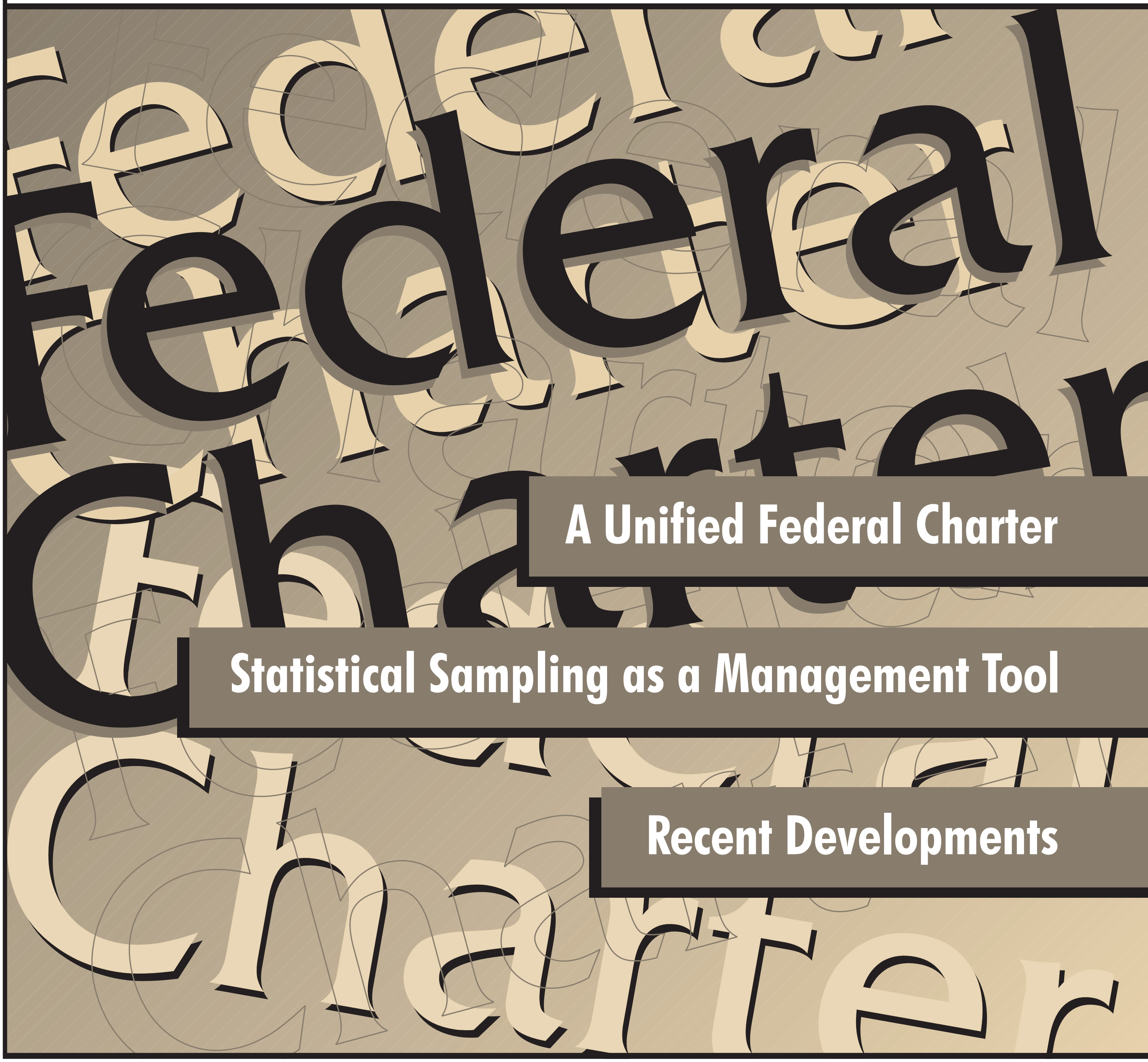
Federal Deposit Insurance Corporation

FDIC Banking Review

1997
Vol. 10, No. 1



A Unified Federal Charter

Statistical Sampling as a Management Tool

Recent Developments

FDIC Banking Review

1997
Vol. 10, No. 1

Single-copy subscriptions are available to the public free of charge. Requests for subscriptions, back issues or address changes should be mailed to: *FDIC Banking Review*, Office of Corporate Communications, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, DC 20429.

A Unified Federal Charter for Banks and Savings Associations

A Staff Study

This article addresses the issues concerning the proposal to establish a single federal charter for banks and savings associations. It is an FDIC staff study and was originally published by the FDIC in October of 1996. Following the introduction, the differences in the powers of banking organizations and thrift organizations are summarized, and data are presented on the various categories of organizations. The next section reviews the arguments and evidence for and against a unification of the federal charters for depository institutions. The final section assumes the decision is to unify the charters and considers the issues that would then have to be resolved. It should be noted from the start, this review does not include the possible expansion of powers beyond those currently exercised by either the banking or thrift industries. Rather, the review is limited to powers that one or the other of the two industries currently possess.

The analysis contained in this study flowed from seven broad principles. Any prospective change needed to:

- ✓ strengthen the safety and soundness of the deposit insurance system and the depository institutions within the system;
- ✓ strengthen the efficiency and competitiveness of the U.S. banking system in financial markets;
- ✓ support reliance on market-based incentives to guide depository institution choices on strategies and business activities for meeting customer needs;
- ✓ reduce the current regulatory burdens and supervisory costs on insured institutions and/or the customers of those institutions;
- ✓ provide flexibility for insured institutions to respond to changes in market conditions, technology, and customer financial needs;
- ✓ increase depository institutions' efficiency and/or effectiveness in meeting specific, legislated, public-policy goals; and
- ✓ increase public access to banking services.

Major Differences Between Federal Savings Associations and National Banks

Federally chartered depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) consist of federal savings associations,[1] which are regulated by the Office of Thrift Supervision (OTS), and national banks, which are regulated by the Office of the Comptroller of the Currency (OCC). Their respective holding companies are savings-and-loan holding companies, which are under the jurisdiction of the OTS, and bank holding companies, which are regulated by the Federal Reserve Board (FRB).

Federal savings associations have historically enjoyed four distinct advantages not accorded national banks. These advantages were: (1) preferential taxation; (2) the most liberal branching rights of all federal depository institutions; (3) expanded subsidiary powers; and (4) virtually unlimited holding company activities. However, the magnitude of these thrift advantages has dissipated over time, and with enactment of the Small Business Job Protection Act on

[1] Technically, there are two distinct federal thrift charters, a federal savings-and-loan association charter and a federal savings bank charter. With the very limited exception of mutual state-chartered savings banks that convert to a federal savings bank charter, the two have identical powers and are referred to collectively in this paper as savings associations.

August 20, 1996, the preferential tax treatment for thrifts has been eliminated.

Balanced against the historical benefits accruing to federal savings associations, national banks have enjoyed the ability to engage in a much wider range of lending activities. National banks were subject neither to an enforced orientation toward a particular area, such as real-estate financing, nor to specific asset-type lending constraints. National banks may focus on a particular area of lending and investment if they desire, but they are not forced to.

This section explores the major areas where savings associations and national banks are treated differently. (For a more detailed comparison of their differences, a table prepared by the OCC and the OTS can be made available upon request from the Division of Research and Statistics of the FDIC).

Lending Constraints

Federal savings associations[2] perform a similar financial intermediation function to that of commercial banks. However, savings-and-loan associations have a distinct focus from that of banks—the provision of home mortgage credit. The laws promulgated by Congress for the industry in the 1930s were motivated by a national policy to encourage home ownership, and this has remained the special focus of the thrift industry since that time.[3]

Federal savings associations are subject to several specific lending constraints. These constraints were also relaxed by the recent legislation. In general, loans secured by nonresidential real estate may not exceed 400 percent of capital. Commercial loans may not exceed 20 percent of assets, and amounts in excess of 10 percent must be used for small-business loans. Unsecured residential construction loans may not exceed the greater of 5 percent of assets or 100 percent of capital. In combination, consumer loans, commercial paper and corporate debt securities may not exceed 35 percent of assets.

In order to receive many of the special benefits of a thrift, an institution must pass the qualified thrift lender (QTL) test, which requires that at least 65 percent of an institution's portfolio assets be qualified thrift investments, primarily residential mortgages and related investments. The Economic Growth and Regulatory Paper Reduction Act of 1996, enacted on September 30, 1996, somewhat relaxed the QTL test by expanding the list of qualified investments to include small-business loans, and by increasing the amount of consumer-oriented loans that can be counted as qualifying assets. It also provided that an institution that qualifies as a domestic building-and-loan under the Internal Revenue Code is considered a qualified thrift lender. (See footnote four.)

Failure to meet the QTL test has several consequences. Probably the most significant is that a holding company owning a nonqualifying savings institution is required to register as a bank holding company. The activities of bank holding companies are significantly more limited than are the activities of most savings-and-loan holding companies. A later section of this report summarizes the differences in powers of bank and savings-and-loan holding companies. Other consequences of failure to meet the QTL test are restricted access to Federal Home Loan Bank (FHLB) financing and accelerated repayment of outstanding FHLB advances.

At the end of 1995, 98 percent of 1,437 savings associations met the QTL test. (As stated above, the test has since been relaxed.) The greatest

Table 1

Savings Institutions

Data as of December 31, 1995

QTL Test Compliance Distribution

Range of QTL Ratio	Savings Institutions (Number)	(Percent)	Total Assets ($MM)	(Percent)	Return on Assets (Percent)
Below 55 percent	12	1	$7,279	1	1.55
55-65 percent	21	1	2,099	0	1.03
65-75 percent	153	11	39,705	5	1.22
75-85 percent	392	27	147,353	19	0.75
85-95 percent	550	38	312,445	41	0.69
Over 95 percent	309	22	262,138	34	0.66
Total	**1,437**	**100**	**$771,020**	**100**	**0.72**

Commercial Banks

Data as of December 31, 1995

QTL Test Compliance Distribution

Range of QTL Ratio	Commercial Banks (Number)	(Percent)	Total Assets ($MM)	(Percent)	Return on Assets (Percent)
Below 55 percent	8,333	84	$3,629,043	84	1.18
55-65 percent	996	10	456,330	11	1.14
65-75 percent	410	4	154,453	4	1.16
75-85 percent	165	2	59,117	1	0.91
85-95 percent	31	0	14,114	0	1.34
Over 95 percent	6	0	1,511	0	0.44
Total	**9,941**	**100**	**$4,314,567**	**100**	**1.17**

Source: Division of Research and Statistics, FDIC

[2] Parenthetically, it is worth mentioning that Section 28 of the Federal Deposit Insurance Act (FDI Act), as added by Section 222 of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, generally limits state-chartered savings associations to activities and equity investments permissible for federal savings associations (12 U.S.C. §21831e).

[3] Federal Home Loan Bank Board, *Agenda for Reform*, Washington, DC, March 1983.

level of profitability of institutions meeting the test, an ROA of 1.22 percent for the group, was achieved by institutions with QTL assets in the range of 65 to 75 percent of portfolio assets (see Table 1). Six percent of commercial banks appeared to have asset portfolios that would meet the QTL test. The ROA of the 410 banks with QTL assets in the range of 65 to 75 percent of portfolio assets was 1.16 percent, which was almost the same as the ROA for all banks, 1.17 percent.

Tax Benefits

As mentioned previously, the repeal of the thrift tax advantage became law on August 20, 1996. Prior to this date, Section 593 of the Internal Revenue Code (IRC) of 1986 permitted thrifts that met the definition of a domestic building-and-loan association[4] to claim deductions for additions to a bad-debt reserve, and to use either the percentage-of-income method or the experience method in calculating such additions.[5] Those thrifts electing to use the percentage-of-income method for additions to their bad-debt reserve were allowed to deduct against their taxable income additions to the reserve equal to 8 percent of taxable income.[6]

Public Law 104-188, the Small Business Job Protection Act, which was signed by the President on August 20, 1996, repealed the special bad-debt reserve provisions for thrifts. According to this law, thrifts are now treated the same as banks for federal income tax purposes. Banks are not permitted to use the percentage-of-income method for accounting for bad debt. Large banks (those with aggregate assets over $500 million) may not use any reserve method of accounting for bad debt, but must deduct bad debts as they occur (specific charge-off method); small banks are allowed to use the experience method or the specific charge-off method. These rules now apply to thrifts.

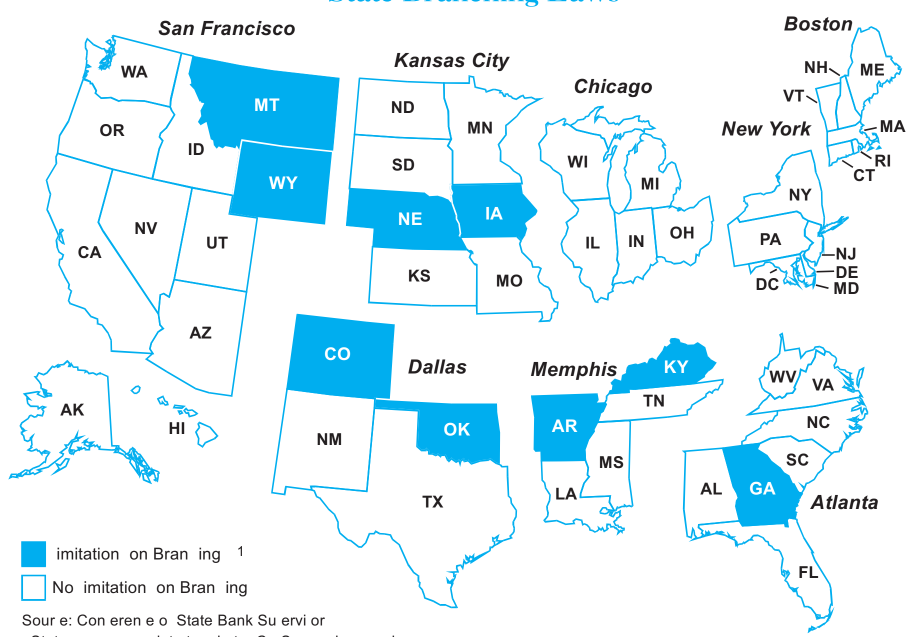
The Small Business Job Protection Act also waived recapture of bad-debt reserves for the years prior to 1988. According to the Act, thrifts need only to recapture reserves set aside after January 1, 1988, rather than their entire bad-debt reserves. Congressional estimates are that there are approximately $14.7 billion in bad-debt reserves in the industry, and that approximately $10.3 billion are pre-1988 reserves and thus exempt from taxation.

Liberal Branching Rights

The federal thrift charter confers the broadest geographic expansion authority of any federally insured depository institution charter. Federally chartered savings-and-loan associations that meet either the QTL test or the building-and-loan test can branch nationally with no "opting in" or "opting out" requirement. They also are not subject to any intrastate branching restrictions whereas banks are subject to a range of restrictions on their statewide branching. Figure 1 provides a graphic representation of state branching laws for commercial banks.

However, once again, the advantage that thrifts enjoyed relative to banks has changed. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 reduced much of the historical branching advantage of savings institutions. Under the terms of the Riegle-Neal legislation, adequately capitalized and managed bank holding companies may acquire a bank in any state beginning on September 29, 1995. As of June 1, 1997, banks will be

Figure 1
State Branching Laws*



Sour e: Con eren e o State Bank Su ervi or
State are grou e into t e eig t C S u ervi ory region .
1 Colora o will ermit unre tri te tatewi e bran ing in 199 , eorgia in 199 , an rkan a in 1999.

---

[4] To qualify as a domestic building-and-loan association, a thrift must pass a test similar to the QTL test. According to 26 U.S.C. §7701(19), at least 60 percent of the institution's total assets must fall within certain categories, largely assets related to real-estate financing. Qualifying assets are similar, but not identical, to assets specified for the QTL test. While no longer relevant to tax treatment, the building-and-loan test may be passed as an alternative to the QTL test to be considered a qualified thrift lender.

[5] Under the experience method, an institution maintains a bad-debt reserve — for which taxable deductions may be taken — that in general is based on the institution's bad-debt experience over the previous six years. Under the percentage-of-income method, the additions to the bad-debt reserve are based on a percentage of the institution's taxable income.

