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DECEMBER 1996



# FEDERAL RESERVE BULLETIN

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Distribution of Credit Risk among Providers of Mortgages  
to Lower-Income and Minority Homebuyers

Treasury and Federal Reserve Foreign Exchange Operations

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# FEDERAL RESERVE BULLETIN

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# Distribution of Credit Risk among Providers of Mortgages to Lower-Income and Minority Homebuyers

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*Glenn B. Canner, Wayne Passmore, and Brian J. Surette, of the Board's Division of Research and Statistics, prepared this article. John L. Gibbons, Lisa Kirch, and Gerald W. Talley provided research assistance.*

The financial institutions that bear the credit risk in mortgage lending are critical because without such participants, mortgages cannot be made. Once an institution agrees to assume the risk that a borrower will not repay a loan as scheduled, the other participants in the mortgage process—originators, funders, and purchasers—are readily available. The bearing of credit risk is an ongoing concern of the mortgage market and the government, and a variety of institutions have evolved for that purpose. The performance of these institutions in taking on credit risk has important public policy implications because home ownership, particularly within lower-income and minority communities, is a well-established national goal and is of intense public interest.

Assessing the performance of mortgage market participants in accepting credit risk is not straightforward for several reasons—lack of data, uncertainties about the most appropriate criteria for assessing performance, and the influence of government subsidies and regulations. The diversity of the participants' goals and strategies also complicates the task: The government mortgage insurers that account for most of the risk-bearing activity in the *government mortgage system* are nonprofit and accept nearly all the credit risk of the mortgages they insure; the mortgage originators, insurers, and purchasers that make up the *conventional mortgage system* are profit-seeking and generally act to spread the risk throughout the system.

In an earlier study we assessed the performance of the major participants in the market for home purchase mortgages by examining the distribution of the mortgage credit risk borne by these institutions.<sup>1</sup> For

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1. Glenn B. Canner and Wayne Passmore, "Credit Risk and the Provision of Mortgages to Lower-Income and Minority Homebuyers," *Federal Reserve Bulletin*, vol. 81 (November 1995), pp. 989–1016.

that analysis we combined 1994 data on mortgages collected pursuant to the Home Mortgage Disclosure Act (HMDA) with 1994 data on private mortgage insurance (PMI) activity made available by private mortgage insurers. With that unique database we obtained rough measures of the amount of credit risk that the major participants bore and the distribution of that risk across institutions by the income and racial or ethnic characteristics of the borrowers and their neighborhoods. We found that the largest government insurer, the FHA, was the most involved with lower-income and minority homebuyers, as measured by both *portfolio share* (the proportion of an institution's own mortgage portfolio extended to these groups) and *market share* (the proportion of all mortgages extended to these groups for which an institution bears the credit risk). Depository institutions generally had higher portfolio and market shares than the two for-profit government-sponsored enterprises that are active in the secondary market, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

In this article we revisit the issue of who bears the credit risk associated with mortgage lending using 1995 data and refined estimates of the amount of mortgage credit risk borne by market participants.<sup>2</sup> In our earlier analysis we measured credit risk in terms of the number of mortgages held or insured; here we go beyond looking at numbers or simple dollar amounts of mortgages held or insured and instead measure risk in terms of the dollar losses that could be expected on the basis of historical experience.

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2. Unless otherwise noted, the focus of this article is mortgages approved during the first ten months of 1995 for the purchase of owner-occupied, single-family homes located in metropolitan statistical areas. Mortgages originated in the final two months of 1995 were excluded from analysis because the lenders that originated those loans may not have had the opportunity to sell them by year-end, when HMDA data must be reported. Because of the public-interest focus on lower-income and minority borrowers and neighborhoods, we present results for only FHA-eligible mortgages (that is, mortgages within the size limits for FHA-backed single-family loans).

Institutions' expected dollar losses are determined primarily by the distribution of loan-to-value ratios within their mortgage portfolios: Higher ratios are associated with higher mortgage default probabilities and loss severity rates. Data on these aspects of mortgage lending are not reported under HMDA and are not readily available elsewhere; we obtained the information in a variety of ways, including discussions with industry participants and modeling based on preliminary data from the Federal Reserve's 1995 Survey of Consumer Finances.

Who bears the credit risk for mortgage lending to lower-income borrowers, black or Hispanic borrowers, lower-income neighborhoods, and minority neighborhoods, and how is that risk distributed? The findings based on our refined estimates of credit risk are in accord with our earlier results: In terms of market share, the FHA, the largest institution in the government mortgage system, outperforms all other institutions or types of institutions. It is the major bearer of credit risk for these groups. For example, the FHA backed about one-third of the dollar amount of mortgages extended in 1995 to lower-income borrowers but assumed *nearly two-thirds* of the credit risk associated with lending to that group.

The market shares of the conventional mortgage system are not only small relative to the amount borne by government institutions; they are also broadly distributed across the major types of institutions in the system. No single institution or set of institutions stands out as a principal bearer of credit risk for the conventional mortgages extended to these borrowers.

The FHA also has a high portfolio share for lending to lower-income or minority borrowers and neighborhoods relative to the participants in the conventional mortgage system. However, some profit-seeking portfolio lenders devote a large share of their portfolio risk to lower-income borrowers and neighborhoods. These lenders—commercial banks, savings associations, and mortgage banks—have low-income portfolio shares similar to the FHA's, although their market shares are only slightly larger than those of others in the conventional mortgage system.

### *THE MANAGEMENT OF MORTGAGE CREDIT RISK*

The credit risk associated with mortgage lending is managed in a variety of ways, mainly by the use of

underwriting standards and the sharing of risk among participants in the mortgage market, including borrowers. Because different groups of borrowers have different credit characteristics, the risk-management approach taken may affect the distribution of mortgage borrowers across income groups, race and ethnic categories, and neighborhoods.

Requiring borrowers to meet certain underwriting standards is the most important step lenders take to manage mortgage credit risk. In assessing the possibility that a prospective borrower may default on a mortgage, lenders evaluate both ability and willingness to repay the loan. They look at sources of income, debt-payment-to-income ratios, assets, employment history, and prospects for income growth. They also review the applicant's credit history and estimate the value of the property for which the mortgage is being sought.

Varying the price of credit by charging riskier borrowers higher interest rates is another means of managing credit risk. Lenders know, for example, that the probability of default, as well as the extent of the loss resulting from default, is strongly related to the loan-to-value ratio of the mortgage: The higher the ratio, the greater the likelihood of default and the larger the potential loss.<sup>3</sup> To compensate for greater risk, lenders may require a borrower who takes out a mortgage having a high loan-to-value ratio to pay a higher interest rate (or, more often, to purchase mortgage insurance, which raises the effective interest rate). They may also price the mortgage according to other characteristics that may influence its riskiness; for example, they may charge higher interest rates on longer-term loans.

The sharing of credit risk is common within the home mortgage industry. First and foremost, lenders share risk with the borrower by requiring the borrower to make a down payment toward the purchase of the home. The larger the borrower's equity stake, the more the value of the home exceeds the loan balance, providing the lender with a greater cushion in case of default.

Credit risk is also shared among institutional participants in the mortgage market. For example, lenders usually require a borrower to purchase mortgage insurance from a public or private mortgage insurer if the down payment is less than 20 percent of the

3. Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, vol. 82 (July 1996), pp. 621–48.

home's appraised value.<sup>4</sup> Lenders also often sell mortgages in the secondary market under terms that relieve themselves of the credit risk associated with the mortgage (that is, the secondary-market institution has no recourse to the seller in the event of default).

Credit risk can also be managed by influencing the probability of default and the extent of losses associated with default. Lenders use a variety of risk-management techniques to encourage timely repayment. For example, they may require a prospective borrower to receive credit counseling or homebuyer education before taking out a mortgage and may work more aggressively with a borrower who becomes delinquent. To lower the losses associated with default, lenders may encourage a seriously delinquent borrower to sell the home before foreclosure (a so-called short sale), thereby avoiding the legal expenses and other costs associated with the often-lengthy foreclosure process. Other methods of loss management include allowing delinquent borrowers to defer payments until their financial circumstances improve and modifying loan agreements.<sup>5</sup>

### THE MAJOR PARTICIPANTS IN THE MORTGAGE MARKET

During the past sixty years, the Congress has created public institutions—and has both granted advantages to and imposed restrictions on private institutions—to influence underwriting standards and other aspects of mortgage lending and, thus, the level and composition of mortgage activity. In recent years, congressional actions have focused on encouraging the provision of mortgage credit to lower-income and minority homebuyers and to those seeking to purchase homes in lower-income neighborhoods and central cities. These actions influence the distribution of credit risk among the participants in the mortgage market.

4. Some lenders extend low-down-payment mortgages without insurance but charge higher interest rates or have the borrower take out a second mortgage (usually equal to 10 percent of the home's appraised value) at a higher interest rate than the first mortgage (usually equal to 80 percent of the home's value), thus effectively providing the mortgage insurance themselves. In addition, some lenders provide low-down-payment mortgages without requiring mortgage insurance as part of their efforts to comply with the Community Reinvestment Act.

5. For a discussion of alternatives to foreclosure, see U.S. Department of Housing and Urban Development, "Providing Alternatives to Mortgage Foreclosure: A Report to Congress," March 1996; and Brent W. Ambrose and Charles A. Capone, Jr., "Cost-Benefit Analysis of Single-Family Foreclosure Alternatives," *The Journal of Real Estate Finance and Economics*, vol. 13 (September 1996), pp. 105–20. Also see the 1995 annual reports of Fannie Mae and Freddie Mac.

### The Nonprofit Government Mortgage System

The Congress has established nonprofit government institutions to promote home ownership among specific groups and in the population at large. Of the nonprofit government institutions, the FHA and the VA have by far the largest home loan programs. Their missions are to promote home ownership by insuring mortgages extended, respectively, to lower- and moderate-income homebuyers and to veterans.<sup>6</sup> Subsidization by the federal government helps these agencies achieve their goals.<sup>7</sup> The FHA plays a larger role in the mortgage market than the VA.

The FHA's activity is limited by the Congress in several ways: by size limits on the mortgages that it can insure, by restrictions on its ability to change insurance premiums, and by limits on the aggregate amount of insurance that it may write each year. The FHA relies on the insurance premiums paid by lower-risk borrowers to cross-subsidize the costs imposed by higher-risk borrowers.<sup>8</sup> Consequently, because private mortgage insurance may cost less, lower-risk borrowers who qualify for privately insured loans tend not to use FHA programs.<sup>9</sup>

A higher proportion of lower-income borrowers than of higher-income borrowers choose mortgages insured by the FHA or the VA. Under these programs, prospective borrowers can qualify for credit with more debt relative to income, with smaller down payments, and with weaker credit histories because the underwriting standards of the FHA and the VA are generally less strict than those used by private mortgage insurers. Many families with lower incomes need the more relaxed underwriting guidelines to qualify for mortgages because they tend to carry relatively higher loads of nonhousing debt, to have fewer assets to draw on when making down payments

6. For a discussion of the FHA and its influence in the housing market, see U.S. Department of Housing and Urban Development, Office of Policy Development and Research, "An Analysis of FHA's Single-Family Insurance Program," October 1995; and General Accounting Office, "Homeownership: FHA's Role in Helping People Obtain Home Mortgages" (GAO/RCED-96-123), August 13, 1996.

7. With respect to its largest single-family mortgage insurance program, the FHA's subsidy primarily takes the form of relief from the need to earn a private market rate of return for shareholders rather than a direct government appropriation.

8. A question arises as to why private mortgage insurers do not "cherry pick" more of the FHA's least risky borrowers, who pay higher premiums than should, in principle, be available in the private market. Among the possible explanations are state regulations limiting the ability of PMI companies to insure mortgages having loan-to-value ratios above 97 percent, the specialization of some mortgage lenders in FHA loans, and borrowers' preferences to finance their home purchases with government-backed loans.

9. See General Accounting Office, "Homeownership: FHA's Role in Helping People Obtain Home Mortgages."



and paying closing costs, and to have histories of credit problems or no credit histories at all. At the same time, upper-income borrowers tend to seek mortgages that exceed the limits on the size of mortgages eligible for FHA insurance or that receive proportionally less backing from the VA, thus reducing their participation in these programs.

Like lower-income borrowers, black and Hispanic borrowers tend to use FHA and VA mortgages relatively often. On average, borrowers in the latter group, compared with their white or Asian counterparts, have lower incomes, less wealth, weaker credit histories, and less-stable employment, and they purchase homes with lower values. In addition, black and Hispanic borrowers are more likely than equally qualified white and Asian borrowers to choose FHA-backed mortgages.<sup>10</sup>

A third nonprofit government institution, the Government National Mortgage Association (Ginnie Mae), is active in the secondary mortgage market; it was created by the Congress to provide liquidity solely for federal housing initiatives. In contrast to other secondary-market institutions, which buy mortgages and sell securities backed by mortgages, Ginnie Mae does not purchase mortgages. Instead, Ginnie Mae guarantees the timely payment of interest and principal for privately issued securities backed by mortgages insured by the FHA or the VA. In our analysis we do not identify Ginnie Mae as a bearer of credit risk; instead, we assume that the entire risk of FHA mortgages is borne by the FHA and that the risk of VA mortgages is borne mainly by the VA. In practice, however, Ginnie Mae bears a small amount of credit risk if, for example, a lender servicing a security backed by FHA and VA loans is unable to make timely payments.

### *The Profit-Seeking Conventional Mortgage System*

The conventional mortgage system is made up of numerous institutions whose profit-seeking drives them to spread the credit risk of conventional mortgages (that is, mortgages that are not insured by the federal government).<sup>11</sup> These institutions are a

diverse group: Some are government-sponsored and others are privately sponsored; some have the capacity to hold mortgages in their portfolios whereas others only insure mortgages; and some are strongly encouraged by government to help meet the credit needs of lower-income homebuyers and neighborhoods whereas others are given no such direction. The three main types of institution in the conventional mortgage system are private mortgage insurers, government-sponsored enterprises, and portfolio lenders.

### *Private Mortgage Insurers*

Private mortgage insurers are profit-seeking institutions that insure, but do not originate or purchase, conventional mortgages. They are not subject to federal laws that encourage the provision of credit to lower-income borrowers or in lower-income neighborhoods, such as the Community Reinvestment Act.

Private mortgage insurance reduces a lender's credit risk by insuring against losses associated with default up to a contractually established percentage of the claim amount.<sup>12</sup> In deciding whether to insure a particular mortgage, a PMI company acts as a review underwriter, evaluating both the creditworthiness of the prospective borrower and the adequacy of the collateral offered as security on the loan. Like the FHA and the VA, PMI companies deny insurance to prospective borrowers who are judged to pose undue credit risk; lenders are free to extend credit to such borrowers, but they must do so without the protection of private mortgage insurance. (See appendix A for data on the disposition of applications for private mortgage insurance in 1995.)

Private mortgage insurers focus on mortgages that have high loan-to-value ratios—a type of mortgage often used by lower-income borrowers. However, they neither receive government support nor have a government mandate to serve lower-income borrowers. Hence, PMI companies serve lower-income borrowers to the extent that it is profitable to do so. To some extent, PMI companies compete directly with the FHA and the VA to insure mortgages that have high loan-to-value ratios.

10. Glenn B. Canner, Stuart A. Gabriel, and J. Michael Woolley, "Race, Default Risk and Mortgage Lending: A Study of the FHA and Conventional Loan Markets," *Southern Economic Journal*, vol. 58 (July 1991), pp. 249–62.

11. One group of *nonprofit* institutions, credit unions, is also part of the conventional mortgage system. Because they account for a very small portion of the mortgage market, credit unions are not discussed in the text; however, they are included in the tables for completeness.

12. The claim amount on a defaulted loan generally includes the outstanding balance on the loan, delinquent interest payments, expenses incurred during foreclosure, costs to maintain the property, and advances the lender made to pay taxes and hazard insurance on the property. For more information on private mortgage insurers, see Glenn B. Canner, Wayne Passmore, and Monisha Mittal, "Private Mortgage Insurance," *Federal Reserve Bulletin*, vol. 80 (October 1994), pp. 883–99.

For homebuyers, private mortgage insurance can differ markedly from FHA or VA insurance.<sup>13</sup> Private mortgage insurance is generally less expensive for borrowers who do not need the underwriting flexibility offered by the FHA or the VA, and it is more available for borrowers seeking larger mortgages. However, many homebuyers, particularly lower-income and minority homebuyers, need the FHA's and VA's more liberal underwriting standards, lower down payments, and lower cash requirements at closing to qualify for a mortgage.

### Government-Sponsored Enterprises

Government-sponsored enterprises (GSEs) are privately owned institutions that blend the characteristics of public and private institutions; they receive certain benefits from their government sponsorship and in exchange are expected to advance certain public policy goals.<sup>14</sup> The GSEs most prominent in the mortgage market, Fannie Mae and Freddie Mac, are, together with Ginnie Mae, the major players in the secondary mortgage market.<sup>15</sup> In contrast to

13. From a lender's perspective, the insurance provided by private mortgage insurers and that provided by the FHA and the VA differ in the level of protection against credit losses. Whereas PMI companies typically limit coverage to 20 percent to 35 percent of the claim amount on a defaulted loan, the FHA covers 100 percent of the unpaid balance of the mortgage as well as most costs associated with the foreclosure and sale of the property. The VA provides loan guarantees, with the guaranteed proportion tied to the size of the mortgage; the guaranteed proportion may not cover all the lender's losses under all circumstances, particularly when property values are falling. For marginally qualified borrowers, some lenders may prefer the added protection afforded by FHA or VA insurance and may encourage these borrowers to apply for such mortgages.

14. For general descriptions of two GSEs—Fannie Mae and Freddie Mac—including the benefits they derive from government sponsorship and their affirmative obligations to promote home ownership among lower-income households, see Congressional Budget Office, "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," May 1996; General Accounting Office, "Housing Enterprises: Potential Impacts of Severing Government Sponsorship," May 1996; U.S. Department of Housing and Urban Development, "Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility," July 1996; and U.S. Department of the Treasury, "Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation," July 11, 1996.

15. For 1995, these three institutions accounted for 58 percent of all mortgage purchases reported under HMDA (see Special Tables, table 4.41, *Federal Reserve Bulletin*, vol. 82 (September 1996), pp. A74–A75). While these institutions dominate secondary market activity, others—including commercial banks, savings associations, insurance companies, and pension funds—are also active purchasers of mortgages. These other institutions buy the same types of loans purchased by Fannie Mae and Freddie Mac, but they also provide a market for lenders that originate nonconforming loans, such as jumbo loans (loans larger than the maximum single-family mortgage that may be purchased by Fannie Mae and Freddie Mac), mobile home loans, loans with lower credit quality, and certain types of adjustable-rate mortgages.

Ginnie Mae, which focuses on government-backed mortgages, Fannie Mae and Freddie Mac purchase conventional mortgages almost exclusively, accepting all or part of the credit risk of the mortgages they purchase. Many of these mortgages are securitized, while others are held directly in their portfolios.

Because Fannie Mae and Freddie Mac are profit-seeking, they may not be able to bear the same degree of credit risk as the FHA or the VA. At the same time, they do not have as much latitude as purely private entities: They have in their charters a congressionally mandated affirmative obligation to promote home ownership among lower-income households. They also have annual affordable housing goals, established by the Department of Housing and Urban Development (HUD), for the purchase of mortgages to lower-income households and in targeted communities.

Even while Fannie Mae and Freddie Mac are encouraged to promote lending to lower-income households, their charters may also create barriers to such lending by limiting the risk they may bear: The mortgages they purchase, unless they carry private mortgage insurance or some other form of credit enhancement (for example, recourse to the lender), must have loan-to-value ratios of 80 percent or less. Therefore, Fannie Mae and Freddie Mac generally bear the entire credit risk only for mortgages that have relatively large down payments—the type of mortgage that may be used less often by lower-income households that have limited savings (some lower-income households, such as retirees, may have substantial financial assets).

### Portfolio Lenders

Portfolio lenders are privately sponsored institutions that are capable of holding mortgages in their own portfolios; among these institutions are commercial banks, savings associations, and some mortgage banks. Portfolio lenders determine their own underwriting standards for the mortgages they hold, thereby controlling the credit risk of their portfolios.

The vast majority of portfolio lenders are depository institutions. However, a diverse group of non-depository portfolio lenders—mortgage bankers, pension funds, insurance companies, and others—also fund mortgages and bear mortgage credit risk. Depository institutions are subject to federal laws and regulations that require them to help meet the credit needs of lower-income households and neighborhoods, but nondepository portfolio lenders are not subject to such rules.

*Depository Institutions Subject to CRA.* Depository institutions benefit from federal deposit insurance and from other services available exclusively to depository institutions. In exchange, they are subject to many regulations not imposed on other portfolio lenders. Among these regulations is the Community Reinvestment Act (CRA), which requires commercial banks and savings associations (but not credit unions) to help meet the credit needs of their communities.<sup>16</sup>

Opposing influences act on depository institutions to affect the extent of their lending to lower-income and minority borrowers and the extent to which they keep these mortgages in their portfolios. On one hand, CRA requirements may lead some depositories to hold mortgages underwritten with greater flexibility than those insured by private mortgage insurers or sold into the secondary market—the type of mortgages often sought by lower-income and minority homebuyers. Moreover, because they may find it difficult to originate and fund traditional thirty-year fixed-rate mortgages profitably, depositories may seek out market niches, collecting better information about a particular group of mortgage borrowers, or may develop products that meet special credit needs.<sup>17</sup> Under these circumstances, they may hold relatively high proportions of nontraditional mortgages, including those extended to lower-income and minority borrowers.

On the other hand, because extending mortgages using more flexible underwriting standards may involve more risk-taking, depository institutions may be tempted to assume the risk of only the least risky mortgages and to pass that of higher-risk mortgages to other institutions, either by selling the loans or by obtaining insurance on them from a third party.<sup>18</sup> They may find it difficult to sell such mortgages, however, because purchasers and insurers guard against accepting the risk of higher-risk mortgages by setting stricter underwriting standards than they would if they had full information about the mortgages' riskiness and by monitoring closely the

adherence of mortgage originators to those standards. Risk-adjusted capital requirements also discourage depository institutions from holding some types of nonconforming loans: For mortgages having a loan-to-value ratio of more than 80 percent and no private mortgage insurance, they must hold more capital to guard against losses.

*Nondepository Portfolio Lenders.* Independent mortgage bankers and private nondepository mortgage purchasers, such as life insurance companies and pension funds, are among the other profit-seeking portfolio lenders that hold credit risk associated with mortgages. These institutions often focus on particular portions of the mortgage market, such as jumbo loans, mobile home loans, some types of adjustable-rate loans, and loans to borrowers who have poor credit histories or other credit characteristics that make their loans nontraditional.

Nondepository portfolio lenders are not subject to the CRA or to other laws intended to encourage lending to lower-income households and neighborhoods. However, like other participants in the mortgage market, they are subject to fair lending laws and to community pressures to be sensitive to the credit needs of lower-income and minority borrowers and neighborhoods. These institutions may also be subject to regulations and other influences that affect their propensity to hold particular types of mortgages in portfolio. For example, life insurance companies are subject to risk-adjusted capital requirements that impose higher capital requirements on mortgages held directly rather than in the form of a mortgage-backed security.

### *THE MEASUREMENT OF PERFORMANCE IN LENDING TO LOWER-INCOME AND MINORITY HOMEBUYERS*

Several government reports, and extensive debates surrounding the recent rewriting of the CRA regulations, point to continued public interest in the performance of the major mortgage market participants in serving the mortgage credit needs of lower-income households. During the past year, four congressionally mandated government reports reviewed the role of Fannie Mae and Freddie Mac in mortgage markets and discussed their performance in serving the credit needs of lower-income homebuyers.<sup>19</sup> Generally,

16. In our analysis we combined the lending activities of commercial banks and savings associations with those of their mortgage banking subsidiaries and affiliates. The CRA regulations allow banks and savings associations to include the lending activities of these institutions when CRA performance is evaluated.

17. See Joseph Blalock, "Successful Fixed-Rate Lending," *Savings and Community Banker* (February 1994), p. 38; and Wayne Passmore, "Can Retail Depositories Fund Mortgages Profitably?" *Journal of Housing Research*, vol. 3, no. 2 (1992), pp. 305–40.

18. For a discussion of this behavior, see Wayne Passmore and Roger Sparks, "Putting the Squeeze on a Market for Lemons: Government-Sponsored Mortgage Securitization," *Journal of Real Estate Finance and Economics*, vol. 13 (July 1996), pp. 27–43.

19. These reports, cited in footnote 14, were required by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

these discussions supported our earlier finding that Fannie Mae and Freddie Mac finance a smaller portion of loans to lower-income homebuyers than do the FHA, the VA, or depository institutions. However, two of the reports emphasized that it is premature to judge these GSEs' performance in encouraging lending to lower-income households because their affordable housing goals set by HUD have been in place only a short period.

The findings of another recent government report, which compared the FHA's performance in financing loans to lower-income and minority households with that of other major institutions in the mortgage market, are also consistent with our previous research. It concluded that "FHA serves disproportionate fractions of lower-income households, blacks and Hispanics, first-time homebuyers, borrowers making low down payments, and households living in underserved neighborhoods when compared with private mortgages insurers, the government-sponsored enterprises, and conventional lenders."<sup>20</sup>

Left unanswered is the larger question of whether the performance of one institution relative to another is the appropriate measure of how well the two institutions are meeting these needs. One institution or type of institution may be performing poorly compared with another, but it may be performing well given the other standards and expectations of the Congress, regulators, and shareholders. While the Congress has focused a variety of institutions toward meeting the needs of lower-income homebuyers—the FHA, depository institutions under CRA, and the GSEs with their affordable-housing goals—it has not specified how performance is to be measured; criteria for measuring performance have therefore been set by regulators.

Shareholders expect their firms to earn a competitive rate of return on their equity. The extent to which profit-seeking institutions subject to regulations encouraging lending to lower-income households should be expected to forgo profits in pursuit of such lending is unclear. To date, the Congress has allowed that these institutions are not expected to significantly diminish their profitability or to endanger their safety and soundness.<sup>21</sup> Hence, one limitation of directly comparing performance across institutions is that

such comparisons may not take into consideration other public and private goals. Recognizing this limitation is particularly important when nonprofit government organizations, such as the FHA and the VA, are compared with profit-seeking institutions.

Moreover, comparing performance on the basis of the bearing of credit risk, as we do, does not take into account efforts to encourage lending to lower-income households and neighborhoods. Almost all institutions in the mortgage market are making special efforts to extend home ownership to borrowers and communities that have traditionally received relatively small proportions of mortgage credit. For example, depository institutions, mortgage bankers, Fannie Mae and Freddie Mac, and the private mortgage insurers have worked together to introduce a host of new programs targeted at lower-income households; prominent among these are Fannie Mae's Community Home Buyers program and Freddie Mac's Affordable Gold program, both of which allow more flexible underwriting standards for the loans these institutions purchase. Recently, these institutions and others have jointly established the American Homeowner Education and Counseling Institute to improve both the education of individuals who counsel potential and current homebuyers and the effectiveness of that counseling.<sup>22</sup>

As important as these programs are—and despite concerns about comparing performance and the lack of perfect measurement criteria—the fact remains that the acceptance of credit risk is at the heart of mortgage lending. Without an institution willing to bear the credit risk of mortgage lending to lower-income and minority households and neighborhoods, such mortgages cannot be made. Originators, funders, and purchasers of mortgages are numerous once an institution agrees to bear the credit risk of lending. The bearer of credit risk is therefore the crucial participant in the mortgage lending process.

### *THE COMPOSITION OF MORTGAGE ACTIVITY IN 1995*

To identify which institutions bore the credit risk for mortgage lending to lower-income and minority borrowers and neighborhoods in 1995, we first looked at mortgages extended by size, by borrower and neighborhood characteristics, and by mortgage holder.

20. See HUD, "An Analysis of FHA's Single-Family Insurance Program," p. ES-1.

21. There is little evidence that profits have been significantly diminished by such lending. See Glenn B. Canner and Wayne Passmore, "The Relative Profitability of Commercial Banks Active in Lower-Income Neighborhoods and to Lower-Income Borrowers," in *Proceedings of the 32nd Annual Conference on Bank Structure and Competition* (Federal Reserve Bank of Chicago, 1996), pp. 531-55.

22. Press release, "American Homeowner Education and Counseling Institute to be Established; Will Lead Industry-wide Effort to Improve Homeowner Education and Counseling Efforts Nationwide," Fannie Mae, May 29, 1996.

### Mortgage Borrowers and Loan Size

We began by assigning each mortgage for the purchase of an owner-occupied home extended during the first ten months of 1995 to one of three loan-size categories: (1) FHA-eligible, (2) GSE-eligible only (GSEO-eligible), and (3) jumbo. The first category was based on size restrictions on FHA loans for the purchase of single-family homes. In 1995, the legislated limit in most areas of the country was \$77,197; it ranged up to \$152,362 for areas with high housing prices and even higher for Alaska and Hawaii. About 71 percent of all mortgages extended in 1995 for the purchase of owner-occupied homes were FHA-eligible (table 1, memo item). Even higher proportions of loans to lower-income borrowers (98 percent) and black or Hispanic borrowers (84 percent) were FHA-eligible.

The GSEO-eligible category covered mortgages that exceeded the FHA's single-family mortgage size limits but not the limits on mortgages that Fannie Mae and Freddie Mac may purchase (\$203,150 in 1995, with higher limits for Alaska and Hawaii). About 23 percent of all mortgages extended in 1995 for the purchase of owner-occupied homes were GSEO-eligible. Fewer than 2 percent of loans to lower-income borrowers, and just over 13 percent of loans to black or Hispanic borrowers, were in this category.

The jumbo category was for mortgages exceeding \$203,150. About 7 percent of all mortgages extended in 1995 for the purchase of owner-occupied homes were in this category. Almost none of the loans to lower-income borrowers, and fewer than 3 percent of loans to black or Hispanic borrowers, were jumbo mortgages.

#### 1. Mortgage loans extended in 1995, grouped by size and distributed by the characteristics of the borrowers and of the census tracts in which the properties are located

Characteristic	FHA-eligible			GSEO-eligible			Jumbo			All		
	Number	Percent	MEMO: As a percentage of character- istic	Number	Percent	MEMO: As a percentage of character- istic	Number	Percent	MEMO: As a percentage of character- istic	Number	Percent	MEMO: As a percentage of character- istic
<b>BORROWER</b>												
<i>Income<sup>1</sup></i>												
Lower .....	563,846	38.0	98.1	10,257	2.2	1.8	605	.4	.1	574,708	27.4	100
Middle .....	535,320	36.1	84.9	91,192	19.2	14.5	3,769	1.7	.6	630,281	30.0	100
Upper .....	384,059	25.9	43.0	373,866	78.7	41.8	136,073	96.9	15.2	893,998	42.6	100
Total .....	1,483,225	100	70.7	475,315	100	22.6	140,447	100	6.7	2,098,987	100	100
<i>Racial or ethnic identity</i>												
Asian, Pacific Islander, or white .....	1,154,635	77.8	68.9	400,559	84.3	23.9	121,160	86.3	7.2	1,676,354	79.9	100
Black or Hispanic .....	247,411	16.7	84.3	38,602	8.1	13.2	7,313	5.2	2.5	293,326	14.0	100
Other <sup>2</sup> .....	81,179	5.5	62.8	36,154	7.6	28.0	11,974	8.5	9.3	129,307	6.2	100
Total .....	1,483,225	100	70.7	475,315	100	22.6	140,447	100	6.7	2,098,987	100	100
<b>CENSUS TRACT</b>												
<i>Income<sup>3</sup></i>												
Lower .....	229,214	15.5	91.3	18,248	3.8	7.3	3,652	2.6	1.5	251,114	12.0	100
Middle .....	856,660	57.8	79.7	187,410	39.4	17.4	31,031	22.1	2.9	1,075,101	51.2	100
Upper .....	397,351	26.8	51.4	269,657	56.7	34.9	105,764	75.3	13.7	772,772	36.8	100
Total .....	1,483,225	100	70.7	475,315	100	22.6	140,447	100	6.7	2,098,987	100	100
<i>Minorities (as a percentage of population)</i>												
Less than 10 .....	743,583	50.1	68.0	278,431	58.6	25.5	71,804	51.1	6.6	1,093,818	52.1	100
10-49 .....	592,271	39.9	71.4	174,504	36.7	21.0	63,283	45.1	7.6	830,058	39.5	100
50-100 .....	147,371	9.9	84.2	22,380	4.7	12.8	5,360	3.8	3.1	175,111	8.3	100
Total .....	1,483,225	100	70.7	475,315	100	22.6	140,447	100	6.7	2,098,987	100	100
<b>Total</b> .....	<b>1,483,225</b>	<b>...</b>	<b>70.7</b>	<b>475,315</b>	<b>...</b>	<b>22.6</b>	<b>140,447</b>	<b>...</b>	<b>6.7</b>	<b>2,098,987</b>	<b>...</b>	<b>100</b>

NOTE. Includes only owner-occupied home purchase mortgages originated in 1995 for which action on the application was taken before November 1, 1995, and for which the property securing the mortgage was located in a metropolitan statistical area (MSA).

*FHA-eligible:* Loans that fell within the FHA mortgage size limits for single-family homes in 1995. Some FHA mortgages are larger than the mortgage limits used for the FHA-eligible category because the FHA establishes higher mortgage limits for two-, three-, and four-family properties. *GSEO-eligible:* Loans that exceeded the FHA single-family mortgage limits but not the maximum single-family loan size that could be purchased by Fannie Mae or Freddie Mac in 1995. *Jumbo:* Loans that exceeded the Fannie Mae and Freddie Mac limits.

1. *Lower:* Less than 80 percent of the median family income of the MSA in which the property related to the loan is located. *Middle:* 80 percent to 120 percent. *Upper:* 120 percent or more.

2. Includes American Indian or Alaskan native, other minorities, and joint (white and minority co-borrowers) as well as borrowers for whom racial or ethnic identity was not reported.

3. *Lower:* Median family income for census tract less than 80 percent of the median family income of the MSA in which the census tract is located. *Middle:* 80 percent to 120 percent. *Upper:* 120 percent or more.

... Not applicable.

SOURCE. 1995 HMDA data.

**Unadjusted Distribution of Mortgage Lending**

The allocation of credit risk across mortgage holders, insurers, and purchasers depends on underlying assumptions about risk-mitigation activities, business relationships, loan-to-value ratio distributions, default rates, and loss severity rates. Because views about the appropriate assumptions may differ, we provide information about the number and dollar amount of mortgages *before* adjusting the data to create our measure of credit risk.

Measuring the overall distribution of mortgage lending in 1995 in terms of the number of home purchase loans extended, before adjustments to

account for private mortgage insurance coverage, indicates that commercial banks and savings associations held or purchased about 37 percent of the mortgages originated (total column in table 2).<sup>23</sup>

23. This number is the sum of the three rows labeled "Depository institutions subject to CRA" in table 2. Other numbers given in this paragraph similarly are sums across categories. The mortgages insured by the FHA are not included in any other categories because the FHA is assumed to bear all of the credit risk for the loans they insure. For this portion of the discussion, mortgages backed by the VA and by private mortgage insurers are assigned to the originator or purchaser that shares the credit risk with these institutions; later, we allocate the risk of these mortgages among the originators, purchasers, and insurers.

**2. Mortgages extended in 1995, grouped by size and distributed by mortgage system and type of holder**  
Percent

Mortgage system and type of holder	FHA-eligible		GSEO-eligible		Jumbo		Total	
	By number	By dollar amount	By number	By dollar amount	By number	By dollar amount	By number	By dollar amount
<b>GOVERNMENT MORTGAGE SYSTEM: LOANS WITH GOVERNMENT INSURANCE</b>								
FHA .....	24.3	26.0	3.4	3.0	.2	.2	18.0	13.7
VA <sup>1</sup> .....	6.8	7.6	8.9	8.6	*	*	6.8	6.4
Depository institutions subject to CRA <sup>2</sup> .....	3.9	4.2	4.7	4.4	*	*	3.8	3.4
Independent mortgage companies <sup>3</sup> .....	2.8	3.3	4.1	4.1	*	*	2.9	2.9
Credit unions .....	.1	.1	.1	.1	*	*	.1	.1
<b>CONVENTIONAL MORTGAGE SYSTEM: LOANS WITH PRIVATE MORTGAGE INSURANCE<sup>4</sup></b>								
Depository institutions subject to CRA <sup>2</sup> .....	5.8	6.3	8.0	7.7	9.7	8.1	6.6	7.1
Fannie Mae and Freddie Mac .....	9.2	10.3	13.1	12.8	.6	.4	9.5	9.1
Independent mortgage companies <sup>3</sup> .....	.5	.6	.8	.7	.6	.5	.6	.6
Other <sup>5</sup> .....	2.1	2.4	3.3	3.2	3.5	2.8	2.4	2.7
Credit unions .....	.2	.2	.2	.2	.1	*	.2	.2
<b>Total</b> .....	<b>17.8</b>	<b>19.8</b>	<b>25.4</b>	<b>24.6</b>	<b>14.5</b>	<b>11.8</b>	<b>19.3</b>	<b>19.7</b>
<b>CONVENTIONAL MORTGAGE SYSTEM: LOANS WITHOUT PRIVATE MORTGAGE INSURANCE<sup>4</sup></b>								
Government-sponsored enterprises (Fannie Mae or Freddie Mac) .....	16.4	18.0	27.3	28.2	2.3	2.0	17.9	18.1
Portfolio lenders								
Depository institutions subject to CRA <sup>2</sup> .....	23.6	19.5	24.4	24.7	59.2	62.5	26.2	29.5
Independent mortgage companies <sup>3</sup> .....	2.3	2.0	2.2	2.2	6.2	6.0	2.6	2.9
Other <sup>5</sup> .....	7.9	6.5	7.7	7.9	17.1	16.7	8.4	8.9
Credit unions .....	1.0	.8	.8	.8	.6	.6	.9	.7
<b>Total</b> .....	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>MEMO:</b>								
Number of loans (and percentage distribution) .....	1,483,225 (70.7)	...	475,315 (22.6)	...	140,447 (6.7)	...	2,098,987 (100.0)	...
Amount of loans, in millions of dollars (and percentage distribution) .....	...	110,370 (49.1)	...	70,423 (31.3)	...	44,035 (19.6)	...	224,827 (100.0)

NOTE. Distributions are based on unadjusted dollars (see text). Also see general note to table 1.

1. Data reported by originator of mortgage.  
2. Includes mortgages originated and held in portfolio by commercial banks and savings associations and their mortgage company affiliates and mortgages sold to commercial banks or savings associations.  
3. Includes mortgages originated and held in portfolio by independent mortgage companies and mortgages sold to affiliates by independent mortgage companies.

4. Data reported by holder of mortgage.  
5. Includes mortgages sold to life insurance companies, pension funds, and other private-sector purchasers.  
\* Less than 0.05 percent.  
... Not applicable.  
SOURCE. 1995 HMDA and PMI data.

Fannie Mae and Freddie Mac purchased about 27 percent, and the FHA backed 18 percent. The remaining 18 percent were held by privately sponsored nondepository institutions, such as independent mortgage companies or their affiliates, or by credit unions.

For the smallest loan-size category, market shares differed somewhat. The FHA backed about 24 percent of FHA-eligible mortgages measured by number of loans. Commercial banks and savings associations held or purchased 33 percent (again summing across loans backed and not backed by private mortgage insurance or the VA), somewhat lower than that group's share of mortgages of all sizes, while the share purchased by Fannie Mae and Freddie Mac was only slightly lower.

When the overall distribution of mortgage lending is measured in terms of dollar amount rather than

number of loans, the relative proportions held by institutions change in a way that reflects their specialization by loan size. The proportion of mortgages originated and held by or purchased by commercial banks and savings associations rises to 40 percent, reflecting the relatively large presence of these institutions in the jumbo mortgage market. Similarly, the FHA's proportion falls to 14 percent, reflecting the limits on the size of mortgages it may insure.

### *Estimation of PMI Coverage*

A complete picture of how credit risk is distributed requires knowledge of which conventional mortgages were backed by private mortgage insurance. Coverage by FHA or VA insurance is reported in the HMDA data, but information on coverage of conventional mortgages by private mortgage insurance is not readily available. Therefore, we estimated PMI coverage by matching the individual mortgage records reported under HMDA with individual records on loans insured by private mortgage insurers (see box "Matching HMDA and PMI Records"). *The matching techniques used here differ from those used in our study of mortgage lending in 1994, and comparisons across years are not appropriate.*<sup>24</sup>

From our matching process, we estimated that roughly 20 percent of the conventional mortgages that were originated and retained by or purchased by depository institutions or their subsidiaries (measured by number of loans) were backed by private mortgage insurance (derived from table 2). That most of these conventional mortgages were not backed by private mortgage insurance implies that depository institutions bear the entire credit risk for most of the conventional mortgages they hold.

#### **Matching HMDA and PMI Records**

To determine which mortgages were covered by private mortgage insurance, we compared individual home mortgage records for 1995 submitted under HMDA with individual records for that year submitted by private mortgage insurers. Mortgages were identified as privately insured if records in the two files "matched" on the following characteristics: purpose of loan, location of the property securing the loan (same state, metropolitan statistical area, county, and census tract), borrower race or ethnic status, loan size, and borrower income. To be considered matches, the records had to list the same loan purpose and property location; race or ethnic status had to be the same unless that information was missing from the PMI record, in which case the records were considered to match if all other criteria were satisfied.

To check for matches on loan size and borrower income, we did two iterations. In the first, we considered the records to match if loan size or borrower income, or both, differed by no more than \$5,000. Of these matches, more than 75 percent did not differ on loan size and more than 50 percent did not differ on borrower income. In the second iteration, which considered only PMI and HMDA records that had not been matched in the first iteration, loan size had to be within \$1,000 but income could differ by as much as \$10,000.<sup>1</sup> This second iteration resulted in an additional 19,400 matches, bringing to 404,073 the total number of conventional mortgages we identified as privately insured (25.6 percent of the 1,579,681 conventional mortgages for home purchase in our database).

