensive supervision of national banks enables us to address—and not overreact to—problems we identify. And, we have believed that approaching *practices* through our supervisory process enables us to more effectively deal with the circumstances presented by each bank, and to design solutions customized to the practices, operations, and risks presented by each bank.

What is notable about the account management guidance issued earlier this year is that it represents a departure from this approach. More telling is the reason why. To be blunt, some players in the industry have been tone-deaf on key issues. Despite the concerns we have expressed informally, despite the obvious importance of the consumer business segment, some industry participants have looked for any excuse to cut corners in customer treatment and drift to the lowest common denominator of account management practices. Banks should not need to have regulators instruct them on how to fairly treat their customers or fairly present their financial performance. Indeed, in today's post-Enron, post–Sarbanes–Oxley environment, managers of companies of all types should be bending over backwards to assure that presentation of their financial information best reflects the economic substance of their business. The fact that the agencies had to issue the account management guidance reflects a failure to "get it."

At the very least, enlightened self-interest should lead bankers to embrace best practices and condemn any outliers for not doing the same. The history of consumer regulation and legislation teaches a valuable lesson here: when some institutions persist in not "getting it," the consequences ultimately are felt by all institutions, when regulators—or Congress—react by setting comprehensive standards that apply to all.

Applying this lesson in the context of the account management guidance is important, because other issues remain, and to the extent the relevant industry continues not to "get it," the industry invites another response from regulators that the industry may well not like. On the question of minimum payments, for example, our guidance did not specify what might be a "reasonable period of time" for an outstanding balance to be amortized. That raises the question of whether the regulatory agencies should impose a limit on the amortization period or require disclosure of the length of time to repay the indebtedness if only the minimum payments are made.

Second, the guidance dealt with the question of negative amortization in the context of minimum payments. But, it can well be argued that negative amortization is a practice that should simply be eliminated. The question is how to do that. A minimum payment that is quite sufficient to amortize the debt alone might be inadequate if overlimit and late fees are added to the financed amount. That would leave financial institutions with two unpalatable choices: either raise the minimum amount or reduce fees.

Third, there are unresolved issues in connection with the repayment of overlimit amounts. Again, part of the problem is definitional: what constitutes "timely repayment" of such amounts, as called for in the guidance? Obviously, overlimit amounts should be subject to more stringent repayment requirements than the original balance. But having just undergone the process of writing and vetting comprehensive guidance, there is an understandable reluctance, on the parts of the industry and the agencies, to go through the process yet again if satisfactory results can be achieved instead through the supervisory process.

We believe that the supervisory process *can* produce satisfactory results. For the agencies' part, it requires that we clearly convey our expectations to management. In the coming weeks, our examiners will be doing just that. Whether we wind up having to do more will depend on the industry's response. This is a time for bankers to "get it"—to demonstrate leadership of their own by reforming their account management practices.

The interagency guidance—and my remarks—have detailed issues arising in connection with credit card lending. But I want to emphasize I could have been talking about other areas of retail banking: payday lending, skip payment plans, debt protection plans, overdraft protection plans. Each of these banking products has come under different degrees of criticism. By and large, many of these are not inherently bad or abusive products, and no one would expect bankers to deliver them without being compensated for their effort. Indeed, over the years the OCC has *encouraged* national banks to look to fee income as a way to diversify their income stream, in order to even out the oscillations in interest income that were so long a source of industry instability. The impressive strength of the banking sector during these trying economic times suggests that this strategy has borne fruit.

But continuing long-term success requires that as bankers pursue more fee-based products and services and enhanced noninterest income, they do so with particular consideration of fairness to customers and fair presentation of their financial performance. Much hinges on the decisions bankers will make regarding the terms on which their retail products are offered and the clarity and integrity with which the performance of those retail products is presented.

You face some important crossroads now in several retail product areas. You have the opportunity to establish a solid foundation for the long-term profitability and success of those products. If you don't, you undermine that foundation, and you enhance the likelihood that regulators will conclude that we need to act, again.

It's up to you.

Thank you very much.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the Risk USA 2003 Conference, on regulatory considerations in the evolution of risk management, Boston, June 10, 2003

I am delighted to be with you this morning and it's a particular honor to address this conference, which is deservedly described in your brochure as "North America's premier annual congress examining the latest innovations, trends, and methodologies for effective risk management and optimal derivatives trading." Having said that, I suspect many of you now may be wondering why one of your keynote speakers at such a conference is a bank regulator, and even worse, *a lawyer*. Regrettably, innovation and trend-setting are qualities not typically associated with either regulators or lawyers.

I hope I have a pleasant surprise in store for you. What I'll talk about this morning is the approach my agency—the Office of the Comptroller of the Currency (OCC)—has taken to the role of banks as financial intermediaries; how this approach has evolved; how it has enabled the national banks we regulate to become robust, vital and *successful and safe and sound* participants in the derivatives markets, and how we take supervisory and regulatory concerns into consideration when we evaluate proposals by national banks to engage in new facets of the derivatives business.

Brief Overview of Banks' Role in the Derivatives Business

At the risk of telling you some things you already know, allow me to provide a little background. First, my agency—the Office of the Comptroller of the Currency—does not print money; we regulate the national banking system, including most of our nation's largest, most complex and sophisticated banks. The largest of these banks are active participants in the derivatives business, and the growth of their business has been a significant component of the overall growth of derivatives markets.

Indeed, the phenomenal growth of derivatives has been one of the defining features of global capital markets over the past decade or two, and an increasingly important part of the commercial banking business worldwide. In 1990, total notionals held by U.S. banks was well under $10 trillion; in the first quarter of 2003, they stood at some *$61.4 trillion*, overwhelmingly in interest rate contracts. U.S. banks generated $3 billion in trading cash instruments and derivatives activities during that same three-month period—a tidy sum that reflects one of the better quarters in recent reporting time periods.

As bullish as these numbers are, they don't begin to tell the whole story. Indeed, for technical reasons, the actual profitability of derivatives trading is even greater than reflected in the reported numbers.

But for banks actively participating in the derivatives market—admittedly, still a relative handful—trading income is but one of the benefits they derive—icing on the cake, as it were. In a recent speech that deserved more attention than it received, Federal Reserve Board Chairman Alan Greenspan endorsed the view that much of the credit for the resilience of the financial system during the economic turbulence of past three years may belong to the improvements in risk measurement and management techniques in use at our leading banks. And of those improvements, he singled out the growing use of derivatives as of particular importance in assisting financial institutions in unbundling and managing financial risks. As a result, U.S. financial institutions were not only able to withstand the largest corporate defaults in history, and the largest sovereign default in history—Argentina—but are now poised to lend again as companies anticipate quickening demand for their products and services in a recovering economy. Derivatives, as a key risk management device, may thus have helped to play a decisive role in keeping the recent recession both shorter and milder than would otherwise have been the case.

Of course, derivatives continue to be controversial in some quarters. They haven't quite overcome the taint of association with Barings and Long Term Capital Management. Their complexity can be daunting. One investment banker famously observed that he had been "trying to explain [the subject] to my parents and my wife for nine years and they still don't understand it. I still have to assure my mother that what I do for a living is legal." Especially in inexperienced or unethical hands, the risks posed by derivatives are very real.

OCC's Approach to National Banks' Derivatives Activities

At the OCC, we have tried to view the derivatives business not in isolation, but rather as part of an overall approach to the business of banking, its safe and sound conduct, and the management of the risks associated with it. Banks are in the business of serving the needs of their customers, and the OCC has consistently taken the position that the national charter is a dynamic instrument for the delivery of bank products and services. When we authorize—indeed, before we authorize—national banks to undertake new banking activities, we also consider how those risks will be managed and mitigated. Banks are quintessential financial intermediaries and derivatives can play an important part in the risk-management strategies employed by financial institutions and their customers. Thus it was logical that banks would seek to enter the derivatives business, and as they did, it presented a new range of legal, regulatory, and supervisory considerations for the OCC.

We initially found national banks have authority to enter into derivatives, including swaps, options, and forwards, by looking to the nature of the investment on which the derivative was based. In those cases when national banks could own the underlying investment, we concluded banks may enter into derivatives with payments tied to the value of those investments. Based on these precedents, national banks were able to launch derivatives businesses that focused on management of interest rate and foreign exchange risks and price risk of particular precious metals.

Later, banks explored with the OCC the possibility of expanding their derivative business to include cash-settled derivatives based on the value of investments that banks generally cannot own, such as commodities (including oil, gas, and electricity) and certain securities (generally equities and some types of debt). Banks sought to provide customers with derivative products useful for managing risks of price fluctuations in those commodities or securities.

In reviewing these proposals, the OCC considered carefully the nature of the transactions and activities involved and determined that cash-settled derivatives with payments tied to the value of securities or commodities essentially involve exchanges of payments, similar to traditional banking activities. We also concluded that this line of business was fundamentally financial intermediation—a new form of banks' long-recognized role as financial intermediaries. I will have more to say about these precedents in a moment.

Today, as in the past, the OCC takes a favorable view of banks' efforts to conduct banking activities in new ways to respond to changing financial needs of customers. In this regard, we also support and *encourage* national banks in their well-established history of serving as leaders in the development of risk management and controls.

Legal Foundation for National Banks' Ability to Conduct Derivatives Activities

Now I get to the part where I explain how our legal positions actually have been constructive.

OCC legal precedents interpret banks' statutory authorities broadly, consistent with both the language and goals of the National Bank Act. We approach banking powers—guided by decisions of the U.S. Supreme Court—as not just the activities listed in the National Bank Act, but as including a more general authority to engage in the business of banking and incidental activities. Our precedents have permitted ever expanding and more sophisticated banking activities. At the same time, and of equal importance, we have developed supervisory guidance to ensure these activities are conducted safely and soundly and we have assembled a talented staff with outstanding expertise, who understand this business and take a risk-focused approach to applying that guidance to the banks they supervise.

Using the procedures, interpretations, and safeguards I have described, the OCC has permitted new and more efficient forms of hedging risk. Banks do not need to hedge each transaction, but can hedge on a portfolio basis to within appropriate risk limits.

The OCC also has permitted hedging with holdings that generally are not permissible for banks. Equity hedges are an example of this. Our decision to permit this new form of hedging was based on evidence from a national bank that conducting the hedges within the bank resulted in substantial savings and reduced operational and other risks arising from the bank's derivatives business. Our legal opinion was that the equity hedges are incidental to that business because they enable the bank to conduct the business more profitably and effectively.

Also permitted are new forms of settlement to allow banks to participate in a broader range of markets. Over the last year, the OCC issued two newsworthy rulings authorizing a national bank to engage in what appeared to be novel types of financial intermediation transactions. In the first case, a bank proposed to add transactions based on the price of electricity to its existing energy-related financial intermediation derivatives. In the second case, a bank proposed to expand its financial intermediation business to include customer-driven, electricity derivative transactions that involve transfers of title to electricity.

In both cases, however, there actually may have been less news than met the eye. The rulings were premised on a common set of assumptions—assumptions that have long been the foundation of our approach to bank powers generally.

First, we held that financial intermediation transactions involving commodities are authorized as part of the business of banking. We have previously recognized, in a variety of contexts, that commodity and commodity index derivatives are a modern form of traditional financial intermediation functions performed by banks. Based in part on that lineage, we have concluded that national banks may make payments to—or receive payments from—customers under commodity derivative contracts in the event of a gain or loss in a metal or energy product or index thereon. These derivative transactions thus have been recognized as permissible for national banks as a financial intermediation activity.

In these arrangements, national banks act as financial intermediaries between customers that want to manage risks resulting from the variations in the price of a particular commodity or commodity index. Customers do not deal directly with one another, but instead make payments to the intermediary bank. Under these authorities, the OCC has determined that national banks may engage in matched and unmatched commodity price index swaps, and manage and warehouse them on a portfolio basis.

Based on similar reasoning, we have permitted national banks to engage in various commodity-linked transactions involving oil, gas, other hydrocarbons, and metals. “Commodity-linked transactions” include making loans, taking deposits, and issuing debt instruments having terms related to commodity prices, sales, or indices, or measured in relation to the future; and entering into swaps, forwards, and other transactions relating to commodity prices and indices, or combinations thereof, in order to assist bank customers in managing their financial exposures.

The second assumption behind our recent approvals was that the electricity derivatives business is the functional equivalent of other commodity derivatives transactions that the OCC has previously determined are permissible for national banks. They are privately negotiated contracts between the parties to the transaction, individually tailored to the specific risk sensitivities of the customers. The parties agree to make payments based on the performance of a particular commodity or commodity index, whether the commodity is a hydrocarbon or a foodstuff.

Third, again, the OCC has long recognized that using derivatives to hedge against the risks associated with bank permissible activities is an integral part of those permissible banking activities. We have determined that national banks may hedge bank permissible commodity derivative transactions with *other* commodity derivatives, such as futures, and swaps and options and other over-the-counter instruments, when conducted in a safe and sound manner as provided in OCC guidance. Hence, as with other commodity derivatives, national banks may hedge bank-permissible electricity derivative transactions with electricity futures, and swaps and options and over-the-counter derivative instruments. Further, we have specifically endorsed the hedging of commodity transactions on a transaction-by-transaction or portfolio basis.

How Supervisory Considerations Intersect with Legal Standards

Perhaps most important, the approval I have described was predicated on the requirement that electricity derivatives—like all financial intermediation transactions that we approve—will be conducted in a safe and sound manner. That is, just because the proposed activity may closely resemble a previously approved activity does not mean that it will automatically qualify for approval itself. Such activities require sophisticated risk measurement and management capacities on the part of a bank, as well as qualified personnel, in order for the activity to operate in a safe and sound manner.

Thus, in order for us to reach the conclusion that the proposed activity was permissible for the bank, the bank was required to demonstrate to the OCC's satisfaction that it had established appropriate risk measurement and management processes—including board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function. In other words, we did *not* reach a general conclusion that the activity was permissible for every national bank. We explicitly linked our conclusion about legal permissibility with our supervisory conclusion about the capacity and expertise of the particular bank to conduct the business in question.

But the Enron debacle and other events that led to the passage of the Sarbanes–Oxley Act reminded us that risk management is not just about financial exposure; it is also about reputation risk. There was time when some questioned why the OCC included "reputation risk" as one of the types of risks that we evaluate in our supervision of national banks. We don't hear that much any more. Certainly many shareholders would agree that events of the last two years have shown that an institution's corporate reputation has a significant economic value.

We recognize that when national banks engage in complex structured transactions involving derivatives, issues concerning the appropriateness of a transaction may arise. Thus, in our review of a bank's risk management approval process, we look to see how the bank evaluates that consideration, in other words, what it does to protect its good name in choosing the transactions it is willing to conduct and the parties with which it is willing to do business. We expect that banks involved in complex structured transactions involving derivatives will subject those transactions to review and oversight through their risk management oversight process to ensure that transactions conform to the bank's standards of appropriateness and integrity.

We look to see if committees independent of the sponsoring business review the complex structured transactions. In addition, we look to see whether the bank has a process by which it will evaluate the purpose of a transaction to assess whether a client has attempted to achieve a financial statement objective that could be construed as materially misrepresenting its financial condition, even if in conformance with generally accepted accounting principles. And, where such could be the case, we look for an undertaking from the bank to take appropriate steps, including declining to participate in the transaction, or requiring its counterparty to make appropriate disclosures concerning the nature and impact of the transaction on the financial position, so that there will be no misperception of the transaction's purpose and effect.

Conclusion

As I have recounted, the derivatives markets play a vital role in the management and intermediation of risk in our financial system, and the participation of banks, in their natural role as financial intermediaries, has, and should continue to, grow. Whether and how much it does, will be influenced by whether regulators—or legislators or government officials—feel the need to intervene to affect the way the business is conducted. And that, in turn, will depend to an important extent on how well *you,* and other industry participants, help to ensure that, in your derivatives business, appropriate attention is paid to both financial and reputation risk.

What does all this presage for the future of banks as participants in this business? The OCC expects that national banks' role as financial intermediaries will continue to grow and evolve in response to customer financial risk management needs and market developments. We view these developments favorably. We support national banks' efforts to better serve customers with new and innovative products. We will continue to strive to take a risk-focused approach to our supervisory responsibilities. But one thing *we will insist on* is that this evolution of activities continues to be coupled with appropriate financial risk controls, and internal checks and balances to ensure that these activities are conducted with integrity and due regard for the bank's good name.

Thank you very much.

Remarks by Mark A. Nishan, Chief of Staff, before the Urban Financial Services Coalition, on improving financial literacy, Washington, D.C., May 29, 2003

It's a distinct and unexpected honor to address the Urban Financial Services Coalition—an organization that's literally been responsible for changing the face of the industry that we serve in our various capacities.

As you know, I'm standing in for Sam Golden, the OCC's Ombudsman, who's grounded at home in Houston, doing his bit to ensure that our agency's operational continuity is safeguarded during the current national security alert. I know that Sam is very disappointed that he's not able to join you today, and I know how much you'd have enjoyed hearing from him. But I'll do my best not to let you—or Sam—down.

After visiting with many of you last night, I already feel as though I'm in the presence of friends. We share many of the same goals, and none is more important—or challenging—than improving the state of financial literacy in our country.

There's no disputing that people who have been through well-designed and well-executed financial education programs are more likely to make sound economic choices, now and in their future. They are more likely to own their own homes and to keep them, with all of the social and economic advantages that go with homeownership. They're more likely to accumulate assets and less likely to be burdened by excessive debt.

As former Treasury Secretary Paul O'Neill said, "Ownership, independence, and access to wealth should not be the privilege of a few. They should be the hope of every American. And financial literacy is an essential tool to make that hope a reality."

The students who are with us today as participants in the coalition's asset-building program are taking important steps toward acquiring that tool—along with the skills to use it intelligently and productively.

When I was growing up on the streets of New York, financial literacy was something you picked up along the way—like a good stickball swing. No one taught you how to do it, least of all in school. We learned how to handle money—to the extent we *had* any—and learned about making financial decisions from our parents and from watching others either succeeding or failing in their financial lives.

It was a hit-or-miss proposition. And many missed—judging by the large numbers of people who might have possessed all the prerequisites for success, but who never had a chance to put them to use, for society's betterment and their own. That's because they were forever scrambling to pay the rent, put food on the table, and keep the bill collector at bay. I knew more than my share of people who fit that description, and I'm sure you did, too.

I was more fortunate. Although by no means affluent, my parents, neither of whom went to college, were my role models. They taught me the importance of education and discipline, self-confidence and humility, responsibility, and modesty. They taught me to accumulate assets whose value would grow instead of more stuff that would never again be worth what it cost. Somehow—because I don't remember paying much conscious attention to their words—some of what they told me evidently sunk in.

Today, we would call the advice my parents gave me a recipe for wealth building. But as logical as it seemed then and as logical as it still seems today, it's probably harder for young people to live up to that ideal amidst today's runaway materialism than it was when I was growing up when there was a lot less "stuff" to be had. Today, the temptations to consume rather than save are everywhere.

On the other hand, as I mentioned, we didn't have the tools or the expertise available to us today, and in that respect, you who are still in high school have a leg up on us old-timers. It was not very long ago that "buyer beware" was the rule of the marketplace. Government assumed a very minimal rule in assuring fair play, and companies, including financial services companies, had only their consciences watching over them to keep them on the straight-and-narrow. For many, the lure of profit proved far stronger than the Golden Rule.

It's remarkable to reflect on how much has changed in this regard. First, financial institutions themselves have discovered the benefits—for themselves as well as for their customers—of taking a direct hand in sponsoring, organizing, and delivering financial literacy programs. According to surveys by the Consumer Bankers Association, nearly all banks contribute to the war on financial illiteracy in some way, with more than half serving as primary sponsors of the programs in which they participated.

I was delighted to see that national banks—those chartered and supervised by the OCC—rank prominently on the list of the Coalition's sponsors, which means that they are also actively supporting the financial literacy activities that we're honoring at this luncheon. Such activities have not only helped millions of Americans become smarter financial consumers, they have earned the banking industry tremendous respect and good will. It should serve to remind us that altruism in combination with self-interest can be a potent force for good.

The role of government has also been decisively transformed. Today, agencies like the OCC are active agents in the effort to protect consumers from abusive business practices and to arm consumers with the information they need to make intelligent financial decisions for their own benefit.

At the OCC, we do this in various ways. We do it by enforcing the laws that bar unfair or abusive practices. We do it by ensuring that regulated institutions make clear and complete disclosure of the terms governing financial relationships, as provided by law and regulation.

We do it by providing consumers with outlets for resolving disputes with their banks. We do it by providing both positive and negative incentives to financial institutions to offer products and services that meet community needs. We do it by encouraging banks to participate in financial literacy programs, as described above. And, last but not least, we do it by participating in those financial literacy programs ourselves.