[6] For tax years prior to January 1, 1987, this percentage was 40 percent.

permitted to merge and consolidate their operations in the various states under one corporate structure, unless the state has "opted out" of interstate branching. As of May 1996, 24 states and Puerto Rico had accelerated the process by permitting interstate branching before June 1997, and an additional 11 states had "opted in" with interstate branching to begin on June 1, 1997. Only one state, Texas, had "opted out." Of the states that have "opted in," however, only Indiana and Puerto Rico allow immediate interstate branching by *de novo* institutions on a nonreciprocal basis and without other restrictions. In regards to intrastate branching, as depicted by the chart on state branching laws, most states have eliminated restrictions on intrastate branching for commercial banks, with much of this liberalization having occurred since 1985. Forty-one states now allow statewide branching and three additional states, Colorado, Georgia, and Arkansas, will permit statewide branching in 1997, 1998, and 1999, respectively. Of the remaining six, all allow statewide branching through acquisition.

Expanded Service Corporation Activities

Federal savings associations may invest up to 3 percent of their assets in service corporations.[7] Service corporations of federal savings associations may "engage in such activities reasonably related to the activities of Federal savings associations as the Office [of Thrift Supervision] may determine and approve" (12 C.F.R. §545.74(c)). Under this "reasonably related" standard the OTS has occasionally, on a case by case basis, approved service corporation activities that would not be permitted to a national bank such as insurance underwriting. In addition, the OTS has approved by regulation a long list of permissible activities for thrift service corporations, for which no prior approval is required. Most of the pre-approved activities are also permissible for national banks. Major activities permissible for service corporations of federal savings associations but not for national banks are (1) real-estate development and real-estate management for third parties and (2) selling many types of insurance on an agency basis.[8]

As of year-end 1995, 1,437 reporting savings associations had investments in a total of 2,035 service corporations. The total reported investments in service corporations were $5.4 billion, which represented less than 1 percent of the assets of the savings associations. The consolidated assets of the service corporations were $18.9 billion, or approximately 2.5 percent of the assets of the savings associations. Table 2 gives a breakdown of the service corporations by major type of activity.

As shown in Table 2, the greatest number of service corporations were in the business of real-estate development and sales (481 service corporations); followed by insurance brokerages and agencies (347 service corporations); acquiring improved real estate for sale or rental (254 service corporations); property management and maintenance (117 service corporations); and mortgage lending (99 service corporations). Of these

Table 2

Active Thrift Subsidiaries as of December 31, 1995[1]

Primary Type of Business[3]	Number of First-Tier Entities	Number of Their Subsidiaries	Consolidated Total Assets[2] ($000)
Subsidiary Savings Association	29	3	$3,326,957
Finance Subsidiary[4]	34	1	4,484,385
Risk-Controlled Arbitrage[4]	3	1	34,735
Real-Estate Development and Sales	287	194	1,391,956
Acquiring Improved Real Estate for Sale or Rental	140	114	450,291
Property Management and Maintenance	82	35	1,513,437
Mortgage Lending[4]	82	17	2,243,052
Mortgage Banking[4]	54	9	790,240
Commercial Lending[4]	3	4	103,056
Consumer Lending[4]	28	5	1,174,043
Insurance Brokerage, Agency[5]	285	62	350,792
Escrow, Trustee Services[4]	35	8	39,056
Appraisal, Inspection Services[4]	28	1	21,309
EDP, RSU Services[4]	38	1	149,702
Other	383	69	2,807,156
Total	**1,511**	**524**	**$18,880,176**

Source: Division of Research and Statistics, FDIC.
[1] Includes service corporations, their subsidiaries and joint ventures; excludes "operating subsidiaries."
[2] Data are from Thrift Financial Report, Schedule CSS, Item 120.
[3] Data are from Thrift Financial Report, Schedule CSS, Item 100.
[4] Activities that are also generally permissible for national banks.
[5] Activities that are also permissible under certain circumstances for national banks.

[7] Not less than one-half of investments in service corporations that exceed 1 percent of a federal association's assets must be primarily for community, inner-city, and community development purposes (12 U.S.C. §1464(c)(4)(B)). Thus, the maximum unfettered investment in service corporations is 2 percent of an association's assets.

[8] Two recent Supreme Court cases have provided authority for national banks to enter insurance-related markets previously unavailable to them. In *NationsBank of N.C., N.A. v. Variable Annuity Life Insurance Co.*, 115 S. Ct. 810 (1995), the Court held that because annuities are not insurance for purposes of the "town of 5,000" rule, national banks may sell annuities in any location. And in *Barnett Bank of Marion County, N.A. v. Nelson*, 116 S. Ct. 1103 (1996), the Court held that states cannot restrict the federal authority granted to national banks under 12 U.S.C.§92 to sell insurance in towns with populations of less than 5,000, although it is still uncertain whether national banks may use this authority to sell insurance in larger towns.

top five thrift service corporation activities, only mortgage lending and, to a limited extent, insurance sales are activities also permissible for national banks.

Ten thrifts accounted for 75 percent of the industry's investments, with two thrifts accounting for approximately 57 percent of the industry's total investment in service corporations at December 31, 1995. These two thrifts are Household Bank FSB of Prospect Heights, Illinois, and Home Savings of America FSB of Irwindale, California.

Few Limitations on Holding Companies

In considering a unification of the federal charters for depository institutions, questions arise not only from the differences between the powers of federally chartered depository institutions but also from the differences between the powers of their holding company owners. Corporate owners of savings associations and banks are holding companies: savings-and-loan holding companies for savings associations and bank holding companies for banks. Savings-and-loan holding companies can be further subdivided into two categories: those in which non-thrift activities are essentially unrestricted[9] and those in which non-thrift activities are restricted. The vast majority of savings-and-loan holding companies fall in the first, or unrestricted, category.

A savings-and-loan holding company in the unrestricted category is either a unitary holding company — one that controls only one savings association subsidiary, which meets the QTL test — or a multiple holding company, all of whose savings association subsidiaries meet the QTL test and where no more than one subsidiary was not acquired in a qualifying supervisory transaction.[10] A savings-and-loan holding company in the restricted category has one or more savings association subsidiaries that do not meet the QTL test. A savings-and-loan holding company that has two or more savings association subsidiaries that were acquired in other than qualifying supervisory transactions would also be in the restricted category.

Unrestricted savings-and-loan holding companies may engage, directly or through their non-thrift subsidiaries, in any activities that do not threaten the safety and soundness of their subsidiary savings associations or that do not have the effect of enabling a savings association to evade applicable laws or regulations. Beyond these generalities, there are no limitations on the scope of permissible activities of savings-and-loan holding companies in the unrestricted category. Thus, savings-and-loan holding companies in the unrestricted category are generally permitted to engage in activities closely related to banking, general securities underwriting and dealing, other financial services, real-estate investment and development, and commercial and industrial enterprises. The latter categories allow activities as diverse as manufacturing (cigarettes, containers, furniture) to retail operations (hotels, drug stores and cosmetics) and services (refuse collection, utilities and advertising). In the submission to Congress last year, the OTS indicated that nearly all savings-and-loan holding companies in existence fell into the unrestricted category.

Another savings-and-loan holding company classification is between diversified and non-diversified. A diversified savings-and-loan holding company is defined by statute as one in which the subsidiary savings association and certain other financial activities represent less than 50 percent of consolidated net worth and consolidated net earnings. One of the few legal consequences flowing from classification as a diversified savings-and-loan holding company is that an exception to the Management Interlocks Act may be triggered.[11] The major affiliations between savings associations and non-banking organizations are found in diversified holding companies.

The counting of savings-and-loan holding companies is complicated by the existence of a number of multi-tiered organizations with a variety of ownership arrangements. As of July 9, 1996, the OTS reported the following number of first-tier thrift holding companies: 28 diversified unitary holding companies; 650 non-diversified unitary holding companies; no diversified multiple holding companies; and 44 non-diversified multiple holding companies. The total number of savings-and-loan first-tier holding companies by this count was 722.

In contrast to most savings-and-loan holding companies, bank holding companies are limited to "non-bank" activities the FRB has found, by regulation or order, to be "closely related to banking and a proper incident thereto." The broad categories of activities the FRB has found to meet these criteria are securities brokerage; to a limited extent securities underwriting; mortgage banking; commercial finance; consumer finance; leasing; small-business investment companies; insurance underwriting; and insurance agency. The insurance activities are severely constricted by statute and are principally limited to credit-related and grandfathered activities.

[9] While non-thrift activities are essentially unrestricted, dividend payments from thrift to parent are restricted to avoid abuses.

[10] Qualifying supervisory transactions consist of transactions involving failed or failing institutions and the participation or oversight of the FDIC or the FSLIC.

[11] One of the exceptions to the Management Interlocks Act is for a person who serves simultaneously as a director of (1) a diversified savings-and-loan holding company and (2) an unaffiliated depository institution or depository institution holding company [12 U.S.C. §3204 (8)(A)]. Also, effective October 1, 1996, the OCC, the FDIC, the FRB, and the OTS issued a final rule permitting management interlocks between institutions with less than $20 million in assets and institutions with more than $20 million in assets that are both located in the same metropolitan statistical area. Management interlocks between unaffiliated institutions in the same community continue to be impermissible, regardless of size.

As of June 1996, the number of bank holding companies was 5,293. These holding companies held almost 80.3 percent of the assets of all FDIC-insured U.S. banks and thrifts. Bank holding company nonbank activities are concentrated in the larger bank holding companies, which are required to report financial data on these activities. According to the latest data available from the FRB, in 1994, 238 holding companies reported nonbank activities to the FRB. Total nonbank assets for these reporting companies were $270.2 billion, and the ratio of nonbank assets to total assets of the organizations was 8.40 percent.

Nonbank net income was $2.9 billion, and the ratio of nonbank net income to total net income was 8.29 percent. For the period 1986 to 1994, the ratio of nonbank assets to total assets for reporting companies ranged from a low of 6.91 percent in 1991, to the high of 8.40 percent in 1994. Over the same period, the ratio of nonbank net income to total net income ranged from a low of 1.22 percent in 1991, to a high of 14.35 percent in 1989.

Pros and Cons of Charter Unification

The recently enacted Deposit Insurance Funds Act of 1996 requires the Secretary of the Treasury to submit a report to the Congress by March 31, 1997, on the issues surrounding the development of a common charter for all insured depository institutions and the abolition of separate and distinct charters for banks and savings associations. The Act further requires that the BIF and the SAIF be unified on January 1, 1999, provided no insured depository institution remains as a savings association at that time.

This section discusses the major arguments for and against abolishing the current two-charter federal system for depository institutions and replacing it with a one-charter system. Because it makes little sense to unify the charters without also unifying the BIF and the SAIF, it assumes that if the charters are unified, the BIF and the SAIF will be merged by January 1, 1999.[12]

The arguments for a unified charter are not clear-cut — conflicting arguments and evidence can be advanced to either support or oppose a position. The major argument for a unified charter is that there is no longer a need for a thrift industry due to structural changes in housing finance: the thrift industry is no longer necessary to satisfy the societal need for which it was established, and therefore the thrift charter should be abolished. This argument is often buttressed with arguments that the long-term viability of the thrift industry is in question, and that the current restrictions on thrift activities hamper the ability of thrift institutions to respond to changes in the marketplace. Replacement of the current federal two-charter system for depository institutions with a one-charter system would "level the playing field" between thrifts and banks and allow them to compete head-on.

These latter arguments for a unified charter, with a few twists, can also be used to support the major opposing position—that there is no need for charter unification, but easier entry and exit between banks and thrifts. This position argues that what is needed are certain adjustments to current law, short of charter unification, that will enable banks and thrifts to switch charter types easily. These changes will "level the playing field," and allow the market to decide of its own accord whether the thrift industry is viable and should survive.

The major arguments are examined below.

Arguments for Unification of Charters. According to proponents of this viewpoint, due to structural changes in housing finance, a separate legal status for a class of institutions to ensure availability of housing finance has become unnecessary. As Federal Reserve Board Chairman Greenspan stated in his September 21, 1995, testimony to the Banking Subcommittee on Financial Institutions and Consumer Credit . . . "The nexus between thrifts and housing largely has been broken without any evident detriment to housing finance availability."

Statistics would appear to bear this out. Over a period of two decades, the thrift industry has seen the gradual erosion of its share of the market that the industry's separate status was designed to foster. Between 1975 and 1994, the market share held by savings institutions dropped from 45 percent of total mortgages to 13 percent; from 56 percent of home mortgages to 14 percent; and from 39 percent of multifamily residential mortgages to 22 percent.[13] Concerning originations, in 1975, thrifts originated 58 percent of home mortgages. By 1994, home mortgage originations by thrifts were down to 20 percent of the total.[14]

Thus, the housing market — the support and development of which has provided the rationale for a legally distinct thrift industry — has come to be less dependent on the thrift industry. Much of the thrift industry's lost share of mortgages it held has gone to federally related mortgage pools—mortgage-backed securities guaranteed or issued by the Government National Mortgage

---

[12] Although not provided for in existing legislation, the BIF and the SAIF could be merged without unifying the two charters. Indeed, thrifts, in the form of state-chartered savings banks, are already insured by the BIF. Similarly, if regulatory consolidation were thought to be desirable, a single regulatory apparatus could be established without charter unification.

[13] Board of Governors of the Federal Reserve System, *Flow of Funds*. Measuring market shares of the mortgage market by the percentage of mortgages directly held results in a slight understatement of the position of savings institutions in the market. Savings institutions also hold securities issued or guaranteed by the government-related issuers of mortgage-backed securities. If their holdings of these securities were considered, savings institutions' share of the total mortgage market in 1994 would increase from approximately 13 percent to approximately 15 percent.

[14] *The Mortgage Market Statistical Annual for 1995*, Inside Mortgage Finance Publications, Inc.

Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Farmers Home Administration. Much of the thrift industry's lost share of mortgages that it originated has gone to mortgage banking companies.

It might be argued that though the thrift industry today appears to be less important to the health of the housing industry than in the past, the housing industry would still be harmed if the forced orientation of thrifts to housing were removed. However, this is not clear. The threshold for the QTL test is 65 percent of portfolio assets invested in specified assets largely related to housing finance. Yet as shown in Table 1, as of year-end 1995, 80 percent of thrifts held 75 percent or more of their portfolio assets in assets that qualified for the QTL test — substantially more than was necessary to meet the test. Therefore, as the QTL constraints appear to be nonbinding, one would not expect that removing these constraints would result in a significant shift in thrift behavior. Moreover, as noted earlier, the QTL test has just been relaxed; thus, to the extent thrifts want to make incremental changes in their portfolios, they will be able to do so.

In addition, thrifts have not demonstrated a desire to expand into other fields by making full use of the asset powers now available to them. For example, federal savings associations can invest up to 10 percent of their assets in commercial loans, but as of year-end 1995, their commercial loans amounted to only 1 percent of assets.[15] At that same date, only 89 institutions had more than 5 percent of their assets in commercial loans. Consequently, any shifts of institutions from or to a focus on housing finance is likely to be over an extended period and in response to market forces.

Indeed, lack of flexibility in responding to changing market forces caused by savings associations' mandatory orientation toward housing is another reason often advanced for eliminating the federal savings association charter. If savings associations cannot redeploy their assets in response to the market, there will be excess capacity in the thrift industry. This in turn will lead to lower profitability, difficulty in attracting new capital, and a tendency to invest in riskier assets in order to maintain earnings. According to this view, it is better to eliminate the savings association charter than risk the losses — especially in light of federal deposit insurance—resulting from an inflexible charter.

Arguments against Unification of Charters. According to proponents of this viewpoint, the market — not the government — should decide whether a charter is obsolete. Thus, while the *status quo* is not desirable because it impedes the workings of the market, if certain adjustments were made to current law to enable banks and thrifts to switch charter types more easily, the institutions themselves could choose their future organizations based upon their individual situations. If thrifts could become banks without penalty and without adverse consequences for themselves or their owners, many, perhaps most, might do so. Removal of many of the barriers to entry and exit would allow the thrifts themselves to decide their future. If housing finance were profitable, then many thrifts — those that are operated with the proper attention to controlling costs and to prudent practices — would likely choose to remain as thrifts. But if housing finance entered a period of doldrums, particularly for an extended period of time, they would be free to reorient their efforts, and the industry would not become burdened with excess capacity.

The current impediments to thrifts switching to banks were described earlier. The major financial penalty — the recapture of bad-debt reserves for thrifts that became banks — has been addressed by legislation. Another restriction — imposition of the banking industry's remaining geographic restrictions upon converting thrifts — has been whittled away over time by activity of the states, and, as discussed earlier, has been addressed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Two major impediments remain to switching charters. They are the prohibition against banks owning service corporations engaged in many insurance activities and real-estate development activities;[16] and the different requirements for thrift and bank holding companies — some corporate owners of thrifts could not qualify as bank holding companies. Short of changing the laws governing banks and bank holding companies, one way to ease these impediments would be to allow a number of years for a thrift or holding company to divest of the impermissible activity.