1. In an earlier analysis we considered records to match only if they were nearly identical on all characteristics. Here we allowed loan size and borrower income to differ somewhat more because it seemed that changes in borrower circumstances and measurement error might cause a borrower's HMDA and PMI records to differ on these criteria.

24. In our previous study we used statistical matching with replacement to match PMI and HMDA records (when a PMI record matched a HMDA record, the PMI record was retained for possible additional matches); here we use statistical matching without replacement (the PMI record was dropped once it matched a HMDA record). Earlier we allocated all of the credit risk of a PMI-insured mortgage to the insurer and therefore did not need to know which institution originated or purchased the mortgage; here we allocate the credit risk for a given mortgage among institutions and therefore had to know the identity of the originator or purchaser—information that is available only from the HMDA record that actually matches the PMI record.

In the matching process for the current study we made several additions to the process used earlier (see box). We added matches on dates of loan approval and PMI approval to better identify matches, randomized the order of HMDA records before matching to remove any potential for bias resulting from the ordering of HMDA data in the Federal Financial Institution Examination Council databases, and changed the matching criteria to allow greater differences in loan size and income. The net result of these changes was more matches, which increased the calculated market share for private mortgage insurers.

By the same process, we estimated that 35 percent of the mortgages purchased by Fannie Mae and Freddie Mac were backed by private mortgage insurance. In contrast to our estimates, industry sources indicated that nearly half of the home purchase mortgages bought in 1995 by Fannie Mae and Freddie Mac were insured by private mortgage insurance. The difference between that figure and our estimate may be a consequence of the large number of PMI records (31 percent) and HMDA records (23 percent) for which detailed geographic information was not reported. (As noted in the box describing the matching process, our procedure required that “matching” records match on the location of the property being financed.) The lack of geographic information on PMI records is unlikely to be related to the type of mortgage holder or purchaser, however, and therefore the extent of PMI coverage is probably understated for other institutions as well. As described in appendix B, we accounted for these differences in our estimates of risk-bearing.

### *THE HOLDERS OF CREDIT RISK ON MORTGAGES EXTENDED IN 1995*

To estimate credit risk, we converted data on the dollar amount of mortgages extended or insured (“unadjusted dollars”) to *risk dollars*—the long-term dollar losses that could be expected on the basis of historical experience. This conversion process involved using loan-to-value ratio (LTV) distributions for each type of institution; estimating the extent of PMI use across institutions; applying historical default and loss severity rates by loan-to-value ratio for each type of institution; and reallocating these risk dollars across institutions to account for risk-sharing arrangements between insurers and other institutions. (Details of the conversion process are given in appendix B.) Because of the public-interest focus on lower-income and minority borrowers and on lower-income and predominantly minority neighborhoods, we present results only for FHA-eligible mortgages.<sup>25</sup>

We measured the amount of credit risk borne by each type of institution in two ways: the share of the institution’s portfolio extended to a particular group

of borrowers (*portfolio share*) and the share of the total dollars extended by an institution to a particular group relative to the total dollars extended by all lenders to that group (*market share*). The portfolio and market shares are calculated using both unadjusted dollars and risk dollars. Dollar amounts unadjusted for credit risk are reported to provide a point of reference; however, risk dollars are a better measure of risk-bearing and are at the heart of our analysis.

### *Portfolio Shares*

Of the major participants in the home mortgage market, the FHA had the highest proportion of its risk dollars extended to lower-income and black or Hispanic borrowers and in lower-income and predominantly minority neighborhoods (table 3). This finding is not surprising because the FHA is government-backed and government-subsidized and thus is able to use more-flexible underwriting standards than many of the other major participants in the mortgage market. The other government agency that directly backs mortgages, the VA, also had a relatively large proportion of its risk dollars in lending to lower-income and black or Hispanic borrowers. However, the VA was not among the higher-ranking institutions for lending in lower-income and predominantly minority neighborhoods.

Among the profit-oriented institutions in the conventional mortgage system, portfolio lenders had relatively large proportions of their risk dollars in lending to lower-income borrowers and in lower-income neighborhoods. This finding may partly reflect the ability of these institutions to profitably underwrite and hold the credit risk of nonconforming mortgages. It may also partly be a function of the rapid expansion of the secondary market for nonconforming mortgages, which has provided opportunities for purchasers such as pension funds and life insurance companies to become involved in nontraditional mortgage lending, such as purchasing loans to borrowers with weak credit histories or unusually high debt-payment-to-income ratios.

The portfolio shares of depository institutions subject to CRA requirements did not differ substantially from those of other portfolio lenders, possibly because both types of institutions are actively involved in nonconforming mortgage markets. The relatively high portfolio shares of conventional mortgages held by nondepository institutions may reflect that group’s traditional orientation toward nonconforming mortgages, such as mortgages for mobile

25. Many households that purchase homes with mortgages larger than the FHA-eligible category limit are not lower income or are lower income but have substantial wealth. Affordable housing initiatives are not intended for these households, although some of them may benefit from these efforts. See Glenn B. Canner and Wayne Passmore, “Implementing CRA: What is the Target?” in *Proceedings of the 31st Annual Conference on Bank Structure and Competition* (Federal Reserve Bank of Chicago, 1995), pp. 171–91.



homes, as well as the extensive use of FHA programs by some nondepositories. Both pursuits may provide opportunities for greater involvement with lower-income and minority borrowers. Similarly, CRA-related programs often generate nonconforming mortgages, perhaps accounting for the high portfolio shares of depository institutions.

The shares of the other major participants in the conventional mortgage market were generally similar to or somewhat smaller than those held by portfolio lenders. There were no striking differences among these institutions; the portfolio shares of Fannie Mae and Freddie Mac and those of private mortgage insurers were similar across all borrower and neighborhood categories.

**Market Shares**

An institution’s underwriting standards and business strategy, along with its charter restrictions and regulatory environment, influence the institution’s presence in a particular market. An institution that aggressively encourages mortgage applications from lower-income and minority households may have a larger market share but a smaller portfolio share than one that makes only a few such mortgages.

The FHA dominated all other lenders in the aggregate amount of risk dollars extended to lower-income

and black or Hispanic borrowers and for properties in lower-income and minority neighborhoods (table 4). About two-thirds of the risk dollars extended to these borrowers and neighborhoods were extended by the FHA. This finding reflects the large (unadjusted) dollar amount of mortgages extended to lower-income and black or Hispanic borrowers, and in lower-income neighborhoods and minority neighborhoods, that were insured by the FHA. In addition, the FHA insured a relatively large proportion of mortgages having very high loan-to-value ratios—mortgages that tend to have relatively high default and loss severity rates. Moreover, the mortgage default and loss severity rates for the FHA’s single-family mortgage portfolio are higher than those experienced by other mortgage lenders or insurers (table B.1).

None of the other institutions had a large market share relative to the FHA’s share. The VA, the second largest holder of risk dollars, held only about one-sixth as many risk dollars as the FHA. As with the FHA, the VA’s portfolio included a high proportion of loans with high loan-to-value ratios, and these loans had higher default rates than conventional mortgages with similar LTVs, resulting in a relatively large market share.

The institutions in the conventional mortgage system all had market shares of 10 percent or less within any given borrower or neighborhood group. None of

**3. Share of institutions’ portfolios of FHA-eligible mortgages extended in 1995 to lower-income or black or Hispanic borrowers or in lower-income or predominantly minority census tracts, by mortgage system and type of holder**

Percent

Mortgage system and type of holder	Borrower characteristic				Census tract characteristic			
	Lower income		Black or Hispanic		Lower income		Predominantly minority	
	Unadjusted	Adjusted	Unadjusted	Adjusted	Unadjusted	Adjusted	Unadjusted	Adjusted
<b>GOVERNMENT MORTGAGE SYSTEM</b>								
FHA .....	37	38	27	24	16	15	13	13
VA .....	33	34	20	18	13	11	8	8
<b>CONVENTIONAL MORTGAGE SYSTEM</b>								
Private mortgage insurers <sup>1</sup> .....	25	26	15	13	12	10	9	9
Government-sponsored enterprises (Fannie Mae or Freddie Mac) .....	24	26	9	14	9	10	8	9
<b>Portfolio lenders</b>								
Depository institutions subject to CRA <sup>2</sup> .....	32	33	11	15	13	14	8	8
Independent mortgage companies <sup>3</sup> .....	28	32	17	19	14	13	13	10
Other <sup>4</sup> .....	31	31	12	16	13	13	9	9
Credit unions .....	22	24	7	9	10	11	5	5
All holders .....	30	35	16	20	13	14	10	11

NOTE. Unadjusted shares are based on dollar amounts of mortgages extended; adjusted shares are based on risk dollars.

1. Mortgages backed by private mortgage insurers.

2. Includes mortgages originated and held in portfolio by commercial banks and savings associations and their mortgage company affiliates and mortgages sold to commercial banks and savings associations.

3. Includes mortgages originated and held in portfolio by independent mortgage companies and mortgages sold to affiliates by independent mortgage companies.

4. Includes mortgages sold to life insurance companies, pension funds, and other private-sector purchasers.

SOURCE. Derived from 1995 HMDA and PMI data.

4. Share of market for FHA-eligible mortgages extended in 1995 to lower-income or black or Hispanic borrowers or in lower-income or predominantly minority census tracts, by mortgage system and type of holder

Percent

Mortgage system and type of holder	Borrower characteristic				Census tract characteristic				Total	
	Lower income		Black or Hispanic		Lower income		Predominantly minority			
	Unadjusted	Adjusted	Unadjusted	Adjusted	Unadjusted	Adjusted	Unadjusted	Adjusted	Unadjusted	Adjusted
<b>GOVERNMENT MORTGAGE SYSTEM</b>										
FHA .....	32	63	42	67	33	63	35	67	26	57
VA .....	8	12	9	11	7	10	7	9	8	12
<b>CONVENTIONAL MORTGAGE SYSTEM</b>										
Private mortgage insurers <sup>1</sup> .....	17	7	18	6	18	7	18	8	20	10
Government-sponsored enterprises (Fannie Mae or Freddie Mac) .....	14	4	10	4	13	4	14	5	18	6
<b>Portfolio lenders</b>										
Depository institutions subject to CRA <sup>2</sup> .....	20	9	13	7	20	10	17	7	19	10
Independent mortgage companies <sup>3</sup> .....	2	2	2	2	2	2	3	2	2	2
Other <sup>4</sup> .....	7	2	5	2	6	3	6	2	6	3
Credit unions .....	1	*	*	*	1	*	*	*	1	*
<b>All holders</b> .....	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

NOTE. Unadjusted shares are based on dollar amounts of mortgages extended; adjusted shares are based on risk dollars.

1. Mortgages backed by private mortgage insurers.

2. Includes mortgages originated and held in portfolio by commercial banks and savings associations and their mortgage company affiliates and mortgages sold to commercial banks and savings associations.

3. Includes mortgages originated and held in portfolio by independent mortgage companies and mortgages sold to affiliates by independent mortgage companies.

4. Includes mortgages sold to life insurance companies, pension funds, and other private-sector purchasers.

\* Less than 0.5 percent.

SOURCE. Derived from 1995 HMDA and PMI data.

these institutions seems to play a dominant role in the bearing of credit risk within this system. To some extent, profit-seeking drives institutions within this system to diversify risk across institutions: Institutions specialize in a part of the mortgage process or within certain market niches, and they often seek to share the risks they incur outside their specialization or niche. Regulatory or legislative constraints, such as the charter requirements restricting the bearing of credit risk of high-LTV mortgages by Fannie Mae and Freddie Mac and risk-adjusted capital requirements for depository institutions, also play a role.

Our calculations of market shares are subject to some uncertainty. We tried many different permutations of the underlying determinants of mortgage credit risk (loan-to-value distributions, default rates, loss severity rates, and risk-sharing arrangements) and found our results to be robust to reasonable changes in these determinants. For example, we calculated market and portfolio shares using alternative LTV distributions for portfolio lenders (appendix B). The primary effect was to alter the market share of depository institutions subject to CRA, reducing or raising the group's market share 2 to 3 percentage points. The gain or loss in market share was almost all accounted for by an offsetting change in the FHA's market share. The market shares of other institutions were mostly unaffected by this change.

**CONCLUSION**

We have revisited the question of who bears the credit risk of home purchase lending to lower-income and black or Hispanic borrowers and in lower-income and minority neighborhoods. In an earlier analysis we measured credit risk rather crudely and found that the FHA was a major bearer of credit risk for mortgage lending to these groups. Here we refine our measure of credit risk, making significant improvements in the way risk is allocated across institutions. *To a much greater extent than before, we find that the FHA is the primary bearer of credit risk for home purchase loans to lower-income and black or Hispanic borrowers and in lower-income and minority neighborhoods.*

The FHA dominates all other institutions in market share, holding about two-thirds of the total credit risk borne by all institutions for FHA-eligible mortgages extended in 1995 to lower-income and black or Hispanic borrowers and in lower-income and minority neighborhoods. The other major nonprofit government mortgage insurer, the VA, accounted for roughly one-tenth of the market. The FHA also had the greatest proportion of its credit risk portfolio in mortgages to lower-income and minority borrowers and neighborhoods.

In contrast, the conventional mortgage system bore only about one-fourth of the credit risk associated

with FHA-eligible mortgages extended in 1995 to lower-income and black or Hispanic borrowers and in lower-income and minority neighborhoods. All of the institutions in this system had small market shares relative to the FHA's, and no single institution or set of institutions seems to have dominated the others. However, some of the participants in the conventional mortgage system, particularly portfolio lenders such as commercial banks, savings associations, and mortgage banks, had larger proportions of their credit risk portfolios in mortgages to lower-income borrowers and neighborhoods than did the other institutions in this system.

#### **APPENDIX A: PRIVATE MORTGAGE INSURANCE IN 1995**

In 1993, the Mortgage Insurance Companies of America (MICA) asked the Federal Financial Institutions Examination Council (FFIEC) to process data from private mortgage insurance companies on applications for mortgage insurance and to produce public disclosure reports based on the data.<sup>26</sup> The MICA request was a response to public and congressional interest in the activities of PMI companies as they relate to issues of fair lending, affordable housing, and community development.

PMI companies record data on each application for private mortgage insurance they act on during a given period. The data include the action taken on the application (approved, denied, withdrawn, or file closed because information was incomplete); the purpose of the mortgage for which insurance was sought (home purchase or refinance); the race or ethnic group, sex, and annual income of the applicant(s); the amount of the mortgage; and the geographic location of the property securing the mortgage.

The FFIEC summarizes the information in disclosure statements similar to those created for financial institutions covered by the Home Mortgage Disclosure Act (HMDA). Disclosure statements for each PMI company are publicly available at the company's corporate headquarters and at a central depository in each metropolitan statistical area (MSA) in which HMDA data are held. The central depository also holds aggregate data for all the PMI companies active in that MSA. In addition, the PMI data are

available from the Federal Reserve Board through its HMDA Assistance Line (202-452-2016).

This appendix summarizes the PMI data for calendar year 1995.<sup>27</sup> Beginning with the release of the 1996 PMI data, summary tables of the types presented in this appendix will appear each year in the Financial and Business Statistics section of the September issue of the *Federal Reserve Bulletin*. The September *Bulletin* currently contains, in the same section, summary tables for the HMDA data for the preceding calendar year.

#### **Summary of the 1995 Data**

For 1995, the eight PMI companies that are actively writing home mortgage insurance submitted data to the FFIEC through MICA. In total, these companies acted on 1,236,237 applications for insurance: 1,108,512 to insure home purchase mortgages on single-family properties and 127,725 to insure mortgages for refinancing existing mortgages (table A.1).

The total number of policies written in 1995 (that is, the total number of loans privately insured) was down about 15 percent from 1994, primarily because of a sharp decline in requests for PMI coverage for refinancings. The decline in applications to insure refinancings reflects a general decline in refinancings: From 1994 to 1995 the number of applications for conventional home refinancings reported in the HMDA data fell 35 percent whereas the number of applications for conventional home purchase loans declined only about 2 percent (data not shown in tables).

The two largest PMI companies, Mortgage Guaranty Insurance Corporation and GE Capital Mortgage Insurance Corporation, in 1995 accounted for about half of all applications for private mortgage insurance and half of all policies written, a drop from 1994, when the two companies accounted for 55 percent of all policies written (table A.2, 1994 data not shown). The decline in share is due entirely to a decline in activity by GE Capital. Two smaller companies, Amerin Guaranty and Commonwealth Mortgage Assurance, saw fairly sizable increases in their shares of the overall market.

The large share of PMI activity accounted for by Mortgage Guaranty and GE Capital extended across

26. Founded in 1973, MICA is the trade association for the PMI industry. The costs to the FFIEC for processing the data, preparing disclosure statements and other reports, and disseminating the data are covered by the PMI companies through MICA.

27. For analyses of the 1993 and 1994 data, see, respectively, Canner, Passmore, and Mittal, "Private Mortgage Insurance," and Canner and Passmore, "Credit Risk and the Provision of Mortgages to Lower-Income and Minority Homebuyers."

A.1. PMI applications received and policies written, grouped by purpose of loan and distributed by insurance company, 1995

Percent

Company	Home purchase		Home refinance		Total	
	Applications	Policies written	Applications	Policies written	Applications	Policies written
Amerin Guaranty .....	3.8	4.8	4.5	6.1	3.9	4.9
Commonwealth Mortgage Assurance .....	10.1	9.6	12.2	11.2	10.3	9.8
GE Capital Mortgage Insurance .....	23.2	23.0	19.4	19.0	22.8	22.6
Mortgage Guaranty Insurance .....	26.8	27.3	27.2	27.9	26.8	27.3
PMI Mortgage Insurance .....	12.7	12.1	13.7	13.0	12.8	12.2
Republic Mortgage Insurance .....	9.6	9.6	9.5	9.3	9.6	9.6
Triad Guaranty Insurance .....	1.5	1.5	1.4	1.4	1.5	1.5
United Guaranty .....	12.2	12.1	12.0	12.0	12.2	12.1
<b>Total</b> .....	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
MEMO						
Number of applications or policies .....	1,108,512	884,745	127,725	94,244	1,236,237	978,989

SOURCE. Federal Financial Institutions Examination Council.

all regions of the country, although GE Capital's market share was relatively smaller in the West and Mortgage Guaranty's share was relatively large in the Midwest (table A.2, upper panel). Smaller firms generally had a more regional orientation, with Amerin Guaranty more active in the West and Triad Guaranty Insurance Corporation and Republic Mortgage Insurance more active in the South (table A.2, lower panel).

Most loans backed by private mortgage insurance in 1995 were for amounts of less than \$150,000 (table A.3). More than 90 percent of all mortgages backed by private mortgage insurance were at or below the loan size limits established for Fannie Mae and Freddie Mac (memo, size conformance items). The average size of the home purchase mortgages backed by private mortgage insurance was \$112,546 and that of the refinancings was \$128,027.

A.2. PMI policies written for home purchase and refinance loans, distributed by insurance company and by region of the country, 1995

Percent

Company	West	Midwest	South	Northeast	All <sup>1</sup>
Distribution by company					
Amerin Guaranty .....	8.5	3.8	4.0	4.6	5.1
Commonwealth Mortgage Assurance .....	12.0	5.0	11.7	12.3	10.0
GE Capital Mortgage Insurance .....	16.8	27.1	21.6	26.5	22.8
Mortgage Guaranty Insurance .....	26.6	33.5	22.9	25.1	27.1
PMI Mortgage Insurance .....	15.7	8.8	12.0	14.1	12.3
Republic Mortgage Insurance .....	8.6	8.5	13.0	4.3	9.3
Triad Guaranty Insurance .....	.3	1.6	2.4	.8	1.5
United Guaranty .....	11.5	11.7	12.4	12.3	12.0
<b>All companies</b> .....	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
MEMO					
Largest two companies <sup>2</sup> .....	43.4	60.6	44.5	51.6	49.9
Largest four companies <sup>3</sup> .....	70.6	81.1	68.9	78.0	74.2
Distribution by region					
Amerin Guaranty .....	38.2	21.4	26.1	14.3	100
Commonwealth Mortgage Assurance .....	27.7	14.2	38.8	19.4	100
GE Capital Mortgage Insurance .....	16.9	33.6	31.3	18.2	100
Mortgage Guaranty Insurance .....	22.5	35.0	28.0	14.5	100
PMI Mortgage Insurance .....	29.3	20.2	32.5	18.0	100
Republic Mortgage Insurance .....	21.2	25.6	46.0	7.1	100
Triad Guaranty Insurance .....	4.5	31.8	55.0	8.8	100
United Guaranty .....	22.0	27.6	34.3	16.2	100
<b>All companies</b> .....	<b>22.9</b>	<b>28.3</b>	<b>33.1</b>	<b>15.7</b>	<b>100</b>

NOTE. Regions are defined by the Bureau of the Census and contain only whole states; see U.S. Department of Commerce, *Statistical Abstract of the United States: 1995* (Government Printing Office, 1995), map on inside front cover.

1. Row totals differ from those shown in table A.1 because information on region was not available for all PMI policies.

2. Mortgage Guaranty Insurance and GE Capital Mortgage Insurance.

3. Mortgage Guaranty Insurance, GE Capital Mortgage Insurance, PMI Mortgage Insurance, and United Guaranty.

SOURCE. Federal Financial Institutions Examination Council.

## A.3. PMI-insured loans, grouped by purpose of loan and distributed by size of loan, 1995

Size of loan (dollars)	Home purchase			Home refinance		
	Privately insured		MEMO: All <sup>1</sup> (percent)	Privately insured		MEMO: All <sup>1</sup> (percent)
	Number	Percent		Number	Percent	
Less than 50,000 .....	84,372	9.5	25.9	4,122	4.4	30.9
50,000–74,999 .....	161,517	18.3	17.3	14,502	15.4	19.7
75,000–99,999 .....	174,314	19.7	14.9	16,890	17.9	14.1
100,000–149,999 .....	277,400	31.4	22.5	31,168	33.1	17.5
150,000–199,999 .....	119,686	13.5	10.2	16,466	17.5	8.4
200,000 or more .....	67,456	7.6	9.2	11,096	11.8	9.3
<b>Total .....</b>	<b>884,745</b>	<b>100.0</b>	<b>100.0</b>	<b>94,244</b>	<b>100.0</b>	<b>100.0</b>
MEMO						
<i>Size conformance</i> <sup>2</sup>						
Conforming .....	830,398	93.9	92.6	85,218	90.4	92.4
Nonconforming .....	54,347	6.1	7.4	9,026	9.6	7.6
<i>Size statistic (dollars)</i> <sup>3</sup>						
Mean .....	112,546		102,591	128,027		98,600
Median .....	103,000		85,000	117,000		73,000

1. Based on all conventional home mortgages reported in 1995 HMDA data.

2. Loans of up to and including \$203,000 conform with size limits imposed on Fannie Mae and Freddie Mac.

3. For loans for which loan size was reported.

SOURCE: Federal Financial Institutions Examination Council.

Compared with all conventional home mortgages in 1995 (table A.3, memo, size statistic items), conventional mortgages involving private mortgage insurance were, on average, larger for both home purchase loans and refinancings. In particular, PMI companies insured a much smaller proportion of mortgages under \$50,000, partly because this size category includes loans for mobile homes, which are covered in the conventional home mortgage data reported under HMDA but are rarely insured by the PMI industry.

### *Characteristics of Applicants for Private Mortgage Insurance*

In 1995, well over half of all applicants for private mortgage insurance had incomes at or above the median for the MSA in which the property securing the loan was located (table A.4). The distributions of PMI applicants by income differed between those seeking insurance for loans to purchase homes and those applying for insurance to refinance an existing loan. In particular, the proportion of insurance applicants for refinancings who were in the highest income grouping (income 120 percent or more of their MSA median family income) was significantly larger (59 percent) than the comparable proportion of insurance applicants for home purchase mortgages (49 percent). This difference likely reflects the higher proportion of first-time, and perhaps younger, homebuyers in the home purchase category.

Like the distribution of applicants for conventional home purchase loans and refinancings observed in

the 1995 HMDA data, most of the applicants for loans backed by PMI were white (about 80 percent) and about half of the applicants were seeking insurance for mortgages to be secured by properties located in predominantly white neighborhoods (neighborhoods with a minority population of less than 10 percent). Overall, about 60 percent of the applicants were seeking insurance to help buy a home or to refinance a mortgage on a property located in the non-central city portion of MSAs.

The distribution of applications to individual PMI companies by applicant income and race or ethnic group generally reflects the aggregate industry distribution (compare table A.4 with table A.5). The differences among the companies were small in most cases and may, in part, reflect differences in regional focus or business orientation from company to company.

### *Disposition of Applications for Private Mortgage Insurance*

PMI companies approved most of the insurance applications on which they acted during 1995—roughly 87 percent of applications to back home purchase loans and 85 percent for refinancings (table A.6). Of the applications for insurance on home purchase loans, 9.3 percent were denied by a PMI company and 2.6 percent were withdrawn by the lender; in a relatively small percentage of cases, the application file was closed after additional information needed by a PMI company to make a decision was not provided. For home refinancing applications, the denial rate was 11.5 percent and the withdrawal

rate was 3.2 percent. The denial rate for applications to insure mortgages for home purchases was little changed from 1994, while the denial rate for refinancings increased, from 8.5 percent to 11.5 percent.

High approval rates for PMI applications are not surprising: Lenders know the prospective borrowers' credit circumstances and the credit underwriting guidelines used by the PMI companies and, therefore, submit only those applications they expect to be approved.<sup>28</sup> However, the evaluation of disposition patterns for mortgage insurance applications is complicated because lenders may submit an application

for insurance to more than one PMI company at a time. Multiple applications are potentially more common for private mortgage insurance than for mortgages because PMI companies do not charge for PMI applications whereas lenders generally charge for mortgage applications.

Overall, nearly 6 percent of the applications in the 1995 data appear to have involved multiple applications (see box "Multiple Applications"). Analysis suggests that it was mainly the applications of marginally qualified applicants that were submitted to more than one PMI company. For example, among the multiple applications, the denial rate was roughly 40 percent for insurance for home purchase mortgages, compared with 7 percent for all home purchase applications excluding the multiple applications (the denial rate for all home purchase applications, 9.3 percent, is shown in table A.6).

28. Also, PMI companies are increasingly delegating decisions about applications to the lending institutions. In such cases, the PMI company becomes aware of an application for insurance only when a lender has selected it as the insurance provider. In fact, nearly all of the business of one PMI company, Amerin Guaranty Corporation, is based on decisions delegated to lenders.

#### A.4. PMI applications, grouped by purpose of loan and distributed by characteristics of applicant and of census tract in which property is located, 1995

Characteristic	Home purchase		Home refinance	
	Number	Percent	Number	Percent
<b>APPLICANT</b>				
<i>Race or ethnic group</i>				
American Indian or Alaskan native .....	3,102	.3	399	.4
Asian or Pacific Islander .....	28,881	3.1	4,159	3.9
Black .....	67,261	7.2	7,248	6.8
Hispanic .....	72,406	7.8	6,645	6.2
White .....	733,187	78.6	85,293	79.5
Other .....	6,364	.7	1,009	.9
Joint (white and minority) .....	22,189	2.4	2,478	2.3
<b>Total .....</b>	<b>933,390</b>	<b>100.0</b>	<b>107,231</b>	<b>100.0</b>
<i>Income (percentage of MSA median)<sup>1</sup></i>				
Less than 80 .....	148,557	20.4	11,291	11.8
80-99 .....	114,329	15.7	12,982	13.5
100-119 .....	112,316	15.4	14,873	15.5
120 or more .....	353,964	48.5	56,724	59.2
<b>Total .....</b>	<b>729,166</b>	<b>100.0</b>	<b>95,870</b>	<b>100.0</b>
<b>CENSUS TRACT</b>				
<i>Racial composition (minorities as percentage of population)</i>				
Less than 10 .....	371,013	49.6	41,234	42.8
10-19 .....	164,676	22.0	21,962	22.8
20-49 .....	136,585	18.3	21,090	21.9
50-79 .....	46,649	6.2	7,292	7.6
80-100 .....	28,776	3.8	4,651	4.8
<b>Total .....</b>	<b>747,699</b>	<b>100.0</b>	<b>96,229</b>	<b>100.0</b>
<i>Income<sup>2</sup></i>				
Lower .....	89,662	12.0	10,389	10.8
Middle .....	371,199	49.7	49,752	51.8
Upper .....	286,223	38.3	35,996	37.4
<b>Total .....</b>	<b>747,084</b>	<b>100.0</b>	<b>96,137</b>	<b>100.0</b>
<i>Location<sup>3</sup></i>				
Central city .....	305,980	40.9	34,316	35.7
Non-central city .....	441,749	59.1	61,914	64.3
<b>Total .....</b>	<b>747,729</b>	<b>100.0</b>	<b>96,230</b>	<b>100.0</b>

NOTE. Not all characteristics were reported for all loans.

1. MSA median is median family income of the metropolitan statistical area (MSA) in which the property related to the loan is located.

2. *Lower*: median family income for census tract less than 80 percent of

median family income for MSA. *Middle*: 80 percent to 120 percent. *Upper*: 120 percent or more.

3. For census tracts located in MSAs.

SOURCE. Federal Financial Institutions Examination Council.

### A.5. PMI applications, grouped by insurance company and purpose of loan and distributed by characteristics of applicant and census tract in which property is located, 1995

Percent

Characteristic	Amerin Guaranty		Commonwealth Mortgage Assurance		GE Capital Mortgage Insurance		Mortgage Guaranty Insurance	
	Purchase	Refinance	Purchase	Refinance	Purchase	Refinance	Purchase	Refinance
<b>APPLICANT</b>								
<i>Race or ethnic group</i>								
American Indian or Alaskan native .....	.3	.3	.4	.3	.4	.6	.3	.3
Asian or Pacific Islander .....	3.4	5.0	3.5	4.3	2.6	3.3	3.1	3.4
Black .....	4.6	4.8	8.7	8.1	8.3	7.7	6.1	5.8
Hispanic .....	7.1	6.9	10.3	8.9	7.2	4.5	6.9	5.5
White .....	80.1	77.0	73.5	74.9	79.7	82.3	80.5	81.4
Other .....	1.7	3.0	1.2	1.2	.0	.0	.8	.9
Joint (white and minority) .....	2.8	3.0	2.5	2.3	1.7	1.6	2.4	2.6
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<i>Income (percentage of MSA median)<sup>1</sup></i>								
Less than 80 .....	15.3	10.3	21.4	13.2	22.5	12.0	20.2	11.7
80–99 .....	14.8	13.3	15.8	14.3	16.3	13.4	15.8	13.6
100–119 .....	16.9	15.1	15.0	16.1	14.7	15.1	15.6	15.4
120 or more .....	53.1	61.3	47.8	56.4	46.5	59.5	48.4	59.3
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>CENSUS TRACT</b>								
<i>Racial composition (minorities as percentage of population)</i>								
Less than 10 .....	49.2	39.0	43.3	37.3	51.5	49.0	52.5	45.1
10–19 .....	23.1	24.5	23.3	22.6	21.0	21.5	21.6	22.4
20–49 .....	18.6	24.9	20.6	23.6	17.3	18.7	16.9	20.8
50–79 .....	6.2	7.8	7.5	9.6	6.0	6.3	5.6	7.2
80–100 .....	2.8	3.9	5.4	6.9	4.2	4.4	3.2	4.4
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<i>Income<sup>2</sup></i>								
Low or moderate .....	9.7	10.6	13.2	13.2	12.9	10.5	11.8	10.5
Middle .....	49.5	51.3	49.7	53.7	50.0	51.6	50.3	51.5
Upper .....	40.8	38.0	37.1	33.1	37.1	37.9	37.9	38.0
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Although most 1995 applications for private mortgage insurance were approved, there were substantial differences across metropolitan areas. In particular, applications for insurance for home purchase mortgages secured by properties located in nearly all California MSAs and in a number of Florida MSAs had relatively high denial rates. These elevated denial rates continue the pattern first observed in the 1993 PMI data. In California, weak housing markets combined with the aggressive pursuit of customers by mortgage originators may have led to higher proportions of marginally qualified applicants for mortgage insurance in these markets. The explanations for high denial rates in Florida are less certain; possibilities include a high proportion of relatively risky types of property (condominiums and second homes) and a local economy that is prone to greater volatility in housing prices. In contrast, many MSAs in the Midwest and some in the South had denial rates well below the 8.2 percent national average for MSAs (for example, Raleigh–Durham, 2.6 percent;

Minneapolis–St. Paul, 3.3 percent; Kansas City, 3.5 percent; Indianapolis, 4.5 percent; Richmond, 4.5 percent; and St. Louis, 4.5 percent).

#### Disposition by Applicant Characteristics

In general, the amount, source, and stability of income can be expected to affect an applicant's ability to qualify for mortgage insurance, although these aspects of income are usually considered in relation to the applicant's existing and proposed debt burden rather than as absolute measures of creditworthiness. Other factors considered in evaluating creditworthiness include the amount of assets available to meet down payment and closing cost requirements, employment experience, and credit history. On average, lower-income households have fewer assets and lower net worth and experience more frequent employment disruptions than do higher-income households; this combination of factors often results in denial of an application.

A.5.—Continued

Characteristic	PMI Mortgage Insurance		Republic Mortgage Insurance		Triad Guaranty Insurance		United Guaranty	
	Purchase	Refinance	Purchase	Refinance	Purchase	Refinance	Purchase	Refinance
<b>APPLICANT</b>								
<i>Race or ethnic group</i>								
American Indian or Alaskan native .....	.3	.3	.3	.5	.3	.4	.2	.2
Asian or Pacific Islander .....	3.9	5.2	2.6	3.3	1.9	1.2	3.4	4.5
Black .....	7.2	7.0	6.9	6.8	6.4	6.9	7.5	6.6
Hispanic .....	9.5	8.1	7.9	5.9	3.7	2.6	7.3	6.2
White .....	75.8	75.8	77.9	80.2	85.2	87.0	78.4	78.9
Other .....	.8	1.0	.6	.7	.6	.4	.9	1.5
Joint (white and minority) .....	2.4	2.6	3.8	2.6	1.9	1.4	2.2	2.1
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<i>Income (percentage of MSA median)<sup>1</sup></i>								
Less than 80 .....	20.5	11.5	18.9	12.2	16.9	9.6	19.2	11.0
80-99 .....	15.7	13.5	15.5	13.5	14.5	15.0	14.8	12.9
100-119 .....	15.8	15.8	15.7	15.9	16.5	16.2	15.2	15.1
120 or more .....	48.0	59.2	49.9	58.4	52.1	59.2	50.7	60.9
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>CENSUS TRACT</b>								
<i>Racial composition (minorities as percentage of population)</i>								
Less than 10 .....	46.2	36.9	48.0	43.4	55.2	54.5	49.8	40.9
10-19 .....	22.7	24.1	22.9	22.7	22.9	21.7	21.8	24.1
20-49 .....	19.9	24.9	19.1	22.7	16.4	16.8	18.5	22.7
50-79 .....	7.0	8.7	6.6	7.2	3.6	4.1	6.2	7.5
80-100 .....	4.2	5.4	3.5	4.0	1.9	2.9	3.7	4.8
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<i>Income<sup>2</sup></i>								
Low or moderate .....	12.5	11.3	11.0	9.9	8.6	8.8	11.0	9.7
Middle .....	50.1	52.3	48.6	52.6	48.7	49.4	48.2	49.6
Upper .....	37.4	36.3	40.3	37.4	42.7	41.8	40.8	40.6
<b>Total .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

1. MSA median is median family income of the metropolitan statistical area (MSA) in which the property related to the loan is located.

2. *Low or moderate*: median family income for census tract less than

80 percent of median family income for MSA of tract. *Middle income*: 80 percent to 120 percent. *Upper income*: 120 percent or more.

SOURCE: Federal Financial Institutions Examination Council.

The 1995 data indicate that most applications for private mortgage insurance were approved but that the rates of approval and denial varied among applicants grouped by income (table A.6). For example, 90 percent of the applicants for insurance for home purchase loans whose incomes placed them in the highest income group were approved for insurance, compared with 83 percent in the lowest income group (income less than 80 percent of their MSA median). The same pattern was found for applications for insurance of refinancings.

Examination of the racial or ethnic characteristics of applicants indicates that greater proportions of Asian, black, and Hispanic applicants than of white applicants had their applications for private mortgage insurance denied in 1995; the denial rate for Native American applicants was about the same as that for white applicants. For example, for insurance for home purchase loans, 13.8 percent of Asian applicants, 19.3 percent of black applicants, 17.6 percent of Hispanic applicants, 10.5 percent of Native Ameri-

can applicants, and 8.5 percent of white applicants were denied. The rate of denial also generally increased as the proportion of minority and lower-income residents in a neighborhood increased.

Differences in PMI denial rates for applicants grouped by race or ethnicity reflect various factors, including the proportion of each group with relatively low incomes. In 1995, 19 percent of the white applicants who applied for insurance to back home purchase loans had incomes that were less than 80 percent of the median family income for their MSA (data not shown in tables). The figures for other groups of applicants in the same income category were roughly 40 percent for black, 35 percent for Hispanic, and 18 percent for Asian applicants. Differences in the distribution of applicants for insurance by income account for some of the differences in denial rates. However, within each income group, white applicants had lower rates of denial than Asian, black, or Hispanic applicants (table A.7).



## Multiple Applications

Of the 1,108,512 applications for insurance for home purchase loans in 1995, 65,714 (5.9 percent) appear to have been multiple applications, and of the 127,725 applications for insurance to back refinancings that year, 7,313 (5.7 percent) appear to have been multiple applications.<sup>1</sup> Multiple applications were identified through a search of the data for applications showing identical census tracts, purposes of loan, and race or ethnic status and similar applicant incomes and loan sizes. (For applicant income and loan size, differ-

ences of \$1,000 or less were allowed.) If two applications appeared to match but both were reported to have been backed by insurance, the applications were assumed not to be duplicates. Applications from Hispanic, black, and Asian applicants—and from applicants not in the highest income category—were more likely than applications from would-be borrowers in other racial or ethnic categories to be sent to more than one PMI company (compare table A.4 with the table below). In addition, denial rates were substantially higher for all categories of applicants with multiple application records (compare table A.6 with the table below).

1. Most matches were of two applications, indicating that a given application was typically not submitted to more than two PMI companies.

Distribution and denial rate for PMI applications sent to more than one company, by purpose of loan and characteristics of applicant and of census tract in which property is located, 1995

Percent

Characteristic	Home purchase		Home refinance	
	Distribution	Denial rate	Distribution	Denial rate
All applications sent to more than one company .....	100	40.2	100	47.1
<i>Race or ethnic group of applicant</i>				
American Indian or Alaskan Native .....	.2	48.8	.2	38.5
Asian or Pacific Islander .....	4.0	43.3	5.1	44.1
Black .....	13.0	52.8	10.8	60.6
Hispanic .....	13.9	47.5	10.2	50.7
White .....	66.4	38.9	70.8	46.6
Other .....	.5	50.9	.6	60.0
Joint (white and minority) .....	2.0	43.0	2.3	44.9
Total .....	100	...	100	...
<i>Income of applicant (percentage of MSA median)<sup>1</sup></i>				
Less than 80 .....	28.7	48.3	16.4	56.5
80-99 .....	17.6	42.3	15.4	49.6
100-119 .....	14.8	38.2	16.4	44.2
120 or more .....	38.9	35.8	51.7	44.4
Total .....	100	...	100	...
<i>Racial composition of census tract (minorities as percentage of population)</i>				
Less than 10 .....	36.8	34.8	32.8	44.3
10-19 .....	22.4	38.7	20.7	46.7
20-49 .....	23.6	45.0	27.3	47.8
50-79 .....	10.1	46.3	10.8	47.0
80-100 .....	7.1	48.7	8.5	57.7
Total .....	100	...	100	...
<i>Income of census tract<sup>2</sup></i>				
Lower .....	16.2	47.1	14.7	50.7
Middle .....	49.6	40.7	51.6	47.9
Upper .....	34.2	36.3	33.7	44.4
Total .....	100	...	100	...
<i>Location of census tract<sup>3</sup></i>				
Central city .....	40.3	42.0	34.1	48.0
Non-central city .....	59.7	39.1	65.9	46.7
Total .....	100	...	100	...
MEMO				
Number of applications sent to more than one company .....	65,714		7,313	

1. MSA median is median family income of the metropolitan statistical area (MSA) in which the property related to the loan is located.

2. *Lower*: median family income for census tract less than 80 percent of

median family income for MSA. *Middle*: 80 percent to 119 percent.

*Upper*: 120 percent or more.

3. For census tracts located in MSAs.

SOURCE: Federal Financial Institutions Examination Council.

Denial rates are also explained in part by differences across racial and ethnic groups in the frequency of multiple applications for insurance by the same applicants. Generally, applications by minorities are more likely to be submitted to more than one PMI company because minority applicants tend to have lower incomes or more complex credit circumstances. Excluding multiple applications submitted for the same individuals reduces denial rates 3 to 4 percentage points for minorities and less than 2 percentage points for whites.

The pattern of denial rates by race or ethnicity differs from the pattern in the HMDA data in one notable way: In the HMDA data, Asian applicants for home purchase loans have a lower denial rate than do white applicants.<sup>29</sup> The high proportion of Asian

applicants in California may help account for their relatively high denial rate for private mortgage insurance. Among Asians applying for home purchase loans with insurance (where the MSA location of the property was reported), 39 percent were seeking to buy homes in California. In contrast, only 11 percent of all PMI applications were for loans to buy homes in California. Slightly more than 20 percent of the Asian applicants in California were denied private mortgage insurance, compared with only 8 percent of Asian applicants outside California (data not shown in tables).

The difference in PMI denial rates between white applicants and black and Hispanic applicants may lead some observers to conclude that race influences the disposition of applications. However, because PMI companies do not have direct contact with prospective borrowers, they would be aware of race or ethnic identities only from the application. Although these disparities raise questions, the extent of any

29. For example, according to the 1995 HMDA data, the denial rate for home purchase mortgages was 12.5 percent for Asian applicants and 20.6 percent for white applicants.