As an example of that participation, I would mention the OCC's contribution to the cause of financial literacy through our relationship—of which Sam Golden is the OCC's sponsor—with the National Academy Foundation and its subsidiary, Academy of Finance.

The NAF, for those of you who may not be familiar with its work, is a nonprofit dedicated to preparing young people for careers in the fields of finance, travel and tourism, and information technology. And not just any young people: 95 percent of the academies are located in inner city high schools.

The OCC's partnership with NAF—and we are one of only four federal agencies to have formally entered into such a partnership—has been responsible for placing hundreds of students in internship opportunities at OCC offices around the country, as well as at the financial institutions that participate in the program. Those institutions are eligible to receive favorable consideration for their contributions under the Community Reinvestment Act.

But bankers tell us that currying favor with regulators is not the main reason why they participate in NAF programs. They do it because they believe it's good business to cultivate talented young people, to demonstrate their commitment to diversity, and to identify their employees of the future. I could not agree more. Good deeds and good business *can* go hand in hand.

Another way the OCC aids in the financial literacy effort is through our Customer Assistance Group, or CAG, which is co-located with the Office of the Ombudsman in Houston. The CAG's goal is to give national bank customers an impartial, sympathetic ear, and a place to turn when they have a problem or a complaint.

We often find that the problem is the result of simple misunderstanding, and when it is, we can usually facilitate a simple resolution. On other occasions, the bank may have failed to live up to its legal and regulatory responsibilities—usually inadvertently, but sometimes as a more deliberate matter. When that occurs, we instruct the bank to correct its practices. And when we see systematic patterns of neglect or abuse, we may make referrals to our examination and legal staff for follow-up action.

But the CAG serves another, less visible function that, to my mind, is just as important as the conflict- and dispute-resolution services we provide to bank customers. Larger financial institutions often commission extensive (and expensive) market research to provide them with feedback on how well they're meeting their customers' needs. What comes back to them can be invaluable.

Yet, the possibility of conflict of interest can never be ruled out. It stands to reason that if a bank has a serious customer-relations problem, bank contractors and employees may not be the best sources to consult about it.

The CAG gives banks another piece of the puzzle—and gives it to them straight, unfiltered and unvarnished. Customer complaint data offer banks an opportunity to identify and address potential and existing problems, and thus to avoid the consequences of problems that go undetected and uncorrected.

To cite just one example, when banks fail to take customer dissatisfaction seriously, they face reputation risk that can cost them dearly in customers and in the revenue those customers generate. That would probably not have been so serious decades ago, when commercial banks were primarily in the business of making commercial loans.

But today, as you know, commercial banks depend on interest and noninterest income from retail banking products far more than ever before. Banks have to work to maintain and expand their retail customer base, and information supplied by the OCC and CAG can be of great value in that enterprise.

We find it gratifying that many national banks have taken these lessons to heart. Banks throughout the country are discovering that it's good business to keep customers satisfied, because satisfied customers are much less likely to become someone *else's* customers.

- It's also good business to keep customers informed of changes in bank policies *beyond* minimum regulatory requirements.

- It's good business for banks to train bank employees so that they're able to provide clear explanations of bank policies when customers express confusion.

- It's good business for banks to make good-faith attempts to evaluate customer complaints on their merits—especially when the cost of resolving the complaint to the customer's satisfaction is less than the cost of fighting it.

- It's good business for banks to go the extra mile—beyond what the laws and regulations require—to safeguard the privacy of customer information, to maintain service fees at reasonable levels, and to steer clear of products and services that might be viewed as abusive.

- And, once again, it's good business for banks to join in the effort to make bank customers *smarter* consumers, through financial literacy programs.

Of course, while many banks have internalized these lessons, others haven't, and the OCC has taken decisive action against those few bad actors that give the rest of the industry a bad name. Utilizing our authority under banking law and the Federal Trade Commission Act, we have taken action against a number of institutions that engaged in false or deceptive practices, requiring them to desist from those practices and to provide restitution ranging into the hundreds of millions of dollars to customers who were harmed by those practices.

Obviously, government has an important role to play in policing the financial services marketplace, and I think that the OCC, over its 140-year history, has fulfilled that responsibility with considerable distinction.

But government cannot be everywhere, and most of us wouldn't want it to be. Ultimately, in a free society, we depend upon individuals to make sound and rational choices in their own best interest. For that we depend on individuals having skills and knowledge equal to our increasingly complex and demanding society.

That's where each of you—and the Coalition—come in. Working together, with the government and the private sector each playing their respective parts, we can make giant strides toward improving the financial literacy of all of our citizens—and in so doing, help build a more prosperous and more productive America.

Thank you.

Interpretations—April 1 to June 30, 2003

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Interpretive Letters

960—February 28, 2003

12 CFR 14

Ms. Beth L. Climo
Executive Director
American Bankers Insurance Association
1120 Connecticut Avenue, NW
Washington, DC 20036

Mr. James D. McLaughlin
Director
Regulatory and Trust Affairs
American Bankers Association
1120 Connecticut Avenue, NW
Washington, DC 20036

Re: Insurance Consumer Protection Rules

Dear Ms. Climo and Mr. McLaughlin:

This is in response to your letter dated March 6, 2002, in which you requested our agencies to clarify the position we expressed in our August 17, 2001, letter concerning the applicability of the disclosure requirements in section 305 of the Gramm–Leach–Bliley Act[1] ("GLBA") and our insurance consumer protection regulations[2] to renewals of insurance policies sold prior to October 1, 2001 ("pre-existing policies"). Your request provided additional information concerning the feasibility and practicality of providing the insurance and credit disclosures in connection with renewals of pre-existing policies.

Our August 17, 2001, letter stated that while other sections of the agencies' regulations implementing section 305 of the GLBA apply to renewals, the disclosure requirements in 12 CFR 14.40, 208.84, 343.40, and 536.40 do not apply to renewals. However, the letter also indicated that these disclosures "should be made" to customers at the time of the first renewal if a policy was initially sold before the rule's effective date (October 1, 2001), and the consumer did not receive the disclosures at the initial sale. You expressed concern in your March 6 letter that this position posed significant practical difficulties for depository institutions.

You also stated in your March 6 letter that nothing in section 305 of the GLBA suggests that the insurance and credit disclosures are required in connection with renewals of pre-existing policies.

[1] 12 USC 1831x.

[2] 12 CFR Parts 14, 208, 343, and 536.

In supplementary materials submitted by Ms. Climo on June 12, 2002, you reiterated your position that section 305 of the GLBA by its terms does not necessarily require that the insurance and credit disclosures be made in connection with renewals of pre-existing policies. In addition, you provided a detailed explanation as to why it would be difficult for depository institutions to make the disclosures in connection with renewals of pre-existing policies. You stated that a depository institution typically has no contact with the customer after the depository institution sells the customer an insurance policy, and the underwriter (or its agent) completes the renewal of an insurance policy.

In addition, you noted that a depository institution usually does not have lists of customers who purchased insurance offered by an agent who solicited on behalf of the depository institution prior to October 1, 2001, nor do agents that sold insurance policies prior to October 1, 2001, on behalf of a depository institution always track the source of their insurance business after the policies are in effect. You advised us that it would be very difficult, or impossible, for an agency to examine its records and determine solicitations and sales on behalf of a depository institution.

On the basis of this additional information, as well as the terms of section 305 of the GLBA itself, this is to clarify that our implementing regulations do not *mandate* disclosures for renewals of policies sold prior to October 1, 2001. Accordingly, in our view section 47(c)(1) of the Federal Deposit Insurance Act, 12 USC 1831x, as added by section 305 of the GLBA, and our implementing regulations at 12 CFR 14.40, 208.84, 343.40, and 536.40, do not require that the disclosures be furnished at the time of renewal of a policy, including a pre-existing policy. Renewals, however, continue to be subject to the other provisions of section 305 of GLBA and the agencies' regulations. Moreover, we also expect that, consistent with applicable safety and soundness requirements, depository institutions will take reasonable steps to avoid customer confusion in connection with renewals of pre-existing policies.

We hope that this clarification is helpful and responds to the concerns you have expressed on behalf of your members.

J. Virgil Mattingly, Jr., General Counsel
Board of Governors of the Federal Reserve System

William F. Kroener, III, General Counsel
Federal Deposit Insurance Corporation

Julie L. Williams, First Senior Deputy
Comptroller and Chief Counsel
Office of the Comptroller of the Currency

Carolyn J. Buck, Chief Counsel
Office of Thrift Supervision

961—March 17, 2003

12 USC 24(7)

Subject: Hedging Risks of DPC Stock Holdings

Dear [ ]:

This is in response to your letter of March 5, 2002, requesting confirmation that [ ] (the "bank") may buy and sell options on the shares of stock of a company when the bank has acquired shares of the company in satisfaction of debts previously contracted ("DPC shares"). The bank would buy and sell the options to hedge the market risk associated with changes in the value of DPC shares. For the reasons discussed below and subject to the limitations described herein, we believe that the proposed hedging activity is permissible for the bank.

Background

In carry out its lending activities, the bank sometimes receives DPC shares as part of contractual workout arrangements. The terms of the workout arrangements sometimes restrict the ability of the bank to dispose of the DPC shares it receives.[1] The bank believes it would be prudent to hedge the risks of holding DPC shares against fluctuations in market value. The bank proposes to use a hedging strategy known as a "butterfly option." Under this hedging strategy, at the time the bank receives DPC shares, the bank will (1) buy a "put" option at a strike price lower than the current market price of the DPC shares and (2) sell a "call" option at a strike price higher than the current market price of the DPC shares. The bank's management believes this hedging strategy will reduce market risk.[2]

The bank commits that it will use the options solely to hedge risk of DPC shares and will not engage in speculation. The bank plans to purchase the butterfly options at the time the bank acquires the DPC shares and anticipates holding the options without adjustment until it disposes of the DPC shares.[3] The bank represents that it will not take anticipatory short positions or maintain residual positions in the options that do not operate as a hedge of market exposure in DPC shares, except as necessary to the orderly taking or unwinding of a hedging position.

[1] The bank sometimes also may acquire DPC shares that have limited marketability for other reasons. For example, the shares may be thinly traded or their transfer may be restricted under the federal securities laws.

[2] The amount the bank receives for selling the call offsets in part the amount the bank pays for purchasing the put. The butterfly thus allows the bank to receive protection against market declines at a reduced cost.

[3] Should the bank wish to change its planned procedures for purchasing and holding the options, the bank should confer with its examiner-in-charge ("EIC") prior to making such a change.

Discussion

National banks are authorized to lend under express authorities in the National Bank Act and as part of the business of banking. They may acquire securities, including shares of stock, through foreclosure or otherwise in the ordinary course of collecting a debt previously contracted (DPC). Such securities may be held for up to five years unless the OCC extends the holding period for up to another five years.[4] Hedging risks arising from that permissible banking activity is an essential and integral part of that banking activity. In our opinion, the bank may buy and sell options as a technique to hedge its market exposures from DPC shares, provided that the bank establishes an appropriate risk measurement and management and compliance process to conduct such hedging activities. This process is necessary for the bank to achieve its risk management objectives in a safe and sound manner and, thus, must be established before the OCC can determine that the proposed activities are convenient and useful in conducting permissible banking activities and thereby permissible as an activity incidental to the business of banking.

A. The National Bank Act ("Act")

A national bank may engage in activities pursuant to 12 USC 24(Seventh) if the activities are part of, or incidental to, the business of banking. Section 24(Seventh) expressly provides that national banks shall have the power:

> To exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.[5]

The Supreme Court has held that this authority is a broad grant of power to engage in the business of banking, including, but not limited to, the five enumerated powers and in the business of banking as a whole. [6] National banks also are authorized to engage in an activity that is incidental

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[4] *See* OCC Interpretive Letter No. 643 (July 1, 1992), *reprinted* in [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,551; OCC Interpretive Letter No. 511 (June 20, 1990), *reprinted* in [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,213.

[5] 12 USC 24(Seventh).

[6] *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*VALIC*"). Judicial cases affirming OCC interpretations establish that an activity is within the scope of the "business of banking" if the activity: [1] is functionally equivalent to or a logical outgrowth of a traditional banking activity; [2] would respond to customer needs or otherwise benefit the bank or its customers; and [3] involves risks similar to those already assumed by banks. *See, e.g., Merchant Bank* v. *State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp.* v. *Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Circuit 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Assn*. v. *Clarke*, 865 F.2d 278, 282 (2d Circuit 1988). In *IAA* v. *Hawke*, 211 F.3d 638 (D.C. Circuit 2000), the court expressed the position that the "logical outgrowth" rationale needed to be kept within bounds, but endorsed the "functional equivalent" component of the test.

to the performance of the five enumerated powers *or* incidental to the performance of an activity that is part of the business of banking.[7] Incidental activities are activities that are permissible for national banks, not because they are part of the powers expressly authorized for banks or the "business of banking," but rather because they are "convenient" or "useful" to those activities.[8]

B. Making Loans and Hedging the Associated Risks Are Part of the Business of Banking

Making loans is an express power listed in the National Bank Act and is recognized as a core part of the business of banking.[9] Lending involves risks that banks must manage as part of the business of banking. Banks hedge loans as a means of managing those risks.[10] The OCC has long recognized that hedging the risks associated with bank-permissible lending activities is an integral part of those permissible banking activities. National banks hedge against the risk of loss due to the interest rate fluctuations inherent in their own loan operations.[11] National banks also hedge

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[7] *VALIC, supra,* at 253.

[8] The leading case defining when an activity is authorized as "incidental" under section 24(Seventh) is *Arnold Tours, Inc.* v. *Camp,* 472 F.2d 427, 431–32 (1st Circuit 1972). In that decision, the First Circuit held that the term "necessary" in section 24(Seventh) should be broadly construed to encompass "incidental" activities that are "convenient or useful" to an expressly enumerated power. The Supreme Court later clarified in *VALIC* that these incidental powers include activities that are convenient and useful to the business of banking as well as those that are convenient and useful to the expressly enumerated powers under the National Bank Act. See *VALIC, supra.* Recently, the Ninth Circuit confirmed that these incidental powers should be broadly construed, stating that "[t]he incidental powers of national banks are thus not limited to activities deemed essential to the exercise of enumerated powers but include activities closely related to banking and useful in carrying out the business of banking." *Bank of America* v. *San Francisco,* 309 F.3d 551, 562 (9th Circuit 2002)

[9] 12 USC 24(Seventh). The National Bank Act provides, in pertinent part, that national banks shall have the power "[t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; . . . by loaning money on personal security." *Id.* This power is often referred to generally as a national bank's lending authority.

[10] OCC Interpretive Letter No. 896 (August 21, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–415 ("agricultural loan hedge letter"). Other banking activities also involve risks that banks must manage as part of the business of banking. *See, e.g.* OCC Interpretive Letter No. 892 (September 13, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–411 ("equity hedge letter") (national bank may hedge risk of derivatives activities by purchasing equity securities); U.S. General Accounting Office, *Equity Hedging—Report to the Honorable James A. Leach, House of Representatives*, GAO–01–945 (August 2001); *Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Investment Deposit Account* (August 8, 1988) ("*MII Deposit*") (national bank may buy and sell futures on the Standard & Poor's ("S&P") 500 Index to hedge deposits with interest rates tied to the S&P 500 Index).

[11] *Comptroller's Handbook,* "Mortgage Banking" (March 1996); OCC letter to Gregory Crane (October 26, 1976); OCC letter to Alan E. Rothenberg, vice president, Bank of America, from Robert Bloom, first deputy comptroller (Policy) (October 11, 1976). Similarly, the Department of the Treasury recognizes that interest rate risk of fixed-rate loans can be neutralized by hedging with appropriate interest rate swap, forward, futures, or option contracts. Department of the Treasury, Banking Industry—Trends and Current Issues: Report titled "Modernizing the Financial System" (November 6, 1995).

bank loans to minimize the credit risk in those transactions.[12] As discussed below, hedging these lending risks by buying and selling options on DPC shares can be part of a bank's permissible lending activities.

C. Buying and Selling Options to Hedge Market Risk on DPC Shares as an Activity That is Incidental to the Business of Banking

Section 24(Seventh) authorizes national banks to engage in "all such incidental powers" as shall be necessary to carry on the "business of banking."[13] An activity is incidental to the business of banking if it is "convenient" or "useful" to an expressly enumerated power or to the business of banking as a whole.[14]

1. Hedging through options can be an effective hedging strategy.

The bank has demonstrated that the proposed option hedging can be an effective hedging strategy. For example, if the market price of DPC shares falls, the bank could exercise its put option and receive cash equal to the strike price of DPC shares. Thus, the proposed hedging can facilitate and improve the bank's ability to reduce credit exposures to its borrowers by protecting the value of DPC shares it receives in a workout.[15]

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[12] OCC Banking Bulletin 96–43: Credit Derivatives, Guidelines for National Banks (August 12, 1996); OCC Interpretive Letter No. 356 (January 7, 1986), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,526. In addition, national banks may assist customers in hedging their own loans against cash market risks, by obtaining, or by assisting customers in obtaining, hedging instruments. OCC letter to Jeffrey S. Lillien, The First National Bank of Chicago (June 13, 1986); OCC letter to Randall R. Kaplan, Caplin & Drysdale from Judith A. Walter, senior comptroller (June 13, 1986); OCC letter to Thomas N. Rose, Eldredge & Clark, from Michael A. Mancusi, senior deputy comptroller for National Bank Operations (November 5, 1985).

[13] 12 USC 24(Seventh).

[14] In considering whether an activity is "convenient" or "useful" and therefore "incidental" to the business of banking, the OCC may consider whether the activity facilitates the operations of the bank as a banking enterprise, enhances the efficiency or quality of the content or delivery of banking services of products, optimizes the use and value of a bank's facilities and competencies, or enables the bank to avoid economic waste in its banking franchise. *See* OCC Interpretive Letter No. 845 (Oct. 20, 1998), *reprinted* in [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,300. *See also* 12 CFR 7.5001(d).

[15] The OCC also permits national banks to engage in certain activities to preserve the value of their real estate DPC property. For example, national banks can make necessary advances to run a business and thereby preserve its going concern value when the business is acquired to secure or collect debt previously contracted. *See* 12 CFR 34.86; OCC Interpretive Letter No. 576 (March 27, 1992) *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,346; OCC Interpretive Letter No. 12 (December 7, 1977) *reprinted in* [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,087.

2. The proposed equity hedging is similar to activities the OCC has previously approved as convenient and useful to bank permissible activities.

The OCC also has long permitted national banks to use futures, options, and options on futures to manage or "hedge" risks arising from permissible banking activities. The OCC has recognized the permissibility of such activities both for the purpose of providing bank customers with the ability to hedge their own risks and as a means for banks to hedge directly the risks that arise from permissible banking activities.[16] For example, in 2000, the OCC considered a proposal to hedge the risk in a bank's agricultural loans by purchasing cash-settled options on futures on commodities that serve as the primary collateral for the loans. The OCC determined that using options on futures contracts on agricultural commodities to hedge bank-permissible lending activities is permissible for national banks.[17] However, the OCC would not permit the bank to engage in the proposed activity until it had an appropriate risk management process in place.[18]

The proposed options hedges are similar to equity hedges the OCC has previously approved for certain national banks as convenient and useful to bank-permissible activities. The OCC has determined that, subject to specified conditions and standards, the national banks could purchase and hold equity securities to hedge risks arising from permissible equity derivative transactions.[19] The OCC concluded that the equity hedges provided the national banks in question with a cost-ef-

[16] *See* OCC Interpretive Letter No. 356, *supra* (bank registered as a futures commission merchant could execute customer orders for agricultural and metals futures in connection with its loans to the customers); *MII Deposit*, *supra*, (bank could offer a deposit with a rate of return based in part on the return on a stock index and could hedge the bank's interest rate risk by purchasing futures on that stock index); OCC Interpretive Letter No. 937 (May 14, 2002) *reprinted in* [2001–2002 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,462 (bank could hedge risks arising from intermediation transactions based on electricity prices); OCC No Objection Letter No. 87–5 (July 20, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 (bank could act as principal in commodity price index swaps with its customers); OCC No Objection Letter 90–1 (February 16, 1990), *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095 (bank could act as principal in unmatched commodity price index swaps with its customers and hedge its price risk exposure using exchange-traded commodity futures); OCC letter from Horace G. Sneed, senior attorney, Legal Advisory Services Division (March 2, 1992) (unpublished) (bank could manage its commodity index swaps on a portfolio basis and hedge the swaps with swaps, exchange–traded futures, or over-the-counter (OTC) options; OCC Interpretive Letter No. 652 (September 13, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600 (bank could engage in equity and equity derivative swaps and hedge risk using futures contracts, options, and similar OTC instruments).

[17] Agricultural loan hedge letter, supra.