Charter Unification Implementation Issues

If a decision were made to unify the federal bank and thrift charters, implementation issues would arise at both the institution and holding company level. Many of these issues, such as the sale of insurance products by depository institutions or the separation between banking and commerce, are legitimate public-policy concerns in their own right. The prospect of charter unification brings them to the fore.

[15] The relationship between the legal limit and actual use of other powers of federal savings institutions as of year-end 1995 was: loans secured by nonresidential real estate—the limit is approximately 32 percent of assets (400 percent of capital, which for the industry stands at approximately 8 percent of assets), loans amounted to 6 percent of assets; unsecured residential construction loans— the limit is the greater of 5 percent of assets or 100 percent of capital (which is approximately 8 percent of assets), residential and nonresidential construction loans together totaled 2 percent of assets. Of course, individual institutions may be closer to these limits.

[16] As discussed earlier, recent judicial decisions have narrowed the differences between banks and thrifts in the sale of insurance.

This section discusses these implementation issues and presents options for dealing with them. Again, as stated in the introduction, the options it examines concern only those powers that either banks or savings associations currently have. It does not broach financial modernization in its broader sense.

This section also reviews the impact that charter unification would have in several related areas: the QTL test, state-chartered thrift institutions, mutual savings associations, and the Federal Home Loan Bank System. Grandfathering is one option to deal with some of the implementation issues that would arise from charter unification. An appendix contains an historical overview of grandfathering within the context of financial industry legislation.

Issues at the Depository Institution Level

At the depository institution level, implementation issues arise in three areas: the asset powers of the depository institution; the powers of thrift service corporations; and branching restrictions.

Asset Powers. At the institution level, commercial banks have more extensive asset powers than savings associations whose investment in certain types of loans is restricted. As discussed in the previous section, the major argument for unifying the federal bank and thrift charters is that there is no longer a need for a special-purpose charter focused on the housing industry. In addition, broader asset powers allow for greater diversification and more competition, while not precluding the possibility of an institution specializing if that is its business strategy. Given the above, if the federal bank and thrift charters were to be merged, the only plausible alternative is to give the resultant institution the asset powers of a national bank.

Savings Association Service Corporations. One of the more difficult questions about charter unification at the institution level concerns the service corporations of federal savings associations. As discussed earlier, federal savings associations can invest up to 3 percent of their assets in service corporations. Also, while national banks can perform most of the pre-approved activities permissible for thrift service corporations, both directly and through operating subsidiaries, they are not permitted to engage in real-estate development and the management of real estate for third parties, or to sell most types of insurance without restriction (although recent judicial decisions have expanded the insurance agency powers of national banks).

As of year-end 1995, there were 255 savings associations with insurance subsidiaries. Most of these were at relatively small institutions, 207 of the 255 had under $1 billion in assets. Although no data are available on the activities of these insurance subsidiaries, anecdotal evidence indicates that many are restricted to the sale of credit-related insurance products, an activity permissible to subsidiaries of national banks.

Insurance brokerage and agency are basically sales-oriented activities and do not present safety-and-soundness issues. The sale of insurance by banks would provide customers with greater choice, and promote greater efficiency in the marketplace. Therefore, if federal bank and thrift charters were merged, a reasonable course of action would be to extend full insurance agency powers to national banks. However, as a practical matter, such a move might encounter significant political opposition.

Unlike insurance, real-estate activities, especially real-estate development, do raise safety-and-soundness issues.[17] FIRREA required that equity investments and loans to service corporations engaged in activities not permissible for national banks be deducted from capital. As a result, federal savings associations no longer engage in real-estate activities on a large-scale basis. Savings associations reported $77.7 billion in real-estate service corporation assets at year-end 1989.[18] By year-end 1995, this figure had fallen to $3.4 billion.

Despite the current low level of real-estate investment by savings associations, the divergent real-estate powers of federal savings associations and banks would need to be addressed if the federal charters were merged. One way to deal with those risks would be to require that any real-estate development or management activities be conducted in a bona fide subsidiary, with the bank's investment (both equity and loans) deducted from capital, and with the subsidiary subject to Section 23 of the Bank Holding Company Act type restrictions. With the exception of the Section 23 requirements, these conditions already apply to thrift service corporations.[19]

Branching Restrictions. As discussed earlier, bank branching powers are in some cases more restrictive than federal savings association branching powers, although they

[17] The FDIC presents the risks in detail in the *Federal Register* publication, 61 FR 43486, "Proposed Rule: Activities and Investments of Insured State Banks," August 23, 1996.

[18] Institutions that were eventually taken over by the RTC held $11.1 billion of this amount.

[19] The FDIC has dealt with real-estate investments by depository institutions in conjunction with applications made by state-chartered banks under Section 24 of the Federal Deposit Insurance Act (12 U.S.C. §1831a). The FDIC deals with each Section 24 case individually. However, in many cases, the FDIC has conditioned its approval of an application from a state-chartered bank to engage in real-estate investment on the following conditions: that the real-estate activity be conducted in an adequately capitalized, separately-operated subsidiary with at least one separate director; that the bank's investment in the subsidiary (except arm's-length end loans) be deducted from capital; that the capital deduction is also used for setting risk-related premiums and prompt corrective action; and that the restrictions of Section 23A and 23B of the Federal Reserve Act apply to transactions with the subsidiary. The FDIC has also proposed a "safe harbor" rule under which institutions meeting certain conditions may engage in real-estate activities after notice to the FDIC if the FDIC does not object.

have come much closer together over time. Full interstate and intrastate branching provides for the greatest diversification of risk, the greatest convenience for customers, and the greatest market efficiencies. Given these facts, the near universality today of statewide branching, and the clear momentum to interstate branching, a reasonable course of action should the federal charters be unified would be to allow full interstate and intrastate branching.

Issues at the Holding Company Level

The most difficult issue regarding the single federal charter concerns holding companies. Except for possible grandfathered situations (and ignoring the complication that would result if thrift charters were continued at the state level), the distinctions between savings-and-loan holding companies and bank holding companies would have to be eliminated. Table 3 contains a list of unitary diversified savings-and-loan holding companies, the type of savings-and-loan holding company most likely to contain significant nonfinancial businesses. As can be seen from the table, as of June 1996, there were only 28 such companies.

Four approaches to eliminating the prospective differences between savings-and-loan holding companies and bank holding companies could be taken (existing affiliations are discussed below): (1) holding companies could be allowed to engage in virtually any activity, the approach taken with unrestricted savings-and-loan holding companies; (2) holding companies could be restricted to a limited number of financially related activities, the approach currently taken with bank holding companies; (3) holding companies could be allowed to engage in most financially related activities, including, with proper safeguards, investment banking and the insurance business, but prohibited from nonfinancial activities; or (4) holding companies whose depository institutions met the QTL

Table 3
28 Thrift Unitary Diversified Holding Companies*
as of June 1996

Holding Company	Type of Business	Thrift Name	Thrift Assets ($000s)
Acacia Mutual Life Insurance Co.	Insurance	Acacia Federal Savings Bank	$515,811
American Mutual Holding Company	Life Insurance	Amerus Bank	1,198,139
B.A.T. Industries	Tobacco, Cigarettes	First FS&LA of Rochester	7,341,422
Carpenters Pension Trust Fund Southern California	Pension Trust	United Labor Bank, FSB	71,114
Club Corp. International	Resorts	Franklin Federal Bancorp., FSB	900,188
Equity Holdings Ltd.	Real Estate	Firstate Fin., F.A.	103,266
Estate of Bernice Pauahi Bishop	Non-Profit Educ.	Southern Cal. FS&LA	1,694,535
First Pacific Investment Ltd.	Numerous Holdings	United Savings Bank	1,526,791
First Pacific Investment Ltd. II	Numerous Holdings	United Savings Bank	1,526,791
Hawaiian Electric Industries, Inc.	Public Electric	American Savings Bank, FSB	3,412,595
Heritage Mutual Insurance Co.	Insurance	Westland Savings Bank SA	91,405
Hy-Vee Food Stores	Grocery	Midwest Heritage Bank, FSB	96,685
Illinois Mutual Life & Casualty Co.	Insurance	Bankplus, FSB	189,909
Krause Gentle Corp.	Gas and Food	Liberty Savings Bank, FSB	76,903
Massachusetts State Carpenters Pension Fund	Pension Trust	First Trade Union Savings Bank, FSB	286,468
Massachusetts State Carpenters Guaranteed Annuity Fund	Trust	First Trade Union Savings Bank, FSB	286,468
McMorgan & Co.	Manages Union Pension Funds	United Labor Bank, FSB	71,114
P H M Corporation	Home Building	First Heights Bank, FSB	252,057
Pacific Electric Wire & Cable	Manufacturer	Pacific Southwest Bank	1,337,198
Prudential Insurance Co.	Insurance	The Prudential Savings Bank, FSB	203,641
Raymond James Financial, Inc.	Security Brokerage	Raymond James Bank, FSB	189,791
Southwest Gas Corp.	Gas Transmission	Primerit Bank, FSB	1,704,885
Sun Life Assurance Co.	Insurance	New London Trust, FSB	288,881
Temple Inland, Inc.	Paper	Guaranty Federal Bank, FSB	9,153,087
The Langdale Co.	Manufacturing-Forest Based Products	Commercial Banking Co.	33,684
The Monticello Cos., Inc.	Medicine Sales	Monticello Bank	23,526
United Services Automobile	Insurance	USAA Federal Savings Bank	5,805,837
Watts Health Systems, Inc.	Health Plans	Family Savings Bank, FSB	167,239

*First-Tier Holding Companies
Source: The Office of Thrift Supervision

test (or similar test) could be allowed to engage in any activity that did not threaten the safety and soundness of the institution.

Of these four options, the third option — permitting bank holding companies to expand into most financially related activities but with a continued prohibition against nonfinancial activities — would appear to be the most desirable. While the elimination of the separation between banking and commerce may be worth considering in the long run, a more cautious policy of bank expansion into other financial activities is probably a more prudent short-term course.

Banking organizations have expertise in managing certain financial risks. They should leverage this expertise before branching out into commercial ventures. In addition, bank regulators should develop a body of experience to evaluate the safety-and-soundness implications of any new financial affiliations before allowing broader affiliations with firms exposed to a different range of risks. On the other hand, compared to the *status quo*, allowing banks to expand into other financially related activities — perhaps through either holding companies or direct subsidiaries — would strengthen banking organizations by allowing diversification of income sources and better service to customers, and would promote an efficient and competitive evolution of U. S. financial markets.

With respect to using the QTL test, or some variant thereof, to determine holding company powers, in order for such an approach to make sense, some nexus would have to be established between the test and broader holding company powers. Absent such a nexus there would be no reason to distinguish between the powers of a holding company of a depository institution that met the test and powers of one that did not.

As to existing affiliations, commercial companies have not historically been a source of risk to the thrift industry. The OTS reports that unitary thrift holding companies, rather than having caused harm to their subsidiaries in the past, have in fact provided a source of strength to them during times of need. Additionally, affiliations between thrifts and commercial organizations do not appear to be extensive.[20] Thus, the grandfathering of existing relationships might be feasible. In fact, some affiliations between commercial companies and bank holding companies were already grandfathered by the 1970 Amendments to the Bank Holding Company Act (see appendix). On the other hand, given the limited number of affiliations, divestiture would not require widespread restructuring of the thrift industry.

Other Issues

Charter unification raises issues in addition to the powers of depository institutions, their affiliates, and their holding companies. The topics in the following discussion concern the QTL test, state-chartered savings associations, mutual savings associations, and the Federal Home Loan Bank System.

QTL Test. If the charters are merged, the QTL test would basically be moot with two possible exceptions. First, as noted earlier, the QTL test could be used to exempt a holding company from the strictures of the Bank Holding Company Act. However, also as noted earlier, such a distinction would only make sense if there was a nexus between the QTL test and holding company powers. Second, the QTL test — or more accurately the percentage of QTL assets — is used to establish the amount of FHLB stock a non-savings association FHLB member must hold for a given amount of advances (the higher the ratio, the less stock). The role of the FHLBs and what characteristics, if any, their members should have is beyond the scope of this study. Depending on the mission of the FHLB System, requiring some continued portfolio orientation (although not necessarily the current QTL assets) in order to enjoy the benefits of FHLB advances may make sense.

State-Chartered Savings Associations. If the federal savings association charter were eliminated, a major question is whether state-chartered savings associations should be eliminated as well. As noted earlier, the Deposit Insurance Funds Act of 1996 requires that the BIF and the SAIF be merged on January 1, 1999, provided no institution remains as a savings association at that time.

Eliminating state-chartered thrifts might prove difficult. In order to eliminate state-chartered thrifts effectively, such a ban would have to include state-chartered savings banks as well as state-chartered savings-and-loan associations. As a general matter, states are allowed to issue limited-purpose charters. In addition to chartering savings-and-loan associations and savings banks, the states issue charters for trust companies, cooperative banks, and industrial banks. To force them to eliminate a specific type of limited charter would be a blow to the dual banking system. It would also be difficult to prevent a state from reincarnating a charter that looked very much like a savings association charter with a different name.

Short of mandating the elimination of the state thrift charter, state-chartered savings associations could be subjected to Section 24 of the FDI Act, which would require that they not engage in any activity not permissible for a national bank without FDIC approval.[21] They could also be made subject to the Bank Holding

[20] Because unrestricted savings-and-loan holding companies are essentially unregulated, only limited data on their activities exist. This makes it difficult to gauge, except in the most general terms, the number engaged in nonfinancial activities, or activities not permissible to a bank holding company.

[21] Under current law, a state-chartered thrift must apply to the FDIC to engage in any activity not permissible to a federal savings association (12 U.S.C. §1831e).

Company Act with whatever grandfathering or other provisions that would apply to federal savings associations.[22] Under such circumstances, state-chartered savings associations would probably lose their attractiveness. Many state-chartered savings associations might choose to convert to banks and some states might eliminate their thrift charters, but this would be accomplished without tampering with the dual banking system.

Mutual Savings Associations. At June 30, 1996, there were 410 mutual federal savings associations and 714 stock federal savings banks. While in number mutuals represent 36 percent of federal savings associations, they accounted for only 10 percent of the assets held by such institutions ($72 billion out of a total of $717 billion in assets). Including state-chartered savings and loans and savings banks there were a total of 943 mutual thrifts and 1,038 stock institutions. Mutual institutions hold a total of 17 percent of thrift assets ($179 billion out of a total of $1,023 billion). Commercial banks all take stock form.

The FDIC Division of Research and Statistics has looked at recently chartered *de novo* savings associations to determine whether the mutual form of organization has proven to be attractive to new industry entrants. According to a preliminary review, only a handful of savings associations over the past ten years have chosen the mutual form of organization. At least two were credit unions converting to savings associations. It is not clear that any of the new mutual charters over this period were true *de novo* mutual savings associations.

Given the large number of mutual thrifts, it does not make sense to change the *status quo* and require conversion. The other options are to grandfather existing mutuals but not grant new mutual charters, or to continue to grant new mutual charters, effectively extending the possibility of the mutual form to commercial banks. Historically, the mutual form of organization has not raised safety-and-soundness concerns. As such, there does not appear to be any reason not to follow this latter course.

Federal Home Loan Bank System (FHLBS). Replacement of the two-charter federal system with a single charter would have an impact on the Federal Home Loan Bank System (FHLBS). Federal savings associations are currently required to be members of the FHLBS. Elimination of the federal thrift charter could result in a voluntary FHLBS that would not have the automatic capital support of the current system. However, it should be noted that as of August 1996, federal savings associations accounted for only 19 percent of FHLBS members (commercial banks accounted for 65 percent, state-chartered thrifts 13 percent, and others 3 percent). Moreover, according to the Federal Housing Finance Board, since April 1995, when FHLBS membership was made voluntary for OTS-regulated state-chartered thrifts, no such thrift has left the system.[23] It is likely that many federal savings associations would also choose to retain their FHLBS membership if such membership were to become voluntary. The FHLBS is therefore unlikely to face crisis if the federal thrift charter were eliminated.

[22] State-chartered savings banks are presently subject to the Bank Holding Company Act unless they elect under §10(e) of the Home Owners Loan Act to be treated as a thrift for purposes of §10 and comply with the QTL test.