**A.6. PMI applications, grouped by characteristics of applicant and of census tract in which property is located and distributed by purpose and disposition of application, 1995**

Percent

Characteristic	Home purchase					Home refinance				
	Approved	Denied	Withdrawn	File closed	Total	Approved	Denied	Withdrawn	File closed	Total
<b>Total</b> .....	<b>87.4</b>	<b>9.3</b>	<b>2.6</b>	<b>.7</b>	<b>100</b>	<b>84.7</b>	<b>11.5</b>	<b>3.2</b>	<b>.6</b>	<b>100</b>
<b>APPLICANT</b>										
<i>Race or ethnic group</i>										
American Indian or Alaskan										
Native .....	84.7	10.5	3.6	1.1	100	86.5	9.8	3.3	.5	100
Asian or Pacific Islander .....	82.0	13.8	3.3	.9	100	79.1	15.8	4.4	.7	100
Black .....	75.7	19.3	3.9	1.1	100	75.3	19.7	4.0	1.0	100
Hispanic .....	77.6	17.6	3.8	1.1	100	75.6	19.3	4.3	.8	100
White .....	88.2	8.5	2.3	.7	100	85.4	10.9	3.2	.6	100
Other .....	84.1	12.6	2.4	.9	100	87.0	10.0	2.2	.8	100
Joint (white and minority) .....	85.6	11.0	2.7	.7	100	83.4	13.0	3.2	.4	100
<i>Income (percentage of MSA median)<sup>1</sup></i>										
Less than 80 .....	83.2	13.7	2.5	.6	100	78.2	18.0	3.3	.5	100
80-99 .....	87.9	9.4	2.1	.6	100	83.8	12.6	3.1	.6	100
100-119 .....	89.6	7.8	2.0	.5	100	85.4	11.1	2.9	.5	100
120 or more .....	90.3	7.0	2.2	.5	100	86.0	10.2	3.2	.5	100
<b>CENSUS TRACT</b>										
<i>Racial composition (minorities as percentage of population)</i>										
Less than 10 .....	92.1	5.8	1.7	.4	100	88.2	8.8	2.6	.4	100
10-19 .....	88.7	8.6	2.2	.5	100	85.2	11.1	3.3	.5	100
20-49 .....	84.6	12.1	2.7	.6	100	82.1	13.6	3.6	.7	100
50-79 .....	80.5	15.5	3.2	.8	100	78.6	16.8	4.0	.6	100
80-100 .....	76.7	18.7	3.6	1.0	100	73.1	21.9	4.3	.7	100
<i>Income<sup>2</sup></i>										
Lower .....	82.7	13.8	2.8	.7	100	79.8	16.2	3.5	.5	100
Middle .....	88.8	8.6	2.1	.5	100	84.8	11.6	3.1	.5	100
Upper .....	90.3	7.1	2.1	.5	100	85.9	10.3	3.2	.6	100
<i>Location<sup>3</sup></i>										
Central city .....	88.1	9.2	2.2	.5	100	84.5	11.7	3.2	.5	100
Non-central city .....	89.0	8.3	2.1	.5	100	84.8	11.5	3.1	.5	100

NOTE. Not all characteristics were reported for all loans.

1. MSA median is median family income of the metropolitan statistical area (MSA) in which the property related to the loan is located.

2. Lower: median family income for census tract less than 80 percent of

median family income for MSA of tract. Middle: 80 percent to 120 percent. Upper: 120 percent or more.

3. For census tracts located in MSAs.

SOURCE: Federal Financial Institutions Examination Council.

## A.7. PMI applications, grouped by purpose and disposition of application, 1995

Percent

Applicant's MSA-relative income and race or ethnic group <sup>1</sup>	Home purchase					Home refinance				
	Approved	Denied	Withdrawn	File closed	Total	Approved	Denied	Withdrawn	File closed	Total
<i>Less than 80 percent</i>										
American Indian or Alaskan native ...	84.7	12.2	2.7	.4	100	82.0	16.0	2.0	.0	100
Asian or Pacific Islander .....	80.4	16.2	2.8	.6	100	73.8	22.4	2.8	1.0	100
Black .....	73.5	22.2	3.5	.8	100	69.3	26.4	3.8	.4	100
Hispanic .....	76.9	19.3	3.1	.8	100	70.0	24.8	4.5	.8	100
White .....	85.3	11.9	2.3	.5	100	79.6	16.8	3.0	.6	100
Other .....	81.8	15.7	1.8	.6	100	81.9	14.9	3.2	.0	100
Joint (white and minority) .....	79.5	17.7	2.1	.7	100	72.3	25.2	2.5	.0	100
<i>80–99 percent</i>										
American Indian or Alaskan native ...	87.1	9.7	2.1	1.2	100	82.9	17.1	.0	.0	100
Asian or Pacific Islander .....	84.0	12.6	2.9	.5	100	77.8	17.6	4.3	.2	100
Black .....	78.4	17.3	3.5	.9	100	75.6	18.3	4.4	1.7	100
Hispanic .....	78.3	17.6	3.2	.9	100	76.1	19.3	4.2	.5	100
White .....	89.7	7.9	1.9	.5	100	84.9	11.8	2.8	.5	100
Other .....	84.2	14.0	1.4	.4	100	87.4	6.8	3.9	1.9	100
Joint (white and minority) .....	86.8	11.0	1.7	.5	100	79.6	16.9	3.0	.5	100
<i>100–119 percent</i>										
American Indian or Alaskan native ...	87.6	8.6	3.2	.6	100	88.6	6.8	2.3	2.3	100
Asian or Pacific Islander .....	83.8	12.8	2.7	.8	100	82.2	12.4	4.9	.5	100
Black .....	79.4	16.6	3.2	.7	100	75.4	19.3	3.7	1.5	100
Hispanic .....	79.3	16.1	3.6	1.0	100	76.7	17.6	4.5	1.1	100
White .....	91.2	6.5	1.8	.4	100	86.5	10.5	2.5	.5	100
Other .....	87.2	9.6	2.3	.8	100	89.1	9.4	.7	.7	100
Joint (white and minority) .....	87.6	9.9	2.0	.6	100	84.7	12.9	2.4	.0	100
<i>120 or more percent</i>										
American Indian or Alaskan native ...	87.1	8.5	3.4	1.0	100	86.6	7.5	5.3	.5	100
Asian or Pacific Islander .....	82.5	13.1	3.5	.9	100	78.7	15.7	4.8	.7	100
Black .....	81.2	14.8	3.2	.8	100	75.9	19.6	3.9	.6	100
Hispanic .....	81.4	14.1	3.5	1.0	100	77.1	17.8	4.1	.9	100
White .....	91.1	6.3	2.1	.5	100	86.7	9.7	3.1	.5	100
Other .....	86.7	10.1	2.5	.6	100	86.4	10.6	2.2	.8	100
Joint (white and minority) .....	88.3	8.7	2.5	.6	100	84.8	11.9	3.1	.2	100

1. Income percentages are the percentages of the median family income of the MSA in which the property related to the loan is located.

SOURCE: Federal Financial Institutions Examination Council.

discrimination cannot be determined from the data submitted by the PMI companies because the companies provide little information about the characteristics of the properties that applicants seek to purchase or refinance or of the financial circumstances of the applicants. For example, applicants' levels of debt, their credit histories, and their employment experiences are not disclosed. Without information about these circumstances and about the specific underwriting standards used by PMI companies, the fairness of the decision process cannot be assessed.

#### APPENDIX B: ADJUSTING THE COMPOSITION OF MORTGAGE ACTIVITY FOR CREDIT RISK

The process of converting dollar amounts of mortgages extended or insured ("unadjusted dollars") to *risk dollars*—the long-term expected loss for each mortgage extended—involved four steps: (1) the use of econometric and institutional information about loan-to-value ratio (LTV) distributions to create such distributions for each type of institution; (2) incorpo-

ration of our PMI matching procedure, modified by institutional information, to determine the extent of PMI use across institutions; (3) application of historical default rates and loss severity rates by loan-to-value ratio for each type of institution to calculate the estimated risk dollars held by each group of institutions; and (4) reallocation of these risk dollars across institutions to account for risk-sharing arrangements between private mortgage insurers and other institutions and between the VA and originators of VA mortgages.

#### Estimating Loan-to-Value Distributions

For most institutions, the distribution of loan-to-value ratios for their mortgage portfolios was not publicly available. Therefore, we developed a model for estimating LTVs for home purchase loans reported in the 1995 HMDA data using preliminary information from the Federal Reserve's 1995 Survey of Consumer Finances (details of this procedure are available upon request from the authors). For some of the institutions for which exact aggregate LTV distribu-

tions were available, we adjusted our estimates to reflect those figures.

Our estimates, together with institutional knowledge, suggest that there are essentially five different distributions of loan-to-value ratios across mortgage holders and insurers (table B.1). The FHA, the VA, Fannie Mae and Freddie Mac, and the PMI companies appear to have LTV distributions significantly different from each other. But the fifth group—depository institutions subject to the Community Reinvestment Act, mortgage bankers, other privately chartered nondepository institutions, and credit unions—appear to differ little from each other. We estimated econometrically that roughly 60 percent of the mortgages held by this latter group have loan-to-value ratios of 80 percent or less, 20 percent have ratios between 80 percent and 90 percent, and 20 percent have ratios greater than 90 percent.

Because data on LTV distributions for this fifth group of institutions were not available, we had no

way of directly evaluating the validity of our estimates. However, aggregate data were available for insured and uninsured conventional home purchase mortgages originated by depository institutions and mortgage bankers as a group.<sup>30</sup> Those data suggest that our estimates underpredicted the proportion in the lowest LTV category but were close to correct for the highest LTV category (table B.2).

For insured mortgages, the distribution of LTVs varies by insurer. Generally, government-insured loans have very high concentrations of mortgages having loan-to-value ratios of 90 percent or higher; we estimated that 93 percent of the loans insured by the VA in 1995 were in this category. In contrast, privately insured mortgages were estimated to be

30. These data are gathered in the Mortgage Interest Rate Survey (MIRS), a monthly survey conducted by the Federal Housing Finance Board. The Finance Board provided us with annual data for 1995.

**B.1. Estimated loan-to-value ratios, default rates, loss severity rates, and risk-sharing proportions used to derive expected losses on mortgages extended in 1995**

Percent

Insurance status and type of risk holder	Estimated loan-to-value ratio (percent)					Estimated default rate, by loan-to-value ratio <sup>1</sup>				Estimated loss severity rate, by loan-to-value ratio <sup>2</sup>				MEMO: Estimated expected cumulative dollar loss per \$100 of mortgages extended by institution <sup>3</sup>
	80 or less	81-90	91 or more		Total	80 or less	81-90	91 or more		80 or less	81-90	91 or more		
			91-95	96 or more				91-95	96 or more			91-95	96 or more	
<b>INSURED MORTGAGES</b>														
FHA .....	6	27	31	36	100	5.2	10.6	12.4	15.5	45.8	44.9	46.8	56.6	6.38
VA .....	1	6	17	76	100	1.1	3.5	6.6	12.2	45.8	44.9	46.8	56.6	4.70
Private mortgage insurers <sup>4</sup> .....	2	48	47	3	100	.8	2.7	6.2	9.6	28.4	34.4	47.9	47.9	1.09
<b>UNINSURED MORTGAGES</b>														
Fannie Mae or Freddie Mac .....	96	2		2	100	.8	2.7		6.2	28.4	34.4		47.9	.59
Depositories subject to CRA <sup>5</sup> .....	61	19		20	100	.8	2.7		6.2	28.4	34.4		47.9	.94
Independent mortgage companies <sup>6</sup> .....	63	18		19	100	.8	2.7		6.2	28.4	34.4		47.9	1.04
Other <sup>7</sup> .....	61	19		20	100	.8	2.7		6.2	28.4	34.4		47.9	1.23
Credit unions .....	62	19		19	100	.8	2.7		6.2	28.4	34.4		47.9	.91
<b>All risk holders</b> .....	...	...	...	...	...	...	...	...	...	...	...	...	...	<b>2.90</b>
<b>Proportion of risk borne by insurer under risk-sharing arrangements</b>														
Private mortgage insurers .....	50	50		60	60	...	...	...	...	...	...	...	...	...
VA .....	80	80		80	80	...	...	...	...	...	...	...	...	...

1. Default rates show the percentage of mortgages originated in 1975-83 that had defaulted by the end of 1992.

2. Total loss before mortgage insurance payout resulting from foreclosure (if any) divided by original mortgage amount.

3. Covers both insured and uninsured mortgages. Derived by multiplying default rate by loss severity rate within each loan-to-value range and then summing across loan-to-value ranges weighted by the dollar proportion of an institution's mortgages in that category. Losses were then reallocated among institutions using risk-sharing rules. Losses are cumulative over ten to eighteen years, based on mortgages originated during 1975-83 and tracked through 1992.

4. Based on discussions with individuals at private mortgage insurance companies. The default rate for the LTV range "96 or more" was estimated using the relationship between default rates for FHA and VA loans in the two highest LTV ranges.

5. Includes mortgages originated and held in portfolio by commercial banks and savings associations and their mortgage company affiliates and mortgages sold to commercial banks and savings associations.

6. Includes mortgages originated and held in portfolio by independent mortgage companies and mortgages sold to affiliates by independent mortgage companies.

7. Includes mortgages sold to life insurance companies, pension funds, and other private-sector purchasers.

... Not applicable.

SOURCE: Federal Housing Administration, U.S. Department of Veterans Affairs, Freddie Mac, 1995 Survey of Consumer Finances, and discussions with individuals at private mortgage insurance companies.

more concentrated in the 80 percent to 90 percent LTV range.

For FHA- and VA-insured mortgages, our econometric estimates were close to the actual aggregate distributions (table B.2). We used our estimates for calculating risk dollars for FHA and VA loans because our model allows us to vary LTV by income and race or ethnic group in a consistent manner. For privately insured mortgages, discussions with industry representatives and information available from annual reports and the trade press indicated that our model significantly overpredicted the proportion of mortgages in the lowest LTV category and underpredicted the proportion in the higher categories. Instead of using the model's prediction, we imposed an LTV distribution based on our information about the industry. However, we applied the model to suggest the extent of variation in the LTV distribution across groups by income and race or ethnic status.

For mortgages purchased by Fannie Mae and Freddie Mac, the model significantly underpredicted the actual proportion of uninsured mortgages in the lowest LTV category (table B.2). This underprediction may not be surprising because the Survey of Consumer Finances does not distinguish between mortgages that are sold and those that the originator keeps in its portfolio, and thus the model cannot account for this type of variation across institutions.

As discussed earlier, Fannie Mae and Freddie Mac generally are not allowed to purchase mortgages with LTVs above 80 percent unless the mortgage is backed by private mortgage insurance or the buyer has recourse to the lender. Almost all of these high-LTV mortgages have private mortgage insurance, so only a small proportion of uninsured mortgages purchased by Fannie Mae and Freddie Mac have LTVs above 80 percent. For uninsured mortgages purchased by Fannie Mae and Freddie Mac, we used a distribution based on information from knowledgeable industry sources. As we did for the PMI industry, we used the model to vary Fannie Mae's and Freddie Mac's LTV distributions across groups by income or by race or ethnic status.

### *Adjusting for Private Mortgage Insurance*

The second step in calculating risk dollars was to adjust our estimates of the extent of private mortgage insurance coverage among conventional home purchase mortgages. Our matching of PMI records to HMDA records probably significantly undercounted the number of mortgages with private mortgage insurance. The exact proportion of mortgages origi-

nated in a given year that are covered by private mortgage insurance is unknown. However, the extent of the undercount for mortgages purchased by Fannie Mae and Freddie Mac is known. Thus, for our estimates of the distribution of risk dollars across types of institutions, we increased the estimated number of mortgages backed by private insurance for all institutions in proportion to the known undercount for Fannie Mae's and Freddie Mac's 1995 home purchase mortgages.

### *Applying Default Rates and Loss Severity Rates*

In the third step we converted dollars of mortgages extended into expected losses by applying average default and loss severity rates. The rates we used were for mortgages originated from 1975 through 1983, with performance measured through the end of 1992. The data came from three sources: Freddie Mac, the FHA, and the VA. Default and loss severity rates for Freddie Mac, which represent a large number of conventional home mortgages but not nonconforming mortgages, were used to calculate credit risk in the conventional mortgage system (table B.1).<sup>31</sup> The appropriateness of applying this single set of rates to all conventional mortgages is unknown; however, only Freddie Mac has made these data public. For the government mortgage system, the FHA and the VA, at our request, provided comparable information on mortgages backed by their insurance programs.

### *Incorporating Risk-Sharing Relationships*

The final step in calculating risk dollars held by different institutions was to account for risk-sharing arrangements. For privately insured mortgages, we estimated that losses are divided 50–50 between the insurer and the insuree if the loan-to-value ratio is

31. Information on default and loss severity rates at Freddie Mac was drawn from Robert Van Order and Peter Zorn, "Income, Location and Default: Some Implications for Community Lending," paper presented at the Conference on Housing and Economics, Ohio State University, Columbus, July 1995. Their default and loss severity rates are estimated through 1992; discussions with the authors as well as the FHA and the VA indicate that estimated default and loss severity rates have fallen since 1992 and that the difference between the default rate for high-LTV loans relative to that for lower-LTV loans is currently less than presented in their study. Because all market participants are affected in the same manner by these trends, we have not attempted to update those estimates.

**B.2. Actual and predicted distributions of loan-to-value ratios for mortgages extended in 1995**

Percent

Loan-to-value range (percent)	FHA mortgages		VA mortgages		Fannie Mae and Freddie Mac mortgages				MIRS mortgages <sup>1</sup>	
	Actual	Predicted	Actual	Predicted	Insured		Uninsured		Actual	Predicted
					Actual	Predicted	Actual	Predicted		
80 or less	3	6	2	1	0	20	96	59	54	49
81–90	12	27	4	6	43	45	2	20	18	26
91 or more	..	..	..	..	57	35	2	21	27	25
91–95	34	31	7	17	..	..	..	..	..	..
96 or more	51	36	88	76	..	..	..	..	..	..
<b>All</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

1. Data for insured and uninsured conventional home purchase mortgages originated by depository institutions and mortgage bankers as a group. From the Mortgage Interest Rate Survey conducted by the Federal Housing Finance Board.

SOURCE: Federal Housing Administration, Department of Veterans Affairs, and industry sources.

90 percent or less and 60–40 if the loan-to-value ratio is greater than 90 percent.<sup>32</sup>

The VA, like private mortgage insurance companies, provides guarantees that may not cover all the losses associated with mortgage defaults. When a borrower with a VA mortgage defaults, the VA has the option to “put back” the home to the mortgage holder if it calculates that such a “put back” is the least costly means (to the VA) of implementing its guarantee. In recent years the VA has rarely exercised this option, but it was used for roughly one-fifth of VA defaults (measured by the number of loans) during the late 1980s, when home values in some regions of the country declined sharply. Thus, estimates of the long-term credit risk of a VA mortgage must provide for this risk-sharing; we estimated that 80 percent of the losses are borne by the VA and 20 percent by the mortgage originator regardless of loan-to-value ratio.

Commercial banks, savings associations, and mortgage companies are the most frequent users of VA guarantees and thus share risk with the VA to a limited extent. Typically, a VA loan is securitized by Ginnie Mae. For Ginnie Mae–backed securities, the institutions that service the mortgages underlying the securities (that is, collect the mortgage payments and distribute them to the holders of the securities) are usually the institutions that hold the mortgages and thus partly bear the cost of default. However, in some cases the originator of a mortgage (who may or may not be the current servicer) may retain some of the

credit risk of that mortgage. Because we lacked information about which institutions service VA loans, we assumed that the type of institution that originated a VA mortgage, as reported in the HMDA data, was the current servicer of the mortgage and hence bore that portion of the credit risk that was not borne by the VA.

*Testing the Robustness of Our Analysis*

We reviewed the effects of varying some of the assumptions and parameters used in our analysis. For example, we varied the LTV distribution for mortgages held by portfolio lenders because we were uncertain about the actual distribution. On one hand, the 1995 Survey of Consumer Finances indicates that 39 percent of the uninsured mortgages had LTVs higher than 80 percent. As Fannie Mae and Freddie Mac purchased very few of these loans, the Survey of Consumer Finances data suggest that an even greater proportion of the uninsured mortgages held by portfolio lenders had an LTV higher than 80 percent.

On the other hand, depository institutions have a strong incentive to hold only mortgages that have an LTV of 80 percent or less or that are covered by private mortgage insurance, because capital requirements for such mortgages are lower. Moreover, data from the Office of Thrift Supervision, the regulator of the savings association industry, indicate that only about 5 percent of the stock of all mortgages held by these institutions had an LTV higher than 80 percent and no private mortgage insurance. Reasonable adjustments to these data indicate that perhaps only as many as 12 percent of the home purchase originations might be in this category. As discussed in the main text, variations in this LTV distribution did not alter our conclusions.

32. Our estimated sharing rule between PMI companies and other institutions is based on conversations with industry participants and on comparing the PMI coverage rates used by Fannie Mae and Freddie Mac with the historic estimated loss severity rates for mortgages with different LTVs.

We also changed the VA risk-sharing arrangement to allocate more risk to the VA and changed the loan-to-value distributions for the FHA and the VA to reflect their reported LTV distributions. These changes raised the FHA's share about 2 percentage points and the VA's share about 1 percentage point.

All other institutions lost less than 1 percentage point of their market share. Thus, we conclude that our results are robust to reasonable changes in the assumptions and parameters that underlie our measures of credit risk. □

# Treasury and Federal Reserve Foreign Exchange Operations

*This quarterly report describes Treasury and System foreign exchange operations for the period from July through September 1996. It was presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager for Foreign Operations, System Open Market Account. Christine Hall was primarily responsible for preparation of the report.<sup>1</sup>*

During the quarter the dollar appreciated 1.6 percent against the Japanese yen, 0.1 percent against the

German mark, and 0.1 percent on a trade-weighted basis against other Group of Ten currencies. Over the quarter, the dollar was supported by expectations that the Federal Reserve would tighten monetary policy—in contrast to expectations for steady policy in Germany and Japan. In addition, sentiment for the prospect of broad participation in the European Monetary Union shifted from doubt early in the quarter to growing confidence late in the quarter, lending support to the dollar against the mark. The U.S. monetary authorities did not undertake any intervention operations in the foreign exchange market during the quarter. However, the U.S. Treasury's Exchange Stabilization Fund (ESF) received a \$7 billion repayment from the United Mexican States related to draw-

1. The charts for the report are available on request from Publications Services, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, DC 20551.

## 1. Foreign exchange holdings of U.S. monetary authorities, based on current exchange rates, 1996:Q3

Millions of dollars

Item	Balance, June 30, 1996	Quarterly changes in balances by source				Balance, Sept. 30, 1996
		Net purchases and sales <sup>1</sup>	Impact of sales <sup>2</sup>	Investment income	Currency valuation adjustments <sup>3</sup>	
<b>FEDERAL RESERVE</b>						
Deutsche marks .....	12,982.1	.0	.0	110.0	-53.2	13,038.9
Japanese yen .....	6,497.3	.0	.0	5.2	-125.7	6,376.8
Interest receivables <sup>4</sup> .....	74.0	...	...	...	...	72.0
Other cash flow from investments <sup>5</sup> .....	.5	...	...	...	...	-3.5
<b>Total .....</b>	<b>19,553.9</b>	...	...	...	...	<b>19,484.2</b>
<b>U.S. TREASURY EXCHANGE STABILIZATION FUND</b>						
Deutsche marks .....	6,571.2	.0	.0	55.4	-26.9	6,599.8
Japanese yen .....	9,523.3	.0	.0	6.0	-180.8	9,348.5
Mexican pesos <sup>6</sup> .....	10,500.0	-7,373.3	.0	373.3	.0 <sup>7</sup>	3,500.0
Interest receivables <sup>4</sup> .....	277.3	...	...	...	...	39.1
Other cash flow from investments <sup>5</sup> .....	4.4	...	...	...	...	1.2
<b>Total .....</b>	<b>26,876.2</b>	...	...	...	...	<b>19,488.6</b>

NOTE. Figures may not sum to totals because of rounding.

1. Purchases and sales include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

2. Calculated using marked-to-market exchange rates; represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate are shown in table 2.

3. Foreign currency balances are marked to market monthly at month-end exchange rates.

4. Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at average cost of acquisition and are not marked to market until interest is paid.

5. Cash flow differences from payment and collection of funds between quarters.

6. See table 4 for a breakdown of Mexican swap activities. Note that the investment income on Mexican swaps is sold back to the Bank of Mexico.

7. Valuation adjustments on peso balances do not affect profit and loss because the effect is offset by the unwinding of the forward contract at the repayment date. Although the ESF does not mark to market its peso holdings, Mexico is obligated to maintain in dollar terms the value of ESF peso holdings resulting from Mexican drawings under the Medium-Term Stabilization Agreement.



ings by Mexico under the medium-term swap facility with the ESF. An additional \$3.5 billion remained outstanding.

### GENERAL STABILITY OF EXCHANGE RATES

For the period as a whole, foreign exchange markets were relatively stable. The average daily trading range of the dollar was substantially less than the ranges observed last year. On average the dollar traded in a daily range of 0.6 percent against both the mark and the yen. This compares with daily dollar ranges of 1.1 percent against the mark and 1.4 percent against the yen in the third quarter of 1995. Additionally, implied volatility on dollar–mark and dollar–yen one-month options generally maintained the low levels of the second quarter of this year.

However, the period was marked by a few brief episodes of sharp dollar movements. The dollar's largest one-day move occurred early in the quarter. On July 16, the dollar traded in a 3.1 percent range against the mark, implied volatility on one-month dollar–mark options spiked higher, and prices of risk reversals indicated a rise in the perceived risk of a further significant dollar decline.<sup>2</sup> As with other sharp dollar moves over the period, the dollar's trading ranges over subsequent days fell toward the period's average, implied volatility on dollar–mark options reverted toward record-low levels, and risk reversal prices moved closer to neutral.

### RESPONSE OF THE DOLLAR TO U.S. INTEREST RATE EXPECTATIONS AND ASSET MARKET PERFORMANCE

Expectations for a Federal Reserve tightening shifted throughout the period. Signs of strong U.S. economic growth and tightening labor markets, yet benign inflation data, made the near-term interest rate outlook uncertain.

Early in the quarter, the dollar reached a twenty-nine-month high against the yen of ¥111.19 while holding above DM 1.52 against the mark after the strong U.S. nonfarm payroll report for June, which led many market participants to anticipate an immi-

2. A risk reversal is an option position consisting of a written put and a purchased call that mature on the same date and are equally out-of-the-money. The price of a risk reversal indicates whether the dollar call or the dollar put is more valuable. If the dollar call is at a premium, the market is willing to pay more to insure against the risk that the dollar will rise sharply. If the dollar put is at a premium, the market is willing to pay more to insure against the risk that the dollar will fall sharply.

nent Federal Reserve tightening. Subsequently, U.S. stock prices declined sharply and a liquidation of long dollar positions ensued. On July 16, the dollar depreciated from opening prices of DM 1.5145 and ¥110.22 to a low of DM 1.4695 and ¥108.27 before partially recovering to close the day at DM 1.4844 and ¥109.32.

Expectations of a near-term Federal Reserve tightening were scaled back after Chairman Greenspan's Humphrey–Hawkins testimony in July. Market participants appeared to focus on his comments about the potential for an economic slowdown in the second half of the year. Subsequent reports of benign inflation further diminished expectations for a tightening, and the August meeting of the Federal Open Market Committee ended with no announced change in policy.

In September, expectations began to build anew for a Federal Reserve tightening at the September 24 FOMC meeting. The August nonfarm payroll data continued to show robust employment growth. The dollar steadily recovered all of its losses against the mark and yen, supported by expectations of higher U.S. short-term interest rates as well as by ongoing strength in the U.S. stock market in September.

The FOMC's decision at the September 24 meeting to keep policy unchanged surprised many market participants. Although the dollar declined sharply on

### 2. Net profits or losses (–) on U.S. Treasury and Federal Reserve foreign exchange operations, based on historical cost-of-acquisition exchange rates, 1996:Q3

Millions of dollars

Period and item	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
<i>Valuation profits and losses on outstanding assets and liabilities, June 30, 1996</i>		
Deutsche marks .....	2,118.7	663.5
Japanese yen .....	1,337.5	1,968.3
<b>Total</b> .....	<b>3,456.1</b>	<b>2,631.7</b>
<i>Realized profits and losses from foreign currency sales, June 30, 1996–Sept. 30, 1996</i>		
Deutsche marks .....	.0	.0
Japanese yen .....	.0	.0
<b>Total</b> .....	<b>.0</b>	<b>.0</b>
<i>Valuation profits and losses on outstanding assets and liabilities, Sept. 30, 1996<sup>1</sup></i>		
Deutsche marks .....	2,065.5	636.6
Japanese yen .....	1,211.2	1,783.0
<b>Total</b> .....	<b>3,276.8</b>	<b>2,419.6</b>

NOTE. Figures may not sum to totals because of rounding.

1. Valuation profits or losses are not affected by peso holdings, which are canceled by forward contracts.

the day of the announcement, it more than recovered its losses the following day. Despite the FOMC's decision to leave policy unchanged, some market expectation for a tightening by year-end remained.

### **SUPPORT OF THE DOLLAR AGAINST THE MARK FROM EXPECTATIONS FOR STEADY OR LOWER GERMAN RATES**

May data for German industrial production and orders, which were released early in the quarter, indicated a third consecutive month-to-month rise in each series. These data contributed to market perceptions that German economic recovery would preclude further Bundesbank interest rate cuts and that market rates would rise by year-end. The perception that German rates had bottomed contributed to the decline in the dollar against the mark in mid-July when declines in U.S. equity prices also weighed on the

dollar. Subsequently, however, market expectations of Bundesbank policy gradually shifted as the mark appreciated against the dollar, growth in the Bundesbank's M3 monetary aggregate decelerated, and German business sentiment deteriorated. Also, Bundesbank officials made periodic comments that held open the possibility of further reductions in the Bundesbank's key repurchase rate. Long-term interest rate differentials between the United States and Germany widened further in favor of the dollar and contributed to the stabilization of the dollar after its sharp decline in mid-July.

On July 25, at its last meeting before the summer recess, the Bundesbank disappointed market expectations, leaving its repo rate unchanged at 3.3 percent, and the German mark rose sharply. The dollar fell from an opening price of DM 1.4905 to a low of DM 1.4723 on the announcement.

However, in a largely unanticipated move, at its August 22 meeting the Bundesbank cut its repo rate 30 basis points to 3 percent. The dollar appreciated after the Bundesbank's decision as interest rate differentials between the United States and Germany widened further in favor of the dollar. After the reduction market participants generally came to expect that monetary policy in Germany would remain stable through the early part of 1997. Reflecting that sentiment, implied yields on three-month Euromark futures contracts through March 1997 declined to levels only slightly above cash rates.

The Bundesbank's cut in the repo rate fostered an impression among many market participants that the Bundesbank was motivated, at least in part, to ease pressures on other European Union members to meet the economic convergence criteria of the Maastricht Treaty. In addition, the anticipated pressures on European currencies during the release of government budgets across Europe did not materialize. This led to sales of German marks against higher-yielding European currencies. In September, the dollar steadily climbed back above DM 1.52.

### **3. Currency arrangements, September 30, 1996**

Millions of dollars

Institution	Amount of facility	Outstanding, Sept. 30, 1996	
<b>FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS</b>			
Austrian National Bank .....	250	0	
National Bank of Belgium .....	1,000	↑	
Bank of Canada .....	2,000		
National Bank of Denmark .....	250		
Bank of England .....	3,000		
Bank of France .....	2,000		
Deutsche Bundesbank .....	6,000		
Bank of Italy .....	3,000		
Bank of Japan .....	5,000		
Bank of Mexico <sup>1</sup> .....	3,000		
Netherlands Bank .....	500		
Bank of Norway .....	250	↓	
Bank of Sweden .....	300		
Swiss National Bank .....	4,000		
<i>Bank for International Settlements</i>			
Dollars against Swiss francs .....	600		
Dollars against other authorized European currencies .....	1,250		
<b>Total</b> .....	<b>32,400</b>		<b>0</b>
<b>U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY ARRANGEMENTS</b>			
Deutsche Bundesbank .....	1,000		0
Bank of Mexico <sup>1</sup>			
Regular swaps .....	3,000	0	
United Mexican States <sup>1</sup>			
Medium-term swaps .....	...	3,500	
<b>Total</b> <sup>1</sup> .....	...	<b>3,500</b>	

1. Facilities available to Mexico comprise short-term swaps between the Bank of Mexico and both the Federal Reserve and the ESF, as well as medium-term swaps and government guarantees between the government of Mexico and the ESF. The total amount available from both medium-term swaps and government guarantees is \$20 billion, less any outstanding drawings on the short-term facilities.

### **SUPPORT FOR THE DOLLAR AGAINST THE YEN FROM RECEDING EXPECTATIONS FOR A TIGHTENING BY THE BANK OF JAPAN**

Early in the quarter, most market participants believed that a hike in Japanese interest rates would soon follow any tightening by the Federal Reserve. This assumption came into question, however, as official commentary and the Bank of Japan's quarterly outlook, released in late July, suggested that the economy had not achieved a "self-sustaining" recov-

ery. A sharp decline in Japanese stock prices in late August further contributed to the belief that the Bank of Japan would not raise rates in the near term.

Additional evidence accumulated to suggest that Japan's economic recovery remained fragile. On August 28, a weak August *Tankan* report showed an unexpected deterioration in business confidence. In mid-September, the second-quarter report on gross domestic product showed an annualized quarter-on-quarter decline of 2.9 percent. On the last day of the quarter, the dollar reached a two-and-a-half year high of ¥111.68 against the yen, boosted by expectations that Japanese investors would increase their investments in higher-yielding foreign assets in the second half of the Japanese fiscal year.

The market's reaction to trade data released during the third quarter was mixed. Early in the period, declines in Japan's trade surplus, the U.S. trade deficit, and the U.S.-Japanese bilateral deficit, albeit all of which occurred at a slower pace than the rate of decline in previous quarters, supported the dollar. At the end of the quarter, U.S. trade data for July indicating a widening overall U.S. deficit as well as a larger bilateral deficit with Japan, prompted a sharp but temporary decline in the dollar.

#### *CONTINUATION OF THE DOWNWARD TREND OF INTEREST RATES IN CANADA*

Low inflation, a firming Canadian dollar, and steady U.S. monetary policy allowed interest rates to continue their downward trend in Canada. Over the period, the Bank of Canada reduced its overnight call money range 75 basis points. The midpoint of the target range ended the quarter at 4 percent, about 125 basis points below the federal funds rate. By the end of the period, positive yield spreads between Canadian government bonds and comparable U.S. Treasuries existed only beyond the five-year maturity sector. The spread between the benchmark ten-year Canadian government bond and the ten-year U.S.

Treasury note narrowed from 99 to 43 basis points over the period.

#### *INVESTOR OPTIMISM IN MEXICO*

The peso strengthened over the quarter despite periodic concerns about a near-term interest rate hike in the United States. Market participants became optimistic about the strength of Mexico's economic recovery, after a 7.2 percent rise in its second-quarter GDP. Domestic interest rates fell, while Mexican Brady debt spreads over U.S. Treasuries fell from 669 to 510 basis points.

Mexico successfully raised funds in the international capital markets in four issues in the third quarter. In July, Mexico issued \$6 billion in five-year, floating-rate notes at a spread of 200 basis points over London interbank offered rates, and in September, it placed a \$1 billion twenty-year Eurobond issue at narrower-than-expected spreads over U.S. Treasuries. On August 5, Mexico repaid in advance \$7 billion of the \$10.5 billion outstanding under the U.S. Treasury's ESF medium-term swap facility. Of this amount, \$5 billion was used to repay the two swaps that had been drawn in April and May of 1995, and \$2 billion was used to pay down 80 percent of the July 1995 drawing. The repayments reduced the amount outstanding from these swaps to \$3.5 billion.

#### *TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES*

At the end of the quarter, the foreign currency reserve holdings of the Federal Reserve System and the ESF were valued at \$19.4 billion and \$15.9 billion, respectively and consisted of German marks and Japanese yen.

The U.S. monetary authorities invest all their foreign currency balances in a variety of instruments that yield market-related rates of return and have a high degree of liquidity and credit quality. A significant portion of these balances is invested in German and Japanese government securities that are held either directly or under repurchase agreement. As of September 30, outright holdings of government securities by U.S. monetary authorities totaled \$6.4 billion and included investments in Japanese treasury bills and German government securities. Japanese and German government securities held under repurchase agreement are arranged either through transactions executed directly in the market or through agreements with official institutions. Government securi-

#### 4. Drawings/rollovers and repayments (–) by Mexican monetary authorities, 1996:Q3

Millions of dollars

Currency arrangements with the U.S. Treasury Exchange Stabilization Fund	Out-standing, June 30, 1996	July	Aug.	Sept.	Out-standing, Sept. 30, 1996
Bank of Mexico					
Regular .....	0	0	0	0	0
Medium-term .....	10,500	0	–7,000	0	3,500

NOTE. Data are on a value-date basis.

ties held under repurchase agreements by the U.S. monetary authorities totaled \$11.0 billion at the end of the quarter. Foreign currency reserves are also

invested in deposits at the Bank for International Settlements and in facilities at other official institutions. □

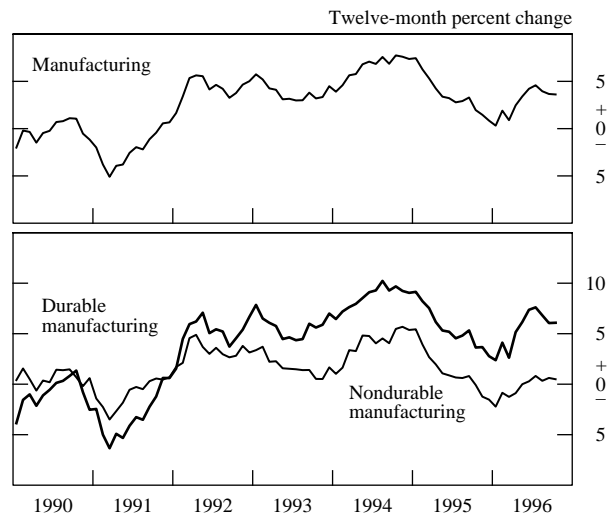
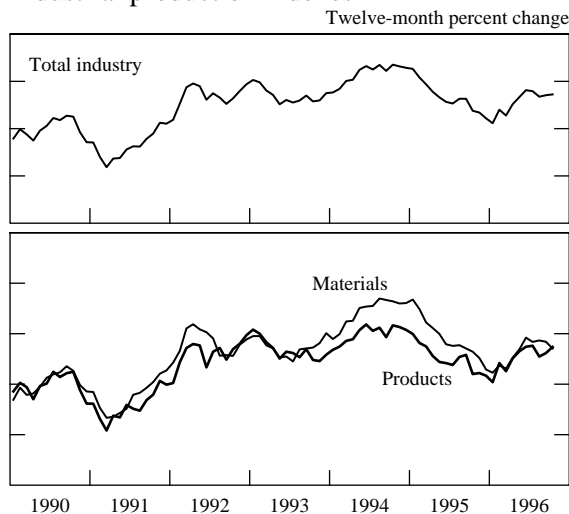
# Industrial Production and Capacity Utilization for October 1996

*Released for publication November 15*

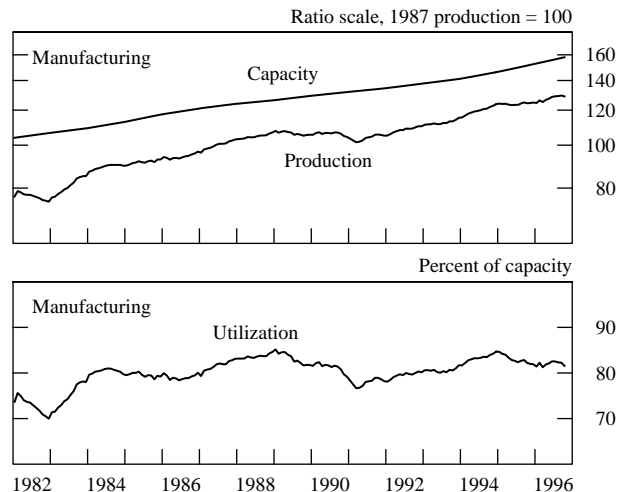
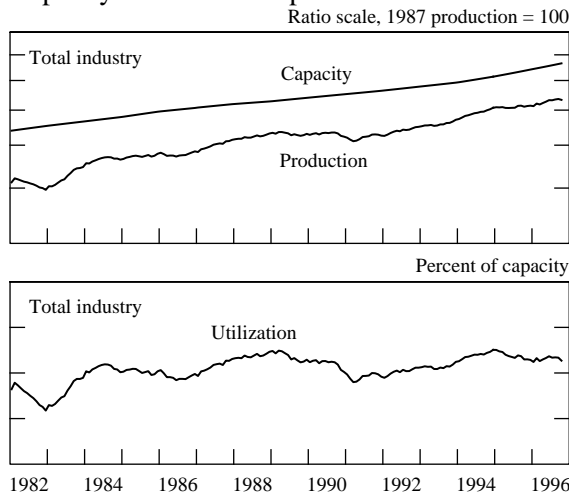
Industrial production decreased 0.5 percent in October after a revised gain of 0.3 percent in September. Sharp drops in the production of motor vehicles and in the output of related parts and materials accounted for the decrease in the overall index. Motor vehicle assemblies dropped more than 7 percent from their

September level; this falloff resulted largely from shortages of parts made at strike-affected plants in Canada and from a strike that had shut down some domestic assembly plants late in the month. Manufacturing output fell 0.5 percent, and mining output dropped 1.0 percent; output at utilities was unchanged. At 126.6 percent of its 1987 average, total industrial production in October was 3.6 percent

## Industrial production indexes



## Capacity and industrial production



All series are seasonally adjusted. Latest series, October. Capacity is an index of potential industrial production.