[18] *Id.*

[19] Similarly, the OCC has determined that national banks may take physical delivery of commodities to hedge bank-permissible commodity-linked derivative transactions as a convenient and useful means to manage the risks arising from those permissible banking transactions. OCC Interpretive Letter Nos. 632 and 684, *supra*.

fective means to hedge risks arising from customer-driven equity derivative transactions and thus were a convenient and useful activity incidental to the business of banking for those banks.[20]

The OCC also has permitted national banks to hedge obligations to make payments on bank-permissible employee compensation and benefit plans with incidental life insurance.[21] The OCC later concluded that it was convenient and useful for a national bank to hedge an employee compensation program with bank–impermissible insurance company products and investments because the hedge virtually eliminated all the risk arising under the program to the bank.[22]

In each case cited above, the hedging instrument was viewed as an asset held incidental to a permissible banking activity in order to hedge the bank's risks or obligations, rather than as a security held by the bank for investment. The transactions were used to manage risks arising from otherwise bank-permissible banking activities and not entered into for speculative purposes. In much the same manner, incidental to the express permissible banking activity of lending, the bank would buy and sell options on equity securities for the sole purpose of hedging its market risk on DPC shares. This conclusion is consistent with the foregoing OCC precedents permitting bank-impermissible investments for hedging purposes to manage risks arising from permissible banking activities.

3. The hedging must be conducted in a safe and sound manner.

Buying and selling options for the stated purpose of hedging market exposures on DPC securities does not automatically qualify that activity as an activity that is incidental to banking, however. The nature of the hedging activity proposed requires specialized risk measurement and management capacities on the part of a bank, and qualified personnel, in order for the activity to be conducted so it will actually perform the function of hedging market risks. Thus, in order for the proposed activity to be permissible for the bank because it is "convenient" or "useful" to conducting authorized banking activities, the bank must establish an appropriate risk measurement and management process for its DPC share hedging activity in accordance with applicable require-

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[20] *See* equity hedge letter, *supra*. *See also* OCC Interpretive Letter No. 684, *supra* (national banks may take physical delivery of equities and commodities to hedge bank-permissible derivative transactions as a convenient and useful means to manage the risks arising from those permissible banking transactions). The General Accounting Office has issued a report agreeing with the OCC's conclusion. United States General Accounting Office, *Equity Hedging—Report to the Honorable James A. Leach, House of Representatives*, GAO–01–945 (August 2001).

[21] OCC Interpretive Letter No. 848 (November 23, 1998), *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–202; OCC Bulletin 96–51 (September 20, 1996), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 35–491.

[22] OCC Interpretive Letter No. 878 (December 22, 1999), *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-373.

ments contained in the OCC's derivatives handbook[23] and OCC Banking Circular No. 277.[24] As part of the bank's risk management process, the bank's management should:

- Document its decisions on hedging DPC share market exposures;
- Develop a clear methodology for determining the amount of market risk from DPC shares that the bank needs to hedge; and
- Establish objective criteria for the purchase and sale of options sufficient to demonstrate that the options will be used solely to hedge against losses.

In addition, the bank should develop and implement compliance policies and procedures to ensure that any potential conflicts of interest are appropriately considered and that the hedges will comply with applicable securities laws, including applicable insider trading standards. Because buying and selling options in respect of DPC shares may raise issues under the federal securities laws, the bank should consult with competent securities counsel to ensure its activities comply with federal securities laws before entering into such transactions.

Finally, the bank's audit or another qualified independent control unit should conduct a review to evaluate the adequacy and effectiveness of the bank's risk and compliance management policies and procedures to ensure that the DPC share hedging activity is conducted in conformance with the applicable requirements of BC–277 and securities laws.

D. Use of Options to Hedge Banking Risk is not Prohibited Underwriting or Dealing under Section 24(Seventh)

Section 24(Seventh) addresses the ability of a national bank to underwrite or deal in securities. Specifically, section 24(Seventh) provides that:

> [t]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

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[23] *Handbook for National Bank Examiners*, "Risk Management of Financial Derivatives" (January 1997) ("derivatives handbook").

[24] October 27, 1993, *reprinted in* [1993–1994 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 62–152, as supplemented by *Supplemental Guidance 1 to BC–277* (January 1997) ("BC–277").

Here, the bank is not "dealing" in or "underwriting" securities as prohibited by section 24(Seventh). Although "dealing" and "underwriting" are not defined in section 24(Seventh),[25] "underwriting" is generally understood as encompassing the purchase of securities from an issuer for distribution and sale to investors.[26] Case law confirms that one cannot be an underwriter in the absence of a public offering.[27]

"Dealing" in securities is generally understood to encompass the purchase of securities as principal for resale to others.[28] Dealing is buying and selling as part of a regular business. A dealer typically maintains an inventory of securities and holds itself out to the public as willing to purchase and sell and continuously quote prices.[29]

Under the above definitions, the bank's use of options on equity securities for hedging exposures resulting from DPC shares is not "underwriting" or "dealing." The bank has committed to sell and purchase debt securities solely for the purpose of hedging. The bank will not purchase securities from an issuer for sale to investors in connection with a public offering—essential elements of underwriting. Further, in conducting hedging activities, the bank will not engage in a regular business of buying and selling equity options in the secondary market, will not publicly offer the equity options from hedging DPC shares to investors and will not hold itself out as available to buy and sell securities.[30]

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[25] Although the securities laws definitions are not dispositive in determining whether a particular type of securities activity is permitted for banks, these definitions provide a useful starting point for characterizing a bank's securities activities. Under section 3 of the Securities Exchange Act of 1934, a "dealer" is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not part of a regular business." 15 USC 78c(a)(5). Under the Securities Act of 1933, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." 15 USC 77(b)(a)(11).

[26] OCC Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; OCC Interpretive Letter No. 329 (March 4, 1985), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499.

[27] *SIA* v. *Board of Governors*, 807 F.2d 1052 (D.C. Circuit 1986), *cert. denied*, 483 U.S. 1005 (1987).

[28] *See* equity hedge letter, *supra* (banks' purchase of equity securities for hedging customer-driven equity derivative transactions is not "dealing" or "underwriting"). *See also* OCC Interpretive Letter No. 393 (July 5, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,617 (national bank with limited market presence not considered a dealer); Louis Loss, *Securities Regulation* 2983–84 (3d ed. 1990).

[29] *Citicorp, J.P. Morgan & Co. Inc., Bankers Trust New York Corporation*, 73 *Federal Reserve Bulletin* 473 n.4 (1987); OCC Interpretive Letter No. 684, *supra;* equity hedging letter, *supra*.

[30] Although securities law is not determinative in interpreting banking law, we note that the Securities and Exchange Commission (SEC) has recognized that entities that purchase and sell securities to hedge their own risks, and that do not hold themselves out as available to buy and sell securities are not dealers under the GSA. *See Fireman's Fund Mortgage Corp.*, 1987 SEC No-Act. LEXIS 2330 (July 20, 1987). *See also Citicorp Homeowners, Inc.*, 1987 SEC No-Act. LEXIS 2596 (October 7, 1987) (involving mortgages and hedging with government securities); *Meridian Mortgage Corp.*, 1987 SEC No-Act. LEXIS 2020 (April 7, 1987) (involving mortgages and hedging with government securities).

Conclusion

The bank may purchase and sell options on DPC shares to hedge the risk of holding those shares against fluctuations in market value, provided the bank has established effective risk measurement and management processes as described in section C.3, above, to conduct the proposed hedging as described herein.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

962—April 21, 2003

12 USC 24(7)

John H. Huffstutler
Associate General Counsel
Bank of America Corporation
NC1–002–29–01
101 South Tryon Street
Charlotte, NC 28255

Re: Authority to Expand Customer-Driven Financial Intermediation Transactions in Electricity Derivatives to Include Transitory Title Transfers

Dear Mr. Huffstutler:

This letter responds to your request for approval from the Office of the Comptroller of the Currency ("OCC") for Bank of America, N.A. ("bank") to expand its financial intermediation business to include customer-driven, electricity derivative transactions that involve transfers of title to electricity.[1] For the reasons discussed below and subject to the limitations described herein, we believe that the proposed transactions are permissible for the bank.

I. Background

The bank engages in a variety of cash-settled, customer-driven financial intermediation transactions involving exchanges of payments based on interest rates, and the value of equities and commodities. The bank's cash-settled financial intermediation derivative transactions involve a wide range of energy-related commodities, including electricity. The bank received authority to engage in customer-driven, cash-settled electricity derivative transactions and hedges in OCC Interpretive Letter No. 937 to assist customers in meeting their financial and risk management needs.[2] The bank now proposes to settle and hedge electricity derivative transactions by accepting and immediately relinquishing title to electricity, as a party in a "chain of title" transfers ("transitory

[1] For the purposes of this letter, the term "electricity derivative transactions" encompasses electricity linked transactions of every type—including derivative products such as futures, forwards, options, swaps, caps, floors and collars, and options thereon—where a portion of the return (including interest, principal, or payment streams) is linked to electricity or the price of electricity.

[2] OCC Interpretive Letter No. 937 (June 27, 2002) *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–462.

title transfers").[3] The bank represents that it does not intend to ever be in a situation where it is required to receive or deliver actual power as a result of an electricity derivative transaction. And, the bank represents that it will engage in transitory title transfers solely for the accommodation of customers or for its own risk management purposes.

The bank has obtained an order from Federal Energy Regulatory Commission ("FERC") granting it general authority to act as a power marketer, thus enabling the bank to engage in transitory title transfers in electricity in interstate commerce at market-based rates.[4] As part of the FERC order, the bank received a number of waivers and authorizations granted to other power marketers (including a waiver of certain FERC filing and accounting requirements, and a blanket authorization to issue securities and assume obligations and liabilities without prior FERC approval).[5]

Under the bank's proposal, it will settle all of its customer-driven electricity derivative transactions in cash or by transitory title transfers. Currently the bank acts as a financial intermediary under electricity derivative contracts that provide for cash settlement.[6] In certain electricity derivatives markets, contracts do not specifically provide for assignment, termination, or offset prior to a transitory title transfer. Instead, participants in these markets settle electricity derivative contracts through title transfers. Financial intermediaries in these markets enter into back-to-back-contracts providing for the receipt and immediate transfer of title to electricity. In order to participate in these markets, the bank seeks to engage in transitory title transfers where the bank takes title to electricity in a "chain of title" and relinquishes title instantaneously.[7]

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[3] Examples of a cash-settled electricity swap, forward, and option transaction are contained in OCC Interpretive Letter No. 937, *supra.* The swap, forward, and option transactions at issue are similar, except that the transactions will provide for transitory title transfer to settle the contracts. The bank expects that less than 20 percent of the total volume (in megawatt hours) associated with the bank's electricity derivative transactions (electricity derivative contracts and hedges) will involve transitory title transfers. The bank will consult with its OCC examiner-in-charge ("EIC") and address any supervisory concerns raised before exceeding the 20 percent of total volume limit.

[4] FERC asserts jurisdiction over entities such as the bank that engage in transitory title transfers. See *Bank of America, N.A.,* 101 FERC ¶ 61,098 (Oct. 30, 2002) (the "FERC order"). Other financial institutions that participate in electricity derivatives markets—including affiliates of Credit Suisse First Boston, Goldman Sachs & Co., Merrill Lynch & Co., Morgan Stanley & Co., and UBS—have also received FERC approval to operate as power marketers authorized to sell electricity in interstate commerce at market-based rates.

[5] By declaratory order, dated Dec. 19, 2002 (Docket Nos. EL02–130–000 and EC02–120–000), FERC granted in part the bank's request for a blanket authorization to acquire "securities" of public utilities without prior FERC approval, subject to certain conditions. Because such declaratory order did not grant all aspects of the bank's request in this regard, the bank has petitioned FERC for a reconsideration of certain of the conditions set out in the order. Any such acquisitions would have to be permissible under federal banking law.

[6] OCC Interpretive Letter No. 937, *supra.* The term "cash-settled electricity derivative transactions" includes any electricity derivative contract that is cash-settled or that can be assigned, terminated, or offset prior to any transitory title transfer.

[7] Accordingly, as noted above, the bank will not enter into transactions where it will hold title to electricity for more than a legal instant. The bank expects that only a small volume of electricity derivative transactions that it enters into (in general, less than 20 percent) will involve transitory title transfers. (*See* note 3 above.)

The bank states that it will engage only in wholesale electricity transitory title transfers. "Wholesale" electricity transitory title transfers are principally to and from other market intermediaries, some of which may, in turn, affect retail delivery. "Retail" delivery involves the transmission of power to an end-user customer and involves a more extensive scheduling function than wholesale delivery.

The bank represents that transitory title transfer transactions pose risks[8] similar in nature to those inherent in cash-settled electricity derivative transactions and it has a demonstrated ability to successfully manage and control such risks. And, because transitory title transfer transactions typically do not entail the physical possession of commodities, these transactions do not appear to involve the customary activities relating to, or risks attendant on, commodity ownership, e.g., production, transportation, transmission, distribution. While transitory title transfer transactions will require the introduction of some new operational processes (e.g., scheduling of power flows), the majority of operational functions, such as passing notices, document transfers, and payments are similar to those regularly performed by national banks in their role as financial intermediaries. Moreover, national banks that engage in transitory title transfer transactions face risks such as counterparty credit risk that are not significantly different than the risks associated with cash-settled electricity derivative transactions.

The bank will manage the market risks in its electricity derivative transactions on a "portfolio basis," and will hedge the resulting net risk exposures. Because the market risk exposures arising from transactions with customers may offset each other, the bank will not need to hedge each transaction individually. The bank will use both cash-settled hedges and those that involve transitory title transfers. There will normally be some market risk that will not be hedged and this residual exposure will be subject to risk management limits as discussed below. The bank represents that residual market risk arising from this activity at all times will be *de minimis* relative to the bank's earnings and capital and will be consistent with a customer-driven business strategy.

The bank believes that electricity transitory title transfers are a natural extension of the bank's existing financial intermediation activities in electricity that will benefit customers as well as the bank. The bank represents that its ability to engage in transitory title transfers will enable the bank to offer customers a broader range of intermediation services that more fully accommodate customers' financial, risk management, and liquidity needs. In many areas of the United States, contracts reflecting the market convention provide for settlement through transitory title transfers. If the bank cannot engage in transitory title transfers it will not be able to provide customers with the option of participating in these markets to address financial and risk management needs. For the bank to provide effective liquidity and risk management solutions for its electricity derivatives

[8] Risks that are similar in nature include credit, compliance, market, transaction, and reputation.

customers, the settlement terms in the electricity derivative transactions it intermediates need to satisfy each customer's particular needs. Accordingly, the bank believes that its ability to settle electricity derivative transactions by transitory title transfer is vital to its ability to assist customers with their particular financial, risk management, and liquidity needs.

The bank states that its ability to participate in a broader range of markets, and offer a broader range of products, also enables the bank to compete more effectively with other intermediaries, diversify its business risks and operate more efficiently and profitably. The bank's proposed expansion of its existing electricity derivatives business will enable the bank to compete more effectively with other market intermediaries that offer customers the option of selecting electricity derivative contracts that settle in cash or by transitory title transfer. By offering customers a broader range of risk management products that more effectively address their individual financial needs, the bank has the ability to attract a broader customer base. Also, as a participant in more than one type of electricity derivative settlement market, the bank will have greater access to relevant price and other related information. And, with greater access to market information, the bank can provide more extensive services to current and prospective customers. In addition, by participating in a broader range of markets and expanding its customer base, the bank may diversify and reduce credit and other risks arising from its electricity derivatives business. Consequently, transitory title transfers enable the bank to operate its electricity derivatives business more competitively, efficiently, and profitably.

The bank represents that the ability to engage in electricity transitory title transfers can reduce the risk that it will be subject to a "market" or "liquidity" squeeze. The bank contends that being limited to electricity derivative transactions that require cash settlement may be disadvantageous because market participants know that the bank is constrained in its ability to cover and exit electricity derivative transactions. In addition, the bank believes if there is limited liquidity or substantial volatility in the electricity derivatives market, the bank's inability to enter into electricity derivative transactions settled by transitory title transfer constrains its ability to choose among various risk management tools to guard against a possible "market" or "liquidity" squeeze.

The bank also represents that the ability to engage in transitory title transfers will increase the bank's hedging options and its ability to control risks in its electricity derivatives business. The bank asserts that this capability will enable the bank to broaden its ability to hedge, on a portfolio basis, its electricity derivative business.

The bank has expertise in conducting energy derivative transactions. Consistent with this expertise, the bank has well-established policies, procedures, and controls that it applies to its customer-driven, cash-settled oil, gas, and electricity derivatives businesses. For example, the bank: (i) hedges the price risk arising from commodity derivatives on a portfolio basis and values transactions using data sets and models implemented in accordance with bank standards; (ii) records credit exposure against customer credit limits; (iii) documents cash-settled customer transactions using the ISDA Master Agreement, with appropriate confirmations;[9] and (iv) uses operations systems that permit booking and settlement of commodity derivatives transactions. The bank represents that it will continue to conduct its activities in customer-driven electricity derivatives consistent with the same policies, procedures, and controls it applies to its existing energy commodity derivatives business (the "commodity derivative product controls").

The bank commits that before engaging in transitory title transfers it will adopt and implement all necessary policies, procedures, and controls to assure that (i) its electricity derivative business is customer-driven and meets all required regulatory standards for conducting a customer-driven derivative business, and (ii) the bank has in place all appropriate mechanisms to identify, monitor, limit, and control the risks inherent in conducting this business so that it complies with all applicable OCC guidance and requirements.[10]

To manage the risks in its expanded electricity derivatives business, the bank represents it will implement those policies, procedures, and controls set forth in OCC guidance, e.g., OCC derivatives handbook and BC–277, to assure the ongoing function and maintenance of an effective risk management process. The bank specifically acknowledges that, as contemplated by the OCC derivatives handbook and BC–277, an effective risk management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, and effective risk control functions that oversee and ensure the continuing appropriateness of the risk management process.

In implementing those policies, procedures, and controls, the bank commits to conducting a full evaluation of (i) pricing, hedging (including portfolio hedging), processing, recordkeeping, documentation, accounting, "back office," and risk management; (ii) the development of adequate knowledge, staff, oversight management, and technology (including contingency planning) to accommodate the activity; (iii) the implementation of appropriate controls (including the commodity derivative product controls discussed above); (iv) the establishment, implementation, and monitoring of appropriate risk management limits with respect to various types of risks—such

[9] We would expect the bank to document all electricity transitory title transfer transactions with appropriately comparable confirmations.

[10] *See, e.g.*, *OCC Handbook*: Risk Management of Financial Derivatives (January 1997) ("OCC derivatives handbook"); OCC Banking Circular No. 277 (October 27, 1993), *reprinted in* 5 Fed. Banking L. Rep. (CCH). ¶ 62–152 ("BC–277"); OCC Bulletin 94–31 (May 10, 1994), *reprinted in* 5 Fed. Banking L. Rep. (CCH) ¶ 62–152.

as market risk, credit risk, and liquidity risk—associated with transitory title transfers;[11] and (v) compliance department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Such a framework will strictly prohibit manipulative practices of any kind, including patterns of trading related to so-called "round tripping" of electricity derivatives transactions and will promote compliance with FERC and other relevant regulatory requirements.[12] Risk control, operations, accounting, legal, compliance, audit, and senior and line management will all be involved in assuring that the risks undertaken by the bank are comparable to, and are addressed in ways comparable to those applicable to, the bank's existing energy-based derivative products and business.

The bank further commits that: (i) it will not run a proprietary book in electricity/electricity derivatives, (ii) any trading in derivatives will be done exclusively to hedge residual open positions related to customer transactions (or incurred in anticipation of customer transactions), and (iii) its electricity derivatives business will be conducted in a safe and sound manner and consistent with prudential risk management practices as prescribed in the OCC derivatives handbook and BC–277.

Furthermore, the bank commits that complex structured transactions involving electricity derivatives will be subject to appropriate review and oversight of the bank's risk management approval process to ensure that such transactions conform to the bank's standards of appropriateness and integrity. In this risk management approval process, committees that are independent of the sponsoring business will review complex structured transactions. These committees will review the transactions for risks presented by the transactions, including credit risk, market risk, operations risk, legal risk, and reputation risk. Furthermore, in the normal course of risk management, the bank will typically evaluate the purpose of transactions to assess whether the client has attempted to achieve a financial statement objective that could be construed as materially misrepresent-

[11] For example, in the context of market and related risks of electricity derivatives, the bank will specifically address such matters as price volatility and concentration of market participants on a geographic and power exchange/power pool/individual customer basis. In the context of options, it will specifically address all of those characteristics identified in the OCC derivatives handbook (e.g., at 20–21 and appendix B) as primary component measures of option sensitivity.