[23] One state-chartered savings-and-loan association, Wauwatosa Savings and Loan Association, managed to exit the system in April 1993.

APPENDIX
Grandfathering in Banking Legislation

This appendix outlines how past legislation mandating changes in the banking industry dealt with the problem of existing activities and ownership arrangements. The approaches taken fall into two general categories: (1) requiring that existing activities and arrangements be ceased or divested; and (2) permitting the continuation of existing activities and arrangements. The second approach is often termed "grandfathering" and itself encompasses a range of controls. At one end of the spectrum, the continuation of existing activities and arrangements has been tightly circumscribed, even "frozen" as they were on a grandfather date. At the other end of the spectrum, few controls have been placed on the continuation, and the activities have thus enjoyed room for growth. An accompanying table summarizes the prohibition, divestiture, and grandfather provisions of the major laws covered in the discussion.

Glass-Steagall. Four provisions of the Banking Act of 1933 largely required the divestiture and continued separation of the investment banking and commercial banking businesses. The divestiture period was one year. The Glass-Steagall Act is still the law, but judicial and regulatory interpretations and developments in financing and investment techniques have eroded many of the distinctions between the two businesses.

Bank Holding Company Act of 1956 — Nonbanking Activities. The Bank Holding Company Act of 1956 generally required multibank holding companies to divest themselves of businesses extraneous to banking. The divestiture period was two years, which the Federal Reserve Board (FRB) could extend in individual cases to a maximum of five years.

Bank Holding Company Act of 1956 — Interstate Banking. The Bank Holding Company Act of 1956 provided that the FRB could not approve an application by a bank holding company to acquire voting shares on substantially all assets of a bank outside of its home state unless the acquisition was expressly permitted by the law of the target state. Twelve existing interstate holding companies were grandfathered. In the late 1970s and throughout the 1980s, states relaxed their laws to permit various degrees of interstate expansion by bank holding companies. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 authorized interstate expansion by bank holding companies beginning one year after its enactment. The Act also authorized interstate branching by banks beginning on June 1, 1997, unless a state either accelerates the effective date or opts out of interstate branching.

Bank Holding Company Act Amendments of 1970. The Bank Holding Company Act Amendments of 1970 brought single-bank holding companies within the jurisdiction of the Act and gave the FRB leeway to expand the nonbanking activities permitted bank holding companies. Companies that became bank holding companies as a result of the Amendments were given a ten-year period to divest impermissible activities they were directly or indirectly engaging in. Two primary grandfathered situations were provided for, the $60-million limitation and the hardship exemption.[1]

$60-Million Limitation. Under Section 4(a)(2) of the Bank Holding Company Act (12 U.S.C. §1843(a)(2)), a company that became a bank holding company as a result of the Amendments and that was engaged in activities on June 30, 1968, that became impermissible because of the Amendments could continue to engage in the activities unless the FRB determined termination was necessary to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. The FRB was required to make such a determination within two years if a company's bank had assets of over $60 million or within two years of the reaching of that level by a bank. The divestiture period after such a determination by the FRB was ten years. Under the $60-million limitation, a bank holding company could only continue existing impermissible nonbanking activities and not engage in new impermissible ones.

Hardship Exemption. Under Section 4(d) of the Bank Holding Company Act (12 U.S.C. §1843(d)), the FRB could grant exemptions from the Act for a company that became a bank holding company as a result of the Amendments, that controlled a single bank on July 1, 1968, and that did not subsequently acquire another bank. The exemptions could be subject to such conditions as the FRB considered necessary to protect the public interest. Unlike the grandfather privileges under the Section 4(a)(2) $60-million exemption, an exemption under Section 4(d) permitted a bank holding company to expand into new nonbanking activities. An exemption had to be based on one of three grounds: (1) to avoid disrupting business relationships that had existed over a long period of years without adversely affecting the banks or communities involved; (2) to avoid forced sales of small locally owned banks to purchasers not similarly representative

[1] The Amendments also exempted from the nonbanking restrictions (1) certain bank holding companies that were also tax-exempt labor, agricultural, or horticultural organizations and (2) any one-bank holding company that was more than 85 percent owned by a single family on June 30, 1968, and continued to be so.

Prohibitions, Divestitures, and Grandfathering in Banking Legislation

Selected banking industry legislation containing prohibition, divestiture, and grandfathering provisions are listed in this table. The provisions are described in greater detail in the accompanying text, which also covers additional legislation.

Law	Prohibitions and Divestitures	Grandfathering
Glass-Steagall Act, 1933	Investment Banking and Commercial Banking — One-Year Divestiture Period	None
Bank Holding Company Act of 1956	(1) Bank Holding Company Nonbank Activities Unless Permissible — Two-Year Divestiture Period, Extendable to Five Years (2) Interstate Bank Holding Companies Prohibited Without State Permission	(1) None (2) Existing Interstate Bank Holding Companies
Bank Holding Company Act Amendments of 1970	Bank Holding Company Nonbank Activities Unless Permissible — Ten-Year Divestiture Period	(1) Existing Nonbank Activities of Bank Holding Companies With Bank Subsidiaries Smaller Than $60 Million in Assets (2) Hardship Exemption
International Banking Act of 1978	U.S. Nonbank Activities of Foreign Banks With Branches, Agencies, or Commercial Lending Companies in U.S. — Seven-Year Divestiture Period	Existing Securities Affiliates
Garn-St Germain Act, 1982	Bank Holding Company Insurance Activities Unless Specifically Permitted by Statute	(1) Existing Insurance Activities (2) Any Insurance Activities by a Bank Holding Company Conducting an Insurance Activity Prior to January 1, 1971
Competitive Equality Banking Act, 1987	Nonbank Banks (Nonbank banks were not prohibited, just brought within the Bank Holding Company Act's definition of a bank.)	Existing Nonbank Banks (Owners that were not bank holding companies could continue ownership without becoming bank holding companies; owners that were bank holding companies could continue ownership despite what might otherwise be violations of interstate banking restrictions.)

of community interests; or (3) to allow retention of a bank so small in relation to the holding company's total interest and so small in relation to the banking market as to minimize the likelihood that the bank's powers to grant or deny credit would be influenced by a desire to further the holding company's other interests.

Altogether, the FRB granted approximately 12 hardship exemptions. Among the companies that received exemptions were The Goodyear Tire & Rubber Company, Olin Corporation, Minnesota Mining and Manufacturing Company, and Beneficial Corporation. Data on the hardship exemptions are presented in an accompanying table.

Foreign Banks — Nonbanking Activities. Among other things, the International Banking Act of 1978 made the restrictions on nonbanking activities contained in the Bank Holding Company Act applicable to a foreign bank that maintained a branch, agency, or commercial lending company in the United States (12 U.S.C. §3106(a)). Foreign banks could retain any nonbank investment or continue any nonbank activity until December 31, 1985. Grandfather privileges were granted beyond that date for direct or affiliate activities conducted on or applied for by July 26, 1978. In addition, foreign banks engaged since July 26, 1978, in underwriting, distributing, or selling securities in the United States through "domestically controlled affiliates" were permitted to engage in new activities through the affiliates or acquire the assets of going concerns through the affiliates. Under an FRB interpretation that was codified into the International Banking Act in 1987, a foreign bank that acquires a bank in the United States loses its grandfather rights.

Bank Holding Company Insurance Activities. In 1982, the Garn-St Germain Act, among other things, amended Section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. §1843(c)(8)) to restrict the insurance activities of bank holding companies. Two grandfather situations were provided for. First, insurance agency activities conducted by a bank holding company on May 1, 1982, or approved for the company by the FRB on or before that date, could be continued. Further, the activities could be expanded to new locations in the state of the bank holding company's principal place of business, in adjacent states, and in other states where the activities were conducted on the grandfather date. And the agency activities could be expanded to include new types of insurance insuring against the same types of risk. Second, the FRB could approve new insurance activities for a bank holding company engaged in insurance agency activities prior to January 1, 1971, pursuant to FRB approval prior to that day. Insurance activities permitted under this second grandfather provision were not limited to those conducted in 1971. The Garn-St Germain amendment also provided for the growth of a $10,000 ceiling it imposed on extensions of credit for which finance company subsidiaries of bank holding companies could sell credit-related insurance. The ceiling increased annually to match the increase in the Consumer Price Index.

Competitive Equality Banking Act — Nonbank Banks. The Competitive Equality Banking Act of 1987 (CEBA) was signed into law on August 10, 1987. The cut-off date used in the grandfather provisions of this legislation was March 5, 1987. Among other things, CEBA closed the "nonbank bank" loophole in the Bank Holding Company Act by broadening the definition of "bank" in that Act to cover any institution that either met the then-existing definition or was insured by the FDIC (12 U.S.C. §1841). Several grandfather situations were provided for:

Nonbank Holding Company Owners. A company that controlled a nonbank bank on March 5, 1987, and was not a bank holding company before the enactment of CEBA would not be treated as a bank holding company solely by virtue of its control of the nonbank bank (12 U.S.C. §1843(f)). Within 60 days after enactment, such companies had to identify themselves to the FRB. In general, grandfather rights would be lost if the company otherwise became a bank holding company or if the nonbank bank did one or more of several things: (1) began to engage in activities in which it was not lawfully engaged on March 5, 1987; (2) offered or marketed products or services of

Section 4(d) Approvals

Holding Company and Bank	Assets of Bank (in $ millions)	Board Action
1. The Goodyear Tire & Rubber Company, Akron, Ohio; The Goodyear Bank, Akron, Ohio	$108	12/07/71 (A)
Goodyear Bank was part of Goodyear until 07/15/82. Now owned by National City Corp of Cleveland.		
2. Olin Corporation, New York, New York; Illinois State Bank, East Alton, Illinois	20	12/07/71 (A)
Illinois State Bank of East Alton was controlled by Olin until 08/12/85. Now a branch of Magna Bank of St. Louis.		
3. Milton Hershey School and School Trust, Hershey, Pennsylvania; The Hershey National Bank, Hershey, Pennsylvania	43	02/17/72 (A)
Hershey National Bank was affiliated with Milton Hershey until 03/14/86. Now a branch of PNC Bank of Pittsburgh.		
4. CPC International, Inc., Englewood Cliffs, New Jersey; Argo State Bank, Summit, New Jersey	30	03/23/72 (A)
Argo State Bank was part of CPC until 08/04/82. It then became part of Harris Bancorp, which became a subsidiary of Bank of Montreal. Still a bank under same identification number. Assets totaled $192,517 (in thousands) as of 12/31/95.		
5. Minnesota Mining and Manufacturing Company, St. Paul, Minnesota; Eastern Heights State Bank, St. Paul, Minnesota	29	05/09/72 (A)
Eastern Heights State Bank is still owned by MMM. Bank assets totaled $376,151 (in thousands) as of 12/31/95.		
6. Beneficial Corporation, Wilmington, Delaware; Peoples Bank and Trust Company, Wilmington, Delaware	20	08/09/72 (A)
Peoples Bank and Trust is still owned by Beneficial Corporation. Bank assets totaled $414,430 (in thousands) as of 12/31/95.		
7. Heldenfels Brothers, Contractors, Corpus Christi, Texas; First National Bank, Rockport, Texas	12	01/05/73 (A)
FNB of Rockport became a branch after it was merged into Victoria Bank and Trust Co. on 12/02/92.		
8. R. R. Donnelley & Sons Company, Chicago, Illinois; Lakeside Bank, Chicago, Illinois	28	05/16/73 (A)
Lakeside Bank was owned by Donnelley until 09/28/93. It is now owned by Lakeside Bancorp. Bank assets totaled $217,965 (in thousands) as of 12/31/95.		
9. The Moody Foundation, Galveston, Texas; The Moody National Bank of Galveston, Galveston, Texas	46	07/12/73 (A)
Moody NB of Galveston was owned by Moody Foundation until 05/25/84. Now owned by Moody Bankshares. Bank assets totaled $289,724 (in thousands) as of 12/31/95.		
10. W. J. Young & Co., Clinton, Iowa; The Clinton National Bank, Clinton, Iowa	38	12/12/74 (A)
Clinton National Bank is still owned by W. J. Young and Co. Bank assets totaled $225,444 (in thousands) as of 12/31/95.		
11. Trustees of Dartmouth College, Hanover, New Hampshire; Dartmouth National Bank, Hanover, New Hampshire	20	02/12/75 (A)
Dartmouth National Bank became a branch of Fleet Bank - NH on 10/01/89.		
12. Charles Stewart Mott Foundation, Flint, Michigan; The Wayne Oakland Bank, Royal Oak, Michigan	425	8/06/79 (A)
The Wayne Oakland Bank was acquired by First of America on 06/06/83.		

affiliates that were not permitted for bank holding companies, or permitted its products or services to be offered or marketed by affiliates whose activities were broader than those permitted for bank holding companies, unless the products or services were offered or marketed as of March 5, 1987, and then only in the same manner; (3) permitted any overdraft on behalf of an affiliate or incurred any overdraft in its account at a Federal Reserve Bank on behalf of an affiliate (with exceptions regarding inadvertent overdrafts and affiliates that were primary dealers); or (4) increased its assets by more than 7 percent in any one 12-month period beginning one year after enactment of CEBA. A company losing its grandfather exemption would have 180 days after loss of the exemption to either divest each bank it controlled or come into compliance with the Bank Holding Company Act. A list of nonbank banks and their parents is given in an accompanying table.

Bank Holding Company Owners. Notwithstanding most other provisions of Section 4 of the Bank Holding Company Act—the then-limitations on interstate banking operations being the main concern—a bank holding company controlling an institution that became a bank by virtue of CEBA generally could retain control of the bank if the bank: (1) did not engage after enactment in any activity that would have caused it to be a bank pre-CEBA (that is, it did not begin both accepting demand deposits and making commercial loans); or (2) did not increase the number of locations from which it conducted business after March 5, 1987 (12 U.S.C. §1843(g)).

Explicit Exemptions. CEBA exempted certain special-purpose banks from the Bank Holding Company Act's new, broader definition of a bank. These exemptions included limited-purpose trust companies, credit-card banks, certain industrial loan companies, and the U.S. branches of foreign banks.

Competitive Equality Banking Act — Savings Banks. CEBA created a grandfathered entity called a "qualified savings bank," which was defined as a state savings bank organized on or before March 5, 1987. Under Section 3(f) of the Bank Holding Company Act (12 U.S.C. §1842(f)) as amended by CEBA, a "qualified savings bank" controlled by a bank holding company was permitted to engage in any activities allowed by the law of its state, other than certain

Nonbank Banks and Their Parents
December 31, 1995

Nonbank	Parent	State	Domestic Assets ($000s)
American Express Centurion Bank	Shearson American Express	NY	$11,173,428
Greenwood TC	Sears Roebuck & Company	IL	10,133,809
First Deposit NB	Providian Corporation	KY	2,183,269
Merrill Lynch Bank & Trust Co.	Merrill Lynch & Company	NY	1,891,714
Custodial Trust Company	Bear Stearns Companies, Inc.	NY	1,769,849
Hurley Street Bank	Sears Roebuck & Company	IL	1,558,562
Firstrust Savings Bank	Semperverde HC	PA	1,378,314
Prudential Bank & Trust Company	Prudential Insurance Company	NJ	1,369,450
Hickory Point Bank & Trust Co.	Archer-Daniels-Midland Company	IL	748,170
J C Penny NB	J C Penny Company	TX	683,531
Travelers Bank	Commercial Credit Company	MD	435,892
American Investment Bank NA	Leucadia National Corporation	NY	210,846
Franklin Bank	Franklin Resources	CA	182,056
Century Bank	State Savings Bank	OH	180,176
First Signature Bank & Trust Co.	John Hancock Mutual Life Ins. Co.	MA	156,959
California Central TR BK CORP	Continental Corporation	NY	139,627
Domestic L&IC	Domestic Credit Corporation	RI	118,166
Fidelity Management Trust Co.	Fidelity Management & Research	MA	89,344
First American Trust Company	First American FC	CA	40,096
Lyndon Guaranty Bk of New York	ITT Corporation	NY	18,714
Avco NB	Textron	RI	1,884
Total			$34,454,856

insurance activities. The grandfather right would be lost if the savings bank was acquired by a company that was not a savings bank or a savings bank holding company, which was defined as a company whose qualified savings bank subsidiaries constituted at least 70 percent of its assets.