## Industrial production and capacity utilization, October 1996

Category	Industrial production, index, 1987 = 100								
	1996				Percentage change				Oct. 1995 to Oct. 1996
	July <sup>r</sup>	Aug. <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>p</sup>	1996 <sup>1</sup>				
					July <sup>r</sup>	Aug. <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>p</sup>	
<b>Total</b> .....	<b>126.3</b>	<b>126.8</b>	<b>127.2</b>	<b>126.6</b>	<b>.0</b>	<b>.4</b>	<b>.3</b>	<b>-.5</b>	<b>3.6</b>
Previous estimate .....	126.4	126.8	127.1	...	.0	.4	.2	...	...
<i>Major market groups</i>									
Products, total <sup>2</sup> .....	122.5	122.4	123.0	122.7	.2	-.1	.5	-.3	3.7
Consumer goods .....	117.3	116.4	116.6	115.8	.4	-.8	.2	-.7	.8
Business equipment .....	170.3	171.0	172.3	172.6	1.0	.4	.8	.2	10.3
Construction supplies .....	112.0	113.5	114.5	114.3	-1.7	1.3	1.0	-.2	5.5
Materials .....	132.1	133.6	133.5	132.6	-4	1.1	-.1	-.7	3.5
<i>Major industry groups</i>									
Manufacturing .....	129.0	129.1	129.5	128.9	.3	.1	.3	-.5	3.6
Durable .....	141.5	142.2	142.6	141.6	.2	.6	.2	-.7	6.1
Nondurable .....	115.2	114.7	115.1	114.9	.5	-.5	.3	-.2	.5
Mining .....	100.9	103.5	103.4	102.4	-1.8	2.5	-.1	-1.0	4.3
Utilities .....	122.6	124.9	125.3	125.3	-3.1	1.9	.3	.0	3.1
Capacity utilization, percent									MEMO Capacity, per- centage change, Oct. 1995 to Oct. 1996
	Average, 1967-95	Low, 1982	High, 1988-89	1995	1996				
				Oct.	July <sup>r</sup>	Aug. <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>p</sup>	
<b>Total</b> .....	<b>82.1</b>	<b>71.8</b>	<b>84.9</b>	<b>83.0</b>	<b>83.4</b>	<b>83.4</b>	<b>83.4</b>	<b>82.7</b>	<b>4.0</b>
Previous estimate .....	...	...	...	...	83.4	83.4	83.3	...	...
Manufacturing .....	81.4	70.0	85.2	82.2	82.5	82.3	82.3	81.6	4.4
Advanced processing .....	80.7	71.4	83.5	80.5	80.8	80.6	80.5	79.8	5.2
Primary processing .....	82.6	66.8	89.0	86.1	86.6	86.6	86.5	86.0	2.5
Mining .....	87.4	80.6	86.5	87.8	90.3	92.6	92.5	91.6	-1
Utilities .....	86.9	76.2	92.6	89.8	89.6	91.1	91.3	91.3	1.4

NOTE. Data seasonally adjusted or calculated from seasonally adjusted monthly data.

1. Change from preceding month.

2. Contains components in addition to those shown.

r Revised.

p Preliminary.

higher than it was in October 1995. The utilization of industrial capacity fell 0.7 percentage point, to 82.7 percent, its lowest level since March.

When analyzed by market group, the data show that the output of consumer goods dropped 0.7 percent in October, with the decline in motor vehicles accounting for much of the loss. The production of other consumer durables, however, also declined noticeably, in a continuation of the losses that have reduced output in this industry more than 4 percent since June. While all major segments of other consumer durables have weakened recently, the appliance segment has had the largest declines over the past few months. The production of consumer nondurables was flat, continuing the sluggishness that has persisted over the past year.

The overall output of business equipment, which had posted sizable monthly gains since May, edged up only 0.2 percent, restrained by the drop in motor vehicle assemblies. Excluding motor vehicles, production of business equipment rose 0.7 percent, led

by another sharp increase in information processing equipment. The output of industrial equipment edged down and has changed little, on balance, in recent months. After several weak months, however, the output of other equipment rebounded strongly with a 1.2 percent gain attributable to a sharp increase in the production of farm equipment.

The output of construction and business supplies was little changed, but the aggregate output of industrial materials fell 0.7 percent. The production of durable goods materials fell 1.0 percent, largely because of a drop in parts and materials used primarily by the motor vehicle industry. The output of nondurable materials changed little over the past two months; although the output of both textile and paper materials increased, production in these sectors still remained below their levels in July. The production of energy materials retreated 0.6 percent, with declines in the production of coal and crude oil.

When analyzed by industry group, the data show that factory output decreased 0.5 percent in October

after a 0.3 percent gain in September; the production of durable goods dropped 0.7 percent, while that of nondurable goods slipped 0.2 percent. The output of durable goods was held down not only by the big drop in motor vehicles and parts but also by decreases of 0.5 percent or more in the production of lumber, primary metals, fabricated metal products, electrical machinery, and miscellaneous manufactures.

The only substantial increases in durable goods production were in computer and office equipment and in instruments; small increases occurred in the output of furniture and of stone, clay, and glass products. Among nondurables, the indexes for textile mill products, paper, petroleum refining, and leather all posted gains of 0.5 percent or more; the production of foods and of printing and publishing also advanced. On the negative side, the output of apparel products and of rubber and plastics products fell more than 1 percent. The production of chemical products also declined.

The factory operating rate dropped 0.7 percentage point, to 81.6 percent. The rate for advanced-processing industries, which includes motor vehicles and parts, also decreased 0.7 percentage point, to 79.8 percent, and the rate for primary-processing industries declined 0.5 percentage point, to 86.0 percent. The operating rate in motor vehicles and parts declined 5.3 percentage points. In addition the operating rate in several of its supplying industries fell at least 1 percentage point; these include primary metals, fabricated metals products, electrical machinery, apparel products, and rubber and plastics products. The operating rate at mines fell 0.9 percentage point, to 91.6 percent, while the rate at utilities remained unchanged, at 91.3 percent.

This release and the history for all published series are available on the Board's World Wide Web site at <http://www.bog.frb.fed.us>.

### *1996 REVISION ANNOUNCEMENT*

The Federal Reserve will publish revisions of its measures of industrial production (IP), capacity, capacity utilization, and industrial use of electric power on January 7, 1997. The revisions of IP, capacity, and capacity utilization will incorporate updated source data for recent years and will feature a change in the method of aggregating the indexes. From 1977 onward, the value-added proportions used to weight individual series will be updated annually rather than quinquennially. In addition, the IP indexes and the capacity measures will be rebased so that 1992 actual

output equals 100. Capacity utilization, the ratio of IP to capacity, will be recomputed on the basis of revised IP and capacity measures.

The aggregate IP indexes will be constructed with a superlative index formula similar to that introduced by the Bureau of Economic Analysis as the featured measure of real output in its January 1996 comprehensive revision of the National Income and Product Accounts. At present, the aggregate IP indexes are computed as linked Laspeyres indexes, with the weights updated every five years. Because of the rapid fall in the relative price of computers and peripheral equipment, that periodic updating of weights is too infrequent to provide reliable estimates of current changes in output, capacity, and capacity utilization. With the publication of the revision, value-added proportions will be updated annually, and the new index number formula will be applied to all aggregates of IP, capacity, and gross value of product. For the most part, relative price movements among the 260 individual components of the IP index are likely to have little visible effect on total IP. However, the more frequent updating of the relative price of the output of the computer industry could lower overall IP growth in some years by as much as ½ percentage point; in other years, the updating of weights will have virtually no effect. Because the new index number formula will slow capacity growth as well as IP growth, the effect of the reaggregation on overall capacity utilization should be small.

The regular updating of source data for IP will include the introduction of annual data from the *1994 Annual Survey of Manufactures* and selected *1995 Current Industrial Reports* of the Bureau of the Census. Available annual data on mining for 1994 and 1995 from the Department of the Interior will also be introduced. Revisions to the monthly indicators for each industry (physical product data, production-worker hours, or electric power usage) and revised seasonal factors will be incorporated back to 1992. In addition, the benchmark index for semiconductor output will be revised back to 1977 to reflect a hedonic price index, similar in concept to what is used for the computer industry.

The statistics on the industrial use of electric power will be revised back to 1972. These revisions stem from three basic sources. First, the new figures incorporate more complete reports received from utilities for the past few years. Second, an updated panel of reporters on cogeneration will be fully integrated into our survey of electric power use. Third, the levels of the monthly electric power series for manufacturing industries will be benchmarked to indexes derived from data published in the Census Bureau's annual

surveys and censuses of manufactures. These indexes will also be revised so that 1992 electric power usage equals 100.

More detail on the plans for this revision is available on the Internet at <http://www.bog.frb.fed.us>, the Board's World Wide Web site. Once the revision is published, the revised data will be available at that site and on diskettes from the Board of Governors of the Federal Reserve System, Publications Services, 202-452-3245. The revised data will also be available

through the Economic Bulletin Board of the Department of Commerce; for information about the Bulletin Board, call 202-482-1986. In addition to the data currently provided, the time series of implicit prices necessary for a user to aggregate IP and capacity under the new methodology will be provided. For information on these revisions, call the Industrial Output Section of the Board of Governors at 202-452-3151. □



## Announcements

### *APPOINTMENT OF A COMMITTEE TO REVIEW THE FEDERAL RESERVE'S PARTICIPATION IN PAYMENT SERVICES*

Federal Reserve Chairman Alan Greenspan has appointed a committee of senior Federal Reserve officials, headed by Board Vice Chair Alice M. Rivlin, to conduct a fundamental review of the Federal Reserve's participation in payment services to banks and other financial institutions.

The Federal Reserve provides payment services, including check clearing and electronic transfer of funds, to financial institutions and charges a price for the service. It provides similar services as agent for the U.S. Treasury and other federal agencies. Payment services are also performed by the private sector.

Formation of the special committee is the next step in the continuing review of Federal Reserve payment services discussed by Dr. Greenspan in testimony earlier this year before the Senate Banking Committee. In announcing on October 17, 1996, the formation of the committee he said: "Given the significant changes occurring in payment processing, this is an opportune time to assess the Fed's role in the payments systems of the twenty-first century."

Besides Dr. Rivlin, other members of the committee are Federal Reserve Governor Edward W. Kelley, Jr., William J. McDonough, President of the Federal Reserve Bank of New York, and Thomas C. Melzer, President of the Federal Reserve Bank of St. Louis.

The committee will consider a wide range of options and will solicit views from within the Federal Reserve System, financial institutions active in the payment system, and other users. The committee has the discretion to bring in outside specialists and consultants as part of its inquiry.

Work will begin immediately, but no time frame was established for the completion of the committee's task. Chairman Greenspan asked that the committee report to the Board of Governors on progress and results.

### *RESULTS OF AN INDEPENDENT AUDIT OF THE LOS ANGELES BRANCH*

An independent outside audit has confirmed that the Los Angeles Branch of the Federal Reserve Bank of

San Francisco maintains an "effective internal control structure" for financial reporting of its currency and coin holdings, the Federal Reserve Board announced on October 22, 1996. The audit by Coopers & Lybrand confirms the results of an examination by the Board's financial auditors as well as the Reserve Bank's internal auditors.

The General Accounting Office (GAO) had called into question the integrity of the Los Angeles Branch's internal controls in a recent report. The GAO's concern was based on errors made by the Branch in reports submitted to the Board rather than on an in-depth review of financial controls. These reports are used only for informational purposes and are distinct from financial accounting records.

The Board retained Coopers & Lybrand to conduct a comprehensive review of the Branch's financial controls to address GAO's concern. In its opinion, Coopers & Lybrand said: "In our opinion, management's assertion that the Los Angeles Branch maintained an effective internal control structure over financial reporting for its coin and currency as of August 31, 1996, is fairly stated, in all material respects. . . ."

As further confirmation of the Branch's internal controls, the Board last month ordered an unannounced count of all currency and coin holdings at the Branch. The results confirmed that the Branch's balance sheet accurately reflected its currency and coin holdings.

### *APPROVAL OF THE USE OF CERTAIN PREFERRED STOCK INSTRUMENTS IN TIER 1 CAPITAL*

The Federal Reserve Board on October 21, 1996, approved the use of certain cumulative preferred stock instruments in tier 1 capital for bank holding companies.

These instruments, which are marketed under a variety of proprietary names such as MIPS and TOPRS, are issued out of a special purpose subsidiary that is wholly owned by the parent company. The proceeds are lent to the parent in the form of a very long-term, deeply subordinated note.

Bank holding companies seeking to issue such securities should consult with their District Federal

Reserve Bank. Such arrangements, which give rise to minority interest upon consolidation of the subsidiary with the parent holding company, normally will be accorded tier 1 capital status. Minority interest in consolidated subsidiaries generally qualifies as tier 1 capital under the Board's current capital adequacy guidelines for bank holding companies.

To be eligible as tier 1 capital, such instruments must provide for a minimum deferral period of five consecutive years on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity.

The amount of these instruments, together with other cumulative preferred stock a bank holding company may include in tier 1 capital, is limited to 25 percent of tier 1. Like other preferred stock includable in capital, these instruments require Federal Reserve approval before they may be redeemed.

#### *AMENDMENTS TO EASE FIREWALL RESTRICTIONS ON SECTION 20 SUBSIDIARIES*

The Federal Reserve Board announced on October 30, 1996, amendments to ease or eliminate three of the prudential limitations, or firewalls, imposed on the operations of section 20 subsidiaries of bank holding companies authorized to underwrite and deal in securities.

The amendments, which are effective January 7, 1997, will accomplish the following:

- Modify the prohibition on director, officer, and employee interlocks between a section 20 subsidiary and its affiliated banks or thrift institutions (the interlocks restriction)
- Eliminate the restriction on a bank or thrift institution acting as agent for, or engaging in marketing activities on behalf of, an affiliated section 20 subsidiary (the cross-marketing restriction)
- Ease the restriction on the purchase and sale of financial assets between a section 20 subsidiary and its affiliated bank or thrift institution (the financial assets restriction).

With respect to interlocks, the Board is (1) eliminating a blanket prohibition on employee interlocks, (2) replacing a blanket prohibition on director interlocks with one limited to a majority of the board of a section 20 subsidiary and an affiliated bank, and (3) replacing a blanket prohibition on officer interlocks with one limited to the chief executive officer of each company.

The Board is expanding an exception to the financial assets restriction for the purchase and sale of government securities to include any asset having a readily identifiable and publicly available market quotation and purchased at that quotation.

#### *APPROVAL OF AN EXPANSION OF FEDWIRE OPERATING HOURS*

The Federal Reserve Board on October 30, 1996, approved a December 8, 1997, effective date to open the Fedwire funds transfer service at 12:30 a.m. Eastern Time (ET). The current operating hours of the Fedwire funds transfer service are 8:30 a.m. to 6:30 p.m. ET. The closing time of the Fedwire funds transfer service remains unchanged.

Previously, the Board determined that expansion of the Fedwire funds transfer service to eighteen hours a day could be a useful component of private-sector initiatives to reduce settlement risk in the foreign exchange markets and to eliminate an operational barrier to potentially important innovation in privately provided payment and settlement services. Participation in the earlier Fedwire operating hours is voluntary for depository institutions.

In conjunction with the expansion of Fedwire operating hours, the Board has also approved a modification to the daylight overdraft posting times to fix at 8:30 a.m. ET the posting time for certain nonwire transactions that are tied to the current opening time of the Fedwire funds transfer service.

#### *REGULATION Y: INTERIM RULE AND PROPOSED ACTION*

The Federal Reserve Board on October 24, 1996, announced an interim rule and requested comment on certain definitions in connection with easing provisions of Regulation Y (Bank Holding Companies) to eliminate the requirement that bank holding companies seek Board approval before engaging *de novo* in permissible nonbanking activities if the bank holding company is well-capitalized and meets other criteria specified in the new Economic Growth and Regulatory Paperwork Act.

The interim rule also implements provisions of the act to establish expedited procedures for well-capitalized bank holding companies that meet the criteria to obtain Board approval to acquire smaller companies that engage in any permissible nonbanking activities listed in Regulation Y as well as to engage in nonbanking activities that the Board has

approved only by order. The interim rule is effective immediately.

Comment on the definitions noted in the following discussion is requested by December 2, 1996.

Because the statutory changes, which the Board recommended, are effective immediately, the Board will apply the procedures now to qualifying proposals. Proposed amendments to Regulation Y will be issued in the near future to implement the changes.

For purposes of determining the capital levels at which a bank holding company shall be considered "well-capitalized" under section 2208 of the act and Regulation Y, the Board has adopted, as an interim rule, risk-based capital thresholds that are the same levels as the levels set for determining that a state member bank is well-capitalized under the provisions established under section 38 of the Federal Deposit Insurance Act and a modified leverage ratio. This definition was effective October 23, on an interim basis. The Board invites public comment on this definition and will adjust the definition as appropriate in light of public comment. The Board also invites comment on how the statutory definitions in section 2208 should be applied to foreign banking organizations.

*AVAILABILITY OF REVISED LISTS OF  
OVER-THE-COUNTER STOCKS AND OF FOREIGN  
MARGIN STOCKS SUBJECT TO MARGIN  
REGULATIONS*

The Federal Reserve Board on October 25, 1996, published a revised list of over-the-counter (OTC) stocks that are subject to its margin regulations (OTC list). Also published was a revised list of foreign equity securities (foreign list) that meet the margin criteria in Regulation T (Credit by Brokers and Dealers).

The lists became effective November 12, 1996, and supersede the previous lists that were effective August 12, 1996. The next revision of the lists is

scheduled to be effective in February 1997. These lists are published for the information of lenders and the general public.

The changes that have been made to the revised OTC list, which now contains 4,718 OTC stocks, are as follows:

- Two hundred sixty-two stocks have been included for the first time, 205 under National Market System (NMS) designation
- Thirty-nine stocks previously on the list have been removed for substantially failing to meet the requirements for continued listing
- One hundred nineteen stocks have been removed for reasons such as listing on a national securities exchange or involvement in an acquisition.

The OTC list is composed of OTC stocks that have been determined by the Board to be subject to margin requirements in Regulations G (Securities Credit by Persons other than Banks, Brokers, or Dealers), T, and U (Credit by Banks for Purchasing or Carrying Margin Stocks). It includes OTC stocks qualifying under Board criteria and also includes all OTC stocks designated as NMS securities. Additional NMS securities may be added in the interim between quarterly Board publications; these securities are immediately marginable upon designation as NMS securities.

The foreign list is composed of foreign equity securities that are eligible for margin treatment at broker-dealers. Effective July 1, 1996, foreign stocks may be included on the foreign list by being deemed to have a "ready market" for purposes of the Securities and Exchange Commission's (SEC) net capital rule. The SEC effectively treats all stocks included on the Financial Times/Standard & Poor's Actuaries World Indices (FT/S&P-AW Indices) as having a ready market for capital purposes. The Board is adding thirty-six foreign stocks and deleting thirty-one, primarily based on changes to the FT/S&P-AW Indices. The revised foreign list now contains 1,965 securities displayed in country order. □

# Legal Developments

## *FINAL RULE—AMENDMENTS TO REGULATIONS G, T, U, AND X*

The Board of Governors is amending 12 C.F.R. Parts 207, 220, 221, and 224, its Regulations G, T, U, and X (Securities Credit Transactions; List of Marginable OTC Stocks; List of Foreign Margin Stocks). The List of Marginable OTC Stocks ("OTC List") is composed of stocks traded over-the-counter ("OTC") in the United States that have been determined by the Board of Governors of the Federal Reserve System to be subject to the margin requirements under certain Federal Reserve regulations. The List of Foreign Margin Stocks ("Foreign List") is composed of foreign equity securities that have met the Board's eligibility criteria under Regulation T. The OTC List and the Foreign List are published four times a year by the Board. This document sets forth additions to and deletions from the previous OTC List and the previous Foreign List.

Effective November 12, 1996, 12 C.F.R. Parts 207, 220, 221, and 224 are amended as follows. Accordingly, pursuant to the authority of sections 7 and 23 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78g and 78w), and in accordance with 12 C.F.R. 207.2(k) and 207.6 (Regulation G), 12 C.F.R. 220.2 and 220.17 (Regulation T), and 12 C.F.R. 221.2(j) and 221.7 (Regulation U), there is set forth below a listing of deletions from and additions to the OTC List and the Foreign List.

### *Deletions From The List Of Marginable OTC Stocks*

#### Stocks Removed For Failing Continued Listing Requirements

American White Cross, Inc.: \$.01 par common  
AW Computer Systems, Inc.: Class A, \$.01 par common

Ben Franklin Retail Stores, Inc.: \$.01 par common  
Biosys, Inc.: No par common  
BPI Packaging Technologies, Inc.: Class B, Warrants (expire 10-07-96)

Capstone Pharmacy Services, Inc.: Warrants (expire 08-23-96)

Cel-Sci Corporation: Warrants (expire 02-06-97)  
Clothestime, Inc.: \$.001 par common

Danskin, Inc.: \$.01 par common  
David White, Inc.: \$3.00 par common  
Diacrin Inc.: Units (expire 12-31-2000)

Ernst Home Center, Inc.: \$.01 par common  
EV Environmental, Inc.: \$.01 par common  
Exstar Financial Corporation: \$.01 par common

First Charter Bank, N.A. (California): \$2.56 par common  
Forrest Oil Corporation: Warrants (expire 10-01-96)

Gametek, Inc.: \$.01 par common  
Gander Mountain, Inc.: \$.01 par common

Independence Bancorp, Inc. (New Jersey): \$1.00 par common  
Interscience Computer Corporation: Warrants (expire 11-15-96)

Liposome Company, Inc., The: Depository Shares

Maxux Energy Corporation: \$4.00 par cumulative convertible preferred  
Medmarco, Inc.: \$.001 par common

New World Power Corporation: \$.01 par common

People's Bank (Connecticut): 8.5% Series A, no par noncumulative convertible preferred

Rally's Hamburgers, Inc.: Rights (expire 09-20-96)  
Republic Security Financial Corp.: Series A, 7.5% par cumulative convertible preferred

Seven Hills Financial Corporation: No par common  
Syquest Technology, Inc.: \$.001 par common

Tapistron International, Inc.: \$.0004 par common; Warrants (expire 06-23-97)

Tinsley Laboratories, Inc.: No par common

U.S. Diagnostic Labs, Inc.: Class B, Warrants (expire 10-14-99)

U.S. Homecare Corporation: \$.01 par common  
Ultradata Systems, Inc.: Class A, Warrants (expire 02-01-98)  
Urethane Technologies, Inc.: \$.01 par common

Veterinary Centers of America, Inc.: Warrants (expire 10-10-96)

Watermarc Food Management Company: \$.05 par common  
Weitzer Homebuilders, Inc.: Class A, \$.01 par common

### Stocks Removed For Listing On A National Securities Exchange Or Being Involved In An Acquisition

AES Corporation, The: \$.01 par common  
 Agrium Inc.: No par common  
 Alexander Energy Corporation: \$.03 par common  
 Allegiance Banc Corporation: \$1.00 par common  
 Ambar, Inc.: \$.01 par common  
 America Online Inc.: \$.01 par common  
 Amserv Healthcare Inc.: \$.01 par common  
 Applied Bioscience International, Inc.: \$.01 par common  
 Atria Software, Inc.: \$.01 par common

Bailey Corporation: \$.10 par common  
 BayBanks, Inc. (Massachusetts): \$2.00 par common  
 Bayport Restaurant Group, Inc.: \$.001 par common  
 Brenco, Inc.: \$1.00 par common  
 Brooktree Corporation: No par common  
 Bugaboo Creek Steak House: \$.01 par common  
 Builders Warehouse Association: \$.008 par common  
 BW/IP, Inc.: Class A, \$.01 par common

Canyon Resources Corporation: \$.01 par common  
 CCB Financial Corporation: \$5.00 par common  
 Cellular Communications International, Inc.: \$.01 par common  
 CFB Bancorp (Florida): \$2.00 par common  
 CFI Industries, Inc.: \$1.00 par common  
 Charter Bancshares, Inc.: \$1.00 par common  
 Chartwell RE Corporation: \$.01 par common  
 Chromcraft Revington, Inc.: \$.01 par common  
 Circle Financial Corporation: \$1.00 par common  
 Citicasters Inc.: Class A, No par common  
 Citizens Security Group, Inc.: \$.01 par common  
 Clinton Gas Systems Inc.: No par common  
 Commerce Bancorp, Inc. (New Jersey): \$1.5625 par common  
 Computer Identities Corporation: \$.10 par common  
 CTL Credit, Inc.: \$.01 par common

Dairy Mart Convenience Stores: Class A, \$.01 par common;  
 Class B, \$.01 par common  
 Davidson & Associates, Inc.: \$10.00 par common  
 DNA Plant Technology Corporation: \$.01 par common;  
 \$.01 par convertible exchangeable  
 Douglas & Lomason Company: \$2.00 par common

Eaton Vance Corporation: Non-voting, \$.125 par common  
 Equity Inns, Inc.: \$.01 par common

Fahnestock Viner Holdings: Class A, No par common  
 Fairfax Bank & Trust Comp: \$1.25 par common  
 Financial Security Corporation: \$.01 par common  
 Financing for Science International Inc.: \$.01 par common;  
 Warrants (expire 05–19–99)  
 Firefox Communications, Inc.: \$.001 par common  
 First Washington Realty Trust, Inc.: \$.01 par common;  
 Series A, cumulative convertible preferred

Fluorsocan Imaging System: \$.0001 par common; Redeemable Warrants (expire 07–11–99)

Geriatric & Medical Companies, Inc.: \$.10 par common  
 Golf Enterprises, Inc.: \$.01 par common  
 Guest Supply, Inc.: No par common

Hometown Bancorporation Inc.: \$1.00 par common  
 Hometown Buffet, Inc.: \$.01 par common

Image Industries, Inc.: \$.01 par common  
 Innkeepers USA Trust: \$.01 par common  
 Interim Services Inc.: \$.01 par common  
 International Jensen Inc.: \$.01 par common  
 Interpoint Corporation: No par common

JLG Industries, Inc.: \$.20 par common

Kahler Realty Corporation: \$.10 par common  
 KFX Inc.: \$.001 par common

Landmark Graphics Corporation: \$.05 par common  
 Leader Financial Corporation: \$1.00 par common  
 Loewen Group Inc., The: No par common  
 Lomak Petroleum, Inc.: \$.01 par common

Maic Holdings, Inc.: \$1.00 par common  
 Mark Twain Bancshares, Inc.: \$1.25 par common  
 MDT Corporation: \$1.25 par common  
 Mercury General Corporation: No par common  
 Microtek Medical, Inc.: \$.01 par common  
 Midlantic Corporation: \$3.00 par common  
 Mississippi Chemical Corp.: \$.01 par common  
 Mountasia Entertainment, Inc.: No par common  
 MSB Bancorp, Inc. (New York): \$.01 par common

N.S. Bancorp, Inc. (Illinois): \$.01 par common  
 Netstar, Inc.: \$.01 par common  
 Network Express, Inc.: No par common  
 NHS Financial, Inc.: No par common  
 NMR of America, Inc.: \$.01 par common  
 NYCOR, Inc.: \$1.00 par common; Class A, \$1.00 par common

Orbit Semiconductor, Inc.: \$.001 par common

Pacific Basin Bulk Shipping: \$.7327 par common; Warrants (expire 09–30–99)  
 Parkway Properties, Inc.: \$1.00 par common  
 Patlex Corporation: \$.10 par common  
 PCI Services, Inc.: \$.001 par common  
 Pediatrix Medical Group, Inc.: \$.01 par common  
 Perpetual State Bank (North Carolina): \$5.00 par common  
 Pet Practice, Inc., The: \$.01 par common  
 Premier Financial Bancorp, Inc.: No par common  
 Professional Sports Care Management Inc.: \$.01 par common

Quaker Chemical Corporation: \$1.00 par common

Regional Acceptance Corp.: No par common  
 Renaissancere Holdings, Ltd.: \$1.00 par common  
 RFS Hotel Investors, Inc.: \$.01 par common  
 Roto-Rooter, Inc.: \$1.00 par common

Scientific Games Holding Corp.: \$.001 par common  
 Security Capital Bancorp (North Carolina): No par common  
 Shaw Group, Inc., The: \$.01 par common  
 Sierra On-line, Inc.: \$.01 par common  
 Station Casinos, Inc.: \$.01 par common; 7% convertible preferred  
 Sunstone Hotel Investors, Inc.: \$.01 par common  
 Sybron Chemicals Inc.: \$.01 par common  
 Syratech Corporation: \$.01 par common  
 Systemed, Inc.: \$.001 par common

Third Financial Corporation: \$.01 par common  
 Tucker Drilling Company, Inc.: \$.01 par common

U. S. Healthcare, Inc.: \$.005 par common  
 Uniroyal Chemical Corporation: \$.01 par common  
 United Companies Financial: \$2.00 par common; \$2.00 par convertible preferred  
 Unnet Technologies, Inc.: \$.001 par common

Varitronic Systems, Inc.: \$.01 par common

Westcott Communications, Inc.: \$.01 par common  
 WFS Bancorp, Inc. (Kansas): \$.01 par common

#### *Additions To The List Of Marginable OTC Stocks*

Abacus Direct Corporation: \$.001 par common  
 ABT Global Pharmaceutical Corporation: No par common  
 Accumed International, Inc.: No par common; Warrants (expire 10-14-97)  
 Ace\*Comm Corporation: \$.01 par common  
 Acrodyne Communications, Inc.: \$.01 par common  
 Advance Paradigm, Inc.: \$.01 par common  
 Advanced Deposition Technologies, Inc.: \$.01 par common  
 Advanced Digital Information Corporation: No par common  
 Advanced Fibre Communications: \$.01 par common  
 Advanced Health Corporation: \$.01 par common  
 Afsala Bancorp, Inc. (New York): \$.01 par common  
 Algos Pharmaceutical Corporation: \$.01 par common  
 AMB Financial Corporation: \$.01 par common  
 American Bankers Insurance Group: Series B, \$1.00 par preferred  
 American Disposal Services, Inc.: \$.01 par common  
 American Healthchoice, Inc.: \$.001 par preferred  
 Anacomp, Inc.: \$.01 par common; Warrants (expire 06-03-2001)  
 Anchor Financial Corporation: \$6.00 par common  
 Anika Research, Inc.: \$.01 par common  
 Applied Analytical Industries, Inc.: \$.001 par common  
 Arqule, Inc.: \$.01 par common

Asia Pacific Resources, Ltd.: No par common  
 Atria Communities, Inc.: \$.10 par common  
 Ault Incorporated: No par common  
 Aware, Inc.: \$.01 par common

Bank of Los Angeles: No par common; Warrants (expire 12-01-98)

Bank United Corporation: \$.01 par common  
 Barbers Hairstyling for Men & Women, Inc., The: \$.01 par common

Beverly Bancorporation, Inc.: \$.01 par common  
 Big Entertainment, Inc.: \$.01 par common  
 Billing Information Concepts Corporation: \$.01 par common  
 Blyvooruitzicht Gold Mining Company Limited: American Depository Receipts

Bre-X Minerals, Limited: No par common  
 Buffelsfontein Gold Mines, Ltd.: American Depository Receipts

Business & Professional Bank (California): No par common

C. R. Anthony Company: \$.01 par common  
 Cadus Pharmaceutical Corporation: \$.01 par common  
 California Independent Bancorp.: No par common  
 Cambridge Heart, Inc.: \$.001 par common  
 Carriage Services, Inc.: Class A, \$.01 par common  
 CCC Information Services Group, Inc.: \$.10 par common

Cellegy Pharmaceutical, Inc.: No par common  
 Cellnet Data Systems, Inc.: \$.001 par common  
 Cherokee Inc.: \$.02 par common

Chester Bancorp, Inc.: \$.01 par common  
 Chromatics Color Sciences: \$.001 par common  
 Claremont Technology Group, Inc.: No par common

CN Biosciences, Inc.: \$.01 par common  
 Coffee People, Inc.: No par common  
 Coinmach Laundry Corporation: \$.01 par common  
 Colossal Resources Corporation: No par common  
 Company Doctor, The: \$.01 par common  
 Connect, Inc.: \$.001 par common

Control Devices, Inc.: \$.01 par common  
 Costilla Energy, Inc.: \$.01 par common  
 County Bank of Chesterfield (Virginia): \$5.00 par common  
 CSI Computer Specialists, Inc.: Class A, \$.001 par common  
 Cuno Incorporated: \$.001 par common  
 Cymer, Inc.: \$.01 par common

D&E Communications, Inc.: \$.16 par common  
 Dailey Petroleum Services Corporation: Class A, \$.01 par common

DBT Online, Inc.: \$.10 par common  
 Diacrin, Inc.: \$.01 par common; Warrants (expire 12-31-2000)

Dialysis Corporation of America: \$.01 par common  
 Diedrich Coffee: No par common  
 Digex, Incorporated: \$.01 par common

Digital Solutions, Inc.: \$.001 par common  
 DNAP Holding Corporation: \$.01 par common  
 Document Sciences Corporation: \$.001 par common  
 Dura Automotive Systems, Inc.: Class A, \$.01 par common

Durban Roodepoort Deep, Ltd.: American Depositary Receipts

Dynamex, Inc.: \$.01 par common

Dynamic Healthcare Technologies, Inc.: \$.01 par common

Dynamotive Technologies Corporation: No par common

E\*Trade Group, Inc.: \$.01 par common

Einstein/Noah Bagel Corporation: \$.01 par common

Electrosource, Inc.: \$.10 par common

Faxsav Incorporated: \$.01 par common

Film Roman, Inc.: \$.01 par common

First Alliance Corporation: Class A, no par common

First Enterprise Financial Group, Inc.: \$.01 par common

First M & F Corporation: \$5.00 par common

Flanders Corporation: \$.001 par common

Fotball USA, Inc.: \$.01 par common; Warrants (expire 08-12-99)

Fountain Powerboat Industries, Inc.: \$.01 par common

FPIC Insurance Group, Inc.: \$.10 par common

FX Energy, Inc.: \$.001 par common

Gargoyles, Inc.: No par common

Geron Corporation: \$.001 par common

GKN Holding Corporation: \$.0001 par common

Golden Bear Golf, Inc.: Class A, \$.01 par common

Gradall Industries, Inc.: \$.01 par common

Grand Premier Financial, Inc.: \$.01 par common

Greenstone Resources, Ltd.: No par common

Grootvlei Proprietary Mines: American Depositary Receipts

Harmony Gold Mining Co., Ltd.: American Depositary Receipts

Healthcor Holdings, Inc.: \$.01 par common

Hibbett Sporting Goods, Inc.: \$.01 par common

Home Bancorp of Elgin, Inc.: \$.01 par common

Hot Topic, Inc.: No par common

House of Fabrics, Incorporated: \$.01 par common

Hvide Marine Incorporated: Class A, \$.001 par common

Inamed Corporation: \$.01 par common

Industir-Matematik International Corporation: \$.01 par common

Integrated Living Communities, Inc.: \$.01 par common

Intelligroup, Inc.: \$.01 par common

Intensiva Healthcare Corporation: \$.001 par common

Interlink Computer Sciences, Inc.: \$.001 par common

International Network Services: No par common

Interwest Home Medical, Inc.: No par common

Invision Technologies, Inc.: \$.001 par common

J. W. Charles Financial Services, Inc.: \$.001 par common

Jacor Communications, Inc.: Warrants (expire 09-18-2001)

Kapson Senior Quarters Corporation: \$.01 par common

Karrington Health, Inc.: No par common

Kitty Hawk, Inc.: \$.01 par common

Kushner-Locke Company, The: Series C, Warrants (expire 07-25-2001)

Lamar Advertising Company: \$.0001 par common

Larson-Davis Incorporated: \$.001 par common

Laser Industries Limited: Ordinary shares (par NIS 0.0001)

Lason, Inc.: \$.01 par common

LCC International, Inc.: Class A, \$.01 par common

Leap Group, Inc., The: \$.01 par common

Lightbridge, Inc.: \$.01 par common

Lightpath Technologies, Inc.: Class A, \$.01 par common

Liquidation World, Inc.: No par common

Luther Medical Products, Inc.: No par common

Markwest Hydrocarbon, Inc.: \$.01 par common

Matrix Capital Corporation: \$.01 par common

McM Corporation: \$1.00 par common

Medi-Ject Corporation: \$.01 par common

Medical Alliance, Inc.: \$.002 par common

Memberworks, Inc.: \$.01 par common

Memco Software Limited: Ordinary shares (NIS .01)

Metro Networks, Inc.: \$.001 par common

Metro One Telecommunications, Inc.: No par common

Metzler Group, Inc., The: \$.001 par common

Microcap Fund, Inc., The: \$.01 par common

Microvision, Inc.: No par common; Warrants (expire 08-27-2001)

Mid-Peninsula Bancorp (California): No par common

Midwest Federal Financial Corporation: \$.01 par common

MIM Corporation: \$.0001 par common

Modacad, Inc.: No par common

Motrovac Technologies, Inc.: \$.01 par common

Mountain Province Mining, Inc.: No par common

Nastech Pharmaceutical Company Inc.: Warrants (expire 12-07-96)

Neotherapeutics, Inc.: No par common; Warrants (expire 09-26-2001)

Netvantage, Inc.: Class A, \$.001 par common; Warrants (expire 05-03-2000)

New York Bagel Enterprises, Inc.: \$.01 par common

Nitinol Medical Technologies, Inc.: \$.001 par common

North County Bancorp (California): No par common

Nu-Tech Bio-Med, Inc.: \$.01 par common

Object Design, Inc.: \$.001 par common

Ocwen Financial Corporation: \$.01 par common

On Command Corporation: \$.01 par common

Optika Imaging Systems, Inc.: No par common

Orckit Communications Limited: Ordinary shares (NIS .10)

Pacific Gateway Exchange, Inc.: \$.001 par common

Park Bancorp, Inc. (Illinois): \$.01 par common

Parts Source, Inc., The: \$.001 par common

Peerless Group, Inc.: \$.01 par common

Peerless Systems Corporation: \$.001 par common

Pegasus Communications Corporation: Class A, \$.01 par common

- Pegasystems, Inc.: \$.01 par common  
 Petroleum Securities Australia Limited: American Depository Receipts  
 Pinnacle Banc Group, Inc.: \$4.69 par common  
 Premis Corporation: \$.01 par common  
 Pro-Dex, Inc.: No par common  
 Professional Staff, plc: American Depository Receipts
- Q.E.P. Co., Inc.: \$.001 par common  
 Quadramed Corporation: \$.01 par common
- R & G Financial Corporation: Class B, \$.01 par common  
 R.H. Phillips, Inc.: No par common  
 Rally's Hamburgers, Inc.: Warrants (expire 09-26-2000)  
 Raster Graphics, Inc.: \$.001 par common  
 RCM Technologies, Inc.: \$.05 par common  
 Redwood Trust, Inc.: 9.74% Class B, \$.01 par cumulative convertible preferred  
 Reliance Bancshares, Inc.: \$1.00 par common  
 Reliv' International, Inc.: No par common  
 Rental Service Corporation: \$.01 par common  
 Research Engineers, Inc.: \$.01 par common  
 Resources Mortgage Capital, Inc.: Series C, par cumulative convertible preferred  
 Response USA, Inc.: \$.008 par common  
 Restrac, Inc.: \$.01 par common  
 RMH Teleservices, Inc.: No par common  
 Rockshox, Inc.: \$.01 par common  
 Rofin-Sinar Technologies, Inc.: \$.01 par common  
 RT Industries, Inc.: \$.001 par common
- Schmitt Industries, Inc.: No par common  
 Security Bank Holding Company: \$5.00 par common  
 Seiler Pollution Control Systems, Inc.: \$.0001 par common  
 Select Software Tools plc: American Depository Receipts  
 Service Experts, Inc.: \$.01 par common  
 Shell Seafood Restaurants, Inc.: \$.01 par common  
 Signature Resorts, Inc.: \$.01 par common  
 Silicon Gaming, Inc.: \$.001 par common  
 Skylands Community Bank (New Jersey): \$2.50 par common  
 Smartserv Online, Inc.: \$.01 par common  
 Solar-Mates, Inc.: \$.001 par common; Warrants (expire 09-29-2000)  
 Source Services Corporation: \$.02 par common  
 South Street Financial Corporation: No par common  
 Specialty Catalog Corporation: \$.01 par common  
 Splash Technology Holdings, Inc.: \$.001 par common  
 SRS Labs, Inc.: \$.001 par common  
 Staffmark, Inc.: \$.01 par common  
 Stat Healthcare, Inc.: \$.01 par common; Warrants (expire 04-21-98)  
 Stericycle, Inc.: \$.01 par common  
 Sterile Recoveries, Inc.: \$.001 par common  
 Storm Technology, Inc.: \$.001 par common  
 Strayer Education, Inc.: \$.01 par common  
 Strongsville Savings Bank (Ohio): No par common  
 Suburban Ostomy Supply Co., Inc.: No par common  
 Summit Bank Corporation: No par common
- Summit Design, Inc.: \$.01 par common  
 Superior Consultant Holdings Corporation: \$.01 par common  
 Swissray International, Inc.: \$.01 par common  
 Synthetech, Inc.: \$.001 par common
- Talx Corporation: \$.01 par common  
 Techniclone International Corporation: No par common  
 Technology Modeling Associates, Inc.: No par common  
 Technology Service Group, Inc.: \$.01 par common; Warrants (expire 05-09-99)  
 Telco Communications Group, Inc.: No par common  
 Telespectrum Worldwide, Inc.: \$.01 par common  
 Teletech Holdings, Inc.: \$.01 par common  
 Teletek, Inc.: \$.0001 par common  
 Thorn plc: American Depository Receipts  
 Transact Technologies, Incorporated: \$.01 par common  
 Transkaryotic Therapies, Inc.: \$.01 par common  
 Tri-Point Medical Corporation: \$.01 par common  
 Tritel Corporation: \$.001 par common  
 Trusted Information Systems, Inc.: \$.01 par common  
 TV Filme, Inc.: \$.01 par common
- U. S. Opportunity Search, Inc.: \$.001 par common  
 Unionbancorp, Inc. (Illinois): \$1.00 par common  
 United Bancorp, Inc. (Ohio): \$1.00 par common  
 Universal Outdoor Holdings, Inc.: \$.01 par common  
 Usana, Inc.: No par common
- Ventana Medical Systems, Inc.: \$.001 par common  
 Versant Object Technology: No par common  
 Viatel Inc.: \$.01 par common  
 Vion Pharmaceuticals, Inc.: \$.01 par common  
 Visigenic Software, Inc.: \$.001 par common
- Warp 10 Technologies, Inc.: No par common  
 Westwood Homestead Financial Corporation: \$.01 par common  
 White Pine Software, Inc.: \$.01 par common  
 Willis Lease Finance Corporation: No par common  
 Winton Financial Corporation: No par common
- Xavier Corporation: \$.0001 par common  
 Xionics Document Technologies, Inc.: \$.01 par common  
 XLConnect Solutions, Inc.: \$.01 par common  
 XOMED Surgical Products, Inc.: \$.01 par common
- Deletions to the Foreign Margin List*
- Australia*  
 Gold Mines of Kalgoorlie Limited: Ordinary shares, par A\$0.05  
 Posgold Limited: Ordinary shares, par A\$0.10
- Canada*  
 Diamond Fields Resources Inc.: No par common  
 Hemlo Gold Mines Inc.: No par common  
 Scott's Hospitality Inc.: No par common subordinate-voting  
 Toronto Sun Publishing Corporation: No par common



*France*

Docks de France SA: Ordinary shares, par 10 French francs  
 Ecco SA: Ordinary shares, par 25 French francs  
 Poliet SA: Ordinary shares, par 50 French francs

*Germany*

Asko Deutsche Kaughaus AG: Bearer shares par DM 50  
 Kaufhof Holding AG: Bearer shares, par DM 50  
 Kaufhof Holding AG: Non-Voting Preferred, par DM 50

*Italy*

SME Societa Meridionale Finanziaria: Ordinary shares,  
 par 1000 lira

*Japan*

Honshu Paper Co., Ltd.: ¥ 50 par common  
 Mitsubishi Warehouse & Transportation Co., Ltd.: ¥ 50  
 par common

*Norway*

Smedvig ASA: Common Shares, par 3 Norwegian krone  
  
 Transocean ASA: Common Shares, par 5 Norwegian krone

*Singapore*

AMCOL Holdings Ltd.: Ordinary shares, par S\$0.25

*Switzerland*

Winterthur Schweizer. Versicherungs GES.: Bearer shares,  
 par 20 Swiss francs

*United Kingdom*

APV plc: Ordinary shares, par 10 p  
  
 BET plc: Ordinary shares, par value 25 p  
 Bilton plc: Ordinary shares, par .125 p  
  
 Dawson International plc: Ordinary shares, par 25 p  
  
 Fisons plc: Ordinary shares, par value 25 p  
 Forte plc: Ordinary shares, par value 25 p  
  
 Laing (John) plc: Ordinary shares, par 25 p  
 Laing (John) plc: A Ordinary Non-voting 25 p  
  
 Merchants Trust plc, The: Ordinary shares, par 25 p  
  
 Sun Alliance Group plc: Ordinary shares, par 25 p  
  
 TSB Group plc: Ordinary shares, par value 25 p  
  
 William Baird plc: Ordinary shares, par 50 p

*Additions to the Foreign Margin List**Germany*

Metro AG: Bearer shares, par DM 50  
 Metro AG: Preferred Type 1, par DM 50

*Italy*

Istituto Bancario San Paolo Ditorino: Ordinary shares, par  
 10,000 lira

Mediaset SPA: Ordinary shares, par 1000 lira

*Mexico*

Apasco SA: Ordinary shares, No par common  
  
 Carso Global Telecom S.A. de C.V.: No par common  
 Cemex S.A. de C.V. (CPO): No par common

Empresas La Moderna S.A. de C.V.: Class Series A registered,  
 No par common

Gruma S.A. de C.V.: Series 1-B fixed, No par common  
 Grupo Financiero Banammex Accival S.A. de C.V.: Series L,  
 No par variable ordinary shares  
 Grupo Financiero Bancomer S.A. de C.V.: Series L registered,  
 No par common  
 Grupo Financiero Bancomer S.A. de C.V.: Series B, No par  
 common  
 Grupo Financiero Inbursa S.A. de C.V.: Series B, No par  
 common  
 Grupo Mexico S.A. de C.V.: Series B, No par common

Industrias PENOLES S.A. de C.V.: No par common

*Norway*

Smedvig ASA: A shares, par 3 Norwegian krone  
 Smedvig ASA: B shares, par 3 Norwegian krone

*United Kingdom*

Alliance Trust plc: Ordinary shares, par 25 p  
  
 British Biotech Group plc: Ordinary shares, par 5 p  
  
 Caledonia Investment plc: Ordinary shares, par 5 p  
 Compass Group plc: Ordinary shares, par 5 p  
 Cowie Group plc: Ordinary shares, par 5 p  
  
 Daily Mail & General Trust plc: A Ordinary Shares, non-  
 voting par 50 p  
  
 EMAP plc: Ordinary Shares, par 25 p  
  
 Hays plc: Ordinary shares, par 1 p  
  
 Laird Group plc: Ordinary shares, par 25 p  
  
 Orange plc: Ordinary shares, par 20 p  
  
 Perpetual plc: Ordinary shares, par 10 p  
  
 Railtrack Group plc: Ordinary shares, par 25 p  
 Refuge Group plc: Ordinary shares, par 5 p  
  
 Scottish Investment Trust plc: Ordinary shares, par 25 p

Scottish Mortgage & Trust plc: Ordinary shares, par 25 p  
 Securicor plc: Ordinary shares, par 5 p  
 Stagecoach Holdings plc: Ordinary shares, par 2.5 p

Thorn plc: Ordinary shares, par 25 p

WPP Group plc: Ordinary shares, par 10 p

#### *FINAL RULE—AMENDMENT TO REGULATION V*

The Board of Governors is repealing 12 C.F.R. Part 245, its Regulation V (Loan Guarantees for Defense Production) as obsolete. This action does not represent any policy change but rather eliminates an outmoded regulation and reduces regulatory burden.