[12] To illustrate, the head of the electricity derivatives desk will be provided with a "best practices" policy that describes the responsibilities of the position in monitoring transactions for market manipulation, including round-tripping. This individual will receive daily position and activity reports to review and monitor consistent with the best practices policy. The bank's compliance division will also receive and review position and activity reports on a daily basis, test for proprietary trading, test the appropriateness of derivative transactions and hedges, and review documentary support on a quarterly basis. Bank employees involved in this business will be subject to applicable "Standards of Professional Conduct" and will be required to attend compliance training. Furthermore, the bank's legal department will provide guidance to the compliance department to ensure FERC rules and regulations as prescribed by the National Power Act are understood with appropriate compliance policies and procedures developed and implemented.

ing its financial condition, even if in conformance with generally accepted accounting principles ("GAAP"). In any instance where it is determined that a proposed transaction may result in materially misleading financial statements, the bank will decline the transaction, condition approval upon the counterparty making express disclosures regarding the nature and financial impact of the transaction on the counterparty's financial position, or take other steps to assure that the bank's role is appropriate. The bank will also have an appropriate process for verifying customers have satisfied any conditions the bank establishes concerning disclosures. As part of the process to determine the appropriateness of a transaction, the bank may seek representations and warranties from the counterparty to the complex structured transaction stating the purpose of the transaction, how the counterparty will account for the transaction, and that the counterparty will account for the transaction in accordance with GAAP, consistently applied.

II. Discussion

In our opinion, the proposed title transfer transactions may be permissible under 12 USC 24(Seventh) as an activity incidental or "convenient and useful" to its electricity derivatives business, provided the bank has established an appropriate risk measurement and management process for the activity that is satisfactory to the bank's EIC.[13]

National Banks May Engage in Electricity Title Transfers to Settle and Hedge Customer-Driven Electricity Derivative Transactions as Activities Incidental to the Business of Banking

The OCC previously determined that the bank may engage in electricity derivative transactions and hedges that are cash-settled.[14] The bank proposes to settle and hedge electricity derivative transactions by transitory title transfers where the bank takes title to electricity in a "chain of title" and relinquishes title instantaneously. The proposed transitory title transfers will enable the bank to participate in markets using this form of settlement and provide customers with a broader range of sophisticated risk management tools to address their financial, risk management, and liquidity needs. Further, the proposed transitory title transfers will enable the bank to compete more effectively and operate more efficiently and profitably. Transitory title transfer capability also will increase the bank's hedging options and its ability to control risks in its electricity derivatives business.

Engaging in transitory title transfers will subject the bank to risks similar in nature to those inherent in cash-settled electricity derivatives where the bank has demonstrated risk management procedures, systems, and controls to appropriately manage and controls such risks. Transitory title transfer transactions typically do not involve taking physical possession of commodities, and thus

[13] This process is necessary for the bank to achieve its customer risk management objectives in a safe and sound manner and, thus, must be established before the OCC can conclude that activities are permissible for the bank.

[14] OCC Interpretive Letter No. 937, *supra.*

do not appear to involve the customary activities relating to commodity ownership. While transitory title transfer transactions will require the introduction of some new operational processes (e.g., scheduling of power flows), the majority of operational functions, such as passing notices, document transfers, and payments, are similar to those regularly performed by national banks in their role as financial intermediaries.

The OCC has previously concluded in a variety of contexts that national banks may engage in instantaneous title transfers as an activity permissible under 12 USC 24(Seventh). In OCC Interpretive Letter No. 684, for example, the OCC determined that it was permissible for a national bank to engage in instantaneous warehouse receipt transfers in furtherance of managing the risks in financial intermediation transactions with customers, involving the exchange of payments based on the value of commodities.[15] The instantaneous warehouse receipt transfers entailed the bank taking possession of a warehouse receipt and instantaneously passing it on to a third party under an offsetting transaction. In OCC Interpretive Letter No. 684, as here, the bank did not propose to take actual delivery by receipt of physical quantities of commodities on bank premises. Rather, transitory title transfers preclude actual delivery by passing title down the chain from the initial seller to the ultimate buyer in a series of instantaneous back-to-back transactions. Each party in the chain has title for an instant but does not take actual physical delivery (other than the ultimate buyer which, in no case, will be the bank). The OCC determined that the warehouse receipt transfers were permissible, where consistent with safe and sound banking principles, and with prior written authorization from OCC supervisory staff.

Analogously, the OCC has previously determined that a national bank may instantaneously acquire and transfer equity and debt securities in the secondary market under 12 USC 24(Seventh), in financial intermediary transactions with customers.[16] The bank purchased the equities and debt securities only for immediate resale to an ultimate purchaser as a riskless principal. The OCC approved the transactions because the bank did not assume any of the customer's risk of loss, did not assume any liability as guarantor or endorser of the value of the securities, and did not have any beneficial ownership of the securities. The purchases and sales of equity and debt securities were in furtherance of bank permissible brokerage activities.

In sum, the ability of the bank to engage in transitory title transfers in connection with its customer-driven electricity derivative transactions will allow the bank to provide customers with a broader range of tools to address their financial, risk management, and liquidity needs. Transitory title transfer capability also will permit the bank to conduct its electricity derivatives business

[15] OCC Interpretive Letter No. 684 (August 4, 1995), *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,632. Warehouse receipts evidence title to commodities. While OCC Interpretive Letter No. 684 characterized the transactions in that letter as involving the "physical delivery" of commodities, included within that characterization were instantaneous warehouse receipt transfers.

[16] OCC Interpretive Letter No. 626 (July 7, 1993) *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,508.

more competitively, efficiently, and profitably and increase its hedging options. The risks to which the bank is exposed are similar in nature to cash-settled electricity derivative transactions where the bank has a demonstrated ability to manage and control such risks. The bank's proposed transitory title transfers are functionally comparable to other title transfers that the OCC has permitted under 12 USC 24(Seventh). Accordingly, subject to satisfying the safety and soundness factors discussed below, the bank's proposed transitory title transfers are incidental or "convenient and useful" to the bank's financial intermediation activities in electricity derivative transactions.

Safety and Soundness Requirements and EIC Approval

For the bank to permissibly engage in transitory title transfers, the bank's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner. Consequently, in order for the OCC to conclude that this activity is permissible for the bank because it is convenient or useful to conducting authorized banking activities, the bank must demonstrate to the satisfaction of the OCC that the bank has established an appropriate risk measurement and management process for its transitory title transfers. As detailed further in the OCC derivatives handbook and BC–277, an effective risk measurement and management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process. Risk control processes will need to become increasingly sophisticated as this business activity grows in size and complexity.

Additionally, the bank's risk management approval process must subject complex structured electricity derivative transactions to appropriate review and oversight to ensure that these transactions conform to the bank's standards of appropriateness and integrity. This should include review and approval of these transactions by independent and qualified individuals. The structured transaction approval process should consider all relevant risks, should require review of transaction appropriateness, and should include evaluation of the purpose of these transactions to determine whether the bank's customer is attempting to achieve a financial statement objective that materially misrepresents its financial condition, regardless of being in conformance with GAAP.

In addition to a satisfactory risk management program, the bank's process must include an independent compliance monitoring program to ensure ongoing compliance with the specific commitments made by the bank in its proposal, including the commitment to continue to conduct its financial intermediation activities in electricity as a customer-driven and non-proprietary trading business. The compliance monitoring program should also ensure that the bank has a supervisory framework that protects against manipulative practices of any kind, including "round tripping," and promotes compliance with FERC and other regulatory requirements. An adequate and effective compliance monitoring program will include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

The OCC will make these determinations though the bank's EIC and the bank may not commence the proposed activities unless and until its EIC has concluded that the foregoing standards are met.

III. Conclusion

The bank may settle and hedge its customer-driven bank permissible electricity derivative transactions by transitory title transfers as an activity incidental to its existing electricity derivatives business, provided the bank has established, to the satisfaction of its EIC, an appropriate risk measurement and management process for its transitory title transfers.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

963—April 14, 2003

12 USC 548
12 USC 52

Subject: Arkansas Franchise Tax and Par Value of National Bank Shares

Dear [ ]:

This is in response to your letter inquiring whether 12 USC 52 prohibits a national bank from decreasing the par value of its shares to $0.01 per share with an offsetting increase to the bank's "capital in excess of par" account. For the reasons discussed below, we conclude that section 52 does not prohibit a national bank from decreasing the par value of its shares and increasing the bank's capital surplus. To the extent that a national bank avails itself of these options, it may affect its state tax obligations pursuant to the operation of 12 USC 548.

I. Background

You have indicated that banks located in Arkansas are required to pay an annual franchise tax pursuant to the Arkansas Corporation Franchise Tax Act of 1979[1] (the "Arkansas Franchise Tax Act"). For a bank with all its property located in Arkansas, the amount of the franchise tax is computed by multiplying the number of the bank's shares outstanding times the par value per share times 0.27 percent.[2] The par value of a bank's shares thus significantly affects the amount of franchise tax payable.

II. Discussion

The National Bank Act does not prohibit a national bank from having shares with a par value of $0.01.[3] Section 52 provides that "[t]he capital stock of each association shall be divided into shares of $100 each, or into shares of such less amount as may be provided in the articles of association." That provision thus establishes a maximum par value per share for a national bank's shares, but does not establish any minimum par value. Prior to December 27, 2000, 12 USC 51 imposed on national banks a minimum aggregate par value requirement ranging from $50,000 to $200,000. Section 51 was repealed in the Financial Regulatory Relief and Economic Efficiency

[1] Ark. Code Ann. §§ 26–54–101 *et seq.* (Michie 2001).

[2] The product of shares outstanding times par value per share may be considered the "tax base." The 0.27 percent may be considered the "tax rate."

[3] You have represented that it is legally permissible under Arkansas law for a state bank organized in Arkansas to have shares with a par value per share of $0.01.

[4] Pub. L. No. 106–569, Title XII, § 1233(c), 114 Stat. 3037.

Act of 2000 (the "2000 Act").[4] The legislative history of the 2000 Act indicates that Congress considered the section 51 minimum capital requirement obsolete since Congress had granted the federal banking agencies the regulatory authority to establish minimum capital requirements in 1983.[5] The minimum capital requirements currently applicable to national banks under this authority are set forth in part 3 of the Office of the Comptroller of the Currency's ("OCC's") rules.[6]

The OCC has previously determined that a national bank could decrease the par value of its shares to $0.01 per share, provided that the bank continued to meet applicable capital requirements.[7] Because the National Bank Act no longer contains a minimum aggregate par value requirement and because section 52 provides only for a maximum par value of $100 per share, a national bank may decrease the par value of its shares to $0.01 and transfer the amount resulting from that decrease to capital surplus.[8] In effecting the decrease in par value and increase in capital surplus, a national bank would of course need to comply with all other applicable legal requirements, including requirements for procedures to amend its articles of association[9] as well as requirements for notifying the OCC.[10] In this connection, the bank must, of course, continue to comply with all applicable capital requirements set forth in the OCC's part 3. National banks

[5] 146 *Congressional Record* H11991 (daily edition December 5, 2000) (section-by-section analysis inserted into record by House bill sponsor, Representative Leach); 146 *Congressional Record* S11607 (daily edition December 5, 2000) (section-by-section analysis inserted into record by Senate bill sponsor, Senator Allard).

[6] 12 CFR 3.1 *et seq*.

[7] *See* Interpretive Letter No. 275 ("IL 275"), *reprinted in* [1983–1984 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,439 (October 21, 1983) (national bank could meet aggregate par value requirement with a combination of common and preferred shares). Subsequent to IL 275, the aggregate par value requirement was eliminated by the repeal of section 51. *See also* letter from Anthony DosSantos, licensing manager, Northeastern District Office, OCC, to John H. Smith, associate counsel, Mellon Financial Corporation (March 3, 2003) (to be published) (bank converting from state to national bank charter may issue zero or no par common shares).

[8] The national bank would not be reducing its capital but merely transferring amounts between two permanent capital accounts. Thus, 12 USC 59, which establishes procedures for a national bank to reduce its capital, would not apply. Except as provided in section 59 and 12 CFR 5.46, a national bank may not withdraw, or permit to be withdrawn, by dividend or otherwise, any portion of its permanent capital. Transferring amounts between the two permanent capital accounts will not affect the bank's obligations under 12 USC 56 (prohibition on withdrawal of capital) or 12 USC 60 (restrictions on dividends). *See* 12 CFR 5.63(a).

[9] The shareholders of a national bank must approve any amendment to the bank's articles of association to change the par value of the bank's capital stock. A certified copy of the amendment to the articles of association also must be forwarded to the OCC. *See* 12 USC 21a. A national bank with shares that are registered under section 12 of the Securities Exchange Act of 1934 must file proxy materials with the OCC pursuant to 12 CFR Part 11.

[10] Changing the par value of a national bank's capital stock when the change is offset by an equal change in the bank's capital surplus does not require prior approval of the OCC. The change, however, does require notice to the OCC and does not become effective until the OCC certifies the change. *See Comptroller's Corporate Manual, Other Changes and Activities, Capital and Dividends* (April 1998).

also should be cognizant that a reduction in par value may affect future directors' qualifying share requirements under 12 USC 72.[11]

When a national bank decreases the par value of its shares, it may have an effect on the bank's state tax liability if the relevant state taxes its state banks, to any degree, based on the par value of those banks' shares. This occurs because 12 USC 548 provides that:

> For the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located.

Without reaching the question of whether the Arkansas franchise tax is the type of tax authorized by section 548,[12] were such to be the case, a national bank nevertheless may still take advantage of corporate options available to it under federal law with regard to its corporate or business configuration, such as setting the par value of its shares. In certain states, that look to the par value of a bank's shares in calculating a bank's tax obligations, taking advantage of such corporate options may, pursuant to section 548, affect the national bank's tax obligations.

I hope the foregoing is responsive to your inquiry.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[11] Under section 72, a national bank director must own a qualifying equity interest of $1,000 in the stock of a national bank or its holding company. In an interpretive ruling, the OCC has stated that the qualifying equity interest may include common or preferred stock that has an aggregate par value of $1,000, an aggregate shareholders' equity of $1,000, or an aggregate fair market value of $1,000. The value of the qualifying interest is determined as of the date purchased or the date on which an individual became a director, whichever value is greater. *See* 12 CFR 7.2005.

[12] *First Agricultural National Bank* v. *State Tax Comm'n*, 392 U.S. 339, 341–46 (1968) (states may only tax national banks as specifically permitted by Congress). *See also, U.S.* v. *State Board of Equalization*, 639 F. 2d 458 (9th Circuit 1980), *cert. denied* 451 U.S. 1028 (1981) and *Michie on Banks and Banking*, chapter 19, section 1 (1998).

964—March 17, 2003

12 CFR 3

Subject: Risk-Based Capital Treatment of GSE Preferred Stock

Dear [ ]:

In your letter of November 13, 2002, you requested confirmation regarding the appropriate risk weight for a national bank's investment in preferred stock issued by United States Government Sponsored Entities (GSEs). The Office of the Comptroller of the Currency ("OCC") applies a 20 percent risk weight to preferred stock issued by a GSE.

The OCC's capital regulations provide for a 20 percent risk weight on "Securities issued by, or other direct claims on, United States Government-sponsored agencies." 12 CFR 3, app. A, section 3(a)(2)(vi). For purposes of this regulation, the term "security" includes preferred stock. Therefore, GSE preferred stock is a security issued by a U.S. government-sponsored agency and receives a 20 percent risk weight. Please be aware, however, that the capital regulations of the other U.S. banking agencies are not identical to the OCC's in this regard. This letter is applicable only to the risk weighting by national banks of their holdings of GSE preferred stock. The treatment described herein supersedes the supervisory policy stated in the 1992 OCC letter that you referenced, which indicated that certain GSE preferred stock should be risk weighted at 100 percent.

If you have any questions, please contact Amrit Sekhon, risk expert, Capital Policy, at (202) 874–5070.

Tommy Snow
Director, Capital Policy

965—February 24, 2003

12 USC 24(7)

Subject: [ ]—[Co.]

Dear [ ]:

This is in response to your letter concerning a purchase of stock that [ ] ("bank"), has made, through an operating subsidiary, in a reinsurance company domiciled in Bermuda. You requested that we review this purchase and permit the bank to retain the stock. We have completed our review and have concluded that this is a permissible activity and the bank may retain its shares of stock in the Bermuda company.

Background

You indicate that the bank has a wholly owned operating subsidiary, [ ] ("sub"). [Sub] is a *[State]* general insurance agency and broker specializing in commercial lines of insurance. Last year, [sub] needed to obtain professional liability insurance for its insurance agents. Professional liability insurance in this context provides protection against legal liability and the cost of defending claims alleging errors and omissions of insurance agents. Under current market conditions, it is a highly specialized type of insurance that is difficult to obtain, and as a result distribution through surplus lines brokers is common. [Sub] contacted over 25 carriers in its search for professional liability coverage, Most declined to even offer quotes, Others offered only limited coverage, had higher deductibles, or had unacceptable ratings. In the end, [sub] management concluded that obtaining the coverage through a program offered by [ ] ("Co."), was the best option.

[Co.] is domiciled in Bermuda and is licensed under the Bermuda Insurance Act of 1978. It does not maintain any offices outside Bermuda. Under the [Co.] program, the insurance is underwritten by [InsurCo.], a large American company whose principal office is in *[State],* and reinsured through a wholly owned subsidiary of [Co.]. According to [Co.]'s private placement memorandum of May 22, 2002, [Co.]'s sole business is underwriting professional liability insurance through this program, and its success depends entirely on the extent to which its shareholders place their business through the program. Coverage under the [Co.] program requires ownership of [Co.] stock, and ownership is limited to participants in the program.[1]

Thus, in order to obtain the coverage that it needed, [sub] was required to purchase 3,470 shares of Class A stock in [Co.] in an amount equal to 20 percent of the first annual premium for the insurance, or $69,400. This amount represents less than 1 percent of the outstanding voting stock

[1] Ownership of [Co.]'s Class A shares is limited to two primary insurers, [InsurCo.] and another American insurance company, and insurance agencies that are insured under the program, all of which are large, domestic insurance agencies like [sub].

of [Co.]. Shares are subject to a call by [Co.] in the event the shareholder terminates its insurance policy and to a put by any shareholder who has owned the shares for at least five years and is no longer insured.

Analysis

Under 12 USC 24(Seventh), national banks possess "all such incidental powers as shall be necessary to carry on the business of banking." The Supreme Court's decision in *NationsBank of North Carolina, N. A.* v. *Variable Annuity Life Insurance Co. ("VALIC")*[2] established that the "business of banking" is not limited to the five powers that are enumerated in section 24(Seventh) but encompasses more broadly activities that are part of the general business of banking. The *VALIC* decision further established that national banks may engage in activities that are incidental to the business of banking as a whole, as well as those that are incidental to the enumerated activities. "Necessary" has been judicially construed to mean "convenient or useful."[3] Thus, since *VALIC*, it is clear that incidental powers under 12 USC 24(Seventh) are those that are convenient or useful to carrying on the general business of banking.

There are several broad categories of activities that the courts have recognized as being incidental to the business of banking. One of these categories consists of activities that facilitate the operation of the bank as a business enterprise. Even though they are not substantive banking activities, they are necessary (i.e., convenient or useful), to the operation of the bank as a business. These activities include such things as hiring employees, owning or renting business equipment, borrowing money, and advertising the bank's services.[4]

Purchasing insurance for the bank's own risk control needs is another such activity. Similar to any other business, there are certain risks involved with operating a bank, and banks must be able to manage these risks. The Office of the Comptroller of the Currency ("OCC") has long recognized that national banks may purchase insurance for themselves as an activity that is incidental to banking.[5] Thus, it is permissible for [sub] to acquire the liability insurance that it needs to conduct its business in a prudent manner.

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[2] 513 U.S. 251 (1995).

[3] *Arnold Tours, Inc.* v. *Camp*, 472 F.2d 427 (1st Circuit 1972).

[4] *Franklin National Bank* v. *New York*, 347 U.S. (1954) (advertising); *Wyman* v. *Wallace*, 201 U.S. 230 (1905) (borrowing money).

[5] E.g., 12 CFR 7.2013; OCC Bulletin 2000–23, *reprinted in* 4 Fed. Banking L. Rep. (CCH) ¶ 35–491 (July 23, 2000); Interpretive Letter No. 845, *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–300 (October 20, 1998); Interpretive Letter No. 554, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L.Rep. (CCH) ¶ 83,301 (May 7, 1990); letter of James M. Kane, Central District counsel (June 8, 1988) (unpublished); Interpretive Letter No. 429, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,653 (May 19, 1988).