Competitive Equality Banking Act — Savings-and-Loan Holding Companies. CEBA grandfathered rights for certain savings-and-loan holding companies that would otherwise cease to qualify as unrestricted savings-and-loan holding companies because of a failure of their savings-and-loan subsidiaries to satisfy a new QTL test. Without grandfather protection, the period to bring savings-and-loan subsidiaries into compliance with the new QTL test was two years. A grandfathered savings-and-loan holding company was one that had received permission prior to March 5, 1987, to acquire control of a savings-and-loan association. Such a grandfathered company was permitted to engage in any activity in which it was lawfully engaged on that date. This grandfather right could be lost for a number of reasons: (1) the holding company acquired control of a bank or another savings-and-loan association (except in a qualified supervisory transaction); (2) any savings-and-loan subsidiary of the holding company failed to qualify under the Internal Revenue Code thrift test; (3) the holding company engaged in any business activity in which it was not engaged on March 5, 1987, and which was not otherwise permissible for savings-and-loan holding companies; (4) any savings-and-loan subsidiary of the holding company increased its number of business locations after March 5, 1987, except by means of a qualified supervisory transaction; and (5) any savings-and-loan subsidiary of the holding company permitted an overdraft on behalf of an affiliate or incurred an overdraft in its account at a Federal Reserve Bank on behalf of an affiliate, except an inadvertent overdraft. CEBA also grandfathered cross-marketing arrangements involving a savings-and-loan subsidiary of a diversified savings-and-loan holding company—a company whose savings-and-loan subsidiary and related activities represented less than 50 percent of its consolidated net worth and consolidated net earnings—and an affiliate to the extent they engaged in such arrangements on March 5, 1987.

FIRREA — Savings Association Activities and Investments. Section 222 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created Section 28 of the FDI Act. Section 28 prohibits any state savings association from engaging in any type of activity, or in an activity in any amount, that is not permissible for a federal savings association unless the FDIC determines the activity would pose no significant risk to the affected insurance fund and the savings association is and continues to be in compliance with certain capital standards (12 U.S.C. §1831e).[2] The compliance date was January 1, 1990, less than four months from the enactment of FIRREA, but divestiture of existing non-conforming assets was not required. State savings associations also cannot make equity investments impermissible for federal associations, except that certain investments in service corporations are permissible. Impermissible investments had to be divested by July 1, 1994.

FDICIA — State Bank Activities. Section 303 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) created Section 24 of the FDI Act, which restricted the charter powers of insured state banks (12U.S.C.§1831a). Section 24 prohibits insured state banks from engaging directly or through subsidiaries in any activities not permissible for a national bank unless the FDIC determines that an activity poses no significant risk to the deposit insurance fund and the bank is in compliance with applicable capital standards. The compliance period was one year from the date of FDICIA's enactment. Certain very limited insurance activities provided through subsidiaries were grandfathered. State banks also cannot make equity investments that are not permissible for a national bank, with certain exceptions and subject to the grandfathering of limited state-permitted investments in listed securities. Impermissible equity investments had to be divested in five years, except a three-year period was provided for compliance with the limitation on state-permitted investments in securities.

Conclusion. Generalizations about Congressional selections between divestiture on the one hand and a grandfather scheme on the other are difficult to make. Each situation had its own unique circumstances. The relative political power of the defenders of the *status quo* and of those who sought change varied considerably from situation to situation, as did the degree of the apparent "evil" that was the subject of the legislation. Nevertheless, it seems reasonable to conclude that the selection was often influenced by magnitude, that is, by the relative scope of the activities concerned. Grandfather solutions appear to have been used more often in situations when the relative impact would not be large.

[2] Under certain circumstances, the FDIC could allow a state association to engage in an activity permissible for federal associations to a greater extent than allowed for federal associations.

Statistical Sampling as a Management Tool in Banking

by Charles D. Cowan*

The purpose of this article is to discuss potential uses of statistical sampling in a financial institution environment. Banks and other financial firms are faced with a number of managerial challenges where the use of sampling can provide information at a reasonable cost. Given today's competitive environment and the move toward consolidation in the banking industry, it is imperative for financial managers to be able to value assets of target institutions quickly and efficiently. Similarly, as customers are faced with an ever increasing array of financial-service providers, the quality of service provided to customers becomes increasingly important for maintaining market share. Manufacturing firms, hotel chains, and other businesses have long used sampling as a means to assure that customers are receiving quality goods and service. Financial institutions similarly can use sampling techniques to monitor the quality of customer service and interactions. The need for this clearly increases as back office processing operations and customer service hot lines become remote from the branch originating the business. The Federal Deposit Insurance Corporation (FDIC) also performs functions that are similar, or identical, to those in banks and thrifts, including the management of loans acquired from failed banks and thrifts and the resultant need to estimate both the financial risk and the value of these loan portfolios. This article describes the use of sampling in a financial setting and focuses, as an illustration, on some of the methods used by the FDIC to value assets in liquidation as part of its preparation of financial statements. By using sampling, as opposed to valuing each asset, significant cost savings are achieved while ensuring the accuracy and quality of the results.

In fulfilling its mission as deposit insurer and receiver of failed banks, the FDIC has acquired hundreds of thousands of assets, including loans and real-estate properties, that it manages until disposition. These range across the broad spectrum of asset types and collateral. Some of the loans will be held by the FDIC until they are paid off in full, some will be resolved through settlement negotiations with the borrower, some will be sold as individual assets, some will be sold as part of a bulk sale, and some will be written off. Similar to the portfolios of banks, the FDIC portfolio is turning over continuously as new loans are acquired, old assets exit the population of assets, and some loans are converted to real and personal property. In banking a similar process occurs. New loans are underwritten with different amounts and types of collateral; loans are paid off, sold, written off, or converted to property owned by the bank through foreclosure.

In order for an institution's management to assess its financial condition, not to mention a potential merger target, it needs to value the asset portfolio. The same is true for the FDIC. The FDIC annually is required to prepare financial statements for each of the insurance funds under its management, in accordance with Generally Accepted Accounting Principles (GAAP), and these statements

*Charles D. Cowan is Director, Management Consulting, Price Waterhouse. This article was prepared when Mr. Cowan held the position of statistician in the FDIC's Division of Research and Statistics.

are audited by the U. S. General Accounting Office. As part of the preparation of its financial statements the FDIC must determine the value of its claim against the various receiverships for failed institutions by determining the value of the underlying assets of the receiverships. Moreover, intermediate valuations are prepared to assist in the monitoring of the financial position of the funds and to assist in the liquidation planning process. The use of sampling allows for more frequent valuations at relatively low cost.

Given the existence of a large number of loans and other assets, and changing conditions in the economy and financial markets, there is no way to value simultaneously all of the loans held in a portfolio. Nor would one want to do so, given the expense and time constraints that surround the preparation of financial statements. Instead, a sample of assets is valued, and the sample is extrapolated to the full population of loans. This process can be repeated multiple times during the year and can be used to track the ongoing value of the portfolio. The same can be done in any bank, using the records and loan systems of the bank and a few formulas that are presented below.

Sampling has become a standard part of audit methodology and is fairly well known and accepted in that profession as a useful tool. This article will, therefore, not attempt to introduce the reader to the rudiments of sampling, but rather will focus on the introduction of some basic assumptions to standard audit sampling methodology. By introducing these assumptions one can decrease the required sample size and make the estimation process more efficient. While the article focuses on the valuation of assets, the same methodologies and techniques can be used to develop a sample of customers to survey regarding their satisfaction with the services provided by the bank.

Basics — The Tools We Use

Suppose one has to value a single pool of homogeneous assets, such as performing commercial loans. The discussion that follows describes how to set a sample size for the valuation of the pool, and how to extrapolate an estimate from the sample to the full population of loans. This methodology can easily be extended to multiple asset types by treating each of the asset types as a stratum, making separate estimates for each by stratum, and adding across strata to derive an estimate for the full population.

There are two basic functions that can be used to estimate the market value of the pool. We assume that for each asset there is a current book value that is known and easily retrievable. We also assume that we are going to select a simple random sample without replacement. The question then becomes: How many assets need to be selected? Alternatively, how large a sample is needed to obtain a good estimate of market value for the entire loan portfolio? The answer is driven by the underlying distribution of the values we are trying to estimate and the "estimator" we plan to use with the sample. An estimator is the mathematical formula that summarizes the data and extrapolates the sample back to the population. One estimator we could use is a direct sample projection, hereafter called the "direct" estimator. Another is the "ratio" estimator that uses the additional information we can get from the book value of the loans. The formulas for each are:

Direct: $\hat{Y}_D = N\,\bar{x}$; where N is the number of assets in the pool, and $\bar{x}$ is the average market value of the assets in the sample.

Ratio: $\hat{Y}_R = (y/x)\,X$; where y is the total market value of assets in the sample; x is the total book value of assets in the sample; and X is the total book value of assets in the population.

Regression: $\hat{Y}_{Regr} = N\,[\bar{y} - b\,(\bar{x} - \bar{X})]$;

where $\bar{y}$ is the average market value of assets in the sample; $\bar{x}$ is the average book value of assets in the sample; and b is the slope coefficient in the regression of y on x.

The direct estimate is simply the average market value of the assets in the sample, multiplied by the number of assets in the population. If we value 100 assets in a sample taken from 1,000 assets in the population, we calculate the average market value for the 100 assets (a market value per asset) and multiply it times 1,000. The ratio estimate works in a similar fashion, but weights the market values obtained from the sample by their book values, rather than by counting each with equal weight, which is what the direct estimate does. The ratio estimate calculates the average recovery rate and multiplies this rate times the total dollar book value in the pool. If the market value is well-correlated with the book value, for example, the larger the book value, the larger the market value, and they track well, then the ratio estimate will be more accurate than the direct estimate. That is, the ratio estimate will, in general, be closer to the true population value than the direct estimate. The regression estimate is similar to the ratio estimate.

If one is to rely on estimates derived from samples, a rule for determining the accuracy of the estimates is needed. This rule usually is determined by the size of the confidence interval around the estimated market value. Suppose we want a 95-percent level of confidence that the true population value will be within plus or minus 5 percent of our estimate. To obtain this, we simply set the ratio of the half confidence interval over the estimate equal to 5 percent .[1]

The market value estimate is obtained from one of the three formulas given above, and the variance is the sampling variance estimated from the sample collected. Sampling variance is the variability due to the fact that each sample yields a slightly different estimate, which on average will be equal to the value we want to estimate. In order to estimate the market value of a portfolio and determine the sample size, one must have some knowledge of the variance of the market value estimate as well as the estimate itself. Obviously this is problematic because we do not know either the market value or its variance.

Knowing this *in advance* of doing the survey is the key to determining the sample size, but this appears somewhat backward because *this is what we are trying to estimate*. However, what we can know in advance is derived by having a good intuitive feel for the data, some expectation about the results one might obtain, possibly from previous analyses, and a little help from probability theory. The next section reviews some assumptions and how they work to solve the above equations to derive the sample size.

Before turning to the use of external knowledge in the sample selection process, it is worth reviewing the definitions for sample variance for both the direct and ratio estimators for market value. The following are the mathematical expressions for the "population recovery rate," that is, the ratio of the population's market value to book value, and the variance of the book and market values for the population as a whole and the variance terms for the *estimates* of market value obtained by using the direct estimator and the ratio estimator:

Population Recovery Rate = $R = Y/X$

Population Variance of Total Book Value = S^2_x

Population Variance of Total Market Value = S^2_y

$$S^2_x = \sum_{i=1}^{N} \frac{(x_i - \overline{X})^2}{N}, \quad \text{where } \overline{X} = \sum_{i=1}^{N} \frac{x_i}{N} = \text{the average book value}$$

$$S^2_y = \sum_{i=1}^{N} \frac{(x_i - \overline{Y})^2}{N}, \quad \text{where } \overline{Y} = \sum_{i=1}^{N} \frac{y_i}{N} = \text{the average market value}$$

The direct estimator for total market value has sampling variance V_D, which is the variance of the estimate because we used a sample:

$$V_D = \left(1 - \frac{n}{N}\right) \frac{N^2}{n} S^2_y$$

N is the number of assets in the population,

n is the number of assets in the sample, which is to be determined.

The ratio estimator for total market value has sampling variance V_R:

$$V_R = \left(1 - \frac{n}{N}\right) \frac{N^2}{n} \left(S^2_y + R^2 S^2_x - 2R\rho S_y S_x\right)$$

where ρ is the correlation between the book value x and the market value y.

[1]The algebraic statement for this measure is:

$$\frac{1.96 * \sqrt{\text{Variance [Market Value Estimate]}}}{\text{Market Value Estimate}} = 5 \text{ percent}$$

The value 1.96 is used to set the width of the confidence interval to cover 95 percent of the sample values that would come from the population.

Incorporating Knowledge in the Planning Process

Knowledge about the values to be estimated can be incorporated in the estimation process in advance, and the use of this information can reduce the sample size needed and improve the accuracy of the estimates. The more information that is available, the more cost-efficient the process of estimating a total will become.

There are many sets of assumptions that can be used to determine in advance the sample size needed to achieve a fixed confidence interval around estimates. This discussion focuses on four that are easy to implement and that highlight the different assumptions made about the data and the estimator to be used. Two of the scenarios are commonplace, while the other two, though less well known, lead to a better understanding of the sample sizes needed for estimation. Each of the four scenarios makes assumptions about what we know about the market values relative to the book values. There is no way to determine sample sizes for the sampling process without making some assumptions, no matter how simplistic.

Scenario 1:

Traditional Sampling Theory With No Connection to the Valuations

The most common procedure in basic survey sampling is to turn any problem into one that assumes a binomial distribution. This approach provides an easy solution to the sample size problem and requires no explicit assumptions about the data. Instead, the approach uses an implicit assumption of an upper bound on the variance. If one is attempting to use sampling to estimate an error rate in financial records, that is, the proportion of records containing an error, the largest variance will be found when the error rate is 0.5. Based on this knowledge, one can work backwards to derive the sample size necessary to satisfy the criterion involving a fixed proportional confidence limit band.

This rationale, however, is inadequate for valuation measures because one is measuring a dollar value, rather than a proportion or number of errors. Hence, while this scenario is commonly used as a fallback procedure for estimating sample size, it is inappropriate for many financial applications because of the need to estimate items calibrated in dollar values.

Scenario 2:

Traditional Sampling Theory With No Probability Assumptions Placed on the Valuations

The simplest assumption is that almost nothing is known about the market value of the assets, but that the book values of the assets in the pool are known. This is a very conservative assumption. By using the book value of all the assets in the population, one can calculate the population value of the variability of the book values (S^2_x) and the population value of the average book value ($\bar{x}$). Both of these are known with certainty and can be calculated easily from the data in most record systems. If one assumes that the relative variability of the market value is equal to the relative variability of the book value, then one can substitute the relative variance of book values for the relative variance of market values. This is *not* the same as assuming that the book value and the market value move in the same direction or that they are correlated in any way.

One can derive the necessary sample size by using the assumption that the relative variances of book values and market values are equal and then solve for the sample size. By plugging these two values into the formula presented above for the confidence interval, one can solve for "n," the sample size needed for the valuation of a portfolio.[2] We do not need to know anything more. Everything is based on one simple assumption, two numbers easily calculated from the population, and reliance is placed on the direct estimator, not the ratio estimator. However, the simple assumption ignores anything else known about the relationship between the book values and the market values. This may be an overly conservative assumption for many situations.

Scenario 3:

Linear Estimators in Sampling Theory Combined With Assumptions That the Values to Be Estimated Have an Underlying Normal Distribution

To use supplemental information for the calculation of the sample size, we need to make some assumptions regarding the joint distributions of the book value and the market value. A simple assumption is that the book value and the market value are related. A commonly made distributional assumption is that the variables are jointly normally distributed. This allows us to incorporate easily a straight line relationship assumption and a parameter for correlation between the variables. The normal distribution is not required — we can actually use any joint distribution that does not constrain the values of either variable, but does allow the two variables to be correlated. However, any moderate distributional assumption like this can lead to some very severe complications, as will be seen as we develop this method.