Effective October 9, 1996, 12 C.F.R. Part 245 is amended as follows:

#### *Part 245—[Removed]*

1. Part 245 is removed.

#### *FINAL RULE—AMENDMENT TO RULES OF PRACTICE FOR HEARINGS*

The Board of Governors is amending 12 C.F.R. Part 263, its Rules of Practice for Hearings, to include a section listing increases in the maximum amounts of each civil money penalty under its jurisdiction. The Board is required to enact such regulation by the Debt Collection Improvements Act of 1996, which requires agencies to adjust their statutorily based civil money penalties to account for inflation.

Effective October 24, 1996, 12 C.F.R. Part 263 is amended as follows:

#### *Part 263—Rules of Practice for Hearings*

1. The authority citation for 12 C.F.R. Part 263 is revised to read as follows:

*Authority:* 5 U.S.C. 504; 12 U.S.C. 248, 324, 504, 505, 1817(j), 1818, 1828(c), 1831o, 1831p-1, 1847(b), 1847(d), 1884(b), 1972(2)(F), 3105, 3107, 3108, 3907, 3909; 15 U.S.C. 21, 78o-4, 78o-5, 78u-2; and 28 U.S.C. 2461 note.

#### *Subpart C—Rules and Procedures for Assessment and Collection of Civil Money Penalties*

2. A new section 263.65 is added to subpart C to read as follows:

#### **Section 263.65—Civil penalty inflation adjustments.**

(a) *Inflation adjustments.* In accordance with the Federal Civil Penalties Inflation Adjustment Act of 1990 (28 U.S.C.

2461 note), the Board has set forth in paragraph (b) of this section adjusted maximum penalty amounts for each civil money penalty provided by law within its jurisdiction. The adjusted civil penalty amounts provided in paragraph (b) of this section replace only the amounts published in the statutes authorizing the assessment of penalties. The authorizing statutes contain the complete provisions under which the Board may seek a civil money penalty. The increased penalty amounts apply only to violations occurring after October 24, 1996.

(b) *Maximum civil money penalties.* The maximum civil money penalties as set forth in the referenced statutory sections are adjusted as follows:

- (1) 12 U.S.C. 324:
  - (i) Inadvertently late or misleading reports, *inter alia*—\$2,000.
  - (ii) Other late or misleading reports, *inter alia*—\$22,000.
  - (iii) Knowingly or recklessly false or misleading reports, *inter alia*—\$1,100,000.
- (2) 12 U.S.C. 504, 505, 1817(j)(16), 1818(i)(2) and 1972(F):
  - (i) First tier—\$5,500.
  - (ii) Second tier—\$27,500.
  - (iii) Third tier—\$1,100,000.
- (3) 12 U.S.C. 1832(c)—\$1,100.
- (4) 12 U.S.C. 1847(b)—\$27,500.
- (5) 12 U.S.C. 1847(d):
  - (i) First tier—\$2,000.
  - (ii) Second tier—\$22,000.
  - (iii) Third tier—\$1,100,000.
- (6) 12 U.S.C. 1884—\$110.
- (7) 12 U.S.C. 3909(d)—\$1,100.
- (8) 15 U.S.C. 78u-2:
  - (i) 15 U.S.C. 78u-2(b)(1)—\$5,500 for a natural person and \$55,000 for any other person.
  - (ii) 15 U.S.C. 78u-2(b)(2)—\$55,000 for a natural person and \$275,000 for any other person.
  - (iii) 15 U.S.C. 78u-2(b)(3)—\$110,000 for a natural person and \$550,000 for any other person.
- (9) 42 U.S.C. 4012a(f)(5):
  - (i) For each violation—\$350.
  - (ii) For the total amount of penalties assessed under 42 U.S.C. 4012a(f)(5) against an institution or enterprise during any calendar year—\$105,000.

#### *ORDERS ISSUED UNDER BANK HOLDING COMPANY ACT*

#### *Orders Issued Under Section 3 of the Bank Holding Company Act*

Nacogdoches Commercial Bancshares, Inc.  
 Nacogdoches, Texas

#### *Order Approving Acquisition of a Bank*

Nacogdoches Commercial Bancshares, Inc. (“NCB”), a bank holding company within the meaning of the Bank

Holding Company Act (“BHC Act”), has applied for the Board’s approval under section 3 of the BHC Act (12 U.S.C. § 1842) to acquire 6.3 percent of the voting shares of Security National Bank, both of Nacogdoches, Texas (“Bank”).<sup>1</sup>

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 36,728 (1996)). The time for filing comments has expired, and the Board has considered the application and all comments received in light of the factors set forth in section 3(c) of the BHC Act.

NCB is the 140th largest commercial banking organization in Texas, controlling approximately \$121 million in deposits, representing less than 1 percent of total deposits in commercial banking organizations in the state.<sup>2</sup> Bank is the 501st largest commercial banking organization in Texas, with approximately \$32 million in deposits, representing less than 1 percent of total deposits in commercial banking organizations in the state. On consummation of the proposal, NCB would become the 122d largest commercial banking organization in Texas, controlling approximately \$153 million in deposits.

NCB proposes to acquire less than 25 percent of the voting shares of Bank, which is not a normal acquisition for a bank holding company. Nonetheless, the requirement in section 3 of the BHC Act that the Board’s approval be obtained before a bank holding company acquires more than 5 percent of the voting shares of a bank suggests that Congress contemplated that a bank holding company may acquire between 5 and 25 percent of the voting shares of a bank or another bank holding company or may acquire control of a bank or another bank holding company by means other than acquiring 25 percent or more of the voting shares. Accordingly, the Board has reviewed the proposal in accordance with the factors set forth in the BHC Act.<sup>3</sup>

### *Competitive Considerations*

NCB and Bank compete directly in the Nacogdoches, Texas, banking market, which consists of Nacogdoches County and the southern one-third of Rusk County, both in

Texas.<sup>4</sup> NCB is the second largest commercial banking organization in the market, controlling approximately \$121 million in deposits, representing 22 percent of total deposits in commercial banks in the market (“market deposits”). Bank is the fifth largest commercial banking organization in the market, with approximately \$32 million in deposits, representing 5.9 percent of market deposits. On consummation of the proposal, NCB would remain the second largest commercial banking organization in the Nacogdoches banking market, controlling approximately \$153 million in deposits, representing 27.9 percent of market deposits. The Herfindahl–Hirschman Index (“HHI”) in the market would increase by 259 points to 2409.<sup>5</sup>

The Board believes that several features of the Nacogdoches banking market mitigate the potential anticompetitive effects of the proposal. Eight commercial bank competitors would remain in the market in addition to NCB, three of which would each control more than 10 percent of market deposits. The Nacogdoches banking market also has several characteristics that make it attractive for entry. Nacogdoches County has the highest level of total deposits and the second highest population among all non-MSA counties in Texas, and the average level of deposits and popula-

1. NCB would acquire the shares from its subsidiary bank, Commercial Bank of Texas, N.A., Nacogdoches, Texas, which acquired the shares in the regular course of securing or collecting a debt previously contracted in good faith. See 12 U.S.C. § 1842(a)(A)(ii); 12 C.F.R. 225.12(b).

2. All banking data are as of June 30, 1995.

3. The Board has indicated that acquisitions of less than a 25-percent voting interest may result in a bank holding company’s obtaining the ability to exercise a controlling influence over the management and policies of another bank holding company. See *McLeod Bancshares, Inc.*, 73 *Federal Reserve Bulletin* 724 (1987); *Hudson Financial Associates*, 72 *Federal Reserve Bulletin* 150 (1986). NCB has indicated that it may seek to influence the management or policies of Bank, including its dividend policies or practices, if, in the view of NCB, circumstances would warrant such action as a means of receiving fair value for its shares.

4. The Board and the courts have found that the relevant banking market for analyzing the competitive effect of a proposal must reflect commercial and banking realities and should consist of the local area where the banks involved offer their services and where local customers can practicably turn for alternatives. See *St. Joseph Valley Bank*, 68 *Federal Reserve Bulletin* 673, 674 (1982). The key question to be considered in making this selection “is not where the parties to the merger do business or even where they compete, but where, within the area of competitive overlap, the effect of the merger on competition will be direct and immediate.” *United States v. Philadelphia National Bank*, 374 U.S. 321, 357 (1963); *United States v. Phillipsburg National Bank*, 399 U.S. 350, 364–65 (1969). The Board has considered NCB’s contention that the relevant banking market consists of Nacogdoches County and Angelina County, also in Texas. The Board believes, however, that the appropriate market for analyzing the competitive effects of the proposal is the Nacogdoches banking market. The Board bases its conclusion on an analysis of employment commuting data, shopping patterns, newspaper circulation, advertising by financial institutions, loan and deposit data, and interviews with local bankers and other officials conducted in 1991, and updated in 1996, by the Federal Reserve Bank of Dallas, and other facts of record that indicate that commuting, travel, and competition between Nacogdoches County and Angelina County are limited.

5. Under the revised Department of Justice Merger Guidelines (49 *Federal Register* 26,823 (June 29, 1984)), a market in which the post-merger HHI is over 1800 is considered to be concentrated. The Justice Department has informed the Board that a bank merger or acquisition generally will not be challenged (in the absence of other factors indicating anti-competitive effects) unless the post-merger HHI is at least 1800 and the merger increases the HHI by 200 points. The Justice Department has stated that the higher than normal HHI thresholds for screening bank mergers for anti-competitive effects implicitly recognize the competitive effect of limited-purpose lenders and other non-depository financial entities.

tion per banking office in Nacogdoches County substantially exceed the averages for all non-MSA counties in the state.<sup>6</sup> Population growth and deposit growth also have substantially exceeded statewide averages for non-MSA counties during recent years.<sup>7</sup> Texas law, moreover, permits Texas banks to branch statewide, thereby providing easy entry to the market by potential competitors.<sup>8</sup> The Nacogdoches banking market also has recently experienced both *de novo* and entry by acquisition.<sup>9</sup> The Department of Justice has reviewed the proposal and advised the Board that consummation of the proposal is not likely to have any significantly adverse competitive effects in the Nacogdoches banking market and any other relevant banking market.<sup>10</sup>

Based on these and all the facts of record, the Board concludes that consummation of the proposal is not likely to have a significantly adverse effect on competition or on the concentration of banking resources in the Nacogdoches banking market or any other relevant banking market.

In light of all the facts of record, the Board also concludes that the financial and managerial resources and future prospects of the organizations involved in the proposal are consistent with approval, as are considerations relating to the convenience and needs of the community to be served and other supervisory factors the Board must consider under the BHC Act.

### Conclusion

Based on the foregoing and all the facts of record, the Board has determined that the proposal should be, and hereby is, approved. The commitments and conditions relied on by the Board in reaching this decision are deemed to be conditions imposed in writing by the Board in connection with its findings and decision, and, as such, may be enforced in proceedings under applicable law.

The proposed acquisition of Bank's voting shares shall not be consummated before the fifteenth calendar day following the effective date of this order, and not later than

6. All market comparison data are as of December 31, 1994, except banking office deposit data as of June 30, 1995. Nacogdoches County has \$59 million per banking office, compared to \$32.7 million per banking office for all non-MSA counties in Texas, and 6,326 persons per banking office, compared to 3,656 persons per banking office for all non-MSA counties in the state.

7. The population in Nacogdoches County increased at an average rate of approximately 1 percent per year from 1990 through 1994, compared to an average decline for all non-MSA counties in Texas during this period. Insured deposits in Nacogdoches County increased at more than twice the average rate for insured deposits in all non-MSA counties in Texas during this period.

8. See Tex. Rev. Civ. Stat. Ann. art. 342-3.203 (West 1996).

9. In 1994, two commercial banks made a *de novo* entry into the market, and two other commercial banks have entered the market in recent years by acquiring existing banks.

10. In addition, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have not objected to the proposal.

three months after the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of Dallas, acting pursuant to delegated authority.

By order of the Board of Governors, effective October 9, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Phillips, Yellen, and Meyer. Absent and not voting: Governor Lindsey.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

### Orders Issued Under Section 4 of the Bank Holding Company Act

First Union Corporation  
Charlotte, North Carolina

#### Order Approving Notice to Acquire a Savings Association

First Union Corporation, Charlotte, North Carolina ("First Union"), a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire all the voting shares of Home Financial Corporation ("Home Financial") and its wholly owned subsidiary, Home Savings Bank, FSB ("Savings Bank"), both of Hollywood, Florida.<sup>1</sup>

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 44,061 (1996)). The time for filing comments has expired, and the Board has considered the notice and all comments received in light of the factors set forth in section 4(c)(8) of the BHC Act.

First Union, with total consolidated assets of \$139.9 billion, operates 12 subsidiary banks in Connecticut, Delaware, the District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Tennessee, and Virginia.<sup>2</sup> First Union is the second largest depository organization in Florida, controlling \$27.8 billion in deposits, representing approximately 15.7 percent

1. After acquiring Home Financial, First Union proposes to merge Savings Bank with and into its subsidiary bank, First Union National Bank of Florida, Jacksonville, Florida ("FUNB-FL"). The Office of the Comptroller of the Currency ("OCC"), the primary federal supervisor of FUNB-FL, has approved the merger under section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. § 1828(c), (the "Bank Merger Act")).

2. Consolidated asset data are as of June 30, 1996. Deposit data are as of June 30, 1995.

of total deposits in depository institutions in the state.<sup>3</sup> Home Financial is the 23d largest depository organization in Florida, controlling \$853.2 million in deposits, representing less than 1 percent of total deposits in depository institutions in the state. On consummation of the proposal, First Union would remain the second largest depository organization in Florida, controlling deposits of \$28.7 billion, representing approximately 16.2 percent of total deposits in depository institutions in the state.

The Board has determined that the operation of a savings association by a bank holding company is closely related to banking for purposes of section 4(c)(8) of the BHC Act.<sup>4</sup> First Union has committed to conform all activities of Savings Bank to those permissible for bank holding companies under section 4(c)(8) of the BHC Act and Regulation Y.<sup>5</sup>

In order to approve the proposal, the Board also must determine that the proposed activities are a proper incident to banking, that is, that the proposal “can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.” As part of its evaluation of these factors, the Board has carefully reviewed the financial and managerial resources of First Union, Home Financial, and their respective subsidiaries in light of all the facts of record, and the effect the transaction would have on such resources.<sup>6</sup> The facts of record include confidential reports of examination from the primary federal supervisors of the organizations assessing their financial and managerial resources. Based on all the facts of record, the Board concludes that the financial<sup>7</sup> and

managerial<sup>8</sup> resources of the organizations involved in this proposal are consistent with approval.<sup>9</sup>

### *Competitive Considerations*

The Board has carefully reviewed the competitive effects of this proposal in light of all the facts of record, including comments from Protestant contending that the proposal would have significant anticompetitive effects in both banking markets. First Union and Home Financial compete directly in the Miami-Fort Lauderdale and Highlands County banking markets, both in Florida.<sup>10</sup>

First Union operates the second largest depository institution in the Miami-Fort Lauderdale banking market, controlling deposits of approximately \$8.1 billion, representing 17 percent of total deposits in depository institutions in the market (“market deposits”).<sup>11</sup> Home Financial oper-

3. In this context, depository institutions include commercial banks, savings banks, and savings associations.

4. See 12 C.F.R. 225.25(b)(9).

5. First Union has committed that all impermissible real estate activities will be divested or terminated within two years of consummation of the proposal, that no new impermissible projects or investments will be undertaken during this period, and that capital adequacy guidelines will be met excluding impermissible real estate investments. First Union also has committed that any impermissible securities or insurance activities conducted by Savings Bank will cease on or before consummation of the proposal. Savings Bank may continue to service any impermissible insurance policies for two years after consummation of the proposal, but may not renew any policies during this two-year period.

6. See 12 C.F.R. 225.24; see also *The Fuji Bank, Limited*, 75 *Federal Reserve Bulletin* 94 (1989); *Bayerische Vereinsbank AG*, 73 *Federal Reserve Bulletin* 155 (1987).

7. In connection with this proposal, the Board received comments from Inner City Press/Community on the Move (“Protestant”) maintaining that the recent downgrading by an independent rating agency of its investor outlook for First Union’s debt raises adverse financial considerations. The Board has carefully reviewed Protestant’s information in light of the overall financial condition of First Union and its subsidiaries, as assessed by their primary federal supervisors.

8. Protestant also contends that two recent settlements by First Union and pending lawsuits related to its sale of mutual funds in Florida raise adverse managerial considerations. The Board has considered these comments in light of the various settlements of these matters and the correction or termination by First Union of the practices that gave rise to these matters and the supervisory assessments of First Union’s managerial resources. Protestant also notes that First Union is the subject of an employment discrimination lawsuit filed by former employees that were laid off in connection with First Union’s acquisition of First American Metro Corp., McLean, Virginia. Pursuant to Department of Labor regulations, First Union is required to file an annual report with the Equal Employment Opportunity Commission (“EEOC”) covering all employees in its corporate structure. See 41 C.F.R. 60–1.7(a) and 60–1.40. The EEOC has jurisdiction for determining whether companies are in compliance with the equal employment statutes. To date, there has been no finding or adjudication of illegal employment practices by First Union.

9. Protestant also maintains that Banco Santander, S.A., Madrid, Spain (“Banco Santander”), has violated the terms of certain passivity commitments made in connection with its acquisition of a minority interest in First Union. See *Banco Santander, S.A.*, 81 *Federal Reserve Bulletin* 1139 (1995). The Board previously reviewed and rejected substantially similar comments from Protestant in connection with Banco Santander’s acquisition of Banco Central Hispano Puerto Rico, Hato Rey, Puerto Rico. See *Statement by the Board of Governors Regarding the Application by Banco Santander, S.A., to Acquire Banco Central Hispano Puerto Rico*, 82 *Federal Reserve Bulletin* 833 (1996); Letter from Jennifer J. Johnson, Deputy Secretary of the Board, to Matthew Lee, Inner City Press/Community on the Move (September 13, 1996).

10. The Miami-Fort Lauderdale banking market is approximated by Dade and Broward Counties, both in Florida. The Highlands County banking market is approximated by Highlands County, Florida.

11. Market data are as of June 30, 1995, and are based on calculations in which the deposits of thrift institutions are included at 50 percent. The Board previously has indicated that thrift institutions have become, or have the potential to become, significant competitors of commercial banks. See *Midwest Financial Group*, 75 *Federal Reserve Bulletin* 386 (1989); *National City Corporation*, 70 *Federal Reserve Bulletin* 743 (1984). Thus, the Board has regularly included thrift deposits in the calculation of market share on a 50-percent weighted basis. See, e.g., *First Hawaiian, Inc.*, 77 *Federal Reserve Bulletin* 52 (1991). Because the deposits of Savings Bank would be acquired by a commercial banking organization under the proposal, those deposits are included at 100 percent in the calculation of First Union’s *pro forma* market share. See *Norwest Corporation*, 78 *Federal Reserve Bulletin* 452 (1992); *First Banks, Inc.*, 76 *Federal Reserve Bulletin* 669, 670 n.9 (1990).

ates the 20th largest depository institution in the market, controlling deposits of approximately \$721 million, representing less than 1 percent of market deposits. On consummation of this proposal, First Union would continue to operate the second largest depository institution in the Miami-Fort Lauderdale banking market, controlling deposits of approximately \$8.8 billion, representing 18.4 percent of market deposits. On consummation of the proposal, the market would remain moderately concentrated, as measured by the Herfindahl-Hirschman Index (“HHI”),<sup>12</sup> the HHI would increase by 37 points to 1051, and numerous competitors would remain in the Miami-Fort Lauderdale banking market.

First Union operates the third largest depository institution in the Highlands County banking market, controlling deposits of approximately \$147.2 million, representing approximately 15.3 percent of total market deposits. Home Financial operates the fifth largest depository institution in the market, controlling deposits of approximately \$132.3 million, representing 6.9 percent of market deposits. On consummation of this proposal, First Union would become the second largest depository institution in the Highlands County banking market, controlling deposits of \$279.5 million, representing approximately 27.1 percent of market deposits. The HHI for the Highlands County banking market would increase 238 points to 2273.

A number of factors indicate that the market concentration as measured by the HHI tends to overstate the competitive effect of the proposal in the Highlands County banking market. For example, eight depository institution competitors, including the subsidiaries of four large bank holding companies, would remain in the market after consummation of the proposal. Three of these competitors in addition to First Union would each control more than 10 percent of market deposits. The Highlands County banking market also has several characteristics that make it attractive for entry by an out-of-market institution. For example, Highlands County is the third largest of the 33 non-MSA counties in Florida, and its population increased 9.6 percent between 1990 and 1995, compared to 9.3 percent for the 32 other non-MSA counties and 9 percent for the state of Florida. In addition, Florida’s interstate and branch banking laws permit both statewide branching and interstate banking, and, therefore, present low legal barriers to entry into the Highlands County

12. Under the revised Department of Justice Merger Guidelines, 49 *Federal Register* 26,823 (June 29, 1984), a market in which the post-merger HHI is between 1000 and 1800 is considered moderately concentrated, and a market in which the post-merger HHI is above 1800 is considered highly concentrated. The Justice Department has informed the Board that a bank merger or acquisition generally will not be challenged (in the absence of other factors indicating anticompetitive effects) unless the post-merger HHI is at least 1800 and the merger increases the HHI by more than 200 points. The Justice Department has stated that the higher than normal threshold for an increase in the HHI when screening bank mergers and acquisitions for anticompetitive effects implicitly recognizes the competitive effects of limited-purpose lenders and other non-depository financial entities.

banking market for in-state and out-of-state depository organizations.<sup>13</sup> Last year, a bank entered the market by acquiring a thrift branch.

The Board sought comments from the United States Attorney General, and the Attorney General stated that consummation of the proposal would not likely have any significantly adverse competitive effects. Based on these and all the other facts of record, the Board concludes that consummation of this proposal is not likely to have a significantly adverse effect on competition or the concentration of banking resources in the Miami-Fort Lauderdale or Highlands County banking markets, or any other relevant banking market.<sup>14</sup>

#### A. Record of Performance under the Community Reinvestment Act

In acting on a proposal to acquire a savings association under section 4(c)(8) of the BHC Act, the Board reviews the records of the relevant depository institutions under the Community Reinvestment Act (12 U.S.C. § 2901 *et seq.*) (“CRA”).<sup>15</sup> The Board has evaluated the record of performance of First Union’s depository institutions and Savings Bank in light of the CRA performance examinations by their primary federal supervisors.

The Board has carefully considered comments from Protestant maintaining that First Union’s record of closing branches, particularly the number of branches closed in Florida,<sup>16</sup> adversely affects its ability to assist in meeting the credit needs of its communities.<sup>17</sup> Protestant also cites data submitted under the Home Mortgage Disclosure Act

13. See Fla. Stat. ch. 168 (1996).

14. In analyzing the competitive effects of the proposed transaction, the Board considered Protestant’s assertion that First Union’s policy of imposing a surcharge on ATM transactions by non-customers would have adverse competitive effects by causing customers of small banks to terminate their relationships and become customers of large banks with extensive ATM networks, like First Union, to avoid the surcharge. The Board notes that Home Financial does not own or operate any ATMs. Thus, the proposed transaction would not expand First Union’s surcharge policy in markets currently served by Home Financial. In addition, Home Financial’s customers would gain access to a large ATM network, and would no longer be subject to First Union’s surcharge policy. Moreover, it would be speculative to conclude how customers of small banks generally would change their banking relationships in response to surcharge fees implemented by large banks.

15. See *Norwest Corporation*, 76 *Federal Reserve Bulletin* 873 (1990).

16. Protestant claims that between April 1994 and September 1995, First Union closed 119 branches and opened only eight branches in Florida. Protestant also argues that First Union has closed more than half the branches operated by a Florida thrift it recently acquired, and that First Union is beginning to close branches acquired in connection with its acquisition of First Fidelity Bancorporation, Newark, New Jersey, in October 1995, in areas where First Union had no prior banking operations.

17. Protestant also questions whether First Union has correctly classified certain branch closings as consolidations or relocations that would not require prior notice to the bank’s primary federal supervisor under Section 42 of the Federal Deposit Insurance Corporation Act (“FDI Act”) as implemented by the Joint Policy Statement Regarding

(“HMDA”) by a number of First Union’s subsidiary banks<sup>18</sup> and First Union’s mortgage company to support its contention that First Union has not adequately provided outreach to, or assisted in meeting the credit needs of, Hispanics and African Americans in its delineated communities, and that First Union may have violated fair lending laws.

An institution’s most recent CRA performance evaluation is a particularly important consideration in the applications process because it represents a detailed on-site evaluation of the institution’s overall record of performance under the CRA by its primary federal supervisor.<sup>19</sup> In addition, the Board considers an institution’s policies and practices for compliance with applicable fair lending laws. The Board also takes into account information on an institution’s lending activities that assist in meeting the credit needs of low- and moderate-income neighborhoods.

*Performance Examinations.* All of First Union’s subsidiary banks received a CRA performance rating of “satisfactory” or “outstanding” in their most recent evaluations for CRA performance by their primary federal supervisors. First Union’s lead subsidiary bank, First Union National Bank of North Carolina, Charlotte, North Carolina, and FUNB-FL received “outstanding” and “satisfactory” ratings, respectively, from their primary federal supervisor, the OCC, at their most recent examination for CRA performance, as of April 1994.<sup>20</sup> Savings Bank also received a “satisfactory” rating from its primary federal supervisor, the Office of Thrift Supervision, at its most recent examination for CRA performance, as of May 1994.

Examiners noted that FUNB-FL has taken a number of actions to ascertain effectively the credit needs of its delin-

eated communities, and has developed a number of affordable credit products in response to identified needs. In addition, the 1994 CRA performance evaluation for FUNB-FL noted that the bank actively participates in government-sponsored programs such as those of the Small Business Administration, the Federal Housing Administration, the Florida Housing Finance Agency, and the Jacksonville Economic Development Authority. Examiners also noted that FUNB-FL’s geographic distribution of credit applications and approvals reflects a reasonable penetration throughout its delineated communities. The 1994 CRA performance evaluation for FUNB-FL also stated that the bank had exhibited a high level of participation in community development programs, and noted that the bank had taken a leadership role in identifying community development opportunities and making investments in worthwhile programs that benefit its local communities, particularly those that benefit low- and moderate-income (“LMI”) areas.

*Record of Opening and Closing Branches. Home Savings Bank Branches.* The Board has considered the effect of the proposal on the branches currently operated by Savings Bank in light of Protestant’s comments and the Branch Policy Statement.<sup>21</sup> Savings Bank operates eight branches in three counties in Florida. First Union indicates that two of Savings Bank’s branches would cease operations and would be merged with two branches of FUNB-FL. One of the branches is located in a LMI census tract and the other is located in a middle-income census tract. In each case, the First Union branch that would survive is located within one-quarter mile of the Savings Bank branch. Savings Bank’s customers would continue to be adequately served because the First Union branches operate in the same neighborhood and census tracts as the branches that would cease operations.<sup>22</sup>

Branch Closings (“Branch Policy Statement”). 12 U.S.C. § 1831r-1; 58 *Federal Register* 49,083 (1993).

18. The banks are located in the District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Tennessee, and Virginia.

19. The Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act provides that a CRA examination is an important and often controlling factor in the consideration of an institution’s CRA record and that reports of these examinations will be given great weight in the applications process. 54 *Federal Register* 13,742 and 13,745 (1989).

20. The OCC conducted joint examinations of eight of First Union’s subsidiary banks in April 1994. The remaining six subsidiary banks, First Union National Bank of Georgia, Atlanta, Georgia; First Union National Bank of Maryland, Rockville, Maryland; First Union National Bank of South Carolina, Greenville, South Carolina; First Union National Bank of Tennessee, Nashville, Tennessee; First Union National Bank of Virginia, Roanoke, Virginia; and First Union National Bank of Washington D.C. each received “satisfactory” CRA performance ratings from the OCC. First Union North, Avondale, Pennsylvania (formerly known as First Fidelity Bank, N.A.) also received a “satisfactory” rating from the OCC at its most recent examination for CRA performance, as of July 1994. In addition, First Union Bank of Connecticut, Stamford, Connecticut (formerly known as First Fidelity Bank), and First Union Bank of Delaware, Wilmington, Delaware (formerly known as First Fidelity Bank) both received “satisfactory” ratings from their primary federal supervisor, the Federal Deposit Insurance Corporation (“FDIC”), at their most recent examinations for CRA performance, as of March 1995 and April 1995, respectively.

21. 58 *Federal Register* 49,083 (1993). First Union has submitted confidential branch closing information in connection with the proposal. Protestant asserts that this information should be disclosed under the Board’s application processing procedures that generally prohibit *ex parte* communications during the processing of an application. The Board notes that its rules regarding access to information under the Freedom of Information Act (“FOIA”) provide the appropriate framework for considering a commenter’s challenge to confidential treatment accorded an applicant’s submissions, and that Protestant’s challenge here was reviewed under those rules and denied. The Board’s rules do not provide a commenter access to information that is otherwise exempt from disclosure under FOIA. Protestant, moreover, has been provided with all non-confidential submissions by First Union that respond to particular issues raised by Protestant.

22. The Board notes that Section 42 of the FDI Act requires that the bank’s primary federal supervisor receive notice at least 90 days before the date of the proposed branch closing, and that the bank provide the reasons and other supporting data for the closure consistent with the institution’s written policy for branch closings. For the reasons noted above, the two Home Savings branches that would cease operations appear to meet the criteria for a relocation. The Joint Policy Statement provides that each federal banking agency must examine compliance with Section 42 of the FDI Act as part of an institution’s CRA performance evaluation and may make adverse findings in the evaluation or take appropriate enforcement action against an institution that fails to comply. The CRA examination for

*Other Branches.* Protestant's allegations also relate to the effects of branch closings by First Union banks in Florida from April 1994 to September 1995 and the branch closings in connection with the First Fidelity acquisition. None of these branch closings is related to the transaction under review in this application.

Section 4 of the BHC Act provides that the Board must evaluate whether the proposed transaction would result in public benefits that outweigh potential adverse effects. Because these branch closings are not related to the Home Savings transaction, the effect of these branch closings is not directly relevant to the factors that must be considered in evaluating the Home Savings transaction. The branch closing policies used by First Union would, however, reflect on the managerial resources and would govern future branch closings at Home Savings. Consequently, the branch closing policies of First Union have been reviewed in this case. FUNB-FL has adopted First Union's corporate policy for branch closures that provides for an objective determination of branches to be closed, consideration of alternative solutions, examination of options to minimize potential adverse effects on and inconvenience to the communities, and sufficient notice to the communities. The policy also requires additional analyses, community contacts and/or review of need ascertainment calls when any branch closing affects a LMI community.

In addition, the effect of all branch closings is reviewed in the CRA examination process and the results of these on-site examinations have been carefully considered.<sup>23</sup> In this case, the Florida branch closings identified by Protestant will be reviewed by the OCC in the next CRA performance examination of FUNB-FL, and the branches of the former First Fidelity banks will be reviewed in the next CRA performance examination by the appropriate federal supervisor for the particular bank that closed the branch. The OCC reviewed the general policy employed by FUNB-FL in closing branches, and the branches actually closed by FUNB-FL before April 1994, in connection with the bank's 1994 CRA performance examination. The OCC determined that FUNB-FL has formal procedures for opening and closing offices that are designed to maintain a reasonable level of services in each delineated community and that its branches are readily accessible to all segments within its delineated communities. The OCC concluded

that the bank had followed its policies in evaluating the impact of branch closings on its communities, including low- and moderate-income areas. First Union has informed the Board that it followed these policies when it closed the Florida branches. First Union also stated that similar policies have been adopted at the former First Fidelity subsidiaries and have been followed in connection with those institutions' branch consolidations and closings.

*HMDA Data and Lending Activities.* The Board has carefully reviewed HMDA data submitted by First Union and First Fidelity in light of Protestant's comments.<sup>24</sup> The Board previously has reviewed 1993 and 1994 HMDA data submitted by First Union and First Fidelity in light of similar comments from Protestant.<sup>25</sup> The data indicate that First Union has continued to increase its percentage of home mortgage loans to LMI individuals and African-American borrowers. For example, 1995 HMDA data for First Union show that, although the overall total number of HMDA-related loans reported for First Union's bank and mortgage subsidiaries generally decreased, the percentage of applications from LMI individuals and African American borrowers increased in most of First Union's service areas. In addition, the number of HMDA-related applications received by FUNB-FL from Hispanics has increased steadily from 1993 to 1995 and the disparity between the rates of approval and denial for Hispanic applicants at FUNB-FL continues to decrease. In 1995, in the Miami MSA, where approximately 49 percent of the population is Hispanic, approximately 52 percent of all HMDA-related applications were from Hispanics.

The data for First Union and First Fidelity also reflect some disparities in the rate of loan originations, denials, and applications by racial group or income level. The Board is concerned when the record of an institution indicates such disparities in lending, and believes that all banks are obligated to ensure that their lending practices are based on criteria that assure not only safe and sound lending, but also assure equal access to credit by creditworthy applicants regardless of race. The Board recognizes, however, that HMDA data alone provide an incomplete measure of an institution's lending in its community because these data cover only a few categories of housing-related lending and provide limited information about the covered loans.<sup>26</sup> HMDA data, therefore, have limitations that make the data

FUNB-FL noted compliance by the bank with Section 42 of the FDI Act. The Board has given the OCC and the FDIC copies of Protestant's comments regarding First Union's designation of recent branch closings as consolidations or relocations for evaluation in the next CRA performance examinations.

23. The on-site CRA examination includes a review of the types of lending and banking services provided by the closed branch, the types of lending and banking services available from the institution's remaining branches and alternative systems for delivering banking services, the proximity of the closed branch to the other branches of the institution, and the needs for lending and banking services of the particular area. An on-site examination also provides examiners with the opportunity to consider the institution's overall business strategy for closing branches such as cost, profitability and effective service delivery.

24. HMDA data filed by the mortgage subsidiary of First Union and First Fidelity have been combined with data for the banking subsidiary operating in each state, as appropriate. First Fidelity's data also include the data for the First Fidelity Urban Investment Corporation. First Union's data do not include the HMDA data reported by First Union Home Equity Bank because the subsidiary takes the majority of its applications by telephone and is therefore not required to record the race of the borrower under applicable law. Data for First Union and First Fidelity have been considered separately because First Union did not consummate its acquisition of First Fidelity until year-end 1995.

25. See *First Union/First Fidelity*, 81 *Federal Reserve Bulletin* at 1147-48.

26. These data, for example, do not provide a basis for an independent assessment of whether an applicant who was denied credit was, in fact, creditworthy. Credit history problems and excessive debt



an inadequate basis, absent other information, for concluding that an institution has engaged in illegal discrimination in lending.

Because of the limitations of HMDA data, the Board has carefully reviewed other information, particularly examination reports that provide an on-site evaluation of compliance by First Union and Savings Bank with the fair lending laws.<sup>27</sup> The examinations of First Union's subsidiary bank, the examinations of First Fidelity's subsidiary banks, and Savings Bank found no evidence of prohibited discrimination or other illegal credit practices at the institutions. Examiners also found no evidence at any of the institutions of any practices intended to discourage applications for the types of credit listed in the banks' CRA statement.

As discussed in more detail in the First Union/First Fidelity Order, the 1994 examinations of First Union's subsidiary banks considered that the geographic distribution of credit showed reasonable penetration of all segments of each bank's communities, including LMI neighborhoods. The 1994 examinations also found that the delineations by all of First Union's subsidiary banks of their local communities were reasonable and did not arbitrarily exclude LMI areas. Finally, the 1994 First Union examinations indicated that all of the subsidiary banks solicited and accepted credit applications from all segments of their delineated communities, including individuals in LMI areas.