Even though national banks generally may not purchase shares of stock for investment purposes, the ownership of stock is incidental to banking, and thus permissible, when it is convenient or useful to the operation of the bank as a business and there is no speculative or investment motive. For example, the OCC has found the ownership of equities to be permissible in instances where such ownership has facilitated the management of risk inherent in equity-related banking activities being conducted by the bank.[6] Stock ownership has also been held to be permissible when it was deemed to be necessary to facilitate a bank's participation in a permissible banking activity or, as in the present case, obtain a product or service that the bank needed for its business.[7]

Accordingly, the OCC has previously approved stock ownership in insurance carriers where it was necessary in order to obtain directors' and officers' liability insurance, a type of coverage analogous to that involved here.[8] The situation you describe in your letter falls squarely within these precedents. As in those letters, it was necessary for [sub] to own shares of [Co.] stock in order to obtain coverage under the [Co.] program. [Sub] was unable to obtain the needed liability insurance from virtually any other source. The only other alternatives were to accept an inferior policy or self-insure.

You note that there is no anticipated return on the [Co.] stock other than dividends and no market for the stock other than repurchase by the issuer at book value under certain circumstances. You believe this demonstrates that the bank and [sub] had no investment or speculative motive in purchasing the stock. The OCC has, in fact, viewed limits on the transferability of stock as evidence of a lack of investment motive[9] and has found that the possibility of receiving dividends does not necessarily indicate the presence of such a motive.[10]

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[6] The OCC has found that it is legally permissible for a national bank to purchase and hold equity securities that banks do not generally have authority to purchase in order to hedge customer-driven, bank-permissible equity derivative transactions. "Equity derivative transactions" are transactions in which a portion of the return is linked to the price of a particular equity security or to an index of such securities. They include such things as equity and equity index swaps, equity index deposits, and equity-linked loans and debt issues. Interpretive letter No. 935, [___–___]Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–460 (May 14, 2002); Interpretive Letter No. 924, [___–___Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–449 (January 2, 2002); Interpretive Letter No. 892, *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–411 (September 8, 2000).

[7] E.g., Interpretive Letter No. 878, *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–375 (December 22, 1999) (national banks may invest in equity mutual funds in order to hedge employee deferred compensation obligations that are tied to the value of the same funds); Interpretive Letter No. 421, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988) (ownership of shares of Government Securities Clearing Corporation to obtain securities clearing services); Interpretive Letter No. 380, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 (December 29, 1986) (shares of an options clearing corporation in order to obtain options clearing services); letter of John E. Shockey, deputy chief counsel (December 19, 1975) (unpublished; purchase of shares in Depository Trust Company to obtain securities clearing and custody services).

[8] Interpretive Letter No. 554, *supra* note 5; letter of James M. Kane, *supra* note 5.

[9] Interpretive Letter No. 421, *supra* note 7.

[10] Interpretive Letter No. 554, *supra* note 5.

Under these circumstances, the bank's indirect purchase of [Co.] stock through [sub] should be treated as a cost of obtaining insurance for the bank, an activity that is permissible under 12 USC 24(Seventh). The investment is nominal, amounting to less than one percent of [Co.]'s outstanding shares and a tiny fraction of one percent of the bank's capital. Accordingly, we conclude that it is permissible for [sub] to retain the shares of [Co.] stock purchased in connection with obtaining liability insurance coverage for itself.

Regulation K of the Board of Governors of the Federal Reserve System, 12 CFR part 211, governs international operations of U. S. banks. The bank should determine whether Federal Reserve approval for the purchase of [Co.] stock is required pursuant to this regulation, and we offer no opinion on that question.

This opinion is based on the representations in your letter. Any material change in the facts could require a different conclusion. I trust that this has been responsive to your inquiry. If you have further questions, please contact Christopher Manthey, special counsel, Bank Activities and Structure Division, at (202) 874–5300.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

966—May 12, 2003

12 USC 29A
12 USC 24(7)

Re: Request by [ ]

Dear [ ]:

This letter responds to your request on behalf of [ ] ("sub"), a wholly owned subsidiary of [ ] ("bank"). [Sub] provides relocation-related services for corporate customers' relocating employees. As part of these services, [sub] wishes to acquire, for a short period of time, title to the relocating employees' residential real estate. The bank believes that [sub] needs to acquire title in order to provide a package of relocation services that is competitive in the marketplace. For the reasons discussed below, and subject to the conditions below, we believe that [sub] may permissibly acquire an interest in the residential real estate of relocating employees.

I. Background

A. [Sub]'s Current Activities

[Sub]'s primary current activity is that of a finder—bringing together unaffiliated companies that provide relocation-related services, i.e., movers, realtors, insurers, with its corporate customers and their relocating employees. [Sub] also makes advances to the relocating employees based on valuations of their homes provided by third-party appraisals. Repayment of these loans is made through the sale proceeds of the homes and is guaranteed by the corporate customers.[1] The bank charges corporate customers an overall fee for the package of relocation services, and the costs of services provided by third parties—such as movers and realtors—are the responsibility of the corporate customers.

The transfer of the residential real estate from the relocating employee to the ultimate purchaser occurs through a "deed-in-blank" process.[2] Once [sub] and the relocating employee agree upon a sales price—based upon the third-party appraisals—the relocating employee signs a limited pow-

[1] Prior to entering into an agreement with a potential corporate customer, [sub] conducts a full evaluation (including credit risk rating) of the financial condition and prospects of the potential customer. [Sub] only contracts with those potential customers for which the evaluation leads [sub] to believe it will be able to rely upon any future guarantees made by the potential customer.

[2] In this process, the relocating employee signs a deed but the buyer's signature remains open. When the property is sold and the transaction closes, the name of the eventual purchaser is inserted on the deed. Title to the property remains vested in the relocating employee's name until the physical closing of the property with the eventual purchaser, at which time the purchaser becomes the title-holder. This process does not require [sub] to take title to the property.

er of attorney and a deed-in-blank (which are held by [sub]), receives the advance from [sub], and moves away. On behalf of its corporate customer, [sub] finds an unrelated third party as realtor to list and market the property. Upon receipt of an acceptable offer, typically not less than 95 percent of the appraised value, [sub] completes the sale on behalf of the departed employee per the power of attorney and the deed is transferred. The sales proceeds are used to repay the advance, with the relocating employee receiving any excess funds. If the actual sales price is less than the agreed-upon sales price, the corporate customer reimburses [sub] for the difference.

The bank represents that approximately 70 percent of the real estate transfers involves [sub]'s holding the deed-in-blank for less than two weeks. In the remaining transfers, [sub] holds the deed-in-blank for some longer period of time. The bank further represents that, during this period of time, [sub] does not manage the real estate. Rather, on behalf of the corporate customer, [sub] finds an unrelated, third-party real estate management company to manage the real estate.

B. [Sub]'s Proposal

For competitive reasons, [sub] wants to start using a "two-deed" process for real estate transfers. Under the two-deed process, rather than sign a blank deed, the relocating employee would deed title to the real estate to [sub]. [Sub] would hold title to the real estate until a purchaser could be located and then would deed title to the purchaser. All other aspects of the two-deed process are identical to the deed-in-blank process.

The bank represents that [sub]'s competition in the employee relocation industry has adopted the two-deed real estate transfer process. The switch to the two-deed transfer process was driven by the reliance of IRS Employment Tax offices on a 1997 Tax Court decision to deny favorable federal tax treatment to relocation home purchase transactions using the deed-in-blank process.[3] In May 2001, the Employee Relocation Counsel—an association of employee relocation companies and professionals—recommended that its members adopt the two-deed real estate transfer process.[4] The bank represents that [sub]'s competitors have adopted the two-deed process and that [sub], in order to remain competitive in the relocation services market, must make use of the two-deed process.

[3] *See Amdahl Corp*. v. *Commissioner*, 108 T.C. 507 (1997). Prior to the *Amdahl* decision, the Internal Revenue Service ("IRS") afforded favorable federal tax treatment to relocation home purchase transactions using the deed-in-blank process. Since the decision, several IRS Employment Tax offices have denied favorable tax treatment to deed-in-blank transactions, instead holding that all home relocation purchase expenses incurred by a corporation on behalf of its employee are taxable as income to the employee and subject to employment taxes. The two-deed transfer process continues to receive favorable federal tax treatment.

[4] *See* http://www.relo-center.com/PDF_Files/ERC_TwoDeed_WhitePaper.pdf (report of the Employee Relocation Council).

II. Discussion

[Sub]'s current activities—acting as a finder and making loans—are part of the business of banking and were approved in an earlier letter.[5] The bank now indicates that [sub] needs to take title to the residential real estate, as part of the two-deed transfer process, in order to provide a competitive package of relocation services. The only issue in permitting [sub] to acquire title to the residential real estate is based upon the restrictions of 12 USC 29. We believe that [sub] may permissibly acquire an interest in the residential real estate of relocating employees, sufficient to permit [sub] to use the two-deed transfer process, subject to the following conditions and restrictions:

(1) [Sub] must use an unrelated third party as nominee to acquire and hold legal title.

(2) [Sub] must not make use of or enjoy the benefit of the property.

(3) [Sub] must contract with an unrelated third party to manage the property.

(4) [Sub] may not hold any property for longer than ninety days and must establish internal policies and procedures for the immediate disposition of properties when that time limit is reached.

Arguably, section 29 is not implicated by the severely circumscribed interest [sub] would acquire.[6] However, for purposes of the following analysis only, we will assume that [sub]'s interest is subject to the restrictions of section 29.

Numerous Office of the Comptroller of the Currency ("OCC") precedents and case law have confirmed that national banks may provide a variety of ancillary nonbanking products and services to promote consumer use or demand for banking products.[7] Indeed, the OCC has found that the acquisition of an interest in real estate may be incidental to a primary permissible transaction. In Interpretive Letter No. 770, the OCC confirmed that a national bank could acquire a leasehold

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[5] Letter from Donelle H. Ward, director for Analysis (December 20, 1990) (unpublished).

[6] *See* Corporate Decision No. 2001–30 (October 10, 2001) (acquisition of an interest in real estate that does not encompass the full right to possess, use, and convey the property does not implicate section 29).

[7] For example, in Interpretive Letter No. 880 the OCC approved, as incidental to a package of permissible real estate investment advisory services, a national bank's taking part in the negotiation of Internal Revenue Code Section 1031 exchange transactions involving real estate. The letter found that such negotiation services were necessary for the bank to compete successfully with types of firms that offered a full range of real estate investment advisory services. The letter also found that the negotiating services constituted an extremely small part of the overall advisory services. Interpretive Letter No. 880, *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–373 (December 16, 1999). This proposition is also supported by case law. *See Clement National Bank* v. *Vermont*, 231 U.S. 120 (1913) (to promote use and demand of its banking service, national bank may compute, report, and pay tax levied on interest earned by bank customers on their deposits); *Miller* v. *King*, 223 U.S. 505 (1912) (to encourage use of bank's deposit services, national bank may institute lawsuit on behalf of customer to collect funds); *Corbett* v. *Devon Bank*, 299 N.E.2d 521 (Ill. App. 1973) (as means of promoting its banking business, national bank may sell state motor vehicle licenses).

interest in the real estate underlying a fuel facility, incidental to the acquisition of the facility for the purposes of leasing, if such leasehold interest is necessary to provide security for the lender's ability to repossess the facility and continue to use or sell the property in the event of default by the lessee. This position was predicated on the real property interests being, in fact, incidental to the primary transaction—the personal property lease.[8]

Here, several factors indicate that [sub]'s acquisition of an interest in the residential real estate is incidental to the relocation services. First, the ability to acquire such interest is necessary to [sub]'s ability to compete successfully with other relocation services providers. If [sub] cannot perform the services in a manner that provides its corporate customers with favorable tax treatment, the bank represents that [sub] would be unable to compete in the relocation services marketplace.

Second, [sub] need not advance any additional funds to acquire the interest in the residential real estate. [Sub] would continue to make an advance to the relocating employee, with that advance secured by the real estate and guaranteed by the employer. Therefore, there is no additional cost to [sub] to acquire the interest under the two-deed transfer process. Third, [sub] will derive no additional revenue as a result of its acquisition of such an interest. [Sub] would continue to charge corporate customers an overall fee for the provision of services but would not charge an additional fee for acquiring the interest in the residential real estate.

Fourth, once the residential real estate is sold to the ultimate purchaser, there would be no additional benefit or detriment to [sub]. Sales proceeds would still be used first to repay the advance from [sub], with the corporate customer guaranteeing any shortfall. Any excess sales proceeds remaining would still flow to the relocating employee, and the costs of services provided by third parties—such as movers and realtors—would remain the responsibility of the corporate customers. Therefore, there is no additional financial upside or downside to [sub]'s acquisition of such an interest.[9]

Fifth, as a result of the conditions and restrictions listed above, [sub]'s interest in the residential real estate would be severely circumscribed. [Sub] must engage a nominee to hold legal title. [Sub] lacks the major elements of beneficial ownership: [sub] must not make use of or enjoy the property, and it must not manage the property. [Sub] may only hold the indicia of ownership in the property for a short period of time and must have policies and procedures in place to dispose

[8] Interpretive Letter No. 770, *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–134 (February 10, 1997). *See also* 61 *Federal Register* 66554, 66556 (December 18, 1996) (reaffirming in the preamble that real estate leasing may be an incidental component of personal property leasing and that OCC would make this determination on a case-by-case basis).

[9] In each case where [sub] acquires an interest in a relocating employee's residential real estate, the contract between [sub] and the corporate customer would require the corporate customer to maintain, at its own expense, a homeowner's insurance policy on the residential real estate. The contract between [sub] and the corporate customer would further provide that the corporate customer will indemnify [sub] for any liability that may arise out of [sub]'s taking an interest in the property.

of the property when that time limit is reached. Indeed, [sub]'s circumscribed interests would not be inconsistent with any of the purposes underlying the restrictions of section 29.[10] The bank's funds, through [sub], would not be removed from the channels of commerce because the bank would not advance any additional funds to acquire the indicia of ownership. There is no speculation in the value of the real estate because any sales proceeds remaining after the equity advance is repaid flow to the relocating employee. Finally, no significant amount of real estate will be accumulated and held by the bank as the bank would be required to dispose of each property within a short time period.

Therefore, for the reasons stated above and subject to the conditions and restrictions listed above, we believe that [sub] may permissibly acquire an interest in the residential real estate of relocating employees incidental to the provision of its package of relocation services. If you have any questions, please contact Steven Key, senior attorney, at (202) 874–5300.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[10] For example, the Supreme Court in *Union National Bank* v. *Matthews*, 98 U.S. 621, 626 (1878), stated that the three purposes underlying section 29 were "to keep the capital of the banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in their hands, to be held, as it were, in mortmain."

967—June 6, 2003

12 USC 24a
12 CFR 5.39

Subject: Insurance Financial Subsidiaries—Risk Management Services

Dear [ ]:

This responds to your letter requesting the Office of the Comptroller of the Currency's ("OCC's") confirmation that [bank] *[City, State]* ("bank") is not required to file a notice if the bank's previously approved insurance agency financial subsidiaries provide risk management services as part of their insurance agency activities. Specifically, the bank would make available training and safety programs designed to reduce the insurance risks of customers in the trucking business.

For the reasons discussed below, we believe the bank's previously approved insurance agency financial subsidiaries are authorized to offer the proposed risk management services as part of their existing insurance agency activities. The bank therefore is not required to file a notice under 12 CFR 5.39.

A. Background

National bank operating subsidiaries and financial subsidiaries are authorized to act as insurance agents or brokers.[1] Operating subsidiaries that act as insurance agents qualify for the OCC's notice procedures,[2] and financial subsidiaries that act as insurance agents also qualify for the OCC's notice procedures, provided the bank has filed a financial subsidiary certification.[3] The bank already owns financial subsidiaries that are engaged in insurance agency activities. The bank submitted the requisite notice and certification to form and operate these financial subsidiaries as insurance agencies in October 2001 ("financial subsidiaries").

You have indicated that many of the larger insurance agencies assist businesses and individuals in managing their risk of loss by providing consulting services to manage risk of loss.[4] You represent that these services include safety programs tailored to specific businesses, such as providing

[1] 12 CFR 5.34(e)(5)(v)(P) and 5.39(e)(1)(ii).

[2] 12 CFR 5.34(e)(5)(v).

[3] 12 CFR 5.39(i)(1) and 5.39(e)(1)(ii).

[4] We understand that insurance agents and brokers often assist customers in selecting insurance carriers and oversee the services being provided to customers by insurance company safety professionals. The insurance agents and brokers provide risk management services to identify new insurance agency business, retain existing profitable insurance business, reduce claims, reduce transactions costs, reduce premiums, improve service, and ensure appropriate insurance coverage.

training and safety programs for customers in the trucking business. You also enclosed materials demonstrating that insurance brokers and agencies routinely offer risk management services.[5] Among these materials were advertisements for insurance agencies demonstrating that insurance agencies are providing risk management services variously described as “Transportation and Fleet Safety”[6] and “Driver Safety Training”[7] courses.[8]

B. Discussion

The bank has requested the OCC to confirm that the bank is not required to file a notice with the OCC if the bank’s previously approved insurance agency financial subsidiaries provide risk management services as part of their insurance agency activities. A bank is required to file a notice for an existing financial subsidiary if the bank seeks OCC approval to commence a new activity in the financial subsidiary authorized under 12 USC 24a.[9]

As you have demonstrated, the financial subsidiaries’ proposed risk management activities are part of an insurance agency’s activities. The Federal Reserve Board has similarly concluded in a letter dated July 10, 2002, that an insurance agency owned by a financial holding company may provide risk management services in connection with its insurance sales activities.[10] The Federal Reserve Board confirmed in its letter that risk management services are encompassed within 12 USC 1843(k)(4)(B) insurance activities, and thus may be conducted by a financial holding company, if the services are provided by an insurance agent or broker in connection with its other insurance sales activities.

[5] The bank identified several insurance brokers or agents that provide risk management services, including Wachovia DavisBaldwin, Hamilton Dorsey Alston Company, Rebsamen Insurance, ABD Insurance and Financial Service, and Arthur J. Gallagher & Co.

[6] Wachovia DavisBaldwin.

[7] ABD Insurance Service.

[8] Examples of other risk management services provided by the insurance agencies included services variously described as Occupational Safety and Health Administration compliance programs, Department of Transportation. compliance programs, substance abuse programs, ergonomics, safety compliance, and training courses.

[9] 12 CFR 5.39(i)(1)(ii) and 5.39(i)(2).

[10] *See* 2002 Federal Reserve Interpretive Letter LEXIS 5 (July 10, 2002). The types of risk management services reviewed by the Federal Reserve Board in its letter included: (i) assessing the risk of a client seeking insurance and identifying the client’s exposure to loss; (ii) designing programs, policies, and systems such as workplace safety programs to reduce the client’s risks; (iii) advising clients about risk management alternatives to insurance such as self-insurance, securitization, or derivatives; and (iv) negotiating insurance coverages, deductibles, and premiums for an insurance client.

The bank's proposal to provide risk management services similarly fits within the bank's existing authorization to engage in insurance activities pursuant to the bank's notice and certification to form and operate its existing financial subsidiaries as insurance agencies in October 2001. Accordingly, the bank is not required to file a notice with the OCC for the bank's insurance agency financial subsidiaries to engage in the proposed risk management activities.

If you have any questions concerning the foregoing, please contact Asa L. Chamberlayne, counsel, at (202) 874–5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

Mergers—April 1 to June 30, 2003

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Most transactions in this section do not have accompanying decisions. In those cases, the OCC reviewed the competitive effects of the proposals by using its standard procedures for determining whether the transaction has minimal or no adverse competitive effects. The OCC found the proposals satisfied its criteria for transactions that clearly had no or minimal adverse competitive effects. In addition, the Attorney General either filed no report on the proposed transaction or found that the proposal would not have a significantly adverse effect on competition.