The use of the assumption of a bivariate normal distribution requires that one know something about five parameters: the two population means, the two population variances, and the correlation between market value and book value. Typically, information is readily available only on two of the five parameters: the mean and variance of the book values (see the previous section). Estimates of the population mean and variance of the market values and the correlation between the book value and the market value are needed. The latter can be estimated by using simple regression analysis. In the case where one assumes a straight line relationship between book value and market value, one can assume to know something about the relative return on the assets, namely the rate of recovery, R. This value will be approximately what one would expect to see as the measure of return in a linear equation:

$$\text{Market Value} = a + b(\text{Book Value}).$$

The value "b" estimated in this relationship is the same as the coefficient "b" estimated with regression analysis. However, one can assume that "b" is approximately equal to R, and from past experience an estimate

---

[2] This result is derived by noting that $E(Y) = R * E(X)$, where Y is the total market value of the portfolio and X is the total book value, and using:

$$\frac{\sqrt{\text{Variance [Market Value Total]}}}{\text{Market Value Total}} = \frac{\sqrt{(1-n/N)\, N^2 / R^2\ S^2_x / n}}{N * R * \bar{X}} = \frac{\sqrt{(1-n/N)}\, S_x / \sqrt{n}}{\bar{X}}$$

Both $\bar{x}$ and S_x are calculated directly from the population, that is, from the book values, so they are known. By inserting these two values into the formula above for the confidence interval, we now can solve for "n," the sample size needed.

$$\frac{1.96 * \sqrt{\text{Variance [Market Value Estimate]}}}{\text{Market Value Estimate}} = \frac{1.96 * \sqrt{\frac{1}{n} - \frac{1}{N}}\ S_x}{\bar{X}} = .05$$

$$n = \frac{1}{\left(\frac{.05 * \bar{X}}{1.96 * S_x}\right)^2 + \frac{1}{N}}$$

[3] Note that the value of "a" in the linear equation is not determined. However, it is not necessary to use regression analysis to estimate it because it is reasonable to assume that it is zero if one is willing to assume that the market value of an asset is zero when the book value is zero.

of R may be obtainable. Specifically, data on past sales, audits, auction information, *etc.*, may be available. This assumption will be formalized in the next scenario.

The use of regression analysis allows for the estimation of the correlation between book value and market value. However, this still requires some knowledge about the variation of the market values (the y's) separate from the variation of the book values (the x's). Because market values and book values are supposed to be closely related, one can define two (extreme) assumptions: (1) the market values are as variable as the book values, or (2) the market values are only a portion of the book values, therefore they vary proportionally less.

Finally, an assumption about the expected market value total is needed: specifically, that the expected value of the market value estimate is equal to the recovery rate, times our known total book value.

Using the regression relationship and the first variance assumption ($S^2y = S^2x$), a simplified variance formula that can be solved for "n" is derived, using the regression estimator given above.[4] This formula looks remarkably like the formula obtained in scenario 2, but it is multiplied by a factor that incorporates information about the expected recovery rate. This factor will play an important role in determining the sample size needed.

If the second variance assumption ($S^2{}_y = R^2 * S^2{}_x$) is used instead, one gets a very strange result — the sampling variance is always equal to zero! This occurs because the assumption leads to a situation in which there are too many restrictions and the variability of the data is assumed away under a normal distribution. This makes no sense, because it may be reasonable to expect the market value to be less than the book value, and that the variability of the market value will be less than the variability of the book value but there still will be variability. Based on these assumptions, this would be a lower bound for the variability of the market value. And logically, if the market value is only a proportion of the book value, one would expect that the variability of the market value would not be greater than the variability of the book value, thus providing an upper bound. This assumption is used because it is conservative.

In this scenario the assumptions placed no limitations on either the book value or the market value of the assets. Both the book value and the market value can take on any value between $-\infty$ and $+\infty$, though very large values of either are highly unlikely, and negative values also are unlikely. In practice one is more likely to find that assets carried with a positive value have a market value that is positive and even highly distressed assets typically will have a sales value slightly greater than zero. There may be exceptions, however, such as in the case of environmentally contaminated property where the costs of remediation (and potential legal liability) are greater than the value of the property cleaned up, thus yielding a negative market value. The normal joint distribution also allows the market value to be greater than the book value, which would happen if market interest rates are below the rates on financial assets or when property has appreciated in value.

Scenario 4:

Ratio Estimators in Sampling Theory Combined With Assumptions That the Values to Be Estimated Have an Underlying Conditional Gamma Distribution

An alternative approach that incorporates more information about the data clearly is more useful in making the sampling process more efficient and cost-effective. For example, when using the assumption that the data were normally distributed (scenario 3), book and market values could conceivably range from $-\infty$ to $+\infty$. Assuming that both the book values and market values in the portfolio are both gamma distributed, one can incorporate both assumptions about the portfolio as well as previously known information. The gamma distribution is a probability distribution that is skewed to the right, implying that the portfolio will have many assets with relatively small book values and only a few with very large book values. In addition, it is assumed that the market value is less than, or equal to, the book value.

Three parameters must be dealt with by using this approach, although there is an additional assumption that the market value is bounded above and below by the book value and zero, respectively. This assumption is consistent with floating-rate assets and those with short maturities. However, it will prove problematic when valuing fixed-rate loans with above-market rates or for fixed assets where depreciation may have reduced the book value below the market value.

Under these assumptions, and using this distribution, one can determine the population variances for both the book value (x) and the market value (y), and also the correlation between the book value and the market value. Substituting these values into the variance equation given above for a ratio estimator, we get:[5]

---

[4] $$n = \frac{1}{\left(\frac{.05 * \bar{X}}{1.96 * S_x}\right)^2 \left(\frac{R^2}{1 - R^2}\right) + \frac{1}{N}}$$

[5] This result is obtained by observing some basic results for gamma distributions, namely that for the population $S^2{}_x = (p+q)/a^2$, $S^2{}_y = p/a^2$, $E(X) = (p+q)/a$, $E(Y) = p/a$ and $\rho = p/(p+q)$ in terms of the parameters of the joint conditional gamma, and then using method of moments techniques we can substitute the known values of $\bar{x}$ and $S^2{}_x$ to solve for functions of the parameter values.

$$\text{Sampling Variance [Market Value]} = \left(1-\frac{n}{N}\right)\frac{N^2}{n}\; S^2_x R\,(1-R)$$

As was the case in scenario 3, there is a fortuitous relationship between the known values and the parameters that causes unknown values to cancel out and thus the equation can be solved directly. This is much more appealing because we can get three parameter values and the interrelationships between market value and book value directly from the three values we can observe or know through other sources, namely, total book value of the portfolio, the variability of the book values, and the anticipated recovery rate.[6]

This results in the equation above, and solving for n again we get:

$$n = \frac{1}{\left(\frac{.05 * \bar{X}}{1.96 * S_x}\right)^2 \left(\frac{R}{1-R}\right) + \frac{1}{N}}$$

The sampling variance equation is much more intuitive because it says that, as R approaches 1.0, which can only happen when all the assets have a market value equal to the book value, the sampling variance declines to zero. The same is true as R approaches 0.0, meaning all assets have no value, and so again there is no sampling variability. By placing bounds on the results when one estimates the market value, and by allowing the market value to be a random value conditional on the book value, one obtains a more sensible solution in terms of prior expectations, and at the same time a more sensible solution in terms of the effort required to conduct the valuation.

Solving for the Sample Size

If the population size N is large, then the term 1 over N in the denominator of each of the solutions disappears, and we get equations for the sample size that are easier to use and interpret. Each of the following equations for the sample size is subscripted to correspond to the assumptions in each of the scenarios discussed above.

$$n_2 = \left[\frac{1.96 * S_x}{.05\bar{X}}\right], \quad n_3 = \left[\frac{1.96 * S_x}{.05\bar{X}}\right]^2 \left(\frac{1-R^2}{R^2}\right), \quad n_4 = \left[\frac{1.96 * S_x}{.05\bar{X}}\right]^2 \left(\frac{1-R}{R}\right)$$

Note that each of the sample sizes can be expressed as a function of the sample size n_2, the sample size required when we make no distributional assumptions. For the sample size required when we assume that the book value and the market value are normally distributed *and* that the variance of the book value is equal to the variance of the market value, we get much larger required sample sizes until the recovery rate exceeds 0.7. Note also that the sample size required for the joint gamma distribution assumption is less than the sample size required for the no assumption scenario when the recovery rate exceeds 0.5. More importantly, the joint gamma assumption always yields a smaller required sample size than the normal assumption. This is especially gratifying, because scenario 4 required fewer assumptions and placed some reasonable bounds on the data to be observed.

[6] Data about the book values of a portfolio should be readily obtainable from accounting records and anticipated recovery rates can be based on previous studies or an *a priori* assumption based on general knowledge of the portfolio.

How to Choose

Based on the preceding discussion, the choices may appear to be exceptionally confusing. How does one use this information and draw a reliable sample? Fortunately, there is good news regarding both the variance estimate and the assumption choices.

First, the variance estimates. The assumptions reviewed above are offered as alternative ways to think about the data before assets are valued in order to avoid the selection of a larger sample than is necessary. However, once the sample has been selected and the valuation completed, the assumptions no longer come into play. The estimation of the market value and the confidence interval around that estimate is strictly a function of the actual data. The assumptions are not used in the estimation process, but only in the equations used to derive sample size. With the equations presented above, one can use either the direct method or the ratio method, and compare the results to see which makes more sense and provides the better confidence interval. The only requirement with respect to their use is that the sample selected is a simple random sample. Thus, even if the assumptions were flawed, the estimates are not a function of the assumptions but of the actual data sampled. However, bad assumptions may lead to the choice of a sample that is either too large or too small, yielding results that may not measure up to expectations.

The other piece of good news is that one can test some of the assumptions before choosing which scenario to use in deriving sample sizes. This is done easily by simply charting the book values as a histogram and determining whether the distribution appears to be uniform, normal, or gamma. (See the appendix for a discussion on how to create the histogram.) This allows a reasoned choice of scenario and distribution assumption to be used in the calculation of sample size. In addition, if one believes that the market values will fall between zero and book value, the choice of scenario 4 is clearly supported.

Hedging Our Sampling Bets

The last point to be made is that this process requires caution. If one uses the assumptions listed above to determine how large a sample to select, significant cost and time savings can be achieved. However, excessive optimism regarding the market value of the assets to be valued can lead to the derivation of a sample size that is too small for the task. For example, if one expects that the market value is 90 percent of the book value of the loans being valued, then one might be able to use the assumptions of scenario 4 to reduce the sample size. However, if the market value of the loans in the portfolio is estimated to be 80 percent after a valuation is completed using a sample that assumed a 90 percent valuation, the sample size was too small to achieve the desired confidence level used in the sample construction. In order to obtain the desired level of confidence the sample size will have to be increased. The impact on the final confidence interval will differ according to the distributional assumption that is used. Specifically, in the situation described for the normal distribution the standard error (half the confidence interval) will increase by 133 percent. For the gamma distribution the standard error of the estimate will increase by approximately 137 percent. In either case, this is a rather large increase in the confidence interval and results from overly optimistic assumptions. This problem can be minimized by the conservatism in making *a priori* assumptions about the value of the portfolio, while at the same time recognizing the cost tradeoffs associated with these decisions.

REFERENCES

Raj, Des. *Sampling Theory*. New York: McGraw-Hill Book Company, 1968.

Mardia, K.V. *Families of Bivariate Distributions*. London: Charles Griffin & Company Limited, 1970.

APPENDIX

Creation of the Histogram

One can easily create a histogram to assess which assumption concerning the distribution of the assets in a portfolio is the appropriate one to use. This process requires that a tabulation of book values of assets be obtained from the general ledger and that 20 segments be created. These segments for tabulation can be created by taking the maximum book value minus the minimum book value and dividing by 20. We call this value w:

$$w = \frac{\text{Maximum book value} - \text{Minimum book value}}{20}$$

The twenty categories appear as follows:

$$\text{Category 1:} \quad \text{Minimum book value} \geq \text{Minimum} + 1w$$
$$\text{Category 2:} \quad \text{Minimum} + 1w \geq \text{Minimum} + 2w$$
$$\ldots$$
$$\text{Category 20:} \quad \text{Minimum} + 19w \geq \text{Maximum}$$

Count the number of assets with book values in each of these ranges and tabulate as a bar chart. If the distribution looks flat, then the portfolio has a uniform distribution and the best plan is to use scenario 2. If the distribution looks bell shaped and symmetric, then the best option is scenario 3, because the data appear to be normally distributed (no unusually large high or low values). If the distribution looks like a mound that leans to the right (most values are smaller, but there are a significant number of large values), then the data are good candidates for scenario 4. Scenario 4 is enhanced if you believe your market values fall between worthless (zero) and the book value.

Recent Developments Affecting Depository Institutions

by Valentine V. Craig*

REGULATORY AGENCY ACTIONS

Inter-Agency Actions

The federal bank and thrift regulatory agencies are engaging in joint or coordinated efforts in a number of regulatory areas that are mentioned specifically in this issue of the *Review*. These joint initiatives concern:

Bank Management Interlocks Rule Changes

On August 2, 1996, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS) published a joint final rule that reinterpreted the Depository Institution Management Interlocks Act (12 U.S.C. 3201-3208). The new rule permits management interlocks within a relevant metropolitan statistical area (MSA) when either of the depository institutions in the MSA has assets of less than $20 million. The intent of this new rule is to expand the pool of available managerial talent for small depository institutions. The final rule implements provisions of the Riegle Community Development and Regulatory Improvement Act, which requires the agencies to review their regulations in order to streamline and modify regulations to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability. *FR, Vol. 61, No. 150. pg. 40293, 8/2/96, OTS Transmittal, No. 154, 9/3/96.*

Flood Insurance

The OCC, the FRB, the FDIC, the OTS, the Farm Credit Administration (FCA), and the National Credit Union Administration (NCUA) adopted a final rule implementing the requirements of the National Flood Insurance Reform Act of 1994. Under the rule, financial institutions are required to escrow flood insurance premiums on properties used as collateral for loans that are located in special flood hazard areas participating in the National Flood Insurance Fund. Lenders are not required to monitor loan portfolios continuously to determine the status of flood insurance coverage. Institutions may charge a fee to determine the need for flood insurance. *OCC News Release, NR 96-90, 8/29/96; FR, Vol. 61, No. 169, pp. 45683-45716.*

Proposal to Amend Risk-Based Transaction Requirements

The OCC, the FRB, the FDIC, and the OTS proposed a rule to amend their respective risk-based capital standards to establish uniform treatment for transactions supported by qualifying collateral. The proposal would allow banks, bank holding companies, and savings associations to hold less capital for transactions collateralized by cash or qualifying securities. In order to receive such capital treatment, the lending institution would need to maintain control over the collateral. *FR, Vol. 61, No. 160, pp. 42565-42570; OTS Transmittal, No. 155, 9/3/96.*

---

*Valentine V. Craig is a program analyst in the FDIC's Division of Research and Statistics.