First Union also has taken a number of steps to increase lending by its subsidiary banks to LMI and minority borrowers. For example, First Union has implemented a second review of denied loan applications for mortgages and consumer loans to ensure that consistent loan decisions are made. The second review is conducted before a final decision is made for all these types of loans for which denial is recommended. Other corporate fair lending programs include semi-annual reviews of files to assess the level of assistance to applicants and the basis for lending decisions, regression modeling to test for variances in rates charged to borrowers, matched-pair shopping to gauge the quality and level of assistance provided to loan applicants, and annual policy reviews to ensure that policies are nondiscriminatory. Examiners noted in First Union's 1994 examinations that management of all the subsidiary banks had implemented comprehensive training and compliance programs to support equal treatment in lending and to ensure that all applicants were treated fairly.

First Union has implemented a number of outreach and lending activities to assist in meeting the credit needs of areas with predominately LMI and minority residents. Outreach efforts noted by examiners included ongoing communications with community, civic, and neighborhood groups

levels relative to income—reasons most frequently cited for a credit denial—are not available from the HMDA data.

27. As noted in the First Union/First Fidelity Order, the OCC, contrary to Protestant's assertion, reviewed a sample of loans made by First Union's mortgage company in reviewing compliance with applicable fair lending laws by First Union's subsidiary banks in the 1994 CRA performance evaluations.

that represent a broad range of communities, including LMI areas. First Union's subsidiary banks also used newspaper and radio to advertise their products and services to LMI residents, including a series featuring CRA-related products that is used in local publications that focus on LMI individuals and minority small business owners. First Union also has implemented a number of specialized lending programs such as the Affordable Home Mortgage Loan, which is a specialized product offering flexible terms such as flexible debt-to-income requirements and lower down payments. Other programs designed for LMI individuals included the Special Home Improvement Loan, which offers rebates for timely payments, flexible debt-to-income ratios, and no origination fee; Special Instant Cash Reserve, a revolving line of credit that acts as an instant loan and overdraft protection; and Special FirstAdvance, an unsecured line of credit with flexible debt-to-income ratios. First Union banks also offered loans under government-insured loan programs, such as the Small Business Administration, the Federal Housing Authority, and the Veterans Administration, and made a number of small business loans to borrowers in LMI census tracts.<sup>28</sup>

## B. Conclusion Regarding CRA Considerations

The Board has carefully reviewed all the facts of record in considering the CRA performance record of Bank, including information provided by commenters to the proposal, First Union's responses, and results of the performance examinations of First Union's subsidiary banks and Savings Bank. Based on this review, and for the reasons discussed above and in the First Union/First Fidelity Order, which are incorporated herein by reference, the Board concludes that considerations relating to the CRA are consistent with approval.<sup>29</sup>

28. The Board has carefully reviewed Protestant's assertion that First Union's account requirements to qualify for lower fees adversely affect the ability of LMI individuals to obtain banking services. The Board previously has noted that First Union provides a full range of credit products and banking services that assist in meeting the credit and banking needs of LMI individuals, including products to provide loans in small amounts to LMI individuals, no-minimum-balance checking accounts for LMI customers that allow a certain number of free posted checks per statement period, and overdraft protection for small business owners. There is no evidence in the record that the fees charged by First Union are based on any factor that would be prohibited under law. While the Board has recognized that banks help serve the banking needs of their communities by making basic banking services available at nominal or no charge, the CRA does not impose any limitation on the fees or surcharges for services.

29. Another protestant ("Florida Protestant") has reiterated his contention that First Union practices "price discrimination" by charging customers outside First Union's home state of North Carolina, particularly in Florida, higher fees for certain services. The Board previously has reviewed Florida Protestant's comments in light of the factors required to be considered under sections 3 and 4 of the BHC Act. See First Union/First Fidelity Order, 81 *Federal Reserve Bulletin* at 1151; First Union/Society First Order. The Board has also reviewed these comments again in this case and concludes that this proposal and prior acquisitions by First Union in Florida would not sufficiently lessen, and have not sufficiently lessened, competition in the relevant

### Conclusion

For the reasons discussed above, and in reliance on all the commitments made in connection with this proposal, and the conditions discussed in this order, the Board concludes that the proposal is not likely to result in decreased or unfair competition, conflicts of interests, unsound banking practices, undue concentration of resources, or other adverse effects. The Board expects, moreover, that the acquisition of Home Financial by First Union would provide added convenience to Home Financial's customers. In particular, Home Financial would be able to offer its customers additional products and services that are currently offered by First Union and its subsidiaries, including discount brokerage services, investment products, credit card services, trust services, management advice, and access to an extensive ATM network. Accordingly, the Board has determined that this proposal can reasonably be expected to produce public benefits that outweigh any adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Based on the foregoing and all other facts of record, including all the commitments made by First Union in connection with this proposal, the Board has determined that the application should be, and hereby is, approved. The Board's approval is expressly conditioned on compliance by First Union with all the commitments made in connection with this proposal and with the conditions referred to in this order. For purposes of this action, the commitments and conditions relied on by the Board in reaching this decision are deemed to be conditions imposed in writing and, as such, may be enforced in proceedings under applicable law.

This proposal shall not be consummated later than three months following the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of Richmond, acting pursuant to delegated authority.

By order of the Board of Governors, effective October 15, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Lindsey, Phillips, Yellen, and Meyer. Absent and not voting: Governor Kelley.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

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banking markets to permit First Union unilaterally to determine pricing policy for the banking industry in Florida or act as a price leader in the markets. The Board has concluded that First Union's prior acquisitions have not given it a dominant market position, and that other firms are likely to have sufficient capacity to prevent First Union from achieving a dominant market position. In addition, there is no evidence that First Union sets its fees on a basis prohibited under applicable fair lending or banking laws, and, in general, fair lending laws do not prohibit a depository institution from charging different fees in different parts of the country. The Board previously has provided Florida Protestant's comments to the OCC, the primary federal regulator of FUNB-FL, and the appropriate agency to determine whether the bank has violated the Equal Credit Opportunity Act (15 U.S.C. §§ 1691 *et seq.*).

The Governor and Company of the Bank of Ireland  
Dublin, Ireland

### Order Approving Notice to Engage in Nonbanking Activities

The Governor and Company of the Bank of Ireland, Dublin, Ireland ("BOI"), a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire a 50-percent equity interest in BBOI Worldwide LLC, Denver, Colorado ("Company"), a *de novo* joint venture company, and thereby engage in providing investment and financial advisory services under section 225.25(b)(4)(ii), (iii) and (iv) of Regulation Y (12 C.F.R. 225.25(b)(4)(ii), (iii) and (iv)) and administrative services to open-end investment companies ("mutual funds" or "funds").<sup>1</sup> BOI would hold its equity interest in Company through its subsidiary, Bank of Ireland Asset Management (U.S.) Limited, Dublin, Ireland ("BIAM"). The remaining 50 percent interest in Company would be held by Berger Associates, Inc., Denver, Colorado ("Berger").

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 49,462 (1996)). The time for filing comments has expired, and the Board has considered the notice and all comments received in light of the factors set forth in section 4(c)(8) of the BHC Act.

BOI, with total consolidated assets of approximately \$32.9 billion, is the 186th largest bank in the world, and the second largest banking organization in Ireland.<sup>2</sup> In the United States, BOI operates a branch in New York, New York, and owns 23.5 percent of the voting shares of Citizens Financial Group, Inc., Providence, Rhode Island.<sup>3</sup>

Both BIAM and Company are investment advisors registered with the SEC under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 *et seq.*) ("Advisers Act") and are subject to the recordkeeping and reporting obligations, fiduciary standards, and other requirements of the Advisers Act and the SEC. Initially, Company would provide advisory and administrative services to funds organized by Berger that would bear the name "Berger/BIAM" ("the Funds").<sup>4</sup>

1. Company would provide advisory services only to institutional customers as defined in Regulation Y. 12 C.F.R. 225.2(g).

2. Asset data are as of March 31, 1996. Foreign ranking data are as of December 31, 1995.

3. The subsidiary banks of Citizens Financial Group are Citizens Savings Bank and Citizens Trust Company, both of Providence, Rhode Island; Citizens Bank of Massachusetts, Boston, Massachusetts; and Citizens NH Bank, Manchester, New Hampshire.

4. The initial group of the Funds has been organized in a master-feeder structure in which several feeder funds may invest in a master portfolio ("Portfolio"). In providing services to the Funds, Company would enter into an investment advisory agreement and an administrative services agreement with each Portfolio. Company then would enter into a sub-advisory agreement with BIAM and a sub-

Berger also is an investment advisor registered with the SEC under the Advisers Act, and it provides discretionary investment management services to institutional clients, including mutual funds, pension and profit-sharing plans. Berger provides certain administrative, recordkeeping, and marketing services with respect to mutual funds for which Berger serves as investment advisor (“Berger Funds”). Berger is currently engaged in organizing and sponsoring mutual funds and plans to distribute funds through Berger Distributors, Inc. Berger has organized seven registered, open-end investment companies, with assets of \$3.4 billion, as of October 7, 1996.

The Board previously has determined by regulation that the investment advisory services that BOI proposes to conduct through Company are closely related to banking and permissible for bank holding companies under section 4(c)(8) of the BHC Act.<sup>5</sup> The Board also previously has determined that the administrative services BOI proposes to provide through Company are closely related to banking within the meaning of section 4(c)(8) of the BHC Act.<sup>6</sup> BOI has committed to conduct the proposed activities subject to the prudential and other limitations established by the Board in *Mellon*, except as discussed below.<sup>7</sup>

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administration agreement with Berger. The Funds would be distributed through Berger’s newly formed broker-dealer subsidiary, Berger Distributors, Inc., or through an independent distributor, and would not be “proprietary mutual funds” (funds sold primarily to customers of BOI). See *Barclays PLC*, 82 *Federal Reserve Bulletin* 158 at n. 7 (1996) (“*Barclays*”).

5. 12 C.F.R. 225.25(b)(4). BOI also proposes to advise customers on the purchase of contracts for the forward delivery of foreign currency to hedge foreign exchange exposure. BOI would provide this advice only in connection with advising a customer to purchase foreign-denominated securities. As proposed, this advice with respect to forward contracts is incidental to the provision of investment advice.

6. See *Mellon Bank Corporation*, 79 *Federal Reserve Bulletin* 626 (1993) (“*Mellon*”). The administrative services that Company would provide to mutual funds include computing the fund’s financial data, maintaining and preserving the records of the fund, accounting and recordkeeping, providing office facilities and clerical support for the fund, and preparing and filing tax returns and regulatory reports for the fund. A complete list of the proposed administrative services is included in Appendix A to this order.

7. Company also would provide telephone shareholder services through a toll-free number. BOI has committed that telephone service operators would not solicit callers to purchase shares in particular mutual funds and that substantive questions about mutual fund performance or strategies would be referred to specific mutual fund distributors or investment advisors. See *The Chase Manhattan Corporation*, 81 *Federal Reserve Bulletin* 883 at n. 52 (1995). BOI proposes that Company be permitted to prepare sales literature for mutual funds it administers. BOI has committed that Company would prepare such literature only at the direction and under the supervision of the distributor for the fund. Responsibility for use of the fund’s sales literature would remain with the distributor, which would be responsible for filing advertisements and sales literature with the National Association of Securities Dealers and for all decisions relating to marketing the fund and arranging for brokers to distribute shares of the fund. See *Barclays* at n. 8.

### *Glass–Steagall Act*

Under the Glass–Steagall Act, a company that owns a member bank may not control “through stock ownership or in any other manner” a company that engages principally in distributing, underwriting or issuing securities.<sup>8</sup> The Board previously has determined that the Glass–Steagall Act does not prohibit a bank holding company from serving as investment advisor to a mutual fund.<sup>9</sup>

In *Mellon*, the Board determined that the bank holding company would not control a mutual fund by virtue of serving as investment advisor to the fund, providing administrative services to the fund and having limited employee interlocks with the fund. The Board reasoned that control of the fund would rest with the board of directors of the fund, which would be wholly independent of Mellon. The Board noted that the policy-making authority for a fund rests with that fund’s board of directors, which, under the federal securities laws, must have a number of independent directors and is responsible for the selection and review of the investment advisor, underwriter and other major contractors with the fund. Mellon also committed that it would not have any director or officer interlocks with funds to which it provided both advisory and administrative services. The Board permitted Mellon to have one director interlock with a fund to which Mellon provided only administrative services (but not investment advisory services) on the rationale that the countervailing influence of an independent advisor, in addition to the presence of the independent directors on the fund’s board of directors, would not permit Mellon to control the fund.

This proposal differs from *Mellon* in the following ways. First, BOI proposes that two officers of Company serve on the 11-member board of trustees of funds for which Company will serve as both investment advisor and administrator. Second, BOI proposes that one of these officers also serve as president of the Funds. These officer and trustee interlocks are in addition to several employee interlocks that are consistent with the Board’s decision in *Mellon*.<sup>10</sup> In this case, despite the absence of an independent investment advisor, the Board does not believe that the proposed interlocks between Company and the Funds would compro-

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8. 12 U.S.C. §§ 221a and 377.

9. 12 C.F.R. 225.25(b)(4); 12 C.F.R. 225.125.

10. BOI proposes that up to three employees of Company assist in the administration of the Funds by serving as assistant secretary, assistant treasurer or assistant vice president of the Funds or Portfolio. Those employees would be supervised by the board of trustees and senior-level officers who, except for the proposed president discussed above, would not work for Company. Those employees would have no policy-making authority at the Funds or Portfolios, and would not be responsible for, or involved in, making recommendations regarding policy decisions. The Board believes that these interlocks, under the conditions described in this order, would not permit BOI to control the Funds.

BOI also proposes to acquire up to 5 percent of the shares of mutual funds for which it provides administrative, but not advisory, services. BOI has committed that such ownership would not be used in any way in marketing or selling the shares of the investment company. See *Mellon* at n. 21.

mise the independence of the boards of trustees of the Funds, or the independent distribution of the Funds, or result in control of the Funds by BOI.

As the Board noted in *Mellon*, under the Investment Company Act of 1940 (“1940 Act”), at least 40 percent of the board of directors of a mutual fund must be individuals who are not affiliated with the mutual fund, investment adviser or any other major contractor to the mutual fund.<sup>11</sup> The 1940 Act and related regulatory provisions require that independent directors annually review and approve the mutual fund’s investment advisory contract and any plan of distribution or related agreement.<sup>12</sup>

Under this proposal, a majority of the trustees of the Funds would be independent of BOI, Berger and Company. Any trustee of the Funds who also serves as an officer or employee of Company would be an “interested person” under the 1940 Act and, therefore, would be required to abstain from voting on the Funds’ investment advisory and other major contracts. In addition, BOI and Berger have committed that only disinterested persons would vote on the contract for administrative services provided to the Funds under the same requirements established for advisory contracts in the 1940 Act. Under these circumstances, the Board believes that the proposed director interlocks would not allow BOI to control the Funds.

The Board also does not believe that the proposed officer interlock between Company and the Funds would increase the ability of BOI to control the Funds in this case. The interlock involves the president of Berger, who, except for his position at Company would not otherwise be an officer, director, or employee of BOI or any of its subsidiaries. As the president of Berger, the officer could be expected to represent the interests of Berger in his positions with Company and the Funds. In this regard, Berger (which is not subject to the BHC Act or the Glass–Steagall Act) is not prohibited from controlling the mutual funds. With the exception of this interlock, there would be no senior officer interlocks between the Funds and BOI or any of its subsidiaries. Moreover, BOI has committed that there would be no other interlock between Berger and Company. The Board believes that, together with the countervailing influence of the independent trustees of the Funds, these facts mitigate the controlling influence that BOI could have on the Funds as a result of this interlock.

Based on the foregoing, the Board concludes that control of the Funds would rest with the independent members of the boards of trustees of the Funds or potentially with Berger, and that the proposed interlocks between Company and the Funds would not compromise the independence of the boards of the Funds or permit BOI to control the Funds. Thus, the Board concludes that this proposal is consistent with the Glass–Steagall Act.

### *Proper Incident to Banking Test*

In order to approve this proposal, the Board also must find that the performance of the proposed activities by BOI “can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.” 12 U.S.C. § 1843(c)(8).

In prior cases, the Board has expressed concern that joint ventures might lead to a matrix of relationships between co-venturers that could break down the legally mandated separation of banking and commerce.<sup>13</sup> The Board has found this concern to be particularly acute where, as here, the joint venture involves a relationship between a bank holding company and a securities firm, and the potential exists for the mingling of permissible and impermissible securities activities.<sup>14</sup>

As noted above, the Board has been concerned that interlocks and other relationships between a securities firm co-venturer and a joint venture company might cause the joint venture company to become engaged in impermissible securities activities. The Board, previously has permitted interlocks between a securities co-venturer and a joint venture company if the interlocks did not involve an officer or employee of the securities co-venturer whose responsibilities consist of selling, marketing, distributing, underwriting or dealing in any bank-ineligible securities, or overseeing the corporate affairs of any of the securities firm co-venturer’s mutual funds. The Board, however, has permitted a bank holding company directly to advise, administer and recommend to customers mutual funds that were sold primarily to customers of the bank holding company. The Board relied on the independence of the board of directors of the funds as well as the independence of the distributors of the funds to determine that the bank holding company was not engaged in impermissible securities activities.<sup>15</sup>

In this case, BOI proposes one officer interlock between Company and Berger in which the Berger officer also would provide investment advice to customers of Company and, unlike prior cases, would recommend to such customers shares of the Funds that are both sponsored and distributed by Berger. This officer is the president of Berger, a senior officer of Company, and trustee and president of the Funds. His responsibilities at Company would include the management of Company’s business and administrative issues, the implementation of new products and coordination of matters relating to the Funds and Company. BOI has committed that there would be no other dual officer or employees of Company and Berger.

11. 15 U.S.C. §§ 80a-2(a)(19) and 80a-10(a).

12. 15 U.S.C. § 15(c); Rule 12b-1(b).

13. See, e.g., *The Maybaco Company and Equitable Bancorporation*, 69 *Federal Reserve Bulletin* 375 (1983).

14. See *The Chuo Trust and Banking Company, Limited*, 78 *Federal Reserve Bulletin* 446 (1992); *Amsterdam-Rotterdam Bank, N.V.*, 70 *Federal Reserve Bulletin* 835 (1984).

15. See *Barclays*.

Notwithstanding these proposed relationships, the Board believes that this joint venture arrangement is not a means to permit BOI to control Berger or to avoid the BHC Act restrictions on the activities of bank holding companies, or result in adverse effects such as misleading customers of the joint venture. Berger is owned and controlled by Kansas City Southern Industries, Inc., and has operated as an investment advisor registered with the SEC for 23 years.<sup>16</sup> Neither BOI nor Company is obligated by any agreement to engage in any sales activities for any mutual fund shares or to enter into any distribution agreement with any mutual fund. Furthermore, BOI will not participate in any of the securities distribution activities prohibited for bank holding companies.<sup>17</sup> Berger Distributors, which would distribute the Funds, is controlled by Berger, and BOI has committed that there would be no interlocks between Berger Distributors and Company.

Moreover, BOI has made a number of commitments similar to those the Board has relied on in other joint venture cases intended to separate the activities of a bank holding company and a joint venture company from the impermissible activities of a securities co-venturer. The commitments include restrictions on BOI extending credit to or investing in Berger without first obtaining the Board's approval, having interlocks with Berger, and engaging in non-arm's length business transactions with Berger. BOI has committed that it will not nominate any director of Berger, and has indicated that, aside from Company, there will be no other significant business relationship between Berger and BOI. BOI also has committed that it will seek the Board's approval to retain its interest in Company in the event that Berger expands its activities beyond its current line of business. The Board believes that these

16. Berger provides discretionary investment management services to institutional clients. As of October 7, 1996, Berger had over \$3.8 billion in assets under management. In contrast to the international investment management services provided by BIAM, Berger's services are focused on U.S. investments. Berger also provides certain marketing, administrative and recordkeeping services to existing Berger funds. It does not underwrite, deal or make a market in bank-ineligible securities.

17. As noted above, BOI proposes that these funds bear the name "Berger/BIAM", reflecting the fact that Berger and BIAM would be providing services to the Funds. The Board's interpretive rule on investment advisory activities (12 C.F.R. 225.125) states that a bank holding company should not act as an investment advisor to an investment company that has a name that is similar to, or a variation of, the name of the holding company or any of its subsidiary banks. In this case, the name proposed is not identical to the name of the bank holding company or any of its subsidiary banks. "BIAM" is sufficiently distinct from "Bank of Ireland" and its use would not likely lead to customer confusion regarding the relationship between BOI and the Funds. The Board's interpretive rule on investment advisory activities requires that if a bank holding company recommends to customers shares of a mutual fund that the bank holding company advises it must caution customers to read the fund prospectus before investing and advise customers in writing that the fund's shares are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any bank, unless that happens to be the case. The holding company must also disclose in writing to the customer the role of the company or its affiliate as investment advisor to the fund.

commitments, coupled with the commitments BIAM has made regarding its relationship with Berger, lessen the likelihood that BOI could control Berger in order to engage in impermissible securities activities.

The Board notes that BOI also would take steps to mitigate concerns about the potential for customer confusion over the relationship between Berger and BOI that could result from the proposed interlocks. Company proposes to provide investment advice only to institutional investors. Company would provide to customers a number of disclosures designed to alert its customers to the relationships among Company, Berger and the Funds. The disclosures include those required by the Board's interpretive rule on investment advisory activities to address conflicts of interest that may be raised by these relationships.<sup>18</sup> Neither BOI nor Company, moreover, would broker shares of any funds for which BOI, Company or Berger acts as an investment advisor. On this basis, the Board believes that this proposal would not likely result in misleading customers of the joint venture.

Based on the foregoing, the Board finds that the proposed joint venture between Berger and BOI to provide advisory and administrative services would not result in Company engaging in any impermissible securities activity, and that the joint venture does not appear to present a framework in which BOI may exercise a controlling influence over the management, policies or affairs of Berger.

In every case involving the proposal of nonbanking activities by a bank holding company under section 4 of the BHC Act, the Board also must consider the financial and managerial resources of the applicant and its subsidiaries and the effect of the transaction on those resources.<sup>19</sup> In this case, the Board notes that BOI meets the relevant risk-based capital standards established under the Basle Accord and has capital equivalent to that which would be required of a U.S. banking organization. Based on these and other facts of record, the Board has determined that financial and managerial considerations are consistent with approval of this proposal.

The Board expects that *de novo* entry of Company into the market for the proposed services would provide added convenience to BOI's customers by offering an expanded range of products and investment management expertise and would increase the level of competition among existing providers of these services by offering an alternative to existing investment advisory firms. In addition, the Board previously has determined that the provision of administrative services to mutual funds within certain parameters is not likely to result in the types of subtle hazards at which the Glass-Steagall Act is aimed or any other adverse effects. There is no evidence in the record, moreover, that consummation of this proposal, subject to the commitments noted above, would result in any significantly ad-

18. See 12 C.F.R. 225.125.

19. 12 C.F.R. 225.24; *Barclays; The Fuji Bank, Limited*, 75 *Federal Reserve Bulletin* 94 (1989); *Bayerische Vereinbank AG*, 73 *Federal Reserve Bulletin* 155 (1987).

verse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices that are not outweighed by the benefits of this proposal.

On the basis of the foregoing and all the other facts of record, including the commitments made by BOI, the Board has determined that the performance of the proposed activities by Company reasonably can be expected to produce benefits to the public that would outweigh any possible adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Based on all the facts of record, including all the commitments and representations made by BOI, and subject to all of the terms and conditions set forth in this order, the Board has determined that the notice should be, and hereby is, approved. The Board's determination is subject to all the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, or to prevent evasion of, the provisions and purposes of the BHC Act and the Board's regulations and orders issued thereunder. The Board's decision is specifically conditioned on compliance with all the commitments and representations made in the notice, including the commitments and conditions discussed in this order. The commitments, representations, and conditions relied on in reaching this decision shall be deemed to be conditions imposed in writing by the Board in connection with its findings and decision, and, as such, may be enforced in proceedings under applicable law.

This proposal shall not be consummated later than three months after the effective date of this order, unless such period is extended for good cause by the Board or the Reserve Bank of Boston, acting pursuant to delegated authority.

By order of the Board of Governors, effective October 21, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Phillips, Yellen, and Meyer. Absent and not voting: Governor Lindsey.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

## Appendix A

- (1) Maintaining and preserving the records of the Portfolios and the Funds, including financial and corporate records.
- (2) Computing net asset value, dividends, performance data and financial information regarding the Funds.
- (3) Furnishing statistical and research data.
- (4) Preparing and filing with the SEC and state securities regulators registration statements, notices, reports and other materials required to be filed under applicable laws.

(5) Preparing reports and other informational materials regarding the Portfolios and the Funds, including proxies and other shareholder communications, and reviewing prospectuses.

(6) Providing legal and other regulatory advice to the Portfolios and the Funds in connection with their other administrative functions.

(7) Providing office facilities and clerical support for the Portfolios and the Funds.

(8) Developing and implementing procedures for monitoring compliance with regulatory requirements and compliance with the Portfolios' and the Funds' investment objectives, policies and restrictions as established by the trustees of the Portfolios and the Funds.

(9) Providing routine fund accounting services and liaison with outside auditors.

(10) Preparing and filing tax returns.

(11) Reviewing and arranging for payment of expenses of the Funds.

(12) Providing communication and coordination services with regard to the Portfolios' and the Funds' transfer agent, custodian, distributor and other service organizations that render recordkeeping or shareholder communication services.

(13) Reviewing and providing advice to the distributor and the Funds regarding sales literature and marketing plans to assure regulatory compliance.

(14) Providing information to the distributor's personnel concerning performance and administration of the Funds.

(15) Participating in seminars, meetings and conferences designed to present information to brokers and investment companies, but not in connection with the sale of shares of the Funds to the public, concerning the operations of the Funds, including administrative services provided by Company to the Funds.

(16) Assisting in the development of additional Portfolios and Funds.

(17) Providing reports to the trustees of the Portfolios and the Funds with regard to the activities of the Portfolios and the Funds.

(18) Providing telephone shareholder services through a toll-free 800 number.

## Appendix B

### *Investment Advisory Commitments*

(1) Except as authorized by a client of Company, no confidential information supplied by the client to Company will be made available to BOI or any of its subsidiaries or Berger.

(2) Company will disclose to each client of Company that Company is an affiliate of BOI and Berger.

(3) Advice by Company to any client on an explicit fee basis will be rendered without regard to correspondent balances maintained by that client at BOI or any depository institution subsidiary of BOI.

(4) Company's financial advisory activities will not encompass the performance of routine tasks or operations for a client on a daily or continuous basis, other than investment company administrative services.

(5) Company will not act as broker in connection with the purchase or sale of, and will not purchase in its sole discretion in a fiduciary capacity, any securities of any Fund or any Berger Fund which invests in variable or fixed rate annuities.

#### *Administrative Services Commitments*

(6) BOI and its subsidiaries, including Company, will not provide administrative services to any U.S. registered open-end investment company<sup>1</sup> that is marketed or sold primarily to customers of BOI or any of its subsidiary banks.

(7) Neither BOI nor any of its affiliates, including Company, will be obligated by any agreement to engage in any sales activities with regard to shares of any U.S. registered open-end investment company and will not enter into any distribution agreement with any such investment company without the prior approval of the Board.

(7A) Company will not engage in the development of marketing plans for any U.S. registered open-end investment company except to give advice to the distributor of such investment company regarding regulatory compliance. Company will not engage in advertising activities with respect to such investment companies. Company personnel may present information about the operations of such an investment company at meetings or seminars for brokers of such an investment company, but sales activities, if any, at such events will be conducted solely by the distributor or another broker-dealer (which will not be an affiliate of BOI) of the investment company.

(7B) Company may prepare sales literature for a U.S. registered open-end investment company only at the direction and under the supervision of its distributor. Responsibility for use of such investment company's sales literature will remain with its distributor, which will be responsible for filing advertisements and sales literature with the National Association of Securities Dealers and for all decisions relating to marketing such investment company and arranging for brokers to distribute shares of such investment company.

(7C) In providing telephone shareholder services through a toll-free 800 number in respect of any U.S. registered open-end investment company, Company will not solicit callers to purchase shares in any such investment company and will refer to the distributor of such investment company any substantive questions regarding the performance of such investment company. Company may refer to BIAM questions regarding the composition of the portfolio of the

investment company, BIAM's investment approach and outlook, and the role of BIAM in relation to the investment company, *provided* that BIAM personnel will not solicit callers to invest in the investment company, respond to requests for investment advice by callers, or answer substantive questions about the performance of the investment company.

(8) Company will provide administrative services only to U.S. registered open-end investment companies whose boards of directors consist of a majority of disinterested persons.

(9) Except to the extent permitted under Regulation Y as such regulation may be amended from time to time:

(i) BOI and its subsidiaries (including Company) will not purchase for their own account shares of any U.S. registered open-end investment company to which BOI or any of its subsidiaries, including Company, provide advisory services, and

(ii) In the event that BOI or any of its subsidiaries provide administrative services, but not advisory services, to a U.S. registered open-end investment company, BOI or its subsidiaries may purchase up to 5 percent of such an investment company's shares, *provided* that such ownership of the investment company not be used in any way in marketing or selling the shares of the investment company.

(9A) Any Administrative Services Agreement or Sub-administration Agreement, and any amendment thereto, will be approved by vote of a majority of the Independent Trustees (*i.e.*, the same vote required for approval of Investment Advisory Agreements). Any agreement between Company and any other U.S. registered open-end investment company, pursuant to which Company provides administrative services, will be approved by a vote of a majority of the trustees or directors of such investment company who are not "interested persons," as such term is defined in the Investment Company Act, if any members of the Board of Managers, officers or employees of Company serve as trustees or directors of such investment company.

#### *Joint Venture Commitments*

(10) The name of Company will not include the words "Berger Associates, Inc." or "Berger."

(11) Neither Berger nor any director, officer, or employee of Berger will:

(i) To the knowledge of BOI, acquire any stock or interest in, or

(ii) Serve concurrently as a director, officer or employee of, BOI or any subsidiary of BOI (other than Company).

In addition, BOI will not acquire any stock or interest in, or have any directors or management officials on the board or committees of, Berger (other than Company); nor shall BOI's name be used by Berger or Berger's name by BOI or any of its affiliates, other than in connection with the activities of Company.

1. References to a "U.S. registered open-end investment company" mean any open-end investment company (mutual fund):

- (i) Organized in the United States,
- (ii) Offered in the United States, or
- (iii) Sold to U.S. residents.

(12) BOI will apply for the Board's prior approval to retain its investment in Company should Berger expand into a line of business other than the businesses it currently engages in. If required by the Board in such circumstances, BOI will divest its investment in Company.

(13) The offices of Berger and Company will have separate entrances.

(14) The names of customers of any of BOI's U.S. subsidiaries, including any branches, agencies or other depository institutions (but not including Company), will not be furnished to Berger.

(15) BOI and its subsidiaries will not act as registrar, transfer agent or custodian for any of the Portfolios, the Funds or the Berger Funds, *provided* that BOI may serve as foreign sub-custodian for Irish securities of the Portfolios pursuant to arrangements with the U.S. custodian of the Portfolios in accordance with Rule 17f-5 under the Investment Company Act.

(16) BOI and its subsidiaries will not, directly or indirectly:

(i) Engage in the public sale or distribution of, or purchase for their own account, any shares of the Funds or the Berger Funds, or

(ii) Whether as underwriter, dealer, or in any other capacity, purchase for their account from Berger any securities as to which Berger is acting as underwriter or dealer.

In addition, the U.S. branches, agencies and subsidiaries of BOI will not, directly or indirectly, engage in the public sale or distribution of, or purchase for their account, any security as to which Berger is acting as an underwriter.

(16A) No director, officer or employee of Berger Distributors, Inc., will serve as a member of the Board of Managers, officer or employee of Company.

(17) Neither BOI nor any of its subsidiaries (including Company) will:

(i) Purchase in its sole discretion any securities of the Funds or the Berger Funds in a fiduciary capacity (including as managing agent) unless the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered, or

(ii) Except to the extent permitted under Regulation Y as such regulation may be amended from time to time, extend credit to any such Fund or Berger Fund or accept securities of any such Fund or Berger Fund as collateral for a loan which is for the purpose of purchasing securities of any such Fund or Berger Fund.

(18) BOI and any subsidiary of BOI will obtain the Board's prior approval before making any investments in or loans to Berger, and will not nominate any director of Berger.

(19) No U.S. office of BOI or any of BOI's U.S. subsidiaries will take into account the fact that a potential borrower competes with Company or Berger in determining whether to extend credit to that borrower.

(20) No office of BOI or any of BOI's subsidiaries will

extend credit directly or indirectly to Company or to any customer of Company on terms more favorable than those afforded similar borrowers in similar circumstances.

(21) Company will not solicit customers of the Berger Funds in their capacity as customers of the Berger Funds and Company will not request or accept access to the customer lists of any Berger Fund.

(22) Company will provide advice only to "institutional customers" as that term is defined in section 225.2(g) of Regulation Y and as that term may be amended from time to time.

(23) None of the dual employees of Company and BOI or its subsidiaries will be engaged in bank-ineligible securities activities, or activities that are impermissible for bank holding companies.

(23A)(i) No more than two members of the Board of Managers, officers or employees of Company will serve as Trustees of the Funds or the Portfolios;

(ii) No more than one of such members of the Board of Managers, officers or employees will serve as a senior officer of the Funds or the Portfolios and any person serving as such senior officer will also be a director, officer or employee of Berger and will not be a director, officer or employee of BOI or its subsidiaries (other than the Company); and

(iii) (A) No more than three officers or employees of Company will serve in junior-level capacities as assistant secretary, assistant treasurer or assistant vice president of the Funds or the Portfolios,

(B) Such persons will have no policy-making authority, and will not be responsible for, or involved in making recommendations regarding, policy-making functions, and

(C) Such persons may perform administrative services for the Funds or the Portfolios, but will be supervised by senior-level officers who do not work for Company as well as by the appropriate Boards of Trustees of the Funds or the Portfolios.

Except as described in this commitment, there will be no other director, officer or employee interlocks between BOI or its subsidiaries (including the Company) and the Funds or the Portfolios.

(23B) The restrictions in Commitment 23A shall apply to any other U.S. registered open-end investment company for which Company provides investment advisory or administrative services.

(23C) No more than one director, officer or employee of Berger will serve as a member of the Board of Managers, officer or employee of Company.

(24) As a subsidiary of a bank holding company, Company will observe the anti-tying provisions of the BHC Act Amendments of 1970 to the extent required under Regulation Y as such regulation may be amended from time to time. Company will be an affiliate of BOI's U.S. bank and thrift subsidiaries for purposes of sections 23A and 23B of the Federal Reserve Act.

(24A) BOI and its U.S. subsidiaries (including Company)



will not provide brokerage services to customers in the U.S. with respect to the shares of a U.S. registered open-end investment company for which BOI, any of its non-bank subsidiaries (including Company), Berger or any of Berger's subsidiaries acts as an investment adviser.

(25) In the event that BOI or any of its U.S. nonbank subsidiaries (including Company) provides investment advisory services to customers in the U.S. with respect to the shares of an investment company for which BOI, any of its nonbank subsidiaries (including Company), Berger or any of Berger's subsidiaries acts as an investment adviser:

(i) BOI will instruct its officers and employees, and the officers and employees of such U.S. nonbank subsidiaries, to:

(A) Caution customers to read the prospectus of the investment company before investing, and

(B) Advise customers in writing that the investment company's shares:

(1) Are not insured by the Federal Deposit Insurance Corporation, are not deposits, and are not obligations of, or endorsed or guaranteed in any way by, any bank, unless that is the case; and

(2) Are subject to investment risks, including possible loss of the principal invested; and

(ii) BOI or such U.S. nonbank subsidiary will disclose in writing to the customer the appropriate entity's role as adviser to the investment company, as well as the existence of any fees, penalties and surrender charges with respect to the investment company's shares; *provided* that the disclosures described in this commitment (ii) may be made orally so long as written disclosure is provided to the customer immediately thereafter.

(26) Neither Company nor any affiliated U.S. bank, thrift, branch, or agency shall express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by Berger unless Company or the affiliate notifies the customer that Berger is underwriting, making a market, distributing or dealing in the security, and that Company is an affiliate of Berger.

(27) Neither Company nor any U.S. bank, thrift, branch, agency, trust or investment adviser affiliated with BOI shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which it has investment discretion ineligible securities:

(i) Underwritten by Berger as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof, and

(ii) From Berger if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the relationship is administered.

(28) All business transactions between BOI and Berger (other than with respect to Company) will be on an arm's-length, non-exclusive, and non-preferential basis. Other

than through Company, BOI will not solicit any business for Berger or vice versa, and there will be no advertising or marketing of each other's services. Neither BOI nor its subsidiaries will refer customers to Berger, and Berger will not refer customers to BOI or its subsidiaries, in each case except for referrals to and by Company.

(29) BOI and its subsidiaries (except for Company) will not distribute prospectuses or sales literature for the Funds or the Berger Funds or make any such literature available to the public at any of their offices.

(30) None of the Portfolios, Funds or Berger Funds will have offices in any building which is likely to be identified in the public's mind with BOI or its subsidiaries (except for Company).

#### *Orders Issued Under Sections 3 and 4 of the Bank Holding Company Act*

River Valley Bancorp  
Madison, Indiana

#### *Order Approving the Formation of a Bank Holding Company*

River Valley Bancorp ("River Valley") has requested the Board's approval under section 3 of the Bank Holding Company Act ("BHC Act") to become a bank holding company by acquiring approximately 96 percent of the voting shares of Citizens National Bank of Madison ("Bank"), all in Madison, Indiana. River Valley also has requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to:

(1) Acquire all the voting shares of Madison First Federal Savings and Loan Association, also in Madison, Indiana ("Madison Savings"),<sup>1</sup> and thereby engage in the operation of a savings association pursuant to section 225.25(b)(9) of Regulation Y (12 C.F.R. 225.25(b)(9)); and

(2) Engage *de novo* in making, acquiring, and servicing loans pursuant to section 225.25(b)(1) of Regulation Y (12 C.F.R. 225.25(b)(1)).

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (61 *Federal Register* 43,361 (1996)). The time for filing comments has expired, and the Board has considered the proposal and all comments received in light of the factors set forth in sections 3(c) and 4(c)(8) of the BHC Act.

River Valley is a nonoperating corporation that would acquire Madison Savings shortly before acquiring Bank. Bank is the 165th largest depository institution in Indiana, controlling \$42.4 million in deposits, representing less than

1. The Office of Thrift Supervision has approved Madison Savings's request to convert from a federal mutual savings and loan association to a federal stock savings and loan association.

1 percent of total deposits in commercial banking organizations in the state.<sup>2</sup> Madison Savings is the 108th largest depository institution in Indiana, controlling \$79.7 million in deposits, representing less than 1 percent of total deposits in depository institutions in the state. On consummation of the proposal, River Valley would become the 76th largest depository institution in Indiana, controlling deposits of \$122.1 million.

The Board previously has determined by regulation that the operation of a savings association by a bank holding company is closely related to banking for purposes of section 4(c)(8) of the BHC Act. River Valley has committed to conform all activities of Madison Savings to those permissible under section 4(c)(8) of the BHC Act and Regulation Y.<sup>3</sup> The Board also has determined by regulation that the proposed lending activities are closely related to banking within the meaning of section 4(c)(8) of the BHC Act. River Valley has committed to conduct these activities subject to the limitations in Regulation Y.

### Competitive Considerations

Sections 3 and 4 of the BHC Act require the Board to consider the competitive effects of a proposed acquisition of a depository institution.<sup>4</sup> River Valley proposes to acquire two depository institutions—Madison Savings and Bank—that compete directly in the Madison, Indiana, banking market (“Madison banking market”).<sup>5</sup> Madison

Savings is the fourth largest depository institution in the Madison banking market, controlling approximately \$79.7 million of the total deposits in depository institutions in the market (“market deposits”), representing 11.7 percent of market deposits.<sup>6</sup> Bank is the third largest depository institution in the market, controlling approximately \$42.4 million in deposits. On consummation of this proposal, River Valley would become the second largest depository institution in the Madison banking market. River Valley would control approximately 32 percent of market deposits and the Herfindahl–Hirschman Index (“HHI”) would increase by 329 points to a level of 2680.<sup>7</sup>

In order to mitigate the adverse competitive effect that might result from consummation of the proposal, River Valley has committed to divest at least one branch in the Madison banking market with deposits totalling at least \$7.5 million.<sup>8</sup> River Valley has committed to sell the

2. All banking data are as of June 30, 1995, and have been adjusted to reflect mergers and acquisitions since that date. In this context, depository institutions include commercial banks, savings banks, and savings associations.

3. River Valley has committed that all impermissible real estate activities will be divested or terminated within two years of consummation of the proposal, that no new impermissible projects or investments will be undertaken during this period, and that capital adequacy guidelines will be met, excluding specified real estate investments. River Valley also has committed that any impermissible securities or insurance activities conducted by Madison Savings will cease on or before consummation.

4. See Section 3 of the BHC Act (12 U.S.C. § 1842(c)), which prohibits the Board from approving an application if the proposal would result in a monopoly, or if the proposal would substantially lessen competition in any relevant banking market, unless such anti-competitive effects are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served; and Section 4 of the BHC Act (12 U.S.C. § 1843(c)(8)), which requires the Board to consider whether a proposal is likely to result in any significantly adverse effects, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

5. The Madison banking market is approximated by Jefferson County, Indiana, and Trimble County, Kentucky. The Board has considered River Valley’s contention that the relevant banking market also includes Carroll County, Kentucky, which is located to the east of Trimble County, in light of relevant precedent and all the facts of record. The Board and the courts have found that the relevant banking market for analyzing the competitive effect of a proposal must reflect commercial and banking realities and should consist of the local area where the depository institutions involved offer their services and where local customers can practicably turn for alternatives. See

*St. Joseph Valley Bank*, 68 *Federal Reserve Bulletin* 673, 674 (1982). The key question to be considered in making this selection “is not where the parties to the merger do business or even where they compete, but where, within the area of competitive overlap, the effect of the merger on competition will be direct and immediate.” *United States v. Philadelphia National Bank*, 374 U.S. 321, 357 (1963); *United States v. Phillipsburg National Bank*, 399 U.S. 350, 364–65 (1969). The Board believes that the appropriate market for analyzing the competitive effects of this proposal is the banking market approximated by Jefferson and Trimble Counties. The Board bases this conclusion on an analysis of employment commuting data, the shopping opportunities available to Trimble County residents in Madison, Indiana, which is the largest city in the market and connected to Trimble County by a bridge over the Ohio River, and the results of an informal survey of local bankers in Trimble County regarding competition with a bank that serves Madison and areas of Trimble County. The Board notes that other facts of record indicate that Carroll County residents are unlikely to commute to Jefferson or Trimble Counties for employment or shopping because of the greater distance to Madison and the presence of Carrollton, the second largest city in the three-county area, in Carroll County.