Nonaffiliated mergers (mergers consummated involving two or more nonaffiliated operating banks), from April 1 to June 30, 2003

Title and location (charter number)	Total assets
Kansas	
American State Bank & Trust Company, National Association, Great Bend (024183)	65,513,000
and The Farmers and Merchants State Bank, Macksville, Kansas	31,984,000
merged on June 27, 2003, under the title of **American State Bank & Trust Company, National Association, Great Bend** (024183)	98,123,000
Ohio	
Peoples Bank, National Association, Marietta (005552)	1,351,989,000
and Kentucky Bank & Trust, Ashland, Kentucky	127,184,000
merged on May 9, 2003, under the title of **Peoples Bank, National Association, Marietta** (005552)	1,492,271,000
Pennsylvania	
Univest National Bank and Trust Co., Souderton (002333)	1,318,808,000
and First County Bank, Doylestown, Pennsylvania	138,653,000
merged on May 17, 2003, under the title of **Univest National Bank and Trust Co., Souderton** (002333)	1,448,694,000
Virginia	
First Community Bank, National Association, Bluefield (023892)	1,477,968,000
and The Commonwealth Bank, Richmond, Virginia	129,802,00
merged on June 6, 2003, under the title of **First Community Bank, National Association, Bluefield** (023892)	1,615,739,000

Affiliated mergers (mergers consummated involving two or more affiliated operating banks), from April 1 to June 30, 2003

Title and location (charter number)	Total assets
California	
J.P. Morgan Trust Company, National Association, Los Angeles (023470)	440,243,000
and J.P. Morgan Chase Interim National Bank, Chicago, Illinoi (024408)	5,563,000
merged on April 1, 2003, under the title of **J.P. Morgan Trust Company, National Association, Los Angeles** (023470)	445,806,000
Connecticut	
U.S. Trust Company, National Association, Los Angeles (022413)	599,342,000
and U.S. Trust Company, Greenwich, Connecticut	465,035,000
merged on May 31, 2003, under the title of **U.S. Trust Company, National Association, Greenwich** (022413)	1,064,377,000
Illinois	
MB Financial Bank, National Association, Chicago (013684)	3,447,976,000
and South Holland Trust & Savings Bank, South Holland, Illinois	533,019,000
merged on May 15, 2003, under the title of **MB Financial Bank, National Association, Chicago** (013684)	4,006,756,000
Bank One, National Association, Chicago (000008)	217,537,000
and Bank One, Kentucky, National Association, Louisville, Kentucky (014320)	5,774,000
and Bank One, Oklahoma, National Association, Oklahoma City, Oklahoma (011230)	3,308,000
merged on May 15, 2003, under the title of **Bank One, National Association, Chicago** (000008)	222,361,000
Massachusetts	
First Financial Trust, National Association, Newton (021882)	2,167,000
and Freedom Trust Company, National Association, Concord, New Hampshire (024426)	1,389,000
merged on June 30, 2003, under the title of **First Financial Trust, National Association, Newton** (021882)	2,191,000
Missouri	
Bank Midwest, National Association, Kansas City, (022015)	2,654,238,000
and Founders Bank, Chesterfield, Missouri	113,850,000
merged on June 13, 2003, under the title of **Bank Midwest, National Association, Kansas City** (022015)	2,768,088,000
Nebraska	
American National Bank, Omaha (015435)	815,311,000
and American National Bank, Lincoln, Nebraska (024188)	22,927,000
merged on June 14, 2003, under the title of **American National Bank, Omaha** (015435)	837,252,000
Ohio	
May National Bank of Ohio, Lorain (021922)	20,077,000
and May National Bank of Arizona, Phoenix, Arizona (021920)	9,193,000
merged on April 15, 2003, under the title of **May National Bank of Ohio, Lorain** (021922)	29,270,000

Affiliated mergers (mergers consummated involving two or more affiliated operating banks), from April 1 to June 30, 2003 (continued)

Title and location (charter number)	Total assets
Texas	
Mission National Bank, San Antonio (023730)	45,174,000
and Clear Lake National Bank, San Antonio, Texas (023711)	40,945,000
merged on June 1, 2003, under the title of **Lone Star Capital Bank, National Association, San Antonio** (023730)	95,860,000
Guaranty National Bank, Gainesville (013698)	173,618,000
and First Bank & Trust, Ennis, Texas	36,195,000
merged on June 30, 2003, under the title of **GNB Financial, National Association, Gainesville** (013698)	209,820,000
West Virginia	
Progressive Bank, National Association, Wheeling (016248)	223,969,000
and Progressive Bank, National Association-Buckhannon, Buckhannon, West Virginia (021144)	39,637,000
merged on June 27, 2003, under the title of **Progressive Bank, National Association, Wheeling** (016248)	263,585,000
Wisconsin	
National Bank of Commerce in Duluth, Duluth (014109)	47,038,000
and National Bank of Commerce in Superior, Superior, Wisconsin (023941)	224,888,000
merged on January 1, 2003, under the title of **National Bank of Commerce, Superior** (014109)	271,926,000
Wyoming	
American National Bank, Cheyenne (011380)	184,251,000
and The Bank of Laramie, National Association, Laramie, Wyoming (023592)	39,658,000
and Stockgrowers State Bank, National Association, Worland, Wyoming (023593)	44,266,000
and Wyoming Bank and Trust Company, National Association, Buffalo, Wyoming (023594)	33,776,000
merged on May 22, 2003, under the title of **American National Bank, Cheyenne** (011380)	299,717,000

Affiliated mergers—thrift (mergers consummated involving affiliated national banks and savings and loan associations), from April 1 through June 30, 2003

Title and location (charter number)	Total assets
Tennessee	
Union Planters Bank, National Association, Memphis (013349)	33,756,000
and Union Planters Bank of Northwest Tennessee, FSB, Paris, Tennessee	137,000
Merged on June 9, 2003, under the title of **Union Planters Bank, National Association, Memphis** (013349)	33,893,000

Corporate Structure of the National Banking System

Contents

Changes in the corporate structure of the national banking system, by state, January 1 to June 30, 2003

						12 USC 214		
	In operation January 1, 2003	Organized and open for business	Merged	Voluntary liquidations	Payouts	Converted to non-national institutions	Merged with non-national institutions	In operation June 30, 2003
Alabama	20	0	0	0	0	0	0	20
Alaska	4	0	0	0	0	0	0	4
Arizona	17	1	1	0	0	0	0	17
Arkansas	44	0	0	0	0	0	0	44
California	89	2	0	1	0	0	1	88
Colorado	49	1	0	0	0	0	0	50
Connecticut	11	0	0	0	0	0	0	12
Delaware	16	2	0	0	0	1	0	17
District of Columbia	5	0	0	0	0	0	0	5
Florida	75	1	0	1	0	1	1	73
Georgia	63	1	0	0	0	1	1	62
Hawaii	1	0	0	0	0	0	0	1
Idaho	2	0	0	0	0	0	0	2
Illinois	179	1	1	0	0	2	1	176
Indiana	34	1	0	0	0	1	2	32
Iowa	53	2	1	0	0	0	0	54
Kansas	102	0	0	0	0	3	0	99
Kentucky	54	0	1	0	0	3	0	50
Louisiana	17	0	0	0	0	0	1	16
Maine	7	0	0	0	0	0	0	7
Maryland	11	0	0	0	0	0	0	11
Massachusetts	24	0	0	0	0	0	0	24
Michigan	29	0	0	0	0	0	1	28
Minnesota	124	1	0	0	0	1	2	122
Mississippi	20	0	0	0	0	0	0	20
Missouri	48	0	0	0	0	0	0	48
Montana	16	0	0	0	0	0	1	15
Nebraska	75	0	1	0	0	0	2	72
Nevada	7	1	0	0	0	0	0	8
New Hampshire	6	0	0	0	0	0	0	6

Changes in the corporate structure of the national banking system, by state, January 1 to June 30, 2003 (continued)

	In operation January 1, 2003	Organized and open for business	Merged	Voluntary liquidations	Payouts	12 USC 214 Converted to non-national institutions	12 USC 214 Merged with non-national institutions	In operation June 30, 2003
New Jersey	25	0	0	0	0	0	1	24
New Mexico	15	0	0	0	0	0	0	15
New York	59	1	0	0	0	0	0	60
North Carolina	07	0	0	0	0	0	1	06
North Dakota	15	0	0	0	0	0	0	15
Ohio	90	1	1	0	0	0	0	90
Oklahoma	93	0	2	0	0	0	0	91
Oregon	04	0	0	0	0	0	0	04
Pennsylvania	85	0	0	0	0	0	0	85
Rhode Island	05	0	0	0	0	0	0	05
South Carolina	26	0	0	0	0	0	1	25
South Dakota	20	0	0	0	0	0	0	20
Tennessee	28	3	0	0	0	0	0	31
Texas	336	1	2	0	0	2	3	330
Utah	07	0	0	0	0	0	0	07
Vermont	08	0	0	0	0	0	0	08
Virginia	39	1	0	0	0	0	0	40
Washington	14	0	0	0	0	0	0	14
West Virginia	22	0	1	0	0	0	0	21
Wisconsin	50	0	1	0	0	2	0	47
Wyoming	21	0	3	0	0	0	0	18
	2,171	21	15	2	0	17	19	2,139

Notes: The column "organized and opened for business" includes all state banks converted to national banks as well as newly formed national banks. The column titled "merged" includes all mergers, consolidations, and purchases and assumptions of branches in which the resulting institution is a nationally chartered bank. Also included in this column are immediate FDIC-assisted "merger" transactions in which the resulting institution is a nationally chartered bank. The column titled "voluntary liquidations" includes only straight liquidations of national banks. No liquidation pursuant to a purchase and assumption transaction is included in this total. Liquidations resulting from purchases and assumptions are included in the "merged" column. The column titled "payouts" includes failed national banks in which the FDIC is named receiver and no other depository institution is named as successor. The column titled "merged with non-national institutions" includes all mergers, consolidations, and purchases and assumptions of branches in which the resulting institution is a non-national institution. Also included in this column are immediate FDIC-assisted "merger" transactions in which the resulting institution is a non-national institution.

Applications for new, full-service national bank charters, approved and denied, by state, January 1 to June 30, 2003

Title and location	Approved	Denied
California		
Commerce National Bank, Fullerton	April 22	
Rock Asia Capital Bank, National Association, Arcadia	June 18	
Illinois		
J.P. Morgan Chase Interim National Bank, Chicago	March 14	
Minnesota		
Falcon National Bank, Foley	April 8	
First National Bank of Hinckley, Hinckley	May 8	
Nevada		
Charles Schwab Bank, National Association, Reno	February 4	
Texas		
Trinity Bank, National Association, Fort Worth	February 14	

Applications for new, limited-purpose national bank charters, approved and denied, by state, January 1 to June 30, 2003

Title and location	Type of bank	Approved	Denied
California			
Western National Trust Company, Los Angeles	Trust (non-deposit)	April 25	
Delaware			
Mellon Trust of Delaware, National Association, Greenville	Trust (non-deposit)	March 24	
Morgan Stanley Trust National Association, Wilmington	Trust (non-deposit)	January 27	
Ohio			
Unizan Financial Services Group, National Association, Canton	Trust (non-deposit)	March 18	
Texas			
First Financial Trust & Asset Management Company, National Association, Abilene	Trust (non-deposit)	June 13	

New, full-service national bank charters issued, January 1 to June 30, 2003

Title and location (charter number)	Date open
Florida	
Commerce National Bank of Florida, Winter Park (024359)	February 3
Illinois	
J.P. Morgan Chase Interim National Bank, Chicago (024408)	April 1
Iowa	
Liberty National Bank, Sioux City (024378)	March 17
Nevada	
Charles Schwab Bank, National Association, Reno (024366)	April 28
Tennessee	
Community National Bank of the Lakeway Area, Morristown (024368)	April 9
Texas	
Trinity Bank, National Association, Fort Worth (024397)	May 28
Virginia	
Citizens National Bank, Windsor (024297)	April 29

New, limited-purpose national bank charters issued, January 1 to June 30, 2003

Title and location (charter number)	Type of bank	Date open
California		
Western National Trust Company, Los Angeles (024398)	Trust (non-deposit)	May 1
Delaware		
Mellon Trust of Delaware, National Association, Greenville (024406)	Trust (non-deposit)	April 1
Morgan Stanley, Trust National Association, Wilmington (024375)		April 16
Indiana		
Merchants Trust Company, National Association, Muncie (024394)	Trust (non-deposit)	January 2
Ohio		
Unizan Financial Services Group, National Association, Canton (024399)	Trust (non-deposit)	March 31

State-chartered banks converted to full-service national banks, January 1 to June 30, 2003

Title and location (charter number)	Effective date	Total assets
California		
Mellon 1st Business Bank, National Association (024400)		
conversion of Mellon 1st Business Bank, Los Angeles	April 1	2,179,863,000
Colorado		
Peoples National Bank Colorado (024396)		
conversion of Peoples Bank, Colorado Springs	February 11	101,870,000
Georgia		
FSGBank, National Association (024424)		
conversion of Dalton Whitfield Bank, Dalton	June 2	175,732,000
IowaCommunity State Bank, National Association (024403)		
conversion of Community State Bank, Ankeny	April 1	500,560,000
Minnesota		
Marshall Bank, National Association (024393)		
conversion of Northwestern State Bank of Hallock, Hallock	February 3	9,802,000
New York		
Oswego County National Bank (024386)		
conversion of Oswego County Savings Bank, Oswego	January 15	173,536,000
Tennessee		
FSGBank, National Association (024425)		
conversion of Frontier Bank, Chattanooga	June 2	239,022,000
FSGBank, National Association (024423)		
conversion of First State Bank, Maynardville	June 2	57,842,000

State-chartered banks converted to limited-purpose national banks, January 1 to June 30, 2003

Title and location (charter number)	Effective date	Total assets
Arizona		
Security Trust Company, National Association (024364) conversion of Security Trust Company, Phoenix	February 1	9,612,000

Nonbanking institutions converted to limited-purpose national banks, January 1 to June 30, 2003

Title and location (charter number)	Effective date	Assets
New Hampshire		
Freedom Trust Company, National Association (024426) conversion of Freedom Trust Company, Concord	June 30	2,337,000

Applications for national bank charters, by state and charter type, January 1 to June 30, 2003

				Charters issued					
	Received	Approved	Denied	New, full-service national bank charters issued	New, limited-purpose national bank charters issued	Full-service national charters issued to converting state-chartered banks	Limited-purpose national charters issued to converting state-chartered banks	Full-service national charters issued to converting nonbanking institutions	Limited-purpose national charters issued to converting nonbanking institutions
Alabama	1	0	0	0	0	0	0	0	0
Alaska	0	0	0	0	0	0	0	0	0
Arizona	0	0	0	0	0	0	1	0	0
Arkansas	0	0	0	0	0	0	0	0	0
California	2	2	1	0	1	1	0	0	0
Colorado	0	0	0	0	0	1	0	0	0
Connecticut	0	0	0	0	0	0	0	0	0
Delaware	1	2	0	0	2	0	0	0	0
District of Columbia	0	0	0	0	0	0	0	0	0
Florida	0	0	0	1	0	0	0	0	0
Georgia	0	0	0	0	0	1	0	0	0
Hawaii	0	0	0	0	0	0	0	0	0
Idaho	0	0	0	0	0	0	0	0	0
Illinois	0	0	0	0	0	0	0	0	0
Indiana	0	0	0	0	1	0	0	0	0
Iowa	0	0	0	1	0	1	0	0	0
Kansas	0	0	0	0	0	0	0	0	0
Kentucky	0	0	0	0	0	0	0	0	0
Louisiana	0	0	0	0	0	0	0	0	0
Maine	0	0	0	0	0	0	0	0	0
Maryland	0	0	0	0	0	0	0	0	0
Massachusetts	0	0	0	0	0	0	0	0	0
Michigan	0	0	0	0	0	0	0	0	0
Minnesota	1	2	0	0	0	1	0	0	0
Mississippi	0	0	0	0	0	0	0	0	0
Missouri	0	0	0	0	0	0	0	0	0
Montana	0	0	0	0	0	0	0	0	0
Nebraska	0	0	0	0	0	0	0	0	0
Nevada	0	1	0	1	0	0	0	0	0
New Hampshire	0	0	0	0	0	0	0	0	1
New Jersey	0	0	0	0	0	0	0	0	0
New Mexico	0	0	0	0	0	0	0	0	0
New York	0	0	0	0	0	1	0	0	0
North Carolina	0	0	0	0	0	0	0	0	0
North Dakota	0	0	0	0	0	0	0	0	0
Ohio	0	0	0	0	1	0	0	0	0
Oklahoma	0	0	0	0	0	0	0	0	0
Oregon	0	0	0	0	0	0	0	0	0
Pennsylvania	0	0	0	0	0	0	0	0	0
Rhode Island	0	0	0	0	0	0	0	0	0
South Carolina	0	0	0	0	0	0	0	0	0
South Dakota	0	0	0	0	0	0	0	0	0
Tennessee	0	0	0	1	0	2	0	0	0
Texas	1	2	0	1	0	0	0	0	0
Utah	0	0	0	0	0	0	0	0	0
Vermont	0	0	0	0	0	0	0	0	0

Applications for national bank charters, by state and charter type, January 1 to June 30, 2003 (continued)

	Received	Approved	Denied	Charters issued					
				New, full-service national bank charters issued	New, limited-purpose national bank charters issued	Full-service national charters issued to converting state-chartered banks	Limited-purpose national charters issued to converting state-chartered banks	Full-service national charters issued to converting nonbanking institutions	Limited-purpose national charters issued to converting nonbanking institutions
Virginia	0	0	0	1	0	0	0	0	0
Washington	0	0	0	0	0	0	0	0	0
West Virginia	0	0	0	0	0	0	0	0	0
Wisconsin	0	0	0	0	0	0	0	0	0
Wyoming	0	0	0	0	0	0	0	0	0
American Samoa	0	0	0	0	0	0	0	0	0
Canal Zone	0	0	0	0	0	0	0	0	0
Fed St Of Micronesia	0	0	0	0	0	0	0	0	0
Guam	0	0	0	0	0	0	0	0	0
No. Mariana Is	0	0	0	0	0	0	0	0	0
Midway Islands	0	0	0	0	0	0	0	0	0
Puerto Rico	0	0	0	0	0	0	0	0	0
Trust Territories	0	0	0	0	0	0	0	0	0
Virgin Islands	0	0	0	0	0	0	0	0	0
Wake Island	0	0	0	0	0	0	0	0	0
Total	6	9	1	6	5	8	1	0	1

*These figures may also include new national banks chartered to acquire a failed institution, trust company, credit card bank, and other limited-charter national banks.

Voluntary liquidations of national banks, January 1 to June 30, 2003

Title and location (charter number)	Effective date	Total assets
California		
JCB Bank, National Association, Los Angeles (018788)	January 31	2,199,000
Florida		
State Street Global Advisors, National Association, Naples (023492)	December 31, 2002	0
New York		
Banco de Galicia y Buenos Aires S.A., New York (080109)	January 30	0

National banks merged out of the national banking system, January 1 to June 30, 2003

Title and location (charter number)	Effective date
California	
North State National Bank, Chico (017216)	April 4
Florida	
Community National Bank of Mid-Florida, Lake Mary (023732)	January 13
Georgia	
Premier National Bank of Dalton, Dalton (023127)	March 31
Illinois	
Uptown National Bank of Chicago, Chicago (014430)	June 20
Indiana	
The Bright National Bank, Flora (013977)	November 15, 2002
Hometown National Bank, New Albany (023090)	March 20
Louisiana	
American Bank, National Association, Ruston (017928)	November 30, 2002
Michigan	
National Bank of Hastings, Hastings (013857)	November 15, 2002
Minnesota	
First National Bank, La Crescent (023581)	April 11
First National Bank, Thief River Falls (015693)	May 12
Montana	
The United States National Bank of Red Lodge, Red Lodge (009841)	January 27
Nebraska	
The First National Bank of Elwood, Elwood (007204)	March 6
City National Bank and Trust Company Hastings, Nebraska, Hastings (013953)	May 31
New Jersey	
Woodstown National Bank, Woodstown (011734)	February 16
North Carolina	
Northwestern National Bank, Wilkesboro (022328)	December 31, 2002
South Carolina	
Carolina Community Bank, National Association, Latta (022969)	May 16
Texas	
Abrams Centre National Bank, Dallas (018120)	May 6
Founders National Bank, Dallas (018468)	April 4
Whisperwood National Bank, Lubbock (017689)	January 2

National banks converted out of the national banking system, January 1 to June 30, 2003

Title and location (charter number)	Effective date	Total assets
Delaware		
The Bank of Delmarva, National Association, Seaford (023037)	May 2	218,478,000
Florida		
Suncoast National Bank, Sarasota (023772)	January 1	55,017,000
Georgia		
Fidelity National Bank, Norcross (016275)	May 9	1,062,895,000
Illinois		
Marseilles Bank, National Association, Marseilles (014524)	December 31, 2002	30,739,000
The Yorkville National Bank, Yorkville (006239)	June 30	234,284,000
Indiana		
The Knisely National Bank of Butler, Butler (014226)	December 31, 2002	48,793,000
Kansas		
Peoples Bank National Association, Coldwater (022010)	May 1	32,723,000
First Commerce Bank, National Association, Marysville (024269)	June 10	16,107,000
Peoples National Bank & Trust, Ottawa (001910)	December 13, 2002	337,590,000
Kentucky		
First Community Bank of Western Kentucky, Inc., Clinton (014259)	December 31, 2002	54,269,000
Trust Company Of Kentucky, National Association, Lexington (023263)	January 1	971,900,000
Community Trust Bank, National Association, Pikesville (007030)	January 1	2,479,983,000
Minnesota		
First Security Bank National Association, Canby (007427)	January 16	37,000,000
Texas		
Big Lake Bank, National Association, Big Lake (020508)	June 20	34,740,000
Mauriceville National Bank, Mauriceville (020548)	February 25	33,000,000
Washington		
Northstar Bank, National Association, Seattle (022662)	June 30	103,731,000
Wisconsin		
The First National Bank of Baldwin, Baldwin (010106)	June 27	112,226,000
Community National Bank, Oregon (016604)	December 30, 2002	124,329,000