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

Final Rule Amending Risk-Based Capital Requirements

The OCC, the FRB, and the FDIC issued a joint final rule, effective January 1, 1997, amending their respective risk-based capital standards to incorporate a measure for market risk for all positions in an institution's trading account and foreign-exchange and commodity positions. The final rule implements an amendment to the Basle Capital Accord, and requires that any bank or bank holding company with significant exposure to market risk to measure the risk using its own internal value-at-risk model and hold a commensurate amount of capital. Mandatory compliance is not required until January 1, 1998. *FDIC, FIL-84-96, 10/10/96; FR, pp. 47358-47378, 9/6/96.*

Guidelines Establishing Standards for Safety and Soundness

The OCC, the FRB, the FDIC, and the OTS jointly amended the Inter-agency Guidelines Estalishing Standards for Safety and Soundness to include asset quality and earnings standards. The guidelines complete the safety-and-soundness standards required by the Federal Deposit Insurance Corporation Improvement Act of 1991. The guidelines give the insured depository institutions the flexibility to adopt systems appropriate to their size and the nature and scope of their activities, and should not require well-managed institutions to modify their operations. The guidelines direct that the systems should be capable of identifying emerging problem assets and preventing deterioration in those assets; and that the systems be able to evaluate and monitor earnings, and ensure they are sufficient to maintain adequate capital and reserves. *FR, Vol. 61, No. 167, pp. 43948-43952; OTS Transmittal, Number 156, 9/3/96.*

Electronic Banking

The U.S. Department of the Treasury held a two-day conference in September on electronic banking and commerce, at which it announced the formation of an inter-agency task force to examine consumer protection issues related to the use of stored-value cards, smart cards, Internet banking, and other electronic banking and commerce products. The task force consists of the U.S. Department of the Treasury, the Federal Trade Commission (FTC), the FRB, and the FDIC. The U.S. Department of the Treasury is also examining international monetary policy, law enforcement, and payment systems regarding the global use of computers to conduct business. It expects to report its conclusions at the Group of Seven meeting next June in Denver, Colorado. *BBR, pg. 436, 9/23/96.*

Check Fraud

The Bank Fraud Working Group, composed of representatives of the OCC, the Federal Bureau of Investigation, the FDIC, the FRB, Internal Revenue Service, the Justice Department, the OTS, the Postal Inspector, and the Secret Service, has produced a booklet entitled “Check Fraud: A Guide to Avoiding Losses.” The booklet describes common check fraud schemes and fraud prevention techniques. Copies can be obtained from the Office of the Comptroller of the Currency, Communications Division, Washington, DC, 20219. *OCC News Release, NR 96-125, 11/12/96.*

Federal Financial Institutions Examination Council (FFIEC)

Community Reinvestment Act (CRA) Information Document

The OTS, the OCC, the FDIC, and the FRB, under the auspices of the FFIEC, produced a document, “Inter-agency Questions and Answers Regarding Community Reinvestment.” The document was published in the *Federal Register* on October 21, 1996. It consolidates information about the revised CRA regulations issued by the agencies on May 4, 1995, and attempts to answer the most frequently asked questions about community reinvestment. Public comment is invited on a continuing basis. *FR, pp. 54647-54667, 11/21/96.*

Bank Rating System Updated

The FFIEC has expanded the Uniform Financial Institutions Rating System, in effect since the late 1970s, to take into consideration an additional risk component. The bank rating system known as “CAMEL” (which stood for Capital Adequacy, Asset Quality, Management Administration, Earnings, and Liquidity) has now been changed to “CAMELS” to adjust for a sixth component, Sensitivity to Market Risk. The new component reflects an institution's sensitivity to interest-rate changes, foreign-exchange rate changes, or commodity or equity price movements. *BBR, pg. 1052, 12/23/96.*

Proposed Electronic Filing Requirement for Call Reports

The FRB, the FDIC, and the OCC, under the aegis of the FFIEC, requested comments on whether to discontinue Call Reports in hard copy form and to require them to be filed electronically or on computer diskette with the agencies' electronic collection agent. Written comments were required by January 3, 1997. *FR, pp. 56737 -56740, 11/4/96.*

Federal Deposit Insurance Corporation

Electronic Banking Issues

On September 12, the FDIC hosted a day-long public hearing on the technological changes occurring in banking, finance and commerce as a result of the evolution of electronic banking. The hearing focused on the use of stored-value cards and federal insurance; what disclosures financial institutions should provide to consumers; and safety-and-soundness concerns. The hearing followed an FDIC Board decision that funds represented by stored-value cards are not generally protected by federal deposit insurance.

Subsequent to this public hearing, the FDIC has begun a monthly "Cyberbanking Speakers Series" for its employees, which is concerned with issues related to electronic banking. The series focuses on the latest electronic technologies and the implications for the financial regulatory system. The first event, held on November 6, 1996, focused on two new developments: "smart-cards" and the government's plans to pay all benefits electronically by the year 1999. The second event, held in December, focused on regulation in the world of electronic banking. *FDIC News, pp. 1-6, 10/96.*

Semiannual Agenda of Regulations

The FDIC published its most recent semiannual regulatory agenda in the *Federal Register* on November 29, 1996. The FDIC publishes the agenda to inform the public of its regulatory actions and to encourage participation in rulemaking. Many of the rules have been sponsored jointly with the other financial regulatory agencies. Some are in response to the Federal Deposit Insurance Corporation Improvement Act and the Riegle Community Development and Regulatory Improvement Act of 1994.

The agenda provides information about the FDIC's current and projected rulemakings, as well as information on existing regulations under review, and completed rulemakings. There are 34 final or proposed changes to FDIC regulations in the most recent agenda. Included in this agenda is the action imposing the one-time special assessment on SAIF-insured institutions and the final rule lowering SAIF assessments. *FDIC News Release, PR-91-96, 12/3/96; FR, pp. 63460-63469, 11/29/96.*

Expansion of Data on World Wide Web

The FDIC expanded it presence on the World Wide Web by providing statistical data on individual FDIC-insured depository institutions. Users are now able to search FDIC records by institution, state, charter type, and asset or deposit size. Available data include quarterly and annual statistics on income and expenses and key profitability ratios; institutional health and performance ratings are not available, however. There is no charge for the service. The Internet address for the FDIC service, called the Institution Directory, or ID service, is www.fdic.gov. *BBR, pg. 1004, December 16, 1996; FDIC News Release, PR-94-96, 12/10/96.*

Bank Insurance Fund (BIF) Premiums Remain at Same Level

Due to the current financial strength of the banking industry and the Bank Insurance Fund (BIF), the FDIC Board of Directors voted to maintain assessment rates for the BIF at current levels (0 to 27 cents per $100 of assessable deposits) for the first six months of 1997. The Board also voted to collect an assessment against BIF-assessable deposits to be paid to the Financing Corporation (FICO) as authorized by the Deposit Insurance Funds Act of 1996 (Funds Act); eliminated the $2,000 minimum annual assessment as required by the Funds Act; and authorized the refund of the fourth-quarter portion of the semiannual minimum assessment ($500) charged to all BIF members. Approximately 8,700 institutions will receive the refund of $500 plus interest. As of June 30, 1996, the BIF reserve ratio was 1.32 percent. *BBR, pg. 911, 12/2/96; FDIC, FIL-99-96, 12/9/96.*

Savings Association Insurance Fund (SAIF) and FICO Assessments Set

The FDIC lowered SAIF assessment rates to a range of 0 to 27 cents per $100 in assessable deposits for the first six months of 1997. The new rates are identical to those previously approved for BIF members, and became effective October 1, 1996, for Sasser and Oakar institutions, and January 1 for all other SAIF-insured institutions. The Board had previously established a risk-based schedule for SAIF assessment rates ranging from 4 to 31 cents per $100 of assessable deposits, and was permitted to adjust the schedule by as much as five cents without notice-and-comment rulemaking.

The FDIC Board also set FICO assessment rates for the 1997 first semiannual period at 6.48 basis points for SAIF members and 1.30 basis points for BIF members. These rates are in addition to the insurance funds' assessments. *FDIC News Release, PR-95-96, 12/11/96.*

Oakar Bank Reporting Requirements

The FDIC has adopted a final rule, effective January 1, 1997, limiting Oakar institutions to membership in their primary insurance fund only. Oakar institutions belong to one FDIC insurance fund but hold deposits that are insured by the other FDIC insurance fund. According to the new rule, BIF-member banks will continue to be BIF-members after acquiring SAIF-insured deposits in Oakar transactions. *BBR, pg. 911, 12/2/96.*

Real-Estate Markets Continue to Improve

The outlook for the nation's real-estate markets continued to be favorable during the third quarter of 1996 according to the FDIC's October 1996 *Survey of Real Estate Trends*. The quarterly survey asks field personnel from all federal bank and thrift regulatory agencies about developments during the prior three months in their local real-estate markets. The national composite index, summarizing assessments of both commercial and residential real-estate markets, stood at 67 in October, down slightly from 68 in July. Values above 50 indicate that more examiners and asset managers at federal bank and thrift regula tory agencies thought conditions were improving than declining.

Respondents to the survey were especially positive concerning trends in commercial markets. The October commercial summary index rose to 72, the most positive assessment of this market in over two years. Almost half of the respondents — 46 percent — reported improving conditions in the commercial market compared to 38 percent in the previous quarterly survey. Additionally, 29 percent of the respondents reported an oversupply of commercial space — the lowest level since the survey began. Eighty-four percent reported above-average or average commercial property sales.

The commercial real-estate survey results showed strong geographic differences. While 68 percent of the respondents considered the commercial market in the West a little better or a lot better than three months before, 48 percent in the South, 39 percent in the Northeast, and 33 percent in the Midwest felt similarly. Only 2 percent of all respondents considered the direction of the commercial market to be a little worse.

Residential markets, while continuing to be strong, did not register the improvements in these markets observed earlier. The summary index for residential markets fell to 63 in October from 69 registered in July. Overall, 35 percent of the respondents to the October survey considered the general direction of the housing market better than three months before; in July, 45 percent of the respondents saw an improved housing market.

Again, the residential survey results showed wide geographic disparities. The assessment for the West again was the most positive, with 55 percent of respondents reporting better housing conditions there over the quarter. This compares to 35 percent of the respondents in the Northeast and South, and 24 percent in the Midwest reporting improvements.

The positive real-estate assessments reported from the West reflect to a large extent improved conditions in California. Almost two-thirds of the respondents reported improving commercial markets in California, and 70 percent reported a strengthened California residential market. *Survey of Real Estate Trends, July 1996 and October 1996.*

Federal Reserve Board

FRB Adopts Final Reg M Rule

On September 18, the FRB adopted a final rule amending Regulation M, substantially changing the way auto-leasing firms disclose the cost of leasing a car. The final rule requires that charges be presented in a more intelligible format, and for the first time, requires disclosure of the total amount due when a lease is signed. According to the Consumer Bankers Association, leasing has increased 30 to 40 percent annually over recent years at some banks. The new disclosure requirements go into effect on October l, 1997. *BBR, pg. 438-439, 9/23/96.*

FRB Recommends Additional Day for Holding Deposits

On October 9, 1996, the FRB recommended to Congress that banks be allowed to hold funds deposited by check an additional day before requiring consumer access to the funds. Current law allows banks to hold funds for two days, but most banks allow access to the funds before the two-day period due to competitive pressures. Check fraud costs the financial industry $600 million a year. According to the FRB study, an additional day-hold would catch 80 percent of all local returned checks before the funds were released. *BBR, pg. 623, 10/14/96.*

Amendment to Loans to Insiders Regulation

In November 1996, the FRB amended its Regulation O, which imposes limits on loans to insiders and insiders of affiliates, and requires that any such insider loans not be on terms unavailable to those not affiliated with the bank or affiliate. The amendment was in response to, and conforms with, the Economic Growth and Regulatory Paperwork Reduction Act of 1996, which amended the preferential lending prohibition by allowing extension of credit to insiders as long as the credit was available to all employees of the lending bank, and insiders were not given preference over other employees. The OTS has also incorporated the FRB amendment, and savings associations and their subsidiaries will be treated in the same manner as banks in this regard. *FR, Vol. 61, No. 218, pp. 57769-57770, 11/8/96; FR, Vol.61, No. 224, pg. 58782, 11/19/96; OTS Transmittal, No. 161, 11/26/96.*

Rules Amended Expediting Bank Entry into Other Businesses

On October 23, the FRB issued interim rules expediting the application process for well-capitalized bank holding companies to enter new nonbank lines of business. The new rule implements provisions of the Economic Growth and Regulatory Paperwork Reduction Act, signed by the President on September 30, which allowed bank holding companies to enter activities permitted under Regulation Y without first notifiying the FRB.

The new rule applies only to well-capitalized bank holding companies. Under the new rule, the FRB defines well-capitalized bank holding companies as those which, on a consolidated basis: (1) maintain a total risk-based capital ratio of 10 percent or more; (2) maintain a Tier 1 risk-based capital ratio of 6 percent or more; (3) maintain either a Tier 1 leverage ratio of 4 percent or more, or have a composite 1 rating, or have implemented risk-based capital measures for market risk; and (4) are not subject to any written agreements to meet and maintain capital levels for any capital measure. *BBR, pg. 683, 10/28/96.*

Preferred Stock to Count for Core Capital

The FRB announced on October 21, 1996, that bank holding companies may use certain cumulative preferred stock to meet Tier 1 capital requirements. The preferred stock should be issued by special-purpose wholly-owned subsidiaries, who lend the proceeds of the offerings to the parent through long-term, subordinated notes. *BBR, pg. 685, 10/28/96.*

External Audits for Poorly Managed Foreign Branches to Be Required

The FRB, in a November 12 guidance to bank examiners, is requiring all foreign bank branches, with mangement ratings of three or lower, to hire independent accountants to perform audits of the branches. The auditors are to look for unreported losses; to verify the accuracy of reports filed with regulators; and to recommend improvements to internal controls and oversight. This development follows the Daiwa bank scandal, in which a New York branch of this Japanese bank hid a $1.1 billion loss from regulators. *AB, 11/18/96.*

Fees for Electronic Funds Transfers Reduced

Effective January 2, 1997, the FRB lowered the price for Fedwire funds transfers to 45 cents per transaction. The FRB estimates that this reduction, coupled with one made in September, should save the industry over $18 million annually. The FRB has also lowered fees on automated clearinghouse transactions. *AB, 11/6/96.*

Other FRB Actions

Effective November 12, 1996, the FRB will exclude corporate and municipal bond interest of "easily-sold" securities from the cap on commercial underwriting revenue. This change will permit certain Section 20 subsidiaries to earn more from underwriting activities. Effective October 21, the FRB also revised the list of fees that banks must disclose under the Truth-in-Lending Act. The FRB also provided some lawsuit relief to banks by increasing the amount by which they could misstate finance charges and avoid liability.

At a meeting of the FRB on December 20, the FRB withdrew a proposal that would have encouraged banks to record the race and gender of consumer and small-business borrowers. At the same meeting, the FRB raised the revenue limit on securities underwriting by commercial banks through their Section 20 subsidiaries from 10 percent to 25 percent. It also adopted a rule protecting the confidentiality of fair-lending self-tests. *AB, pg. 3, 9/13/96; AB, 12/23/96; WSJ, 12/23/96.*

Office of the Comptroller of the Currency

Derivatives Activity Increases

The OCC reported that commercial bank derivatives activity increased dramatically in the second quarter of 1996, with the notional amount of bank derivatives rising $1.2 trillion to $19 trillion for the quarter. Nine banks accounted for 94 percent of the total notional amount of derivatives; 507 banks held derivatives during the quarter, an increase of 42 over the previous quarter. Interest-rate and foreign-exchange contracts accounted for 98 percent of the notional amount of the derivatives. Approximately $8 trillion of the derivatives were futures and forward trades; swaps constituted almost $7 trillion; and over $4 trillion of the derivatives were options. *OCC News Release, NR 96-97, 9/13/96.*

OCC Provides Incentives to Banks Entering Low-Income Areas

The OCC has waived branching or chartering fees for national banks entering low- and moderate-income areas that are unserved by other depository institutions. These fees range from $700 for opening a branch to $17,400 for receiving an independent bank charter. According to the OCC, 12 million U. S. households, or 12.5 percent of the population, do not have an account with a depository institution. The OCC is also planning an educational forum to assist bankers in understanding the banking needs of this population. *AB, 10/1/96.*

Insurance Sales

In November, the OCC gave permission to First Union Corp. and Mellon Bank to sell and market insurance anywhere, including from bank offices, as long as the insurance applications were processed, and the agent commissions paid, from a town with fewer than 5,000 persons. *AB, pg. 2, 11/14/96.*

Expedited Process Allowing Bank Entry into Other Activities

The OCC issued a final rule on November 20, 1996, revising OCC Part 5 rules governing bank corporate activities. The new rule creates an expedited approval process for well-managed and well-capitalized banks (banks with a CAMEL 1 or 2 rating, a Satisfactory CRA rating, and without enforcement orders against them) to enter into other bank-related businesses through their subsidiaries. Banks may also apply for approval to engage in business activities through subsidiaries that are impermissible for the parent, but these requests will not receive expedited approval. The new rule is expected to facilitate entry into securities and insurance underwriting, data processing, and information delivery by bank subsidiaries. The rule took effect on December 31, 1996. *BBR, pp. 873-875, 11/25/96.*

OCC Amends Rules on National Bank Trust Activities

Effective January 29, 1997, the OCC has eliminated several restrictions governing bank fiduciary activities. The new rules removed many restrictions on collective investment funds. They rescind an OCC provision barring individual trust accounts from constituting more than 10 percent of a collective investment fund; eliminate another provision barring banks from putting more than 10 percent of a fund into one investment; eliminate restrictions on treatment of a fiduciary's money before it is invested; and codify an earlier OCC interpretive ruling that national banks in a particular jurisdiction have the same powers as state-chartered fiduciaries. *AB, 12/31/96.*

Office of Thrift Supervision

Lending and Investment Regulations Streamlined

The OTS issued a final rule, effective October 30, 1996, that updated, reorganized and streamlined its lending and investment regulations. The final rule almost cut in half the number of lending and investment regulations — from 43 to 22 — and brings OTS regulations more in line with those of the other banking agencies. In many instances, more general rules have replaced detailed rules to allow institutions greater flexibility. For convenience, all lending-related regulations have been reorganized in new Part 560. Other changes are: the rule increases thrifts' commercial lending authority through service corporations; does away with limits on the amount of loans relative to the value of collateral and payback periods for manufactured housing; modifies requirements for the selection of indices to set interest rates on adjustable-rate mortgages; narrows disclosure requirements for adjustable-rate mortgages; modifies restrictions on federal savings institutions in regard to investment in state housing authorities and government obligations; and relaxes limits on leasing.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996, passed by Congress on September 30, 1996 — the same day as the OTS new regulation — expands thrift lending powers in many instances beyond that provided in the final rule. The OTS will issue guidance to thrifts on the impact of this new law. *OTS Transmittal, No. 158, 10/24/96; FR, pp. 50951-50984, 9/30/96.*

Expanded Lending and Investment Authority for Thrifts

The OTS published interim rules on November 27 expanding thrifts' ability to make credit-card, education, and small-business loans. Although the regulation is in effect immediately, the OTS invites comments for 60 days.