6. Market deposit data are as of June 30, 1996. Market share data are based on calculations in which the deposits of thrift institutions are included at a 50-percent weighted basis. The Board previously has indicated that thrift institutions have become, or have the potential to become, major competitors of commercial banks. See *Midwest Financial Group*, 75 *Federal Reserve Bulletin* 386 (1989); *National City Corporation*, 70 *Federal Reserve Bulletin* 743 (1984). Thus, the Board has regularly included thrift deposits in the calculation of market share on a 50-percent weighted basis. See, e.g., *First Hawaiian Inc.*, 77 *Federal Reserve Bulletin* 52 (1991). Because the deposits of Madison Savings would be acquired by a commercial banking organization under this proposal, these deposits are included at 100 percent in the calculation of River Valley’s *pro forma* market share. *Norwest Corporation*, 78 *Federal Reserve Bulletin* 452 (1992).

7. Under the revised Department of Justice Merger Guidelines, 49 *Federal Register* 26,823 (June 29, 1984), a market in which the post-merger HHI is above 1800 is considered highly concentrated. The Department of Justice has informed the Board that a bank merger or acquisition generally will not be challenged (in the absence of other factors indicating anticompetitive effects) unless the post-merger HHI is at least 1800 and the merger increases the HHI by at least 200 points. The Justice Department has stated that the higher than normal HHI thresholds for screening bank mergers for anticompetitive effects implicitly recognize the competitive effect of limited-purpose lenders and other non-depository financial entities.

8. River Valley has committed to execute a sales agreement to accomplish this divestiture before consummation of this proposal and

branch to an out-of-market depository institution or to one of the two competitors in the market that each control less than 5 percent of market deposits. Under the terms of the commitment, River Valley would not control more than approximately 30 percent of market deposits, and the HHI would not increase by more than 258 points to 2609.<sup>9</sup>

At least six depository institutions would remain in the market, the largest of which is a subsidiary of one of the largest commercial banking organizations in the region. This institution currently controls approximately 41.3 percent of market deposits. Data also indicate that the Madison banking market has become less concentrated and more competitive in recent years. During the last five years, for example, the HHI for the market has decreased by 879 points, and market deposits for the largest institution in the market have decreased by approximately 12 percentage points. During the same period, three smaller competitors in the market each have increased their market deposits by 3 to 5 percent.

In accordance with the BHC Act, the Board sought comments from the Department of Justice (“DOJ”), the Office of the Comptroller of the Currency (“OCC”), the Office of Thrift Supervision (“OTS”), and the Federal Deposit Insurance Corporation (“FDIC”) on the competitive effects of the proposal. The DOJ advised the Board that consummation of the proposal would not likely have any significantly adverse effects on competition in any relevant banking market, and has not objected to consummation of the proposal.<sup>10</sup> Based on all the facts of record and for the reasons discussed in this order, the Board concludes that consummation of the proposal is not likely to have a significantly adverse effect on competition or on the concentration of resources in the Madison banking market or in any relevant banking market.

#### *Other Considerations*

In light of all the facts of record, the Board concludes that the financial and managerial resources and future prospects of the institutions involved are consistent with approval, as are considerations relating to the convenience and needs of the community to be served and other supervisory factors. For the reasons discussed above, and in reliance on all the

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to complete the divestiture within 180 days of consummation. River Valley also has committed that, if it is unsuccessful in completing the divestiture within 180 days of consummation, it will transfer the unsold branch to an independent trustee that is acceptable to the Board and that will be instructed to sell the assets promptly. In addition, River Valley has committed to submit an executed trust agreement acceptable to the Board stating the terms of the divestiture within 150 days of consummation of the acquisition if the sale of the branch has not been consummated at that time.

9. Divestiture to an out-of-market thrift would increase the HHI by 258 points to 2609, and divestiture to an out-of-market commercial bank would increase the HHI by 210 points to 2561. Divestiture to the larger of the two in-market competitors would increase the HHI by 223 points to 2574 and divestiture to the smaller in-market competitor would increase the HHI by 219 points to 2570.

10. The OCC, OTS, and FDIC also have not objected to consummation of this proposal.

commitments made in connection with the proposal, the Board also concludes that the proposal is not likely to result in decreased or unfair competition, conflicts of interests, unsound banking practices, undue concentration of resources, or other adverse effects. In addition, the record in this case indicates that there are numerous competitors engaged in the lending activities proposed by River Valley. The Board expects, moreover, that the proposal would result in efficiencies and economies of scale and, accordingly, enable River Valley to provide increased convenience and improved services to the customers of Bank and Madison Savings such as access to a broader array of banking products and services than currently is offered by either institution individually. Accordingly, the Board has determined that the proposal can be expected to produce public benefits that outweigh any adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

#### *Conclusion*

Based on the foregoing and all the facts of record, including the proposed divestiture, the Board has determined that the proposal should be, and hereby is, approved. The Board’s approval is specifically conditioned on compliance by River Valley with the divestiture commitment and other commitments made in connection with the proposal. The Board’s determination also is subject to all the conditions in Regulation Y and to the Board’s authority to require such modification or termination of the activities of a holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, or to prevent evasion of, the provisions and purposes of the BHC Act and the Board’s regulations and orders issued thereunder. The commitments and conditions relied on by the Board in reaching this decision are deemed to be conditions imposed in writing by the Board in connection with its findings and decision, and, as such, may be enforced in proceedings under applicable law.

The acquisition of Bank shall not be consummated before the fifteenth calendar day following the effective date of this order, and the acquisition of Bank and Madison Savings shall not be consummated, and the proposed lending activities of River Valley shall not commence, later than three months following the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of St. Louis, acting pursuant to delegated authority.

By order of the Board of Governors, effective October 28, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Phillips, Yellen, and Meyer. Absent and not voting: Governor Lindsey.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

*ORDERS ISSUED UNDER BANK MERGER ACT*

The Chase Manhattan Bank  
New York, New York

*Order Approving the Merger of Banks and Establishment of Bank Branches*

The Chase Manhattan Bank, New York, New York ("Chase Bank"), a state member bank, has requested the Board's approval under section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. § 1828(c)) (the "Bank Merger Act") to merge with Chemical Bank New Jersey, N.A., Morristown, New Jersey ("CBNJ"), with Chase Bank surviving the merger. As part of the transaction, Chase Bank also has applied under section 9 of the Federal Reserve Act (12 U.S.C.321) to establish branch offices at the current locations of the CBNJ branches.<sup>1</sup>

Notice of this proposal, affording interested persons an opportunity to submit comments, has been given in accordance with the Bank Merger Act and the Board's Rules of Procedure (12 C.F.R. 262.3(b)). As required by the Bank Merger Act, reports on the competitive effects of the merger were requested from the United States Attorney General, the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation. The time for filing comments has expired, and the Board has considered the proposal and all the facts of record, in light of the factors set forth in the Bank Merger Act and section 9 of the Federal Reserve Act.

Chase Bank and CBNJ are wholly owned subsidiaries of The Chase Manhattan Corporation, New York, New York ("Chase").<sup>2</sup> Chase is the largest commercial banking organization in New York, controlling deposits of approximately \$75 billion, representing 30.3 percent of the total deposits in commercial banking organizations in New York. In New Jersey, Chase is the sixth largest commercial banking organization, controlling deposits of approximately \$5 billion, representing 5.7 percent of the total deposits in commercial banking organizations in New Jersey.<sup>3</sup>

*Riegle-Neal Act Analysis*

Section 102 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal Act") (Pub. L. No. 103-328, 108 Stat. 2338 (1994)) authorizes banks, after June 1, 1997, to conduct interstate mergers and

1. The locations of the branches that Chase proposes to establish are listed in the Appendix.

2. On January 5, 1996, the Board approved the merger of Chemical Banking Corporation ("Old Chemical") and The Chase Manhattan Corporation ("Old Chase"), both of New York, New York. See *Chemical Banking Corporation*, 82 *Federal Reserve Bulletin* 239 (1996) ("Chemical/Chase Order"). The resulting bank holding company is known as The Chase Manhattan Corporation, and Chase Bank was formed by a merger of the two lead banks of Old Chemical and Old Chase.

3. Deposit data are as of June 30, 1995.

to convert the acquired bank offices into branches of the acquiring institution. The Riegle-Neal Act, however, provides that an interstate merger may be approved prior to June 1, 1997, "if the home state of each bank involved in the transaction has in effect, as of the date of the approval of such transaction, a law that:

- (i) Applies equally to all out-of-state banks; and
- (ii) Expressly permits interstate merger transactions with all out-of state banks."<sup>4</sup>

New York and New Jersey have adopted laws, which apply equally to all out-of-state banks, that allow interstate mergers between banks located in their states and out-of-state banks to occur prior to June 1, 1997.<sup>5</sup> An application requesting approval of this proposal is pending with the New York Superintendent of Banks.<sup>6</sup> In light of the foregoing, it appears that this proposal complies with the New York and New Jersey interstate banking laws.

*Competitive Considerations*

The Bank Merger Act provides that the Board may not approve an application if the effect of the acquisition of another bank is to substantially lessen competition in any section of the country unless the Board finds that the anticompetitive effects of the proposal are clearly outweighed in the public interest by the probable effect of the proposal in meeting the convenience and needs of the community.<sup>7</sup> The proposal represents a reorganization of Chase's existing banking operations. Based on all the facts of record, consummation of the proposal would not have any significantly adverse effects on competition or concentration of banking resources in any relevant banking market.

*Other Factors Under the Bank Merger Act*

The Bank Merger Act also requires the Board to consider the financial and managerial resources and future prospects

4. 12 U.S.C. § 1831u(a)(3)(A) (1994).

5. The interstate banking laws of New Jersey provide that an out-of-state bank may establish branches of a New Jersey state bank acquired by acquisition or merger provided that the state has not opted out of the provisions concerning interstate branching. N.J. Stat. Ann. § 17:9A-148 (1996). Effective February 6, 1996, the New York Banking Law was amended to authorize state-chartered banks to merge with out-of-state banks, and subsequently maintain as branch offices the main office and branches acquired by merger or acquisition. N.Y. Banking Law §§ 600(6), 105(5)(a) (1996). In addition, an out-of-state branch may maintain one or more branches located in New York acquired by means of an acquisition transaction, if the superintendent finds that the laws of the out-of-state bank's home state would authorize a New York bank to maintain branches in that state under comparable circumstances. *Id.* at § 223.

6. New Jersey does not require an application for mergers involving a national bank unless the surviving bank is a New Jersey state-chartered bank.

7. 12 U.S.C. § 1828(c)(5)(B).

of the existing and proposed institutions, and the convenience and needs of the community to be served.<sup>8</sup>

### A. Supervisory Factors

The Board carefully has considered the financial and managerial resources and future prospects of Chase and its subsidiaries in light of all the facts of record, including a review of confidential reports of examination prepared by the primary federal supervisors of the organizations assessing the financial and managerial resources of the organizations. The Board notes that the proposal represents a corporate reorganization of Chase and its subsidiaries which will result in a more efficient organization, and does not involve an expenditure of additional resources. Based on all the facts of record, the Board concludes that these considerations for the organizations involved in the proposal are consistent with approval.<sup>9</sup> The Board also concludes that

8. Inner City Press/Community on the Move, Bronx, New York ("Protestant") contends that the Chemical/Chase Order misanalyzed and misinterpreted a number of issues raised by the merger of Old Chemical and Old Chase, including the potential anticompetitive effects of the merger, the impact of the announced branch closings on low- to moderate-income ("LMI") communities and communities with predominantly minority populations, the reliability of the data submitted under the Home Mortgage Disclosure Act ("HMDA") relating to loans made through the New York City Housing Partnership, and Chase's luxury auto lending, which Protestant maintains has the effect of excluding LMI and minority borrowers. In addition, Protestant argues that the availability of new information since the Chemical/Chase Order, including Chase's HMDA data for 1995, criticisms by the General Accounting Office of examiner fair lending training and enforcement policies of the federal financial supervisory agencies, and Chase's characterization of certain branch closings as not in connection with the merger, require the Board to reconsider the conclusions reached in the Chemical/Chase Order on these issues. As explained in the Chemical/Chase Order, the Board concluded, on the basis of all the facts of record, that the proposal met the competitive, convenience and needs, and other statutory factors the Board is required to consider and should be approved. The Board has already denied Protestant's request that the Board reconsider its decision in the Chemical/Chase merger.

9. Protestant maintains that certain aspects of Chase's operations raise adverse managerial considerations, including trading in unregistered copper futures by Chase Bank, problems with Automated Teller Machine ("ATM") services and billing errors in Chase's secured credit card program, and the departure of mid- and high-level management from Chase. Protestant also alleges that Chase made several misleading and inaccurate media announcements regarding branch closings in LMI areas and specific branch closings in Westchester County. For example, Protestant cited press reports stating that Chase would not close any branches in Westchester County before Chase subsequently gave notice to close two branches in the county. Protestant's allegations regarding the closure of LMI branches are discussed below, and the Board notes that neither of the Westchester County branches proposed for closure is located in a LMI neighborhood. The Board also has received comments from an individual who is generally opposed to the proposal and from another individual who is seeking information regarding certain monies allegedly owed to him by a number of government entities. The Board has reviewed all of these allegations in light of supervisory assessments of Chase's managerial resources. The Board also has reviewed the Federal Reserve System's discussions with the New York City Housing Partnership ("NYCHP") referenced in the Chemical/Chase Order. As a result of

all factors required to be considered under the Federal Reserve Act are consistent with approval.

### B. Convenience and Needs Factor

The Board has long held that consideration of the convenience and needs factor includes a review of the records of the relevant depository institutions under the Community Reinvestment Act (12 U.S.C. § 2901 *et seq.*) ("CRA"). As provided in the CRA, the Board has evaluated this factor in light of examinations by the primary federal supervisors of the CRA performance records of the relevant institutions. As noted above, this proposal represents a reorganization of Chase's existing banking operations, and would not result in any expansion of Chase's deposit-taking facilities.

The Board also has carefully considered comments from Protestant alleging that Chase has abandoned LMI areas through branch closings since the Chemical/Chase merger.<sup>10</sup> In addition, Protestant contends that 1995 HMDA data for Chase indicate some disparities in the rate of denials and originations for housing-related loans by racial groups.<sup>11</sup>

An institution's most recent CRA performance evaluation is a particularly important consideration in the applications process because it represents a detailed on-site evaluation of the institution's overall record of performance under the CRA by its primary federal supervisor.<sup>12</sup> In addition, the Board considers an institution's policies and practices for compliance with applicable fair lending laws. The Board also takes into account information on an institution's lending activities that assist in meeting the credit needs of low- and moderate-income neighborhoods, in-

these discussions, the NYCHP will send adverse action letters to applicants deemed ineligible for the program.

10. Protestant also contends that Chase has not opened the branches and ATMs in LMI areas identified in connection with the Board's approval of the Chemical/Chase Order and has not made any progress in connection with the CRA commitment discussed in the Chemical/Chase Order. The Board notes that the merger of Old Chemical and Old Chase, which involved two of the largest domestic bank holding companies, was not consummated until July 14, 1996, and that Chase has already begun to implement the programs and policies discussed in the Chemical/Chase Order. Chase's announced CRA commitment discussed in the Chemical/Chase Order also provides that Chase will issue annual public announcements on its performance and will meet with interested groups periodically to discuss its performance in local communities.

11. Protestant objects to the pending request filed by The Chase Manhattan Bank (USA), Wilmington, Delaware ("Chase Delaware"), to be designated as a limited-purpose bank under the new regulations jointly promulgated by the federal financial supervisory agencies to implement the CRA, because the bank offers a wide variety of credit products. See 60 *Federal Register* 22,156 (May 4, 1995). The OCC, Chase Delaware's primary federal supervisor, is responsible for acting on the requested designation, and such requests are not reviewable by the Board. See 12 C.F.R. 25.25(b).

12. The Board notes that the Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act provides that a CRA examination is an important and often controlling factor in the consideration of an institution's CRA record and that reports of these examinations will be given great weight in the applications process. 54 *Federal Register* 13,742, 13,745 (1989).

cluding programs and activities initiated since its most recent CRA performance examination.

*Performance Examinations.* Chase Bank has not been evaluated for CRA performance since the merger of Old Chemical and Old Chase in July 1996. Prior to the merger, Old Chemical's lead bank was rated "outstanding" by the Federal Reserve Bank of New York at its most recent examination for CRA performance, as of March 13, 1995 ("1995 Chemical Examination"). Old Chase's lead bank also received an overall CRA performance rating of "outstanding" from its primary federal supervisor, the Office of the Comptroller of the Currency ("OCC") at its most recent examination for CRA performance, as of October 27, 1995 ("1995 Chase Examination").<sup>13</sup> CBNJ received a "satisfactory" rating from the OCC at its most recent examination for CRA performance, as of December 7, 1995 ("CBNJ Examination"). All other subsidiary banks of Old Chemical and Old Chase received "outstanding" or "satisfactory" ratings at the most recent examinations of their CRA performance by their primary federal supervisors.

*Branch Openings and Closings.* Protestant alleges that Chase has abandoned LMI communities since the Chemical/Chase merger. The Board notes that Protestant's contentions generally relate to branch closings resulting from the Chemical/Chase transaction, and that Chase has not proposed the closure of any branches as a result of this proposal.

Chase previously announced that it would close seven branches that it operates in LMI census tracts in New York City in connection with the Chemical/Chase merger. The record indicates that, as of August 1996, Chase had given notice to close only one of these branches located in LMI census tracts. The Board notes that Chase has also closed one additional branch located in an LMI census tract in New York City that had not been disclosed in the Chemical/Chase application. This branch is located in an LMI census tract in Queens ("LMI Branch"). The Board has considered Protestant's contention that Chase misrepresented the number of branches to be closed in LMI areas in light of the entire record.<sup>14</sup> Chase has stated that it has

moved the LMI Branch and two other branches in middle-income census tracts to a *de novo* branch. Chase has indicated that the new facility, which is located approximately one-half mile from the LMI Branch, would be a more modern full-service facility that would serve customers better, and would include three 24-hour ATMs that were not available at the LMI Branch. Chase would continue to operate more than 60 consumer branches in LMI census tracts out of approximately 260 consumer branches in New York City.<sup>15</sup>

More generally, since the Chemical/Chase Order, Chase indicates that Chase Bank has closed or relocated a total of 13 branches through August 1996 (including the LMI branches discussed above), and has provided customer, community and regulatory notifications to close or relocate 14 more branches. The record indicates that a substantial number of these closures are within one mile of another full-service Chase Bank branch ("receptor branches"). In addition, Chase Bank has added new 24-hour ATMs at many of the receptor branches to increase services to these areas. Chase also indicates that since the merger, it has installed 23 of the 47 planned new 24-hour ATMs in branches located in LMI areas.

The Board has also reviewed the branch closing policies for Old Chemical and Old Chase and their records of branch openings and closings. The branch closing policies for both banks require consideration of a number of factors, including current market conditions, market potential, consumer satisfaction and product usage, demographics, and community needs. The 1995 Chemical and Chase Examinations concluded that the institutions' branch closing policies were satisfactory and that the institutions' records of opening and closing branches had not negatively affected its communities, including LMI communities. In addition, the effect of all branch closings is reviewed in the CRA examination process as part of the institution's overall evaluation. Chase has also provided customer, community and regulatory notifications in connection with the branches closed since the merger.<sup>16</sup>

*HMDA Data and Lending Activities.* The Board has carefully reviewed 1994 and 1995 HMDA data in view of Protestant's contention that Chase's bank and mortgage subsidiaries have inadequate and discriminatory lending records. These data show that in some respects, such as in the denial rate to African-American loan applicants as compared to the denial rate to white applicants, Chase's performance is comparable to or exceeds the performance of lenders in the aggregate in certain markets. In other

13. The 1995 Chase Examination was not publicly released until after the Board issued the Chemical/Chase Order. This examination represented a CRA rating increase from "satisfactory" to "outstanding" for Old Chase's lead bank.

14. Chase indicates that the LMI Branch was inadvertently identified as a branch that would be retained in an LMI census tract. Chase has stated that it has reviewed its overall branch consolidation plan and has determined that this was an isolated instance. Section 42 of the Federal Deposit Insurance Act (12 U.S.C. § 1831r-1) ("FDI Act") and the Joint Policy Statement on Branch Closings (58 *Federal Register* 49,083 (1993)) ("Joint Policy Statement") require that a bank's primary federal supervisor receive notice at least 90 days before the date of the proposed branch closing. The Board notes that Chase complied with Section 42 of the FDI Act, and has provided notice to the Federal Reserve System at least 90 days before the date of the proposed branch closing, including the reasons and other supporting data for the closure consistent with the institution's written policy for branch closing. Chase also has stated that if its plans for LMI branches vary from previous submissions, it would discuss these

instances with the Federal Reserve System prior to the 90-day notification.

15. Consumer branches exclude limited access specialized facilities such as private banking, middle market business offices, and private access corporate locations.

16. Protestant states that Chase has characterized its branch closings as consolidations and contends that certain of the closings should not be considered consolidations under the Joint Policy Statement. The record indicates that regardless of whether the cessation of branch operations was categorized as a consolidation or a closing, Chase has complied with Section 42 of the FDI Act.

respects, however, the data show disparities in application and origination rates to African-American loan applicants as compared to white applicants in certain markets.

The Board is concerned when the record of an institution indicates such disparities in lending, and believes that all banks are obligated to ensure that their lending practices are based on criteria that assure not only safe and sound lending, but also assure equal access to credit by creditworthy applicants regardless of race. The Board recognizes, however, that HMDA data alone provide an incomplete measure of an institution's lending in its community because these data cover only a few categories of housing-related lending and provide limited information about the covered loans.<sup>17</sup> HMDA data, therefore, have limitations that make the data an inadequate basis, absent other information, for concluding that an institution has engaged in illegal discrimination in lending.

Because of the limitations of HMDA data, the Board has carefully reviewed other information such as the examinations reports of the banks' primary supervisors. The 1995 Chemical and Chase Examinations found that neither bank engaged in practices that would discourage individuals from applying for credit. Examiners at both institutions also found that the community delineations were reasonable and that the geographic analysis of lending data demonstrated that there was a reasonable penetration throughout each bank's delineated communities, including LMI census tracts. Fair lending reviews were conducted during both CRA examinations and examiners found no evidence of discrimination or other illegal credit practices.<sup>18</sup> In addition, examiners noted in the examinations that management of the banks had implemented comprehensive written policies, procedures, and training programs to support fair and equal treatment of loan applicants. Chase has indicated that Chase Bank and its mortgage affiliate have a multiple review process for residential mortgage applications to ensure that credit policies and procedures are consistently applied and that fair lending objectives are met.

On consummation of the transaction, Chase proposes to merge Chase Bank with CBNJ, after which the operations of CBNJ would be subject to the CRA policies, procedures and programs of Chase Bank. The Board has carefully reviewed the CRA performance records of the two banks that were merged to form Chase Bank in light of several recent applications filed by Old Chemical and Old Chase.<sup>19</sup>

17. For example, these data do not provide a basis for an independent assessment of whether an applicant who was denied credit was in fact creditworthy. Thus, credit history problems and excessive debt levels relative to income—reasons most frequently cited for a credit denial—are not available from the HMDA data.

18. The 1995 Chase Examination specifically noted that Chase Manhattan Mortgage Corporation actively and regularly solicits mortgage applications from all segments of the bank's market area. Examiners also found that the bank was the second largest home purchase mortgage lender in LMI areas, and noted that no other HMDA reporter in New York City has a better mortgage parity lending record.

19. See Chemical/Chase Order; *Chase Manhattan Corporation*, 81 *Federal Reserve Bulletin* 883 (1995); *Chase Manhattan Corporation*, 81 *Federal Reserve Bulletin* 467 (1995).

In these applications, particularly the Chemical/Chase Order, the Board carefully reviewed the CRA performance records of Old Chemical and Old Chase, including their lending, marketing and outreach activities, the services provided through their branches, their branch closing policies, and the actions that both institutions had taken to increase their lending in LMI areas.

Chase engages in a variety of lending and community development programs designed to help meet the credit needs of the communities in its service area, including the credit need of LMI neighborhoods. For example, Chase Bank offers a variety of affordable mortgage products to increase the availability of mortgage financing to LMI individuals or communities, including the Federal National Mortgage Association's Affordable Housing Partnership Program, The Affirmative Mortgage Program which provides flexible underwriting criteria, the Chase Assisted Settlement for Homebuyers Loan which helps borrowers pay for closing costs and part of the down payment, the State of New York Mortgage Agency Mortgage Program which offers a fixed rate of interest below the prevailing conventional interest rate and longer repayment terms, and NYC Urban Home Loan which enables borrowers to finance extensive renovations, rehabilitations, and conversions of one- to four-family residences in New York City. In addition, The Chase Community Development Corporation ("CCDC") finances construction and rehabilitation of affordable housing and commercial revitalization projects, provides financing to small businesses that may qualify for government-guaranteed loans, and finances smaller non-profit community organizations. The Minority- and Women-Owned Business Development Program enables businesses owned by minorities and women to have an equal opportunity to bid on contracts and receive technical assistance, and may refer business owners to the CCDC for small business loans.

*Conclusion on Convenience and Needs Factor.* The Board has carefully considered the entire record in its review of the convenience and needs factor under the Bank Merger Act. As noted above, the proposal is a corporate reorganization of Chase's existing banking operations, and does not represent an expansion of banking activities. Based on all the facts of record, including information provided by Protestant and Chase and CRA performance examinations, the Board concludes that the efforts of Chase to help meet the credit needs of all segments of the communities served, including residents of LMI areas, are consistent with approval. In this light, the Board concludes that convenience and needs considerations,<sup>20</sup> including the

20. Protestant refers to a newspaper article that discusses the elimination of 300 jobs by Chase in Jericho, New York, where only four employees were offered new jobs as an example of the diminished access to credit, particularly for LMI households and small businesses, caused by the Chemical/Chase merger. The effect of the proposed acquisition on employment in a community is not among the factors required to be considered under the Bank Merger Act. The convenience and needs factor has been consistently interpreted by the federal banking agencies, the courts, and Congress to relate to the

CRA performance records of Chase and its subsidiary banks are consistent with approval.

### Conclusion

Based on the foregoing and all the facts of record,<sup>21</sup> the Board has determined that the applications should be, and hereby are, approved.<sup>22</sup> The Board's approval of this proposal is specifically conditioned on compliance by Chase Bank with the commitments made in connection with this proposal and the conditions discussed in this order. For purposes of this action, the commitments and conditions relied on in reaching this decision are both conditions imposed in writing by the Board and, as such, may be enforced in proceedings under applicable law.

The merger of Chase Bank and CBNJ may not be consummated before the fifteenth calendar day following the effective date of this order, and the proposal may not be consummated later than three months after the effective date of this order, unless such period is extended for good cause by the Board or the Federal Reserve Bank of New York, acting pursuant to delegated authority.

By order of the Board of Governors, effective October 28, 1996.

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effect of a proposal on the availability and quality of banking services in the community. *See Wells Fargo & Company*, 82 *Federal Reserve Bulletin* 445, 457 (1996). The Board has also considered the steps taken to mitigate the impact of job losses from the Chemical/Chase merger, which include career transition programs to provide employees with outplacement assistance and financial support for retraining and education.

21. Protestant contends that the record before the Board is incomplete because Chase has not responded to specific issues raised by Protestant. The Board is required under applicable law and its processing procedures to act on applications within specified time periods. As discussed above, the Board has carefully reviewed the record in this case, and based on all the facts of record, including Protestant's comments, confidential supervisory information, and reports of examination, the Board concludes that the record is sufficient to act on this proposal at this time, and that delay or denial of this proposal on the grounds of informational insufficiency is not warranted.

22. Protestant has requested that the Board hold a public meeting or hearing on these applications. The Board is not required under the Bank Merger Act or the Federal Reserve Act to hold a public hearing or meeting in this case. Under the Board's rules, the Board may, in its discretion, hold a public hearing or meeting on an application to clarify factual issues related to the application and to provide an opportunity for testimony, if appropriate. 12 C.F.R. 262.3(e) and 262.25(d). The Board has carefully considered Protestant's request. In the Board's view, interested parties have had a sufficient opportunity to present written submissions, and have submitted substantial written comments that have been considered by the Board. Protestant's request fails to show why a written presentation would not suffice and to summarize what evidence would be presented at a hearing or meeting. *See* 12 C.F.R. 262.3(e). On the basis of all the facts of record, the Board has determined that a public meeting or hearing is not necessary to clarify the factual record in these applications, or otherwise warranted in this case. Accordingly, the request for a public meeting or hearing on these applications is hereby denied.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Phillips, Yellen, and Meyer. Absent and not voting: Governor Lindsey.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

### Appendix

#### *Branch offices of CBNJ to be established by Chase Bank:*

612 Main Street, Boonton, Morris County, New Jersey 07005  
1459 Main Avenue, Clifton, Passaic County, New Jersey 07011  
57 Diamond Spring Road, Denville, Morris County, New Jersey 07834  
St. Clare's Hospital, Second Floor, Pocono Road, Denville, Morris County, New Jersey 07834  
186 Ridgedale Avenue, Florham Park, Morris County, New Jersey 07932  
188-190 Main Street, Fort Lee, Bergen County, New Jersey 07024  
235 Main Street, Hackensack, Bergen County, New Jersey 07601  
Village Road, New Vernon, Morris County, New Jersey 07976  
331 Lafayette Avenue, Hawthorne, Passaic County, New Jersey 07506  
1152 Liberty Avenue, Hillside, Union County, New Jersey 07205  
101 Hudson Street, Jersey City, Hudson County, New Jersey 07302  
2 Waverly Place, Madison, Morris County, New Jersey 07940  
180 Franklin Turnpike, Mahwah, Bergen County, New Jersey 07430  
183 Millburn Avenue, Millburn, Essex County, New Jersey 07041  
800 Morris Turnpike, Short Hills, Essex County, New Jersey 07078  
475 Bloomfield Avenue, Montclair, Essex County, New Jersey 07042  
19 North Fullerton Avenue, Montclair, Essex County, New Jersey 07042  
17 Watchung Plaza, Montclair, Essex County, New Jersey 07042  
600 Valley Road, Upper Montclair, Essex County, New Jersey 07043  
580 Valley Road, Upper Montclair, Essex County, New Jersey 07043  
636 Speedwell Avenue, Morris Plains, Morris County, New Jersey 07950  
296 E. Hanover & Ridgedale Avenues, Morristown, Morris County, New Jersey 07960  
17 Park Place, Morristown, Morris County, New Jersey 07960  
225 South Street, Morristown, Morris County, New Jersey 07960  
460 Bergen Boulevard, Palisades Park, Bergen County, New Jersey 07650  
E. 36 Midland Avenue, Paramus, Bergen County, New Jersey 07652



100 Parsippany Road, Parsippany, Morris County, New Jersey 07054

53 North Beverwyck Road, Lake Hiawatha, Morris County, New Jersey 07034

1699 Littleton Road, Parsippany, Morris County, New Jersey 07054

148 Market Street, Paterson, Passaic County, New Jersey 07505

E. 33rd Street and McLean Boulevard, Paterson, Passaic County, New Jersey 07514

124 Haledon Avenue, Prospect Park, Passaic County, New Jersey 07508

1 West Hanover Avenue, Mt. Freedom, Morris County, New Jersey 07970

84 East Ridgewood Avenue, Ridgewood, Bergen County, New Jersey 07450

686 Kinderkamack Road, River Edge, Bergen County, New Jersey 07661

67 Summit Avenue, Summit, Union County, New Jersey 07901

825 Riverview Drive, Totowa, Passaic County, New Jersey 07512

2000 Morris Avenue, Union, Union County, New Jersey 07083

566 Bloomfield Avenue, Verona, Essex County, New Jersey 07044

1050 Hamburg Turnpike, Wayne, Passaic County, New Jersey 07470

865 Bloomfield Avenue, West Caldwell, Essex County, New Jersey 07006

206 East Broad Street, Westfield, Union County, New Jersey 07090

525 Cedar Hill Avenue, Wyckoff, Bergen County, New Jersey 07481

#### *Electronic Facilities*

Pocono Road (St. Clare's Hospital), Denville, Morris County, New Jersey 07834

5 Belmont Drive, Somerset, Somerset County, New Jersey 08873

115 South Jefferson Road, Whippany, Hanover Township, Morris County, New Jersey 07981

110 Cokesbury Road, Lebanon, Hunterdon County, New Jersey 07430

Bay and Highland Avenues, Montclair, Essex County, New Jersey 07042

100 Madison Avenue, Morristown, Morris County, New Jersey 07960

15 E. Midland Avenue, Paramus, Bergen County, New Jersey 07652

Simon & Schuster Company, 1 Lake Street, Upper Saddle River, Bergen County, New Jersey 07458

1400 Willowbrook Mall, Wayne, Passaic County, New Jersey 07470

#### *ORDERS ISSUED UNDER INTERNATIONAL BANKING ACT*

Banca di Roma S.p.A.  
Rome, Italy

#### *Order Approving Establishment of Branches and Agencies*

Banca di Roma S.p.A. ("Bank"), Rome, Italy, a foreign bank within the meaning of the International Banking Act ("IBA"), has applied under section 7(d) of the IBA (12 U.S.C. § 3105(d)) to establish branches in New York, New York, and Chicago, Illinois, and agencies in San Francisco, California, and Houston, Texas. The Foreign Bank Supervision Enhancement Act of 1991 ("FBSEA"), which amended the IBA, provides that a foreign bank must obtain the approval of the Board to establish a branch or agency in the United States.

Notice of the application, affording interested persons an opportunity to comment, has been published in a newspaper of general circulation in New York (*New York Post*, October 27, 1992), Chicago (*Chicago Tribune*, October 22, 1992), San Francisco (*San Francisco Chronicle*, October 24, 1992), and Houston (*Houston Post*, October 21, 1992). The time for filing comments has expired, and the Board has considered the application and all comments received.

Bank, with total consolidated assets of approximately \$134 billion, is the second largest bank in Italy.<sup>1</sup> Cassa di Risparmio di Roma Holding S.p.A. ("CRRH"), a financial holding company that owns 64.5 percent of Bank's shares, is Bank's largest shareholder. Istituto per la Ricostruzione Industriale ("IRI"), a holding company owned by the Government of Italy, owns 13.9 percent of Bank's shares and 35 percent of the shares of CRRH. Ente Cassa di Risparmio di Roma ("ECRR"), an Italian foundation, owns 9.8 percent of Bank's shares and 65 percent of the shares of CRRH (ECRR and IRI are collectively referred to herein as "Parents"). No other single shareholder holds 5 percent or more of the shares of Bank.

In addition to a network of approximately 1,300 branches in Italy, Bank operates 13 foreign branches and has 9 foreign representative offices. Bank also owns several subsidiaries, including banks that operate in Europe.

Bank was formed as the result of the merger of Banco di Roma S.p.A. ("Banco di Roma") and Banco di Santo Spirito S.p.A. ("Banco di Santo Spirito"), both of Rome, Italy. Before the merger, each of the two predecessor banks had operations in the United States.<sup>2</sup> The Board was given prior notice of the merger, and, pursuant to Regulation K,

1. All data are as of December 31, 1995.

2. Banco di Roma operated branches in New York and Chicago and agencies in San Francisco and Houston. Banco di Santo Spirito, which legally was the surviving corporation in the merger, operated a branch in New York. As a result of the consolidation, the two New York branches were combined into one location and now operate as a single branch of Bank. In light of the fact that Bank now operates only one branch in a single location in New York, a city in which Banco di

allowed the merger to proceed before an application to establish the offices was filed and acted upon by the Board.<sup>3</sup>

The Bank of Italy, which approved the merger of Banco di Roma and Banco di Santo Spirito, has no objection to the continued operation of the existing branches and agencies of Bank. Bank also has received the requisite approval from the respective state banking authorities to maintain the branch in Chicago and the agencies in San Francisco and Houston and to change the name and location of the New York branch.

In order to approve an application by a foreign bank to establish branches and agencies in the United States, the IBA and Regulation K require the Board to determine that the foreign bank applicant engages directly in the business of banking outside of the United States, and has furnished to the Board the information it needs to adequately assess the application. The Board also generally must determine whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor (12 U.S.C. § 3105(d)(2) and (6)). The Board also may take into account additional standards as set forth in the IBA (12 U.S.C. § 3105(d)(3)-(4)) and Regulation K (12 C.F.R. 211.24(c)).

Bank engages directly in the business of banking outside the United States through its banking operations in Italy and elsewhere. Bank also has provided the Board with the information necessary to assess the application through submissions that address the relevant issues.

Regulation K provides that a foreign bank will be considered to be subject to comprehensive supervision or regulation on a consolidated basis if the Board determines that the bank is supervised and regulated in such a manner that its home country supervisor receives sufficient information on the foreign bank's worldwide operations, including the relationship of the foreign bank to any affiliate, to assess the overall financial condition of the foreign bank and its compliance with law and regulation (12 C.F.R. 211.24(c)(1)).<sup>4</sup>

The Board has considered the following information concerning supervision by home country authorities.

Santo Spirito had preexisting authority to operate a branch, Bank's application to establish the New York branch is moot.

3. 12 C.F.R. 211.24(a)(3).

4. In assessing this standard, the Board considers, among other factors, the extent to which the home country supervisors:

(i) Ensure that the bank has adequate procedures for monitoring and controlling its activities worldwide;  
(ii) Obtain information on the condition of the bank and its subsidiaries and offices through regular examination reports, audit reports, or otherwise;  
(iii) Obtain information on the dealings with and relationship between the bank and its affiliates, both foreign and domestic;  
(iv) Receive from the bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the bank's financial condition on a worldwide consolidated basis;  
(v) Evaluate prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

These are indicia of comprehensive, consolidated supervision. No single factor is essential and other elements may inform the Board's determination.

Bank's primary supervisor is the Bank of Italy.<sup>5</sup> The Bank of Italy's supervision extends to CRRH, which is considered the parent of the banking group. The Bank of Italy monitors the operations of Bank through information obtained from a combination of the review of reports submitted by Bank and from direct on-site inspections. While there is no prescribed frequency for inspections, the Bank of Italy uses the reports it receives from Bank for purposes of conducting "off-site reviews" that allow the Bank of Italy to monitor the financial condition of Bank.

Bank is required to submit a number of reports to the Bank of Italy periodically, and the Bank of Italy may require such additional information as it deems necessary to carry out supervision of Bank and Bank's affiliated companies. The Bank of Italy performs regular off-site reviews of reports filed by Bank and its banking company affiliates. Off-site reviews result in periodic ratings of the bank in the areas of capital, profitability, risks, organization, and liquidity. Reports filed by Bank include semi-annual consolidated balance sheets and income statements, quarterly reports on capital ratios, country exposures, loans and deposits, and credit granted to affiliated companies, and monthly balance sheets and detailed average balances for certain asset and liability accounts. In addition, all Italian banks are required to transmit to the Bank of Italy information regarding any violations of law discovered through their internal control systems. The Bank of Italy also reviews the minutes of meetings of Bank's board of directors, and proposals and findings of Bank's board of auditors.

The Bank of Italy employs both general and targeted on-site inspections of Bank. General inspections cover all the activities of Italian banks. In response to special developments, targeted inspections may be conducted that focus on specific issues. The frequency of general inspections is in the discretion of the Bank of Italy and is determined by matters such as the condition of the bank and the nature of its operations. The general inspections are designed to assess profitability, capital adequacy, the reliability of the reports submitted to the Bank of Italy, asset quality, and the quality of the bank's management and internal organization. Inspections also review the adequacy of internal controls related to Bank's worldwide operations and extend to the branches and subsidiaries of Bank outside Italy.

Italian companies, including banks, are required to employ statutory auditors. The statutory auditors are elected at the general shareholders' meeting and are separate from the internal and external auditors. The statutory auditors are required to verify matters relating to corporate governance and compliance with law, as well as the company's accounts. The statutory auditors are required to transmit to

5. The ultimate responsibility for bank supervision in Italy rests with the Comitato Interministeriale per il Credito ed il Risparmio ("CICR"), a body presided over by Italy's Minister of the Treasury and composed of various government ministers. The CICR is responsible for setting the general principles of supervision which are then incorporated into regulations and applied to individual banks by the Bank of Italy.

the Bank of Italy copies of the minutes of its meetings and reports of irregularities in the bank's management or violations of law.

Companies listed on an Italian stock exchange, including Bank, also are required to have their annual financial statements audited by external auditors. External auditors perform annual audits of Bank's domestic and foreign operations. Bank employs the same auditing firm, or its local affiliates, worldwide. Copies of the audited financial statements are provided to the Bank of Italy.

Italian banks are subject to certain restrictions with respect to transactions with affiliates and investments in other companies. The Bank of Italy limits the extensions of credit to affiliates by a bank or a banking group to 20 percent of the bank's or banking group's capital. In addition, prior approval from the Bank of Italy is required for a bank to make investments in other companies when such investments exceed certain thresholds.

The Bank of Italy has various enforcement powers over Italian banks, including Bank. These enforcement powers include the power to impose monetary fines, suspend or terminate a bank's officers, and to dissolve a bank's board of directors. If criminal violations of law are suspected, the Bank of Italy refers the case to the appropriate judiciary authorities.