Federal branches and agencies of foreign banks in operation, January 1 to June 30, 2003

	In operation January 1	Opened January 1–June 30	Closed January 1–June 30	In operation June 30
Federal branches				
California	1	0	0	1
Connecticut	1	0	1	0
District of Columbia	1	0	0	1
New York	36	2	0	38
Washington	1	0	0	1
Limited federal branches				
California	7	0	0	7
District of Columbia	1	0	0	1
New York	2	0	0	2
Federal agencies				
Florida	5	0	0	1
Illinois	1	0	0	1
Total United States	56	2	1	53

Financial Performance of National Banks

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Assets, liabilities, and capital accounts of national banks
June 30, 2002 and June 30, 2003
(Dollar figures in millions)

	June 30, 2002	June 30, 2003	Change June 30, 2002—June 30, 2003 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,105	2,048	(57)	(2.71)
Total assets	$3,739,541	$4,160,761	$421,220	11.26
Cash and balances due from depositories	192,980	233,050	40,069	20.76
Noninterest-bearing balances, currency and coin	142,702	163,956	21,253	14.89
Interest bearing balances	50,278	69,094	18,816	37.42
Securities	616,255	743,461	127,207	20.64
Held-to-maturity securities, amortized cost	26,174	23,414	(2,760)	(10.54)
Available-for-sale securities, fair value	590,081	720,047	129,966	22.03
Federal funds sold and securities purchased	146,399	178,656	32,257	22.03
Net loans and leases	2,278,178	2,452,521	174,343	7.65
Total loans and leases	2,325,544	2,500,557	175,014	7.53
Loans and leases, gross	2,328,368	2,503,068	174,700	7.50
Less: Unearned income	2,824	2,510	(314)	(11.11)
Less: Reserve for losses	47,366	48,037	671	1.42
Assets held in trading account	159,420	181,358	21,939	13.76
Other real estate owned	1,864	2,118	254	13.63
Intangible assets	89,825	89,523	(302)	(0.34)
All other assets	254,620	280,074	25,453	10.00
Total liabilities and equity capital	3,739,541	4,160,761	421,220	11.26
Deposits in domestic offices	2,025,585	2,293,878	268,293	13.25
Deposits in foreign offices	385,203	417,636	32,433	8.42
Total deposits	2,410,788	2,711,513	300,725	12.47
Noninterest-bearing deposits	490,843	609,786	118,943	24.23
Interest-bearing deposits	1,919,945	2,101,727	181,783	9.47
Federal funds purchased and securities sold	259,473	318,481	59,008	22.74
Other borrowed money	377,189	382,450	5,261	1.39
Trading liabilities less revaluation losses	27,246	28,941	1,695	6.22
Subordinated notes and debentures	67,401	69,556	2,156	3.20
All other liabilities	241,493	266,106	24,613	10.19
Trading liabilities revaluation losses	76,602	80,147	3,546	4.63
Other	164,891	185,958	21,067	12.78
Total equity capital	355,951	383,714	27,763	7.80
Perpetual preferred stock	2,698	2,651	(47)	(1.73)
Common stock	12,942	12,682	(260)	(2.01)
Surplus	194,840	203,862	9,022	4.63
Retained earnings and other comprehensive income	149,987	171,770	21,783	14.52
Other equity capital components	(41)	(48)	(7)	NM

NM indicates calculated percent change is not meaningful.

Quarterly income and expenses of national banks
Second quarter 2002 and second quarter 2003
(Dollar figures in millions)

	Second quarter 2002	Second quarter 2003	Change Second quarter 2002—second quarter 2003 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and Domestic	Amount	Percent
Number of institutions	2,105	2,048	(57)	(2.71)
Net income	$14,149	$15,286	$1,137	8.04
Net interest income	34,792	35,251	460	1.32
Total interest income	51,941	48,741	(3,201)	(6.16)
On loans	39,713	37,809	(1,904)	(4.79)
From lease financing receivables	1,832	1,576	(256)	(13.96)
On balances due from depositories	456	452	(4)	(0.77)
On securities	7,944	7,201	(743)	(9.35)
From assets held in trading account	923	824	(99)	(10.77)
On federal funds sold and securities repurchased	746	570	(176)	(23.63)
Less: Interest expense	17,150	13,489	(3,660)	(21.34)
On deposits	11,570	8,760	(2,810)	(24.28)
Of federal funds purchased and securities sold	1,316	1,111	(205)	(15.57)
On demand notes and other borrowed money*	3,438	2,884	(554)	(16.11)
On subordinated notes and debentures	826	734	(92)	(11.13)
Less: Provision for losses	7,796	6,288	(1,508)	(19.35)
Noninterest income	26,710	28,210	1,500	5.62
From fiduciary activities	2,265	2,156	(109)	(4.81)
Service charges on deposits	4,878	5,127	249	5.11
Trading revenue	2,141	1,299	(842)	(39.33)
From interest rate exposures	725	215	(510)	(70.34)
From foreign exchange exposures	957	1,158	201	21.05
From equity security and index exposures	270	79	(191)	NM
From commodity and other exposures	191	(155)	(346)	NM
Investment banking brokerage fees	1,212	1,198	(14)	(1.15)
Venture capital revenue	24	89	65	NM
Net servicing fees	2,610	1,980	(629)	(24.12)
Net securitization income	3,606	3,734	128	3.56
Insurance commissions and fees	500	497	(3)	(0.53)
Insurance and reinsurance underwriting income	NA	142	142	NM
Income from other insurance activities	NA	356	356	NM
Net gains on asset sales	944	2,296	1,352	143.22
Sales of loans and leases	845	1,890	1,045	123.67
Sales of other real estate owned	25	(7)	(32)	(128.99)
Sales of other assets (excluding securities)	74	413	339	459.15
Other noninterest income	8,616	9,835	1,220	14.16
Gains/losses on securities	531	1,347	816	153.85
Less: Noninterest expense	33,093	35,821	2,728	8.24
Salaries and employee benefits	13,561	15,239	1,678	12.37
Of premises and fixed assets	3,921	4,208	287	7.32
Goodwill impairment losses	3	0	(3)	(87.82)
Amortization expense and impairment losses	1,016	1,140	124	12.24
Other noninterest expense	14,596	15,233	637	4.37
Less: Taxes on income before extraordinary items	7,150	7,416	267	3.73
Income/loss from extraordinary items, net of income taxes	156	3	(154)	(98.35)
Memoranda:				
Net operating income	13,645	14,353	708	5.19
Income before taxes and extraordinary items	21,143	22,700	1,557	7.36
Income net of taxes before extraordinary items	13,993	15,284	1,291	9.22
Cash dividends declared	8,129	9,721	1,591	19.57
Net charge-offs to loan and lease reserve	7,852	6,567	(1,284)	(16.36)
Charge-offs to loan and lease reserve	9,188	7,938	(1,250)	(13.61)
Less: Recoveries credited to loan and lease reserve	1,336	1,370	34	2.56

* Includes mortgage indebtedness
NM indicates calculated percent change is not meaningful.
NA Not available

Year-to-date income and expenses of national banks
Through June 30, 2002, and through June 30, 2003
(Dollar figures in millions)

	June 30, 2002	June 30, 2003	Change June 30, 2002—June 30, 2003 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,105	2,048	(57)	(2.71)
Net income	$27,760	$30,377	$2,618	9.43
Net interest income	70,188	70,355	167	0.24
Total interest income	103,512	97,500	(6,012)	(5.81)
On loans	79,541	75,703	(3,839)	(4.83)
From lease financing receivables	3,667	3,221	(445)	(12.14)
On balances due from depositories	937	852	(85)	(9.08)
On securities	15,536	14,292	(1,245)	(8.01)
From assets held in trading account	1,672	1,626	(45)	(2.72)
On federal funds sold and securities repurchased	1,478	1,167	(311)	(21.03)
Less: Interest expense	33,324	27,145	(6,179)	(18.54)
On deposits	22,395	17,694	(4,702)	(20.99)
Of federal funds purchased and securities sold	2,630	2,167	(463)	(17.59)
On demand notes and other borrowed money*	6,672	5,812	(860)	(12.89)
On subordinated notes and debentures	1,627	1,472	(155)	(9.51)
Less: Provision for losses	16,112	12,786	(3,325)	(20.64)
Noninterest income	53,051	55,427	2,376	4.48
From fiduciary activities	4,454	4,186	(268)	(6.02)
Service charges on deposits	9,475	10,036	561	5.92
Trading revenue	3,821	2,943	(878)	(22.97)
From interest rate exposures	1,342	416	(926)	(69.00)
From foreign exchange exposures	1,737	2,307	570	32.84
From equity security and index exposures	522	325	(196)	(37.62)
From commodity and other exposures	222	(108)	(330)	(148.82)
Investment banking brokerage fees	2,440	2,349	(91)	(3.72)
Venture capital revenue	193	57	(135)	(70.26)
Net servicing fees	5,539	4,421	(1,118)	(20.18)
Net securitization income	7,178	7,365	187	2.61
Insurance commissions and fees	966	1,028	62	6.38
Insurance and reinsurance underwriting income	NA	240	240	NM
Income from other insurance activities	NA	788	788	NM
Net gains on asset sales	2,032	3,681	1,649	81.16
Sales of loans and leases	2,073	3,164	1,091	52.62
Sales of other real estate owned	15	(9)	(24)	NM
Sales of other assets(excluding securities)	(56)	526	582	NM
Other noninterest income	16,953	19,361	2,407	14.20
Gains/losses on securities	890	2,473	1,583	177.75
Less: Noninterest expense	66,141	70,178	4,037	6.10
Salaries and employee benefits	27,396	30,163	2,767	10.10
Of premises and fixed assets	7,807	8,401	594	7.61
Goodwill impairment losses	6	41	35	621.34
Amortization expense and impairment losses	1,911	2,178	267	13.98
Other noninterest expense	29,022	29,396	374	1.29
Less: Taxes on income before extraordinary items	14,188	14,904	716	5.04
Income/loss from extraordinary items, net of income taxes	71	(9)	(81)	NM
Memoranda:				
Net operating income	27,097	28,694	1,596	5.89
Income before taxes and extraordinary items	41,876	45,291	3,414	8.15
Income net of taxes before extraordinary items	27,688	30,387	2,699	9.75
Cash dividends declared	21,543	19,760	(1,783)	(8.28)
Net charge-offs to loan and lease reserve	16,132	13,406	(2,726)	(16.90)
Charge-offs to loan and lease reserve	18,719	16,010	(2,709)	(14.47)
Less: Recoveries credited to loan and lease reserve	2,587	2,605	17	0.67

* Includes mortgage indebtedness
NM indicates calculated percent change is not meaningful.
NA Not available

Assets of national banks by asset size, June 30, 2003

(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,048	886	993	123	46	7,833
Total assets	$4,160,761	$47,871	$272,334	$373,078	$3,467,478	$7,485,044
Cash and balances due from	233,050	3,213	13,945	22,653	193,239	419,350
Securities	743,461	11,862	67,937	75,163	588,500	1,444,446
Federal funds sold and securities purchased	178,656	2,888	11,160	21,128	143,481	372,789
Net loans and leases	2,452,521	27,707	165,601	228,038	2,031,175	4,213,722
Total loans and leases	2,500,557	28,109	168,025	231,760	2,072,664	4,290,965
Loans and leases, gross	2,503,068	28,140	168,211	231,847	2,074,869	4,294,413
Less: Unearned income	2,510	31	187	88	2,205	3,448
Less: Reserve for losses	48,037	402	2,424	3,722	41,489	77,244
Assets held in trading account	181,358	0	52	286	181,020	408,580
Other real estate owned	2,118	80	306	215	1,517	4,401
Intangible assets	89,523	142	1,766	7,579	80,037	131,823
All other assets	280,074	1,980	11,566	18,018	248,510	489,934
Gross loans and leases by type:						
Loans secured by real estate	1,219,212	16,911	112,707	127,494	962,100	2,205,242
1– to 4–family residential mortgages	619,065	6,968	39,839	55,907	516,351	1,009,672
Home equity loans	163,100	479	6,071	9,081	147,469	246,265
Multifamily residential mortgages	34,237	434	4,340	4,703	24,761	76,666
Commercial RE loans	260,038	5,271	44,242	40,785	169,740	577,244
Construction RE loans	97,807	1,655	13,017	14,901	68,234	218,689
Farmland loans	13,397	2,104	5,198	1,655	4,439	39,708
RE loans from foreign offices	31,567	0	0	462	31,105	36,999
Commercial and industrial loans	523,122	4,577	27,749	39,257	451,540	890,880
Loans to individuals	432,483	3,367	18,017	41,503	369,596	690,407
Credit cards*	187,529	127	2,880	15,504	169,018	251,126
Other revolving credit plans	32,404	47	357	1,742	30,257	37,044
Installment loans	212,550	3,193	14,780	24,256	170,322	402,237
All other loans and leases	328,250	3,284	9,738	23,594	291,633	507,884
Securities by type:						
U.S. Treasury securities	26,534	551	2,115	2,724	21,143	62,197
Mortgage-backed securities	466,350	3,231	25,902	39,314	397,903	816,638
Pass-through securities	350,595	2,433	17,070	25,260	305,833	548,494
Collateralized mortgage obligations	115,755	798	8,832	14,055	92,070	268,144
Other securities	201,820	8,063	39,518	32,174	122,065	473,384
Other U.S. government securities	75,406	5,435	22,350	15,274	32,347	242,693
State and local government securities	50,047	2,052	12,486	7,810	27,699	108,695
Other debt securities	69,612	386	3,575	8,294	57,357	103,930
Equity securities	6,755	190	1,107	796	4,662	18,066
Memoranda:						
Agricultural production loans	18,544	2,777	5,463	2,441	7,864	45,780
Pledged securities	359,061	4,326	30,739	35,654	288,342	726,553
Book value of securities	729,632	11,632	66,517	73,051	578,432	1,418,311
Available-for-sale securities	706,218	9,794	57,877	65,649	572,899	1,323,456
Held-to-maturity securities	23,414	1,839	8,640	7,402	5,533	94,855
Market value of securities	744,202	11,919	68,246	75,370	588,667	1,447,220
Available-for-sale securities	720,047	10,023	59,297	67,760	582,967	1,349,590
Held-to-maturity securities	24,155	1,896	8,949	7,610	5,700	97,630

*Prior to March 2001, also included "Other revolving credit plans."

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Past-due and nonaccrual loans and leases of national banks by asset size
June 30, 2003
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	$100 million to $1 million	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,048	886	993	123	46	7,833
Loans and leases past due 30-89 days	$24,396	$394	$1,722	$2,253	$20,027	$42,789
Loans secured by real estate	10,986	206	942	997	8,841	19,792
1-4 family residential mortgages	7,208	114	453	634	6,007	11,877
Home equity loans	783	3	30	38	712	1,157
Multifamily residential mortgages	190	3	20	24	143	321
Commercial RE loans	1,425	50	276	179	920	3,629
Construction RE loans	829	19	119	108	583	1,842
Farmland loans	110	17	44	15	35	362
RE loans from foreign offices	440	0	0	0	440	605
Commercial and industrial loans	4,154	80	356	445	3,273	7,633
Loans to individuals	7,718	78	340	699	6,601	12,878
Credit cards	3,977	3	94	350	3,530	5,882
Installment loans and other plans	3,741	75	246	349	3,071	6,996
All other loans and leases	1,538	30	84	112	1,312	2,486
Loans and leases past due 90+ days	7,852	102	390	707	6,652	12,588
Loans secured by real estate	2,823	59	214	182	2,368	4,468
1-4 family residential mortgages	2,158	29	104	95	1,930	3,015
Home equity loans	97	0	4	7	86	177
Multifamily residential mortgages	25	0	5	1	18	63
Commercial RE loans	209	12	67	43	87	598
Construction RE loans	108	6	15	27	60	263
Farmland loans	62	12	19	9	22	177
RE loans from foreign offices	164	0	0	0	164	175
Commercial and industrial loans	586	14	77	105	390	1,329
Loans to individuals	4,220	14	70	407	3,729	6,305
Credit cards	3,115	2	35	270	2,808	4,112
Installment loans and other plans	1,105	12	36	137	920	2,192
All other loans and leases	223	15	30	12	166	486
Nonaccrual loans and leases	27,242	263	1,309	1,537	24,134	44,081
Loans secured by real estate	8,219	137	774	928	6,381	14,312
1-4 family residential mortgages	3,259	41	212	421	2,584	5,347
Home equity loans	357	1	8	20	327	493
Multifamily residential mortgages	144	4	15	20	105	259
Commercial RE loans	2,656	52	395	343	1,867	5,123
Construction RE loans	807	16	80	94	618	1,675
Farmland loans	216	24	64	29	100	479
RE loans from foreign offices	780	0	0	0	780	935
Commercial and industrial loans	14,102	75	340	471	13,216	22,672
Loans to individuals	2,145	15	87	68	1,975	3,150
Credit cards	340	0	44	37	259	782
Installment loans and other plans	1,805	14	43	31	1,716	2,368
All other loans and leases	2,877	36	108	77	2,656	4,109

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Liabilities of national banks by asset size
June 30, 2003
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,048	886	993	123	46	7,833
Total liabilities and equity capital	4,160,761	47,871	272,334	373,078	3,467,478	7,485,044
Deposits in domestic offices	2,293,878	40,110	219,886	239,758	1,794,124	4,247,908
Deposits in foreign offices	417,636	0	357	2,547	414,732	678,062
Total deposits	2,711,513	40,110	220,242	242,304	2,208,856	4,925,970
Noninterest bearing	609,786	6,793	35,422	44,484	523,087	1,024,877
Interest bearing	2,101,727	33,317	184,820	197,820	1,685,769	3,901,093
Federal funds purchased and securities sold	318,481	438	6,971	34,400	276,673	622,402
Other borrowed funds	382,450	1,368	14,018	41,253	325,811	611,374
Trading liabilities less revaluation losses	28,941	0	0	0	28,940	87,237
Subordinated notes and debentures	69,556	3	194	3,198	66,163	97,249
All other liabilities	266,106	415	3,044	8,970	253,676	464,358
Equity capital	383,714	5,537	27,865	42,953	307,359	676,454
Total deposits by depositor:						
Individuals and corporations	2,095,228	25,019	151,645	193,015	1,725,549	3,794,206
U.S., state, and local governments	130,158	3,366	16,870	16,009	93,913	241,179
Depositories in the United States	72,902	677	3,213	2,156	66,856	106,070
Foreign banks and governments	83418.15	2	341	1,216	81,859	153,174
Domestic deposits by depositor:						
Individuals and corporations	1792627.304	25,019	151,621	190,772	1,425,215	3,304,876
U.S., state, and local governments	130,158	3,366	16,870	16,009	93,913	241,179
Depositories in the United States	33,151	677	3,170	2,132	27,172	57,169
Foreign banks and governments	8,352	2	51	945	7,354	13,639
Foreign deposits by depositor:						
Individuals and corporations	302600.957	0	23	2,244	300,334	489,330
Depositories in the U.S.	39751.476	0	43	24	39,684	48,901
Foreign banks and governments	75,066	0	291	271	74,504	139,534
Deposits in domestic offices by type:						
Transaction deposits	388,719	12,430	54,484	35,325	286,479	737,904
Demand deposits	312,654	6,662	31,300	26,291	248,401	556,796
Savings deposits	1,307,931	9,426	73,393	132,057	1,093,055	2,217,213
Money market deposit accounts	960845.274	5,144	42,654	89,787	823,260	1,593,650
Other savings deposits	347085.428	4,282	30,739	42,269	269,795	623,563
Time deposits	597,229	18,254	92,008	72,376	414,591	1,292,791
Small time deposits	323,819	12,266	57,033	41,330	213,190	683,204
Large time deposits	273,409	5,988	34,975	31,045	201,400	609,587