The rule changes implement provisions of the Economic Growth and Regulatory Paperwork Act of 1996 (EGRPRA). EGRPRA permits thrifts to make credit-card and educational loans without any percentage of assets investment limit. Additionally, it permits loans secured by business or agricultural real estate to be made in amounts up to 400 percent of capital, with additional secured and unsecured business and farm loans allowed in amounts of up to 20 percent of assets. It restricts loans above 10 percent of assets to small-business loans. The new law also amends the qualified thrift lender (QTL) test of the Home Owners' Loan Act to count small-business, credit-card, and educational loans as qualified thrift investments without restriction; other consumer loans can now count as qualifed thrift investments in amounts up to 20 percent of the thrifts' assets. The legislation also gives thrifts the option of complying with the amended QTL test requirements or the Internal Revenue's domestic building-and-loan association compliance requirements. *BBR, pg. 929, 12/2/96; OTS Transmittal, Number 163, 12/2/96; FR, Vol. 61, pp. 60179-60185, 11/27/96.*

Corporate Governance Rules Streamlined

The OTS revised its corporate governance rules, effective January 1, 1997. The revisions, the first since 1983, reduced by 36 percent the number of charter and bylaw rules and policy statements on corporate governance. Savings institutions may now notify the OTS after adopting charter and bylaw amendments that have been preapproved by the agency rather than filing an application and paying a fee. The final rule permits federal stock savings associations, and in some cases federal mutual savings associations, to follow the corporate governance law of their home state, their holding company's home state, or Delaware General Corporation Law or the Model Business Corporation Act. Other revisions remove restrictions on the location of shareholder meetings; authorize the gathering of proxies by telephone or electronically; and remove requirements for formal stockholder meetings when unanimous written consent of shareholders exists. The revisions do not require any institutions to change their charters. *OTS Transmittal, No. 164, 12/10/96; FR, Vol. 61, No. 233, pp. 64007-64021.*

National Credit Union Administration

Multiple-Group Fields of Membership

A three-judge D. C. Circuit Court ruled on July 30 (*First National Bank & Trust Co.* v. *National Credit Union Administration*) that federal credit unions may only serve members of a single occupational group. At year-end 1995, almost 2,000 of the approximate 7,300 federal credit unions had multiple-group fields of membership. The NCUA has permitted multiple-occupational groups for federal credit unions since 1982.

Following the Circuit Court ruling, the NCUA requested a delay to enforcement of a October 25 injunction banning federal credit unions from adding new groups from outside the single occupational common bond to existing fields of membership. Also, on November 14, the NCUA adopted interim rules permitting occupation-based credit unions to serve an entire profession rather than just the employees of a single company, subject to certain distance restrictions. The NCUA plan also would allow credit unions with members at several local companies to retain members by converting to community-based institutions, and expanded the community credit union charter to permit institutions to serve occupational groups, associational groups, and community groups in areas with populations of less than a million people.

The banking industry asked the court to block the NCUA membership policy on the grounds that the agency violated the Administrative Procedures Act by not publishing advanced notice of the November 14 meeting and by not providing advanced notice of the rule change. On December 4, the U. S. District Court for D.C. set aside the NCUA interim field of membership policy and declared null and void all charter conversions and common bond redesignations approved by the NCUA under its new policy. The Court also denied the NCUA's request for a delay of the October 25 injunction. On December 24, the U. S. Court of Appeals granted a temporary stay on the injunction and allowed credit unions the right to serve all companies within their existing fields of membership, but prevented them from signing up new "non-core" members.

The National Association of Credit Unions on December 30 asked the Supreme Court to hear the case; the American Bankers Association has also filed a brief asking the Supreme Court to reject the case. *BBR, pg 454, 9/23/96; AB, pg. 1, 11/15/96; BBR, pg. 895, 11/25/96; BBR, pp. 983-984, 12/9/96; NYT, 12/25/96; AB, 12/31/96.*

STATE LEGISLATION AND REGULATION

California

The state of California enacted legislation, effective January 1, 1997, protecting banks from toxic waste cleanup liability under state and local law. The new statute provides immunity from environmental clean-up costs to unsecured lenders and fiduciaries if they were not responsible for the contamination and did not manage the property before foreclosure. The state statute expands recently passed federal protections, which protected only lenders with a security interest in the property. California environmental laws are considered to be the toughest in the nation according to its state banking trade group. *AB, 11/4/96.*

Delaware

Banks in Delaware are eligible to receive a $400 tax credit for every new employee hired above a minimum of 50 beginning in 1997. In order to qualify for the credit, the banks must invest a minimum of $15,000 per new employee. The credit may not exceed half of the bank's franchise tax. *AB, pg. 3, 11/15/96.*

Florida

State regulators in Florida have proposed a new state savings bank charter that would allow either mutual or stock form of ownership. The state currently offers charters for commercial banks and savings and loans; the state did away with mutual ownership in 1992. The proposed state charter would allow thrifts to continue in business should the federal thrift charter be merged into a federal bank charter. It might also be used by credit unions to convert to state savings banks should the courts ultimately disallow expansion outside a credit union's original common bond. Thirty other states currently offer a state savings bank charter. *AB, 12/10/96.*

Michigan

The Michigan Financial Institutions Bureau reduced many of the fees it charges its financial institutions, beginning in October 1996. Bank application fees were reduced to $6200 from $9000; consolidation application fees were cut to $1800 from $2200; and fees to convert to a state bank were decreased to $1300 from $2200. It also abolished the requirement that banks publish the relocation of principal offices and new branches, and abolished the $1000 fee. *AB, 11/25/96.*

BANK AND THRIFT PERFORMANCE

President Signs Small-Business Tax Bill

On August 20, 1996, President Clinton signed the Small Business Jobs Protection Act, which contains some major provisions affecting depository institutions. Of special importance, it repeals the Internal Revenue Code Section 593 bad-debt reserve recapture requirements for thrifts. Under this new law, thrifts need only record as income bad-debt reserves set aside after 1987 rather than their entire bad-debt reserves. This removes a major financial disincentive for thrifts converting to banks. Additionally, the new law allows for tax-free conversion of common trust funds to mutual funds; subject to certain restrictions, repeals the 50 percent interest exclusion on Employee Stock Ownership Plan loans made by financial institutions; creates "financial asset securitization investment trusts (FASITs), allowing for the securitization of debt obligations; and allows some financial institutions to be eligible for Subchapter S Treatment. *BBR, pg. 281, 8/26/96.*

SAIF Capitalization Bill Enacted

On September 30, 1996, President Clinton signed legislation capitalizing the SAIF and warding off a default on FICO bonds. The legislation also approximately equalized the premiums that banks and savings and loans pay for insurance. Legislation to capitalize the SAIF had been debated for two years. The new legislation requires the banking industry to assist in paying the $8 billion in interest on FICO bonds. According to the legislation, the thrift industry is responsible for approximately 59 percent of the $780 million annual interest for the next three years, and the banking industry the remainder. After three years, the two industries will share the cost on a *pro rata* basis. Thrifts are also required to make a one-time payment of $4.7 billion to capitalize the SAIF. The only exception to the special assessment is for banks that own thrift deposits (for example, Sasser and Oakar banks), whose special assessment has been reduced by 20 percent. *The Washington Post, 10/2/96; FDIC News, pg. 1, 11/96; AB, 10/2/96.*

Commercial Banks' Earnings

Commercial bank earnings were $38.6 billion for the first nine months of 1996, a 4.8-percent increase from the same nine-month period a year before, according to preliminary data released by the FDIC.

Approximately $13.2 billion in net earnings were reported for the third quarter of 1996. This represented the third-highest quarterly net income ever reported, but is a 4.5-percent decline ($618 million) from the previous quarter, and a 4.8-percent decline ($666 million) from third-quarter earnings a year earlier. However, almost all of the third-quarter earnings decline was due to the one-time SAIF assessment. The commercial banks' share of the assessment was approximately $1 billion, with an after-tax net income impact of approximately $650 million.

Third-quarter net interest income was a record $41.4 billion, a 5.2-percent increase over the third quarter of 1995. More than half — 58 percent — of insured banks reported earnings gains for the 1996 third quarter, and almost three-quarters reported return on assets (ROA) in excess of one percent. Third-quarter ROA for the industry was an annualized 1.19 percent. Asset-quality indicators remained favorable overall, with noncurrent loans falling to the lowest level in the 15 years that they have been reported. However, an increase in troubled loans to individuals, primarily credit-card loans, was reported. At the end of the third quarter, 2.71 percent of credit-card loans were reported 30-89 days overdue; 1.83 percent were reported past 90 days overdue or in non-accrual status; and an annualized year-to-date net charge-off rate of 4.31 percent was reported.

Profitability at FDIC-insured savings institutions remained strong despite a reported net loss of $55 million for the third quarter of 1996. This loss was largely due to the $3.5 billion special SAIF assessment levied on the industry. Net earnings for the quarter would have been approximately $2.2 billion, compared to $2.6 billion in the previous quarter, absent the SAIF assessment. Almost two-thirds of institutions reported losses for the quarter. However, of the 340 savings institutions with no SAIF deposits, only 5 percent were unprofitable for the quarter. Net earnings for the first three quarters of 1996 were $4.9 billion, a decrease of $1.1 billion from net earnings for the third quarter the previous year.

The SAIF became fully capitalized as of October 1, 1996. A special assessment against all SAIF-assessable deposits raised $4.5 billion, which brought the SAIF reserve ratio to 1.27 percent of insured deposits. *The FDIC Quarterly Banking Profile, Second Quarter 1996 and Third Quarter 1996; FDIC News Release, PR-75-96, 9/11/96; PR-96-96, 12/13/96.*

Delinquency Rates Improve in Third Quarter

According to an OCC survey of examiners at the 82 largest national banks, released on September 11, credit risk increased for the 12-month period ending May 1996, despite tightening of retail underwriting standards. The survey reported that credit cards, middle-market commercial loans and indirect consumer loans were responsible for most of the increased risk during the period.

At the same time, the FDIC reported a sharp rise in charge-off rates, with levels rising from 1.40 percent of loans during the second quarter of 1994 to 2.24 percent of loans during the second quarter of this year. The American Bankers Association (ABA) also reported a 13-basis point rise in late credit-card payments during the second quarter of 1996, raising the late-payment ratio to 3.66 percent, the highest level since 1974. However, according to the ABA, this ratio fell to 3.48 percent during the third quarter of 1996, the first improvement in two years.

Meanwhile, the Mortgage Bankers Association reported that the third quarter of 1996 represented the third straight quarter of improvement in mortgage delinquency rates. For the three months ended September 30, mortgage delinquencies fell to 4.16 percent on a seasonally adjusted basis from 4.35 percent the previous quarter. Improvements in mortgage delinquencies occurred in all categories — 30-day, 60-day, and 90-day-or-more delinquencies. *AB, pg. 1, 9/12/96; BBR, pg. 439, 9/23/96; The Washington Post, 12/14/96; AB, 12/19/96.*

Tax Ruling Affecting Banks

The U.S. Tax Court upheld the Internal Revenue Service (IRS) in a dispute over international tax laws, ruling that Riggs National Bank of Washington, DC, was not entitled to the tax write-offs it had taken to reduce taxes on profits from loans to Brazil. The Tax Court ruled that bank and Brazilian officials in an "elaborate legal fiction" came up with a plan to withhold taxes from the interest paid to the bank, thereby creating a U.S. tax write-off that the bank passed on to Brazil in the form of lower interest rates. The decision is expected to cost 300 American banks hundreds of millions of dollars in federal taxes. *The Washington Post, 12/12/96.*

Thrifts May Seek "Lost Profits"

The U. S. Court of Federal Claims ruled that thrifts may use the "lost-profits" theory to determine damages against the government for reneging on favorable goodwill accounting. Under the lost-profits theory, a plaintiff can sue for profits that would have been earned had there been no breach-of-contract. In 1989, the Congress changed the period for goodwill amortization from 40 years to five years, forcing many thrifts into bankruptcy. The suit of Glendale Federal Bank, the first of the more than 100 thrifts seeking redress, will begin on February 24. *AB, 12/20/96.*

Merger of Federal Banking Regulators Suggested

In a recently issued report, the General Accounting Office found the bank oversight system in the United States to be duplicative and inefficient, and recommended collapsing the OTS, the OCC, and the supervisory and regulatory responsibilities of the FDIC into a new independent federal banking agency. It recommended that the FRB maintain its independence, and also concluded that the FDIC retain its power to examine any bank. *AB, 11/27/96.*

"Smart Cards"

The three major U. S. card companies — MasterCard, American Express, and Visa — continue to work on developing consumer-friendly "smart-cards." MasterCard announced that it had acquired 51 percent of Mondex International, a British maker of "smart cards." The Mondex card combines credit, debt and stored-value functions. American Express has also announced an agreement with Banksys, a Belgian company, to test market its smart card. Visa International has also developed a smart card. *WSJ, 12/19/96.*

Credit-Card Cobranding

Sears Roebuck, which issues its own proprietary store card, has introduced a cobranded card with MasterCard International, and is testing it in several markets in the Midwest and Texas. The issuer of the card is Sears National Bank of Phoenix. People's Bank in Connecticut has also announced that it is issuing a cobranded VISA card with T.J. Maxx amd Marshalls. L.L. Bean recently issued a cobranded Visa card with MBNA Bank of Delaware. *AB, pg. 1, 9/11/96.*

Fidelity and Schwab Work With Banks' Trusts and Mutual Funds

Fidelity Investments of Boston, MA, the mutual fund giant and number two discount broker in the United States, bought part of a bank trust-processing firm in May through which it plans to offer record-keeping services linking Fidelity funds and the Fidelity fund supermarket to bank trust departments. Charles Schwab, the number one discount broker in the United States, has announced plans to serve as a fund-trading clearinghouse for bank brokerage firms and trust departments, permitting them to offer Schwab's fund supermarket to bank customers under their own names. *WSJ, pg. A5, 9/23/96.*

NationsBank Offering Its Mutual Funds through Schwab and Fidelity

NationsBank Corp. of Charlotte, NC, has announced that it will offer seven of its 44 mutual funds through the Charles Schwab OneSource network. The bank also offers its own fund supermarket, called Fund Solutions, and its funds are also available through Fidelity Investment's Funds-Network. After its acquisition of Boatmen's Bancshares of St. Louis is completed, NationsBank will be the fourth-largest bank manager of mutual funds. *AB, pg. 1, 9/11/96.*

Home Banking Network

IBM and 15 major banks, representing more than half the retail banking population of the United States and Canada, formed a home banking network, Integrion Financial Network. Integrion will offer bank-branded remote banking services through the Internet, on-line consumer networks, personal financial software, and telephone. The network is expected to compete with systems currently operated by Microsoft and Intuit, which have been providing on-line banking software that connects to dozens of financial institutions. Integrion will allow any bank to join its network, and says it is interested in signing up banks as either additional co-owners or customers. Both owner-banks and customer-banks will be charged the same service rates. On December 2 the FRB approved purchases of voting shares in Integrion for Norwest Corp. of Minneapolis and several foreign banks. *AB, pg. 1, 9/10/96, The Washington Post, 9/10/96; BBR, pg. 954, 12/9/96.*

Foreign Bank Activities

Japan

Japanese bank regulators announced the closure of Hanwa Bank, the first closure of a Japanese bank in the postwar era. Hanwa, a regional commercial bank, made substantial real-estate loans through two affiliates during the 1980s, and has reported $694 million in bad loans. The Bank of Japan is reportedly extending more than $360 million in loans to repay depositors. *The Washington Post, 11/22/96.*

Mexico

The government of Mexico plans to begin to dispose of the estimated $40 billion in assets (book value) that it acquired in its bank-bailout effort. The assets consist primarily of loans and real estate. The government has created an agency called Asset Valuation and Sale (VVA). The VVA is expected to begin the sales by holding two auctions early in 1997. *WSJ, 12/23/96.*