With respect to the monitoring of its worldwide operations, Bank's internal audit department conducts regular audits of all its foreign and domestic offices and bank subsidiaries. In addition, internal auditors are posted at each foreign branch of Bank. Any violations of law discovered by Bank's internal auditors must be reported to the Bank of Italy. The branches also submit periodic reports to Bank's head office.

Based on all the facts of record, including the information described above, the Board concludes that Bank is subject to comprehensive supervision on a consolidated basis by its home country supervisor.

The Board also has taken into account the additional standards set forth in section 7 of the IBA (*see* 12 U.S.C. § 3105(d)(3)-(4); 12 C.F.R. 211.24(c)(2)). Bank has provided the Board with the information necessary to assess the application through submissions that address the relevant issues. As noted above, the Bank of Italy does not object to the continued operation of the existing branches and agencies of Bank. In addition, the Bank of Italy may share information on Bank's operations with other supervisors, including the Board.

Italy is a signatory to the Basle risk-based capital standards, and Italian risk-based capital standards meet those established by the Basle Capital Accord and the European Union. Bank's capital is in excess of the minimum levels that would be required by the Basle Capital Accord and is considered equivalent to capital that would be required of a U.S. banking organization.

Managerial and other financial resources of Bank also are considered consistent with approval. In making this determination, the Board also has taken into account the fact Bank will continue to operate only those offices that

previously had been operated by the two banks prior to the merger. Bank continues to maintain controls and procedures for the branch and agencies in order to ensure compliance with U.S. law, as well as controls and procedures for its worldwide operations generally.

The Board also has reviewed the restrictions on disclosure in relevant jurisdictions in which Bank operates and has communicated with relevant government authorities about access to information. Bank and Parents have committed to make available to the Board such information on the operations of Bank and any affiliate of Bank that the Board deems necessary to determine and enforce compliance with the IBA, the Bank Holding Company Act of 1956, as amended, and other applicable federal law. To the extent that the provision of such information is prohibited or impeded by law, Bank and Parents have committed to cooperate with the Board to obtain any necessary consents or waivers that might be required from third parties in connection with disclosure of certain information. In addition, subject to certain conditions, the Bank of Italy may share information on Bank's operations with other supervisors, including the Board. In light of these commitments and other facts of record, and subject to the condition described below, the Board concludes that Bank has provided adequate assurances of access to any necessary information the Board may request.

On the basis of all the facts of record, and subject to the commitments made by Bank and Parents, as well as the terms and conditions set forth in this order, the Board has determined that Bank's application to establish a state-licensed branch in Chicago and state-licensed agencies in San Francisco and Houston should be, and hereby is, approved. Should any restrictions on access to information on the operations or activities of Bank and its affiliates subsequently interfere with the Board's ability to obtain information to determine and enforce compliance by Bank or its affiliates with applicable federal statutes, the Board may recommend termination of any of Bank's direct or indirect activities in the United States. Approval of this application is also specifically conditioned on Bank's and Parents' compliance with the commitments made in connection with this application and with the conditions in this order.<sup>6</sup> The commitments and conditions referred to above are conditions imposed in writing by the Board in connection with its decision, and may be enforced in proceedings under 12 U.S.C. § 1818 or 12 U.S.C. § 1847 against Bank, its offices, and its affiliates.

By order of the Board of Governors, effective October 9, 1996.

6. The Board's authority to approve establishment of the branch and agencies parallels the continuing authority of the states of Illinois, California, and Texas to license offices of a foreign bank. The Board's approval of this application does not supplant the authority of these states to license the respective branch and agencies of Bank in accordance with any terms or conditions that they may impose.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Phillips, Yellen, and Meyer. Absent and not voting: Governor Lindsey.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

Istituto Bancario San Paolo di Torino, S.p.A.  
Turin, Italy

### *Order Approving Establishment of a Branch*

Istituto Bancario San Paolo di Torino, S.p.A. ("Bank"), Turin, Italy, a foreign bank within the meaning of the International Banking Act (the "IBA"), has applied under section 7(d) of the IBA (12 U.S.C. § 3105(d)) to establish a federally licensed branch in New York, New York. The Foreign Bank Supervision Enhancement Act of 1991 ("FBSEA"), which amended the IBA, provides that a foreign bank must obtain the approval of the Board to establish a branch in the United States.

Notice of the application, affording interested persons an opportunity to submit comments, has been published in a newspaper of general circulation in New York, New York (*The New York Times*, May 13, 1996). The time for filing comments has expired, and all comments have been considered.

Bank, with assets of approximately \$159 billion as of December 31, 1995, is the largest commercial bank in Italy. Gruppo Bancario San Paolo di Torino, S.p.A. ("Gruppo"), Turin, Italy, owns approximately 65 percent of Bank's voting shares, and no other single shareholder holds more than 5 percent of Bank's voting shares. Gruppo is the sole and wholly owned subsidiary of Compagnia di San Paolo ("Compagnia"), Turin, Italy, an Italian foundation (Gruppo and Compagnia are collectively referred to herein as "Parents"). Bank operates nearly 1200 branches in Italy and has extensive banking and nonbanking operations outside Italy.

In the United States, Bank operates a branch in Los Angeles, California, and a limited branch in New York, New York. Bank's New York branch currently limits its deposit-taking activities to those that are incidental to international or foreign business.<sup>1</sup> Bank proposes to convert its existing New York branch to a full-service branch, which would no longer be subject to such limitations on its deposit-taking activities.

The main products offered by Bank's New York limited branch are committed revolving lines of credit, money

1. Currently, Bank's home state under the IBA and Regulation K is California. Because Bank's New York branch is outside Bank's home state, under the IBA it cannot engage in full service deposit activities and must limit its deposit taking to that of a corporation organized under section 25A of the Federal Reserve Act (the Edge Act) (12 U.S.C. § 611 *et seq.*). Following approval of its proposed branch in New York, Bank would redesignate New York as its home state for the purposes of the IBA and Regulation K, transfer the assets and liabilities of the Los Angeles branch to the New York branch, and downgrade the Los Angeles branch to a representative office.

market facilities, letters of credit, foreign exchange, capital markets products, and structured products related to the Italian market. The New York branch proposes to continue to offer those services and to expand its deposit products. Bank also engages indirectly in certain nonbanking activities in the United States.

In order to approve an application by a foreign bank to establish a branch in the United States, the IBA and Regulation K require the Board to determine that the foreign bank applicant engages directly in the business of banking outside of the United States and has furnished to the Board the information it needs to assess the application adequately. The Board also generally must determine that the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor (12 U.S.C. § 3105(d)(2) and (6); 12 C.F.R. 211.24(c)(1)). The Board may also take into account additional standards set forth in the IBA and Regulation K (12 U.S.C. § 3105(d)(3)-(4); 12 C.F.R. 211.24(c)).

Bank engages directly in the business of banking outside of the United States through its banking operations in Italy and elsewhere. Bank also has provided the Board with the information necessary to assess the application through submissions that address the relevant issues.

Regulation K provides that a foreign bank will be considered to be subject to comprehensive supervision or regulation on a consolidated basis if the Board determines that the bank is supervised and regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the bank, including its relationship to any affiliates, to assess the bank's overall financial condition and its compliance with law and regulation (12 C.F.R. 211.24(c)(1)).<sup>2</sup> In making its determination under this standard, the Board has considered the following information.

Bank's primary supervisor is the Bank of Italy. The Board previously has determined, in connection with the application involving another Italian bank, Banca di Roma, S.p.A., that the bank was subject to home country supervision on a consolidated basis.<sup>3</sup> The Board also has deter-

2. In assessing this standard, the Board considers, among other factors, the extent to which the home country supervisors:

- (i) Ensure that the bank has adequate procedures for monitoring and controlling its activities worldwide;
- (ii) Obtain information on the condition of the bank and its subsidiaries and offices through regular examination reports, audit reports, or otherwise;
- (iii) Obtain information on the dealings with and relationship between the bank and its affiliates, both foreign and domestic;
- (iv) Receive from the bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the bank's financial condition on a worldwide consolidated basis; and
- (v) Evaluate prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

These are indicia of comprehensive, consolidated supervision; no single factor is essential and other elements may inform the Board's determination.

3. See *Banca di Roma, S.p.A.*, 82 *Federal Reserve Bulletin*, 1144 (1996).

mined that Bank and Gruppo are supervised by the Bank of Italy on substantially the same terms and conditions as Banca di Roma and its parent company. Based on all the facts of record, the Board has concluded that Bank is subject to comprehensive supervision and regulation on a consolidated basis by its home country supervisor.

The Board has taken into account the additional standards set forth in section 7 of the IBA and in Regulation K. (See 12 U.S.C. § 3105(d)(3)-(4); 12 C.F.R. 211.24(c)(2)). Bank has provided the Board with the information necessary to assess the application through submissions that address the relevant issues. In addition, the Bank of Italy has no objection to Bank's proposal to establish a branch in New York.

Italy is a signatory to the Basle risk-based capital standards, and Italian risk-based capital standards meet those established by the Basle Capital Accord and the European Union. Bank's capital is in excess of the minimum levels that would be required by the Basle Capital Accord and is considered equivalent to capital that would be required of a U.S. banking organization. Managerial and other financial resources of Bank also are considered consistent with approval, and Bank appears to have the experience and capacity to support the proposed branch. In addition, Bank has established controls and procedures in the branch to ensure compliance with applicable U.S. law, as well as controls and procedures for its worldwide operations generally.

Finally, the Board has reviewed the restrictions on disclosure in relevant jurisdictions in which Bank operates and has communicated with relevant government authorities about access to information. Bank and Parents have committed to make available to the Board such information on the operations of Bank and any affiliate of Bank that the Board deems necessary to determine and enforce compliance with the IBA, the Bank Holding Company Act of 1956, as amended, and other applicable federal law. To the extent that the provision of such information may be prohibited or impeded by law or otherwise, Bank and Parents have committed to cooperate with the Board to obtain any necessary consents or waivers that might be required from third parties in connection with disclosure of certain information. In addition, subject to certain conditions, the Bank of Italy may share information on Bank's operations with other supervisors, including the Board. In light of these commitments and other facts of record, and subject to the condition described below, the Board has concluded that Bank has provided adequate assurances of access to any necessary information the Board may request.

On the basis of all the facts of record, and subject to the commitments made by Bank and Parents, as well as the terms and conditions set forth in this order, the Board has determined that Bank's application to establish a federally licensed branch in New York should be, and hereby is, approved. Should any restrictions on access to information on the operations or activities of Bank or any of its affiliates subsequently interfere with the Board's ability to

determine and enforce compliance by Bank or its affiliates with applicable federal statutes, the Board may require termination of any of Bank's direct or indirect activities in the United States or, in the case of an office licensed by the OCC, recommend termination of such office. Approval of this application also is specifically conditioned on Bank's and Parents' compliance with the commitments made in connection with this application and with the conditions in this order.<sup>4</sup> The commitments and conditions referred to above are conditions imposed in writing by the Board in connection with its decision and may be enforced in proceedings under 12 U.S.C. § 1818 or 12 U.S.C. § 1847 against Bank, its offices, or its affiliates.

By order of the Board of Governors, effective October 15, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Lindsey, Phillips, Yellen, and Meyer. Absent and not voting: Governor Kelley.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

Unibanco - Uniao de Bancos Brasileiros, S.A.,  
Sao Paulo, Brazil

*Order Approving Establishment of a Representative Office*

Unibanco - Uniao de Bancos Brasileiros, S.A. ("Bank"), Sao Paulo, Brazil, a foreign bank within the meaning of the International Banking Act ("IBA"), has applied under section 10(a) of the IBA (12 U.S.C. § 107(a)) to establish a representative office in Miami, Florida. The Foreign Bank Supervision Enhancement Act of 1991, which amended the IBA, provides that a foreign bank must obtain the approval of the Board to establish a representative office in the United States.

Notice of the application, affording interested persons an opportunity to submit comments, has been published in a newspaper of general circulation in Miami, Florida (*Miami Daily Business Review*, July 17, 1996). The time for filing comments has expired, and the Board has considered the application and all comments received.

Bank, with approximately \$24 billion in assets,<sup>1</sup> is the third largest bank in Brazil. Bank has over 800 domestic branches and operates 31 domestic subsidiaries, which

4. The Board's authority to approve the establishment of the proposed branch parallels the continuing authority of the Office of the Comptroller of the Currency ("OCC") to license federal offices of a foreign bank. The Board's approval of this application does not supplant the authority of the OCC to license the proposed branch of Bank in accordance with any terms or conditions that the OCC may impose.

1. Data are as of March 31, 1996, unless otherwise noted.

provide services such as insurance, leasing, credit card, and investment management. Bank also has branches located in New York, New York, the Cayman Islands, Nassau, Bahamas, a representative office in London, and bank subsidiaries located in Luxembourg and Paraguay.

Unibanco Holdings, S.A. ("Unibanco Holdings"), Sao Paulo, Brazil, is Bank's immediate parent and owns 90 percent of the shares of Bank. The remainder of Bank's shares is widely held. Bank's ultimate parent, E. Johnston Participacoes Ltda., S.A. ("E. Johnston"), Sao Paulo, Brazil, indirectly owns 68 percent of Unibanco Holdings.<sup>2</sup> Bank, Unibanco Holdings, and E. Johnston are subject to the requirements of the Bank Holding Company Act by virtue of Bank's New York branch, and each is a qualifying foreign banking organization under Regulation K (12 C.F.R. 211.23(b)).

The proposed representative office would solicit loans, promote Bank's products and services to potential and existing customers, and serve as a liaison between Bank's correspondent banks, its New York branch, and its head office. In addition, the proposed representative office would monitor Bank's operations in the U.S. for compliance with applicable laws and regulations, conduct compliance training for Bank's employees in the United States, oversee the electronic data processing activities of Bank in the United States, and perform other back-office functions in support of Bank's New York branch.

In acting on an application to establish a representative office, the IBA and Regulation K provide that the Board shall take into account whether the foreign bank engages directly in the business of banking outside of the United States, has furnished to the Board the information it needs to assess adequately the application, and is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor (12 U.S.C. § 3107(a)(2); 12 C.F.R. 211.24(d)). The Board may also take into account additional standards as set forth in the IBA (12 U.S.C. § 3105(d)(3)-(4)) and Regulation K (12 C.F.R. 211.24(c)(2)).

The Board generally has required foreign banks that propose to establish a representative office to be subject to a significant degree of supervision by their home country supervisor, as determined with reference to a number of factors.<sup>3</sup> A foreign bank's financial and managerial resources are reviewed to determine whether its financial condition and performance demonstrate that it is capable of complying with applicable laws and has an operating record that would be consistent with the establishment of a representative office in the United States. All foreign banks,

whether operating through branches, agencies, or representative offices, will be required to provide adequate assurances of access to information on their operations and those of their affiliates necessary to determine compliance with U.S. laws.

Bank is subject to the regulatory and supervisory authority of the Central Bank of Brazil ("Central Bank"), which is the bank supervisory authority in Brazil and, as such, is the home country supervisor of Bank. The Central Bank has no objection to Bank's establishment of the proposed representative office. The Board has previously determined in connection with an application to establish a representative office by another Brazilian bank that the bank was subject to a significant degree of supervision.<sup>4</sup> In this case, Bank is supervised by the Central Bank on the same terms and conditions as the other Brazilian bank. Based on all the facts of record, the Board has determined that factors relating to the supervision of Bank by its home country supervisor are consistent with approval of the proposed representative office.

The Board also has determined that Bank engages directly in the business of banking outside of the United States through its banking operations in Brazil. Bank has provided the Board with information necessary to address relevant issues and to assess the application adequately.

The Board also has taken into account the additional standards set forth in section 7 of the IBA and Regulation K (12 U.S.C. § 3105(d)(3),(4); 12 C.F.R. 211.24(c)(2)). As noted above, the Central Bank has no objection to Bank's establishment of the proposed representative office. In addition, the Central Bank may share information on Bank's operations with other supervisors, including the Board.

Taking into consideration Bank's record of operations in its home country, its overall financial resources, and its standing with its home country supervisors, the Board also has determined that financial and managerial factors are consistent with approval of the proposed representative office. Bank appears to have the experience and capacity to support the proposed representative office and has established controls and procedures for the proposed representative office to ensure compliance with U.S. law.

The Board also has reviewed the restrictions on disclosure under applicable law and has communicated with relevant government authorities regarding access to information about Bank's operations. Bank and its ultimate parent have committed to make available to the Board such information on the operations of Bank and any of its affiliates that the Board deems necessary to determine and enforce compliance with the IBA, the Bank Holding Company Act of 1956, as amended, and other applicable Federal law. To the extent that disclosure of such information to the Board may be prohibited or impeded by law, Bank

2. Other entities that hold an interest in Unibanco Holdings greater than 5 percent but less than 15 percent are Commerzbank AG, Frankfurt, Germany, Dai-Ichi Kangyo Bank, Tokyo, Japan, and Bahema Participacoes, S.A., Sao Paulo, Brazil.

3. See *Citizens National Bank*, 79 *Federal Reserve Bulletin* 805 (1993). See also *Promstroybank of Russia*, 82 *Federal Reserve Bulletin* 599 (1996)(addressing standards applicable to representative offices with limited activities).

4. See *Banco Bandeirantes, S.A.*, 81 *Federal Reserve Bulletin* 742 (1995).

and its ultimate parent have committed to cooperate with the Board to obtain any necessary consents or waivers that might be required from third parties in connection with disclosure of certain information. In light of these commitments and other facts of record, and subject to the condition described below, the Board concludes that Bank has provided adequate assurances of access to any necessary information the Board may request.

On the basis of all the facts of record, and subject to the commitments made by Bank and its ultimate parent, as well as the terms and conditions set forth in this order, the Board has determined that Bank's application to establish a representative office should be, and hereby is, approved. Should any restrictions on access to information on the operations or activities of Bank and any of its affiliates subsequently interfere with the Board's ability to determine the compliance by Bank or its affiliates with applicable federal statutes, the Board may require termination of any of Bank's direct or indirect activities in the United States. Approval of this application is also specifically conditioned on compliance by Bank and its ultimate parent with the commitments made in connection with this appli-

cation and with the conditions in this order.<sup>5</sup> The commitments and conditions referred to above are conditions imposed in writing by the Board in connection with its decision, and may be enforced in proceedings under 12 U.S.C. § 1818 against Bank and its affiliates.

By order of the Board of Governors, effective October 9, 1996.

Voting for this action: Chairman Greenspan, Vice Chair Rivlin, and Governors Kelley, Phillips, Yellen, and Meyer. Absent and not voting: Governor Lindsey.

JENNIFER J. JOHNSON  
*Deputy Secretary of the Board*

5. The Board's authority to approve the establishment of the proposed office parallels the continuing authority of the State of Florida to license offices of a foreign bank. The Board's approval of this application does not supplant the authority of the State of Florida and its agent, the Florida Department of Banking and Finance, to license the proposed office of Bank in accordance with any terms or conditions that the Florida Department of Banking and Finance may impose.

#### *APPLICATIONS APPROVED UNDER BANK HOLDING COMPANY ACT*

##### *By the Secretary of the Board*

Recent applications have been approved by the Secretary of the Board as listed below. Copies are available upon request to the Freedom of Information Office, Office of the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

#### Section 3

Applicant(s)	Bank(s)	Effective Date
Whitney Holding Corporation, New Orleans, Louisiana	Liberty Holding Company, Pensacola, Florida Liberty Bank, Pensacola, Florida Whitney National Bank of Florida, Pensacola, Florida	October 7, 1996

#### Section 4

Applicant(s)	Bank(s)	Effective Date
Bank America Corporation, San Francisco, California	Arrowhead LLC, San Jose, California	October 30, 1996
National City Corporation, Cleveland, Ohio	Muirfield Mortgage Limited Partnership, Dallas, Texas	October 11, 1996
National City Mortgage Company, Miamisburg, Ohio		
SouthTrust Corporation, Birmingham, Alabama	Preferred Bank, A Federal Savings Bank, Palmetto, Florida	October 9, 1996
SouthTrust of Florida, Inc., Jacksonville, Florida		

*By Federal Reserve Banks*

Recent applications have been approved by the Federal Reserve Banks as listed below. Copies are available upon request to the Reserve Banks.

## Section 3

Applicant(s)	Bank(s)	Reserve Bank	Effective Date
1st United Bancorp, Boca Raton, Florida	Park Bankshares, Inc., Lake Park, Florida First National Bank of Lake Park, Lake Park, Florida	Atlanta	October 17, 1996
Central Financial Corporation, Hutchinson, Kansas	Mesquite Financial Corporation, Mesquite, Nevada	Kansas City	October 17, 1996
Chambers Bancshares, Inc., Danville, Arkansas	Bank of Rogers, Rogers, Arkansas	St. Louis	October 22, 1996
Citizens Corporation, Franklin, Tennessee	Peoples State Bancshares, Inc., Grant, Alabama	Atlanta	October 11, 1996
Harrison Group, Inc., Franklin, Tennessee	Peoples State Bank, Grant, Alabama		
Colony Bancorp, Inc., Fitzgerald, Georgia	Broxton State Bank, Broxton, Georgia	Atlanta	October 4, 1996
Commerce Bancshares, Inc., Bloomington, Minnesota	Geneva State Bank, Geneva, Minnesota	Minneapolis	October 17, 1996
Community Bank Shares of Indiana, Inc., New Albany, Indiana	Community Bank of Southern Indiana, New Albany, Indiana	St. Louis	October 9, 1996
Community First Bankshares, Inc., Denver, Colorado	First National Bank of Boulder County, Boulder, Colorado	Kansas City	October 23, 1996
DCB Financial Corp., Delaware, Ohio	The Delaware County Bank & Trust Company, Delaware, Ohio	Cleveland	October 17, 1996
Delaware International Bancshares, Inc., Dover, Delaware	The International Bank, Corpus Christi, Texas	Dallas	October 11, 1996
Dublin Bancshares, Inc., Dublin, Texas	Gustine-DeLeon Bancshares, Inc., DeLeon, Texas	Dallas	October 23, 1996
Eberhardt, Inc., Elberton, Georgia	Pinnacle Financial Corporation, Elberton, Georgia	Atlanta	October 4, 1996
JAM Family Partnership II, L.P., Elberton, Georgia			
First Bankshares of West Point, Inc., West Point, Georgia	Canebrake Bancshares, Inc., Uniontown, Alabama First State Bank of Uniontown, Uniontown, Alabama	Atlanta	September 27, 1996
First Financial Company of Saint Jo, Dover, Delaware	The First National Bank of Saint Jo, Saint Jo, Texas	Dallas	October 4, 1996
First International Bancshares, Inc., Corpus Christi, Texas	Delaware International Bancshares, Inc., Dover, Delaware The International Bank, Corpus Christi, Texas	Dallas	October 11, 1996
Hibernia Corporation, New Orleans, Louisiana	Texarkana National Bancshares, Texarkana, Texas Texarkana National Bank, Texarkana, Texas	Atlanta	October 18, 1996



## Section 3—Continued

Applicant(s)	Bank(s)	Reserve Bank	Effective Date
Hometown Financial Group, Inc., Flanagan, Illinois	Flanagan State Bank, Flanagan, Illinois	Chicago	October 7, 1996
Keystone Financial, Inc., Harrisburg, Pennsylvania	Keystone National Bank, Lancaster, Pennsylvania	Philadelphia	September 13, 1996
McConnell & Co., Elberton, Georgia	Pinnacle Financial Corporation, Elberton, Georgia	Atlanta	October 4, 1996
JAM Family Partnership I, L.P., Elberton, Georgia			
Mesquite Financial Corporation, Mesquite, Nevada	Mesquite State Bank, Mesquite, Nevada	Kansas City	October 17, 1996
Nolte Family Limited Partnership, Kenesaw, Nebraska	First Kenesaw Company, Inc., Kenesaw, Nebraska	Kansas City	October 18, 1996
Northern Trust Corporation, Chicago, Illinois	Metroplex Bancshares, Inc., Dallas, Texas Metroplex Delaware Financial Corporation, Dallas, Texas Bent Tree National Bank, Dallas, Texas	Chicago	October 11, 1996
Robertson Holding Company, Speedwell, Tennessee	Commercial BancGroup, Inc., Harrogate, Tennessee	Atlanta	October 18, 1996
The Royal Bank of Scotland Group plc, Edinburgh, Scotland	Farmers & Mechanics Bank, Middletown, Connecticut	Boston	October 11, 1996
The Royal Bank of Scotland plc, Edinburgh, Scotland			
The Governor and Company of the Bank of Ireland, Dublin, Ireland			
Citizens Financial Group, Inc., Providence, Rhode Island			
Saint Jo Bancshares, Inc., Saint Jo, Texas	First Financial Company of Saint Jo, Dover, Delaware The First National Bank of Saint Jo, Saint Jo, Texas	Dallas	October 4, 1996
Sussex Bancorp, Franklin, New Jersey	The Sussex County State Bank, Franklin, New Jersey	New York	October 11, 1996
Union Illinois Company Employee Stock Ownership Trust, Swansea, Illinois	Union Illinois Company, Swansea, Illinois	St. Louis	October 22, 1996
Valley Bancshares, Inc., Nisswa, Minnesota	Minnesota Bancshares Corporation, Augusta, Wisconsin Brainerd National Bank, Baxter, Minnesota	Chicago	October 21, 1996

## Section 4

Applicant(s)	Nonbanking Activity/Company	Reserve Bank	Effective Date
Brunsville Bancorporation, Inc., Brunsville, Iowa	To engage <i>de novo</i> in insurance agency activities	Chicago	October 8, 1996
Caisse Nationale de Credit Agricole, Paris, France	Daniel Breen & Company, L.P., Houston, Texas Indosuez Carr Futures, Inc., Chicago, Illinois Banque Indosuez, Paris, France Breen Trust Company, Houston, Texas	Chicago	September 26, 1996
Cardinal Bankshares Corporation, Floyd, Virginia	To engage <i>de novo</i> in making and servicing loans	Richmond	October 2, 1996
Centura Banks, Inc., Rocky Mount, North Carolina	CLG, Inc., Raleigh, North Carolina	Richmond	October 2, 1996
Commercial Capital Corporation, DeKalb, Mississippi	Kemper Finance, Inc., DeKalb, Mississippi	Atlanta	October 16, 1996
Farmers Capital Bank Corporation, Frankfort, Kentucky	FCB Services, Frankfort, Kentucky	St. Louis	September 24, 1996
FBOP Corporation, Oak Park, Illinois	Topa Savings Bank, FSB, Beverly Hills, California	Chicago	October 15, 1996
Regency Savings Bank, F.S.B., Naperville, Illinois	Topa Thrift and Loan, Beverly Hills, California		
Franklin National Bankshares, Inc., Mount Vernon, Texas	Franklin National Mortgage Corporation, Mount Vernon, Texas	Dallas	October 3, 1996
Fremont Bancorporation, Fremont, California	To engage directly <i>de novo</i> in commercial lending and loan servicing activities	San Francisco	October 1, 1996
Maedgen & White, Ltd., Lubbock, Texas	Plains Service Corporation, Lubbock, Texas	Dallas	October 16, 1996
Plains Capital Corporation, Lubbock, Texas			
Merrill Bancorporation, Inc., Merrill, Iowa	To engage <i>de novo</i> in insurance agency activities	Chicago	October 8, 1996
Mid Am, Inc., Bowling Green, Ohio	Nemo Industries, Inc., Ft. Meyers, Florida	Cleveland	October 1, 1996
Mid Am Recovery Services, Inc., Toledo, Ohio			
National Bancorp of Alaska, Inc., Anchorage, Alaska	To directly engage <i>de novo</i> in the activity of making community development investments	San Francisco	October 1, 1996
National Commerce Bancorporation, Memphis, Tennessee	Kenesaw Leasing, Inc., Knoxville, Tennessee	St. Louis	September 26, 1996
Norwest Corporation, Minneapolis, Minnesota	The Mortgage Center, Springfield, Massachusetts	Minneapolis	October 16, 1996

## Section 4—Continued

Applicant(s)	Nonbanking Activity/Company	Reserve Bank	Effective Date
Norwest Corporation, Minneapolis, Minnesota Norwest Financial Services, Inc., Des Moines, Iowa Norwest Financial Inc., Des Moines, Iowa	To engage <i>de novo</i> in Maine in: (1) making, acquiring, or servicing loans or other extensions of credit relating to consumer finance, sales finance, and commercial finance (including but not limited to accounts receivable financing, factoring, and other secured lending activities); (2) underwriting and selling credit life insurance; (3) selling on an agency basis credit accident and health insurance, credit property and casualty insurance, and involuntary unemployment insurance; (4) issuing and selling at retail money orders and traveler's checks; (5) servicing loans and other extensions of credit for other persons; and (6) offering and selling bookkeeping, payroll, and other management reporting and data processing services	Minneapolis	October 8, 1996
Peoples Heritage Financial Group, Inc., Portland, Maine	Family Bancorp, Haverhill, Massachusetts	Boston	October 11, 1996
Richey Bancorporation, Inc., Glendive, Montana Community First Bancorp., Inc., Glendive, Montana	To engage in management consulting services	Minneapolis	October 24, 1996
The Royal Bank of Scotland Group plc, Edinburgh, Scotland The Royal Bank of Scotland plc, Edinburgh, Scotland The Governor and Company of the Bank of Ireland, Dublin, Ireland Citizens Financial Group, Inc., Providence, Rhode Island	NYCE Corporation, Woodcliff Lake, New Jersey	Boston	October 18, 1996
Summit Bancorp., Princeton, New Jersey	Central Jersey Financial Corp., East Brunswick, New Jersey Central Jersey Savings Bank, SLA, East Brunswick, New Jersey	New York	October 18, 1996

## Section 4—Continued

Applicant(s)	Nonbanking Activity/Company	Reserve Bank	Effective Date
Union-Calhoun Investments, Ltd., Rockwell City, Iowa	Wetter Tax Service, Rockwell City, Iowa	Chicago	October 11, 1996
Washington State Bancshares, Inc., Washington, Louisiana	To engage <i>de novo</i> in making, acquiring, or servicing loans or other extensions of credit, including issuing letters of credit	Atlanta	October 21, 1996
Westamerica Bancorporation, San Rafael, California	Westamerica Commercial Credit, Inc., Fairfield, California	San Francisco	October 3, 1996

## Sections 3 and 4

Applicant(s)	Nonbanking Activity/Company	Reserve Bank	Effective Date
The Maddox Corporation, Blakely, Georgia	First State Bancshares of Blakely, Inc., Blakely, Georgia	Atlanta	October 4, 1996
Stichting Prioriteit ABN AMRO Holding, Amsterdam, The Netherlands	First Southwest Bancorp, Inc., Donalsonville, Georgia		
Stichting Administratiekantoor ABN AMRO Holding, Amsterdam, The Netherlands	First Federal Savings Bank of Southwest Georgia, Donalsonville, Georgia		
ABN AMRO Holding N.V., Amsterdam, The Netherlands	CNBC Bancorp, Inc., Chicago, Illinois	Chicago	September 26, 1996
ABN AMRO Bank N.V., Amsterdam, The Netherlands	Columbia National Bank of Chicago, Chicago, Illinois		
ABN AMRO North America, Inc., Chicago, Illinois	Columbia Financial Services, Inc., Chicago, Illinois		
	CNBC Development Corporation, Chicago, Illinois		
	CNBC Investment Corporation, Chicago, Illinois		
	CNBC Leasing Corporation, Chicago, Illinois		
	Sky Mortgage Company, Chicago, Illinois		
	Sky Finance Company, Chicago, Illinois		
Taylor Capital Group, Inc., Wheeling, Illinois	Cole Taylor Bank, Chicago, Illinois	Chicago	October 21, 1996
	CT Mortgage Company, Inc., Altamonte Springs, Florida		

*APPLICATIONS APPROVED UNDER BANK MERGER ACT**By the Secretary of the Board*

Recent applications have been approved by the Secretary of the Board as listed below. Copies are available upon request to the Freedom of Information Office, Office of the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

Applicant(s)	Bank(s)	Effective Date
The Bank of New York, New York, New York	The Bank of New York (NJ), West Paterson, New Jersey	October 7, 1996
Compass Bank, Jacksonville, Florida	The Putnam Trust Company, Greenwich, Connecticut	October 22, 1996
First Knoxville Bank, Knoxville, Tennessee	Enterprise National Bank, Jacksonville, Florida	October 24, 1996
Manufacturers and Traders Trust Company, Buffalo, New York	Bank of Madisonville, Madisonville, Tennessee	October 30, 1996
	United Southern Bank, Morristown, Tennessee,	
	GreenPoint Bank, New York, New York	

*By Federal Reserve Banks*

Recent applications have been approved by the Federal Reserve Banks as listed below. Copies are available upon request to the Reserve Banks.

Applicant(s)	Bank(s)	Reserve Bank	Effective Date
1st United Bank, Boca Raton, Florida	First National Bank of Lake Park, Lake Park, Florida	Atlanta	October 17, 1996
Bank of Gainesville, Gainesville, Missouri	Douglas County Bank, Ava, Missouri	St. Louis	October 16, 1996
Crestar Bank DC, Vienna, Virginia	Crestar Bank, Richmond, Virginia	Richmond	September 26, 1996
	Crestar Bank MD, Bethesda, Maryland		
First Virginia Bank - Colonial, Richmond, Virginia	First Virginia Bank - South Hill, South Hill, Virginia	Richmond	October 10, 1996
Marine Midland Bank, Buffalo, New York	Morgan Guaranty Trust Company of New York, New York, New York	New York	October 18, 1996

**PENDING CASES INVOLVING THE BOARD OF GOVERNORS**

*This list of pending cases does not include suits against the Federal Reserve Banks in which the Board of Governors is not named a party.*

*American Bankers Insurance Group, Inc. v. Board of Governors*, No. 96-CV-2383-EGS (D.D.C., filed October 16, 1996). Action seeking declaratory and injunctive relief invalidating a new regulation issued by the Board under the Truth in Lending Act relating to treatment of fees for debt cancellation agreements. On October 18, 1996, the district court denied plaintiffs' motion for a temporary restraining order, and set a hearing on their motion for preliminary and permanent injunctive relief for December 17, 1996.

*Clifford v. Board of Governors*, No. 96-1342 (D.C. Cir., filed September 17, 1996). Petition for review of Board order dated August 21, 1996, denying petitioners' motion to dismiss enforcement action against them.

*Artis v. Greenspan*, No. 96-CV-02105 (D. D.C., filed September 11, 1996). Class complaint alleging race discrimination in employment.

*Leuthe v. Board of Governors*, No. 96-5725 (E.D. Pa., filed August 16, 1996). Action against the Board and other Federal banking agencies challenging the constitutionality of the Office of Financial Institution Adjudication.

*Long v. Board of Governors*, No. 96-9526 (10th Cir., filed July 31, 1996). Petition for review of Board order dated July 2, 1996, assessing a civil money penalty and cease and desist order for violations of the Bank Holding Company Act.

*Esformes v. Board of Governors*, No. 96-1916 (S.D. Fla., filed July 12, 1996). Complaint challenging Board denial of administrative request for confidential supervisory information. Plaintiffs' motion for an expedited hearing was denied on August 1, 1996. On September 20, 1996, the Board filed a motion to dismiss or for summary judgment. On October 8, the plaintiffs moved for voluntary dismissal of the action.

*Board of Governors v. Interamericas Investments, Ltd.*, No. 96-7108 (D.C. Cir., filed June 14, 1996). Appeal of district court ruling granting, in part, the Board's application to enforce an administrative investigatory subpoena for documents and testimony. Appellants' motion for a stay of the district court ruling was denied on September 12, 1996. On October 23, 1996, appellants filed a voluntary dismissal of the action.

*Interamericas Investments, Ltd. v. Board of Governors*, No. 96-60326 (5th Cir., filed May 8, 1996). Petition for review of order imposing civil money penalties and cease and desist order in enforcement case. Petitioners' brief was filed on July 26, 1996, and the Board's brief was filed on September 27, 1996. On August 20, petitioners' motion for a stay of the Board's orders pending judicial review was denied by the Court of Appeals.

*Kuntz v. Board of Governors*, No. 96-1137 (D.C. Cir., filed April 25, 1996). Petition for review of a Board order dated

March 25, 1996, approving an application by CoreStates Financial Corp., Philadelphia, Pennsylvania to acquire Meridian Bancorp, Inc., Reading, Pennsylvania. The Board's motion to dismiss was filed on June 3, 1996. On October 24, 1996, the court dismissed the action.

*Kuntz v. Board of Governors*, No. 96-1079 (D.C. Cir., filed March 7, 1996). Petition for review of a Board order dated February 7, 1996, approving applications by The Fifth Third Bank, Cincinnati, Ohio, and The Fifth Third Bank of Columbus, Columbus, Ohio, to acquire certain assets and assume certain liabilities of 25 branches of NBD Bank, Columbus, Ohio. Petitioner has moved to consolidate the case with *Kuntz v. Board of Governors*, No. 95-1495. On April 8, 1996, the Board filed a motion to dismiss the action.

*Henderson v. Board of Governors*, No. 96-1054 (D.C. Cir., filed February 16, 1996). Petition for review of a Board order dated January 17, 1996, approving the merger of First Citizens BancShares, Inc., Raleigh, North Carolina, with Allied Bank Capital, Inc., Sanford, North Carolina. Petitioners' motion for a stay was denied on March 7, 1996. Oral argument on the merits is scheduled for January 17, 1996.

*Research Triangle Institute v. Board of Governors*, No. 1:96CV00102 (M.D.N.C., filed February 12, 1996). Contract dispute. On May 3, 1996, the Board filed a motion to dismiss the action.

*Inner City Press/Community on the Move v. Board of Governors*, No. 96-4008 (2nd Cir., filed January 19, 1996). Petition for review of a Board order dated January 5, 1996, approving the applications and notices by Chemical Banking Corporation to merge with The Chase Manhattan Corporation, both of New York, New York, and by Chemical Bank to merge with The Chase Manhattan Bank, N.A., both of New York, New York. Petitioners' motion for an emergency stay of the transaction was denied following oral argument on March 26, 1996. The Board's brief on the merits was filed July 8, 1996. The case has been consolidated for oral argument and decision with *Lee v. Board of Governors*, No. 95-4134 (2d Cir.).

*Menick v. Greenspan*, No. 95-CV-01916 (D. D.C., filed October 10, 1995). Complaint alleging sex, age, and handicap discrimination in employment. On October 30, 1996, the parties filed a stipulation of dismissal.

*Kuntz v. Board of Governors*, No. 95-1495 (D.C. Cir., filed September 21, 1995). Petition for review of Board order dated August 23, 1995, approving the applications of The Fifth Third Bank, Cincinnati, Ohio, to acquire certain assets and assume certain liabilities of 12 branches of PNC Bank, Ohio, N.A., Cincinnati, Ohio, and to establish certain branches. The Board's motion to dismiss was filed on October 26, 1995.

*Lee v. Board of Governors*, No. 95-4134 (2nd Cir., filed August 22, 1995). Petition for review of Board orders dated July 24, 1995, approving certain steps of a corporate reorganization of U.S. Trust Corporation, New York, New York, and the acquisition of U.S. Trust by Chase Manhattan Corporation, New York, New York. On September 12, 1995, the court denied petitioners' motion for an emergency

stay of the Board's orders. The Board's brief was filed on April 16, 1996.

*Beckman v. Greenspan*, No. 95-35473 (9th Cir., filed May 4, 1995). Appeal of dismissal of action against Board and others seeking damages for alleged violations of constitutional and common law rights. The appellants' brief was filed on June 23, 1995; the Board's brief was filed on July 12, 1995.

*Money Station, Inc. v. Board of Governors*, No. 95-1182 (D.C. Cir., filed March 30, 1995). Petition for review of a Board order dated March 1, 1995, approving notices by Bank One Corporation, Columbus, Ohio; CoreStates Financial Corp., Philadelphia, Pennsylvania; PNC Bank Corp., Pittsburgh, Pennsylvania; and KeyCorp, Cleveland, Ohio, to acquire certain data processing assets of National City Corporation, Cleveland, Ohio, through a joint venture subsidiary. On April 23, 1996, the court vacated the Board's order. On July 31, 1996, the full court granted the Board's suggestion for rehearing en banc, and vacated the April 23 panel decision.

*In re Subpoena Duces Tecum*, Misc. No. 95-06 (D.D.C., filed January 6, 1995). Action to enforce subpoena seeking pre-decisional supervisory documents sought in connection with an action by Bank of New England Corporation's trustee in bankruptcy against the Federal Deposit Insurance Corporation. The Board filed its opposition on January 20, 1995. Oral argument on the motion was held July 14, 1995.

*Board of Governors v. Pharaon*, No. 91-CIV-6250 (S.D. New York, filed September 17, 1991). Action to freeze assets of individual pending administrative adjudication of civil money penalty assessment by the Board. On September 17, 1991, the court issued an order temporarily restraining the transfer or disposition of the individual's assets.

#### *FINAL ENFORCEMENT ORDERS ISSUED BY THE BOARD OF GOVERNORS*

Peter R. Nardin  
New York Branch of  
Credit Suisse  
Zurich, Switzerland

The Federal Reserve Board announced on October 2, 1996, the issuance of an Order of Prohibition against Peter R. Nardin, a former officer and institution-affiliated party of the New York Branch of Credit Suisse, Zurich, Switzerland.

#### *TERMINATION OF ENFORCEMENT ACTIONS*

*The Federal Reserve Board announced on October 9, 1996, the termination of the following enforcement actions:*

Liberty Agency, Inc.  
Kirk, Colorado

Written Agreement dated November 18, 1993; terminated August 13, 1996.

First FSB Bancshares, Inc.  
Mt. Calm, Texas

Written Agreement dated February 18, 1994; terminated August 23, 1996.

First Security Bancshares, Inc.  
Lake Park, Iowa

Written Agreement dated January 23, 1995; terminated September 26, 1996.

Citizens Bank  
BankSouth Corporation  
First Chattanooga Corporation  
All of Lawton, Oklahoma

Written Agreements dated August 27, 1992; terminated October 4, 1996.