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Off-balance-sheet items of national banks by asset size
June 30, 2003
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 million	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,048	886	993	123	46	7,833
Unused commitments	$3,993,634	$63,999	$511,528	$398,817	$3,019,291	$5,438,055
Home equity lines	199,041	354	5,234	8,963	184,491	285,177
Credit card lines	2,733,034	60,024	479,668	343,543	1,849,799	3,428,662
Commercial RE, construction and land	82,896	940	8,751	11,733	61,472	172,866
All other unused commitments	978,663	2,680	17,875	34,577	923,530	1,551,351
Letters of credit:						
Standby letters of credit	170,287	118	1,653	4,032	164,484	282,190
Financial letters of credit	140,057	77	1,040	2,859	136,080	237,015
Performance letters of credit	30,231	41	612	1,173	28,405	45,174
Commercial letters of credit	16,362	20	433	429	15,480	24,419
Securities lent	148,318	26	61	5,807	142,423	705,818
Spot foreign exchange contracts	354,760	0	1	193	354,566	609,075
Credit derivatives (notional value)						
Reporting bank is the guarantor	132,413	0	15	0	132,398	363,871
Reporting bank is the beneficiary	177,973	0	0	0	177,973	438,454
Derivative contracts (notional value)	30,885,244	14	4,320	22,016	30,858,894	65,838,709
Futures and forward contracts	7,192,987	1	1,659	2,688	7,188,638	12,657,643
Interest rate contracts	4,678,832	1	1,654	2,587	4,674,590	8,344,339
Foreign exchange contracts	2,498,536	0	6	101	2,498,429	4,224,818
All other futures and forwards	15,619	0	0	0	15,619	88,485
Option contracts	6,691,095	12	1,499	5,379	6,684,205	14,304,766
Interest rate contracts	5,613,976	11	1,470	5,192	5,607,302	12,107,201
Foreign exchange contracts	918,141	0	0	180	917,961	1,429,560
All other options	158,978	1	29	6	158,942	768,005
Swaps	16,690,776	0	1,147	13,949	16,675,680	38,073,976
Interest rate contracts	15,945,296	0	1,129	10,608	15,933,558	36,481,172
Foreign exchange contracts	653,482	0	2	3,339	650,141	1,437,672
All other swaps	91,998	0	16	2	91,980	155,132
Memoranda: Derivatives by purpose						
Contracts held for trading	28,399,802	0	74	2,275	28,397,453	62,393,301
Contracts not held for trading	2,175,055	14	4,231	19,741	2,151,070	2,643,083
Memoranda: Derivatives by position						
Held for trading—positive fair value	587,935	0	0	29	587,905	1,368,275
Held for trading—negative fair value	573,007	0	0	9	572,998	1,335,415
Not for trading—positive fair value	28,841	0	23	463	28,355	35,649
Not for trading—negative fair value	23,176	0	31	660	22,485	27,997

Quarterly income and expenses of national banks by asset size
Second quarter 2003
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,048	886	993	123	46	7,833
Net income	$15,286	$32	$863	$1,502	$12,890	$25,517
Net interest income	35,251	452	2,501	3,292	29,007	59,948
Total interest income	48,741	634	3,561	4,521	40,024	84,960
On loans	37,809	503	2,835	3,597	30,875	64,043
From lease financing receivables	1,576	3	19	62	1,492	2,328
On balances due from depositories	452	6	14	26	406	804
On securities	7,201	110	639	722	5,730	13,842
From assets held in trading account	824	0	1	2	821	2,027
On fed. funds sold & securities repurchased	570	9	36	79	446	1,205
Less: Interest expense	13,489	182	1,060	1,229	11,018	25,011
On deposits	8,760	169	900	782	6,909	16,439
Of federal funds purchased & securities sold	1,111	2	24	115	971	2,210
On demand notes & other borrowed money*	2,884	12	134	301	2,437	5,298
On subordinated notes and debentures	734	0	2	31	701	1,064
Less: Provision for losses	6,288	43	200	490	5,554	9,233
Noninterest income	28,210	202	1,331	3,250	23,428	46,114
From fiduciary activities	2,156	10	138	340	1,668	5,244
Service charges on deposits	5,127	60	319	359	4,389	7,950
Trading revenue	1,299	0	4	8	1,287	3,236
From interest rate exposures	215	0	3	9	203	1,508
From foreign exchange exposures	1,158	0	0	1	1,157	1,489
From equity security and index exposures	79	0	0	(3)	81	300
From commodity and other exposures	(155)	0	0	0	(155)	(117)
Investment banking brokerage fees	1,198	1	18	37	1,142	2,464
Venture capital revenue	89	(0)	(0)	(1)	90	161
Net servicing fees	1,980	52	76	275	1,578	2,187
Net securitization income	3,734	(1)	90	272	3,374	5,029
Insurance commissions and fees	497	9	22	35	431	821
Insurance and reinsurance underwriting income	142	0	2	3	137	188
Income from other insurance activities	356	9	20	33	294	633
Net gains on asset sales	2,296	10	154	436	1,697	3,888
Sales of loans and leases	1,890	6	154	434	1,295	3,425
Sales of other real estate owned	(7)	0	3	(1)	(9)	(11)
Sales of other assets(excluding securities)	413	3	(3)	2	411	474
Other noninterest income	9,835	62	511	1,489	7,773	15,134
Gains/losses on securities	1,347	4	44	70	1,229	2,728
Less: Noninterest expense	35,821	541	2,488	3,867	28,925	61,670
Salaries and employee benefits	15,239	231	1,171	1,297	12,540	27,310
Of premises and fixed assets	4,208	55	306	337	3,510	7,840
Goodwill impairment losses	0	0	0	0	0	1
Amortization expense and impairment losses	1,140	2	18	128	992	1,327
Other noninterest expense	15,233	252	992	2,106	11,884	25,191
Less: Taxes on income before extraord. items	7,416	41	325	753	6,298	12,389
Income/loss from extraord. items, net of taxes	(9)	(0)	1	0	(10)	7
Memoranda:						
Net operating income	14,353	30	830	1,452	12,041	23,657
Income before taxes and extraordinary items	22,700	73	1,188	2,254	19,185	37,887
Income net of taxes before extraordinary items	15,284	33	863	1,502	12,887	25,498
Cash dividends declared	9,721	79	393	682	8,566	21,983
Net loan and lease losses	6,567	23	153	423	5,968	9,515
Charge-offs to loan and lease reserve	7,938	31	202	538	7,166	11,528
Less: Recoveries credited to loan & lease resv.	1,370	8	50	115	1,198	2,013

* Includes mortgage indebtedness
Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Year-to-date income and expenses of national banks by asset size
Through June 30, 2003
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 million	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,048	886	993	123	46	7,833
Net income	$30,377	$155	$1,691	$2,940	$25,591	$50,395
Net interest income	70,355	887	4,980	6,653	57,836	119,164
Total interest income	97,500	1,261	7,137	9,140	79,962	169,889
On loans	75,703	991	5,653	7,252	61,807	127,784
From lease financing receivables	3,221	6	38	126	3,051	4,736
On balances due from depositories	852	12	28	51	761	1,567
On securities	14,292	229	1,313	1,476	11,274	27,787
From assets held in trading account	1,626	0	1	5	1,620	4,161
On fed. funds sold & securities repurchased	1,167	18	69	156	924	2,526
Less: Interest expense	27,145	375	2,157	2,487	22,126	50,725
On deposits	17,694	346	1,840	1,614	13,893	33,469
Of federal funds purchased & securities sold	2,167	3	47	235	1,883	4,488
On demand notes & other borrowed money*	5,812	25	265	588	4,934	10,634
On subordinated notes and debentures	1,472	0	5	51	1,417	2,134
Less: Provision for losses	12,786	64	393	1,004	11,324	18,716
Noninterest income	55,427	403	2,608	6,095	46,322	90,414
From fiduciary activities	4,186	19	271	656	3,240	10,185
Service charges on deposits	10,036	116	618	700	8,602	15,472
Trading revenue	2,943	0	6	15	2,922	6,279
From interest rate exposures	416	0	5	9	402	2,653
From foreign exchange exposures	2,307	0	0	1	2,306	2,850
From equity security and index exposures	325	0	0	3	322	785
From commodity and other exposures	(108)	0	0	0	(108)	(61)
Investment banking brokerage fees	2,349	2	35	89	2,224	4,669
Venture capital revenue	57	(0)	(1)	(1)	59	103
Net servicing fees	4,421	95	159	550	3,617	5,232
Net securitization income	7,365	9	191	585	6,580	9,799
Insurance commissions and fees	1,028	15	45	80	887	1,654
Insurance and reinsurance underwriting income	240	0	5	5	229	334
Income from other insurance activities	788	15	40	74	658	1,319
Net gains on asset sales	3,681	16	278	581	2,805	6,791
Sales of loans and leases	3,164	13	276	571	2,305	6,110
Sales of other real estate owned	(9)	1	4	2	(16)	(4)
Sales of other assets(excluding securities)	526	3	(2)	8	516	684
Other noninterest income	19,361	130	1,005	2,841	15,384	30,231
Gains/losses on securities	2,473	11	88	112	2,262	4,815
Less: Noninterest expense	70,178	1,002	4,953	7,433	56,790	120,727
Salaries and employee benefits	30,163	458	2,338	2,580	24,788	54,185
Of premises and fixed assets	8,401	110	607	670	7,014	15,577
Goodwill impairment losses	41	0	0	0	40	43
Amortization expense and impairment losses	2,178	4	36	204	1,934	2,551
Other noninterest expense	29,396	430	1,972	3,980	23,014	48,371
Less: Taxes on income before extraord. items	14,904	78	638	1,482	12,705	24,562
Income/loss from extraord. items, net of taxes	(9)	(0)	1	0	(10)	7
Memoranda:						
Net operating income	28,694	146	1,625	2,860	24,061	47,132
Income before taxes and extraordinary items	45,291	234	2,329	4,423	38,305	74,951
Income net of taxes before extraordinary items	30,387	156	1,690	2,940	25,601	50,388
Cash dividends declared	19,760	131	976	1,857	16,795	37,578
Net loan and lease losses	13,406	41	280	853	12,231	19,098
Charge-offs to loan and lease reserve	16,010	56	375	1,067	14,512	22,967
Less: Recoveries credited to loan & lease resv.	2,605	15	95	214	2,281	3,869

* Includes mortgage indebtedness
Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Quarterly net loan and lease losses of national banks by asset size
Second quarter 2003
(Dollar figures in millions)

	All national banks	National banks				Memoranda: All commercial banks
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	
Number of institutions reporting	2,048	886	993	123	46	7,833
Net charge-offs to loan and lease reserve	$6,567	$23	$153	$423	$5,968	$9,515
Loans secured by real estate	483	3	26	33	421	787
1-4 family residential mortgages	197	1	9	17	170	334
Home equity loans	89	(0)	0	2	87	115
Multifamily residential mortgages	4	(0)	1	1	3	9
Commercial RE loans	98	1	14	8	76	199
Construction RE loans	41	0	2	7	32	72
Farmland loans	3	(0)	1	(1)	3	5
RE loans from foreign offices	0	0	0	0	0	0
Commercial and industrial loans	1,926	7	47	112	1,761	2,983
Loans to individuals	3,831	11	71	267	3,482	5,248
Credit cards	2,701	6	44	199	2,452	3,765
Installment loans and other plans	1,131	5	27	68	1,030	1,483
All other loans and leases	323	2	9	12	301	494
Charge-offs to loan and lease reserve	7,938	31	202	538	7,166	11,528
Loans secured by real estate	584	4	32	47	501	937
1-4 family residential mortgages	233	2	11	23	198	391
Home equity loans	104	0	1	2	101	134
Multifamily residential mortgages	8	0	1	3	5	14
Commercial RE loans	127	1	16	11	99	245
Construction RE loans	49	1	3	7	39	84
Farmland loans	5	0	1	0	3	10
RE loans from foreign offices	57	0	0	0	57	59
Commercial and industrial loans	2,302	10	62	137	2,093	3,545
Loans to individuals	4,612	15	94	334	4,169	6,378
Credit cards	3,133	7	53	234	2,840	4,398
Installment loans and other plans	1,479	8	42	101	1,329	1,980
All other loans and leases	437	3	13	20	401	665
Recoveries credited to loan and lease reserve	1,370	8	50	115	1,198	2,013
Loans secured by real estate	101	1	6	14	80	150
1-4 family residential mortgages	36	0	2	7	27	56
Home equity loans	15	0	0	1	14	19
Multifamily residential mortgages	4	0	0	2	2	5
Commercial RE loans	29	0	3	3	23	46
Construction RE loans	8	0	1	1	7	12
Farmland loans	2	0	0	1	1	5
RE loans from foreign offices	6	0	0	0	6	6
Commercial and industrial loans	375	2	15	25	332	562
Loans to individuals	781	4	24	68	686	1,130
Credit cards	432	1	9	35	388	633
Installment loans and other plans	349	3	15	33	299	497
All other loans and leases	114	1	5	8	100	171

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Year-to-date net loan and lease losses of national banks by asset size
Through June 30, 2003
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,048	886	993	123	46	7,833
Net charge-offs to loan and lease reserve	13,406	41	280	853	12,231	19,098
Loans secured by real estate	917	5	42	59	811	1,416
1-4 family residential mortgages	424	3	15	36	370	641
Home equity loans	171	(0)	1	4	166	219
Multifamily residential mortgages	7	0	1	1	5	14
Commercial RE loans	158	2	19	11	126	329
Construction RE loans	72	1	5	7	60	121
Farmland loans	3	(0)	2	(0)	2	9
RE loans from foreign offices	82	0	0	0	82	84
Commercial and industrial loans	3,956	16	76	209	3,655	6,130
Loans to individuals	7,765	18	147	558	7,042	10,499
Credit cards	5,480	7	93	410	4,970	7,476
Installment loans and other plans	2,285	10	54	148	2,072	3,023
All other loans and leases	769	4	15	27	723	1,053
Charge-offs to loan and lease reserve	16,010	56	375	1,067	14,512	22,967
Loans secured by real estate	1,113	7	53	83	970	1,714
1-4 family residential mortgages	496	4	20	47	425	752
Home equity loans	197	0	1	5	190	254
Multifamily residential mortgages	14	0	1	3	10	22
Commercial RE loans	211	2	23	17	169	417
Construction RE loans	95	1	6	9	80	155
Farmland loans	8	0	2	1	5	19
RE loans from foreign offices	92	0	0	0	92	94
Commercial and industrial loans	4,645	20	102	255	4,268	7,226
Loans to individuals	9,266	24	196	686	8,360	12,656
Credit cards	6,310	8	110	477	5,716	8,668
Installment loans and other plans	2,956	16	87	210	2,644	3,988
All other loans and leases	986	5	24	43	913	1,371
Recoveries credited to loan and lease reserve	2,605	15	95	214	2,281	3,869
Loans secured by real estate	197	2	11	24	159	297
1-4 family residential mortgages	72	1	4	11	56	112
Home equity loans	26	0	0	1	24	34
Multifamily residential mortgages	7	0	0	2	5	8
Commercial RE loans	54	0	5	6	42	89
Construction RE loans	23	0	1	2	20	33
Farmland loans	5	1	1	1	2	10
RE loans from foreign offices	10	0	0	0	10	10
Commercial and industrial loans	689	4	26	45	613	1,096
Loans to individuals	1,502	6	49	129	1,317	2,158
Credit cards	830	1	17	67	745	1,192
Installment loans and other plans	672	6	32	62	572	966
All other loans and leases	217	2	9	16	191	319

Inclusion of a bank in self-liquidation had a material impact on the June 2003 results for banks with assets under $100 million.

Number of national banks by state and asset size
June 30, 2003

	All national banks	National banks: Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
All institutions	2,048	886	993	123	46	7,833
Alabama	20	11	8	1	0	150
Alaska	3	1	0	2	0	6
Arizona	16	5	6	3	2	45
Arkansas	42	12	30	0	0	166
California	81	30	38	10	3	281
Colorado	49	23	23	2	1	169
Connecticut	9	1	7	1	0	26
Delaware	11	1	5	2	3	28
District of Columbia	4	2	2	0	0	4
Florida	70	19	44	7	0	262
Georgia	61	24	35	2	0	318
Hawaii	1	0	1	0	0	7
Idaho	1	0	1	0	0	16
Illinois	172	65	97	7	3	672
Indiana	28	5	15	7	1	149
Iowa	52	28	22	2	0	406
Kansas	99	67	29	3	0	362
Kentucky	49	22	26	1	0	220
Louisiana	15	5	8	1	1	140
Maine	6	1	4	0	1	17
Maryland	11	2	9	0	0	72
Massachusetts	13	3	9	1	0	39
Michigan	26	9	16	0	1	159
Minnesota	118	70	44	2	2	464
Mississippi	20	8	10	2	0	97
Missouri	46	23	19	3	1	343
Montana	15	12	2	1	0	79
Nebraska	72	48	22	2	0	264
Nevada	8	1	4	3	0	34
New Hampshire	5	2	2	0	1	15
New Jersey	22	0	15	6	1	79
New Mexico	15	6	6	3	0	51
New York	57	10	40	6	1	136
North Carolina	6	0	4	0	2	72
North Dakota	15	6	6	3	0	104
Ohio	86	34	38	7	7	196
Oklahoma	89	48	39	1	1	273
Oregon	3	1	1	1	0	34
Pennsylvania	80	18	51	8	3	172
Rhode Island	4	2	0	1	1	8
South Carolina	25	11	12	2	0	76
South Dakota	19	8	8	2	1	91
Tennessee	31	8	19	1	3	189
Texas	326	186	128	10	2	662
Utah	7	2	3	0	2	56
Vermont	8	2	6	0	0	14
Virginia	38	7	28	2	1	130
Washington	13	9	4	0	0	79
West Virginia	20	8	10	2	0	69
Wisconsin	43	13	27	2	1	271
Wyoming	18	7	10	1	0	44
U.S. territories	0	0	0	0	0	17

Total assets of national banks by state and asset size
June 30, 2003
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
All institutions	$4,160,761	$47,871	$272,334	$373,078	$3,467,478	$7,485,044
Alabama	4,128	707	2,030	1,390	0	209,512
Alaska	5,763	69	0	5,694	0	6,950
Arizona	49,499	220	3,008	5,197	41,074	52,361
Arkansas	8,944	693	8,251	0	0	33,196
California	292,929	1,719	11,039	22,467	257,705	436,406
Colorado	24,212	1,169	5,784	2,414	14,845	46,712
Connecticut	3,025	95	1,802	1,129	0	4,865
Delaware	110,675	80	1,152	3,896	105,547	151,808
District of Columbia	569	166	403	0	0	569
Florida	31,141	1,346	11,962	17,833	0	75,633
Georgia	19,928	1,457	7,008	11,463	0	199,498
Hawaii	402	0	402	0	0	23,622
Idaho	278	0	278	0	0	3,468
Illinois	357,981	3,469	25,490	17,507	311,515	510,449
Indiana	79,651	236	5,942	20,851	52,623	120,944
Iowa	17,967	1,562	6,117	10,288	0	50,912
Kansas	16,750	3,481	8,504	4,765	0	39,930
Kentucky	16,123	1,483	5,293	9,347	0	48,385
Louisiana	27,073	244	1,702	7,279	17,847	46,952
Maine	27,918	17	2,187	0	25,714	30,513
Maryland	2,813	137	2,676	0	0	35,872
Massachusetts	3,584	206	2,097	1,280	0	132,988
Michigan	54,705	393	4,598	0	49,714	179,005
Minnesota	83,986	3,657	9,858	3,662	66,809	110,639
Mississippi	11,115	459	2,354	8,302	0	38,729
Missouri	28,363	1,303	5,078	10,191	11,792	79,338
Montana	2,772	566	575	1,631	0	14,270
Nebraska	17,110	2,298	5,232	9,579	0	32,988
Nevada	25,954	48	2,199	23,708	0	42,392
New Hampshire	14,767	68	494	0	14,205	17,740
New Jersey	43,482	0	4,932	25,255	13,295	90,710
New Mexico	11,475	405	2,282	8,788	0	16,806
New York	552,376	634	13,235	15,393	523,115	1,602,995
North Carolina	989,436	0	1,596	0	987,840	1,111,529
North Dakota	12,138	281	1,877	9,980	0	18,996
Ohio	494,655	1,839	11,481	21,820	459,515	596,766
Oklahoma	23,980	2,489	8,446	1,516	11,529	47,072
Oregon	8,824	65	214	8,545	0	18,619
Pennsylvania	140,032	1,108	16,518	18,537	103,869	184,511
Rhode Island	197,292	39	0	6,212	191,041	209,847
South Carolina	6,950	669	2,581	3,700	0	30,781
South Dakota	51,887	272	3,117	12,581	35,917	61,389
Tennessee	93,180	565	6,655	1,160	84,800	118,024
Texas	97,674	9,735	32,660	20,788	34,492	157,644
Utah	30,050	78	641	0	29,331	130,104
Vermont	1,444	112	1,332	0	0	6,000
Virginia	30,332	262	8,336	8,642	13,091	96,622
Washington	1,893	469	1,423	0	0	25,587
West Virginia	6,902	482	2,304	4,117	0	19,630
Wisconsin	22,058	685	7,210	3,908	10,254	84,348
Wyoming	4,576	335	1,979	2,262	0	7,245
U.S. territories	0	0	0	0	0	73,174

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