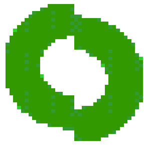
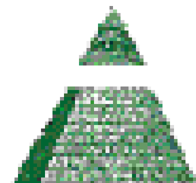


Comptroller of the Currency
Administrator of National Banks

VOLUME SEVENTEEN

Quarterly Journal

No. 4



Office of the Comptroller of the Currency
December 1998

Comptroller . . . . John D. Hawke Jr.

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Background

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

The OCC regulates national banks by its power to:

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

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

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

The Comptroller

John D. Hawke Jr. was sworn in as the 28th Comptroller of the Currency on December 8, 1998. Prior to his appointment Mr. Hawke served for 3½ years as Under Secretary of the Treasury for Domestic Finance. He oversaw development of policy and legislation on financial institutions, debt management, and capital markets; served as chairman of the Advanced Counterfeit Deterrence Steering Committee; and was a member of the board of the Securities Investor Protection Corporation. Before joining Treasury, he was a senior partner at the Washington, D.C. law firm of Arnold & Porter, which he joined as an associate in 1962. In 1975 he left to serve as general counsel to the Board of Governors of the Federal Reserve System, returning in 1978. At Arnold & Porter he headed the financial institutions practice. From 1987 to 1995 he was chairman of the firm.

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

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

The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year in March, June, September, and December. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and congressional testimony, material released in the interpretive letters series, statistical data, and other information of interest to the administration of national banks. Suggestions, comments, or questions on content may be sent to Rebecca W. Miller, Senior Writer-Editor, Communications Division, Comptroller of the Currency, Washington, DC 20219–0001. Subscriptions are available for $100 a year by writing to Publications—QJ, Comptroller of the Currency, P.O. Box 70004, Chicago, IL 60673–0004. You may now view the *Quarterly Journal* on the World Wide Web at http://www.occ.treas.gov/qj/qj.htm.

Quarterly Journal

Office of the Comptroller of the Currency

John D. Hawke Jr.

Comptroller of the Currency

The Administrator of National Banks

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Condition and Performance of Commercial Banks

Overview

Looking back over the past five years, we certainly can say that banks have been active and successful participants in a strong and stable domestic economic environment. The real growth rate of the gross domestic product was more than 3.7 percent, coupled with continued good news on the inflation and employment fronts. And we have been in the fortunate position over the last six quarters of reporting record-shattering earnings for the banking industry.

While commercial bank earnings did not hit a new record in the third quarter of 1998, banks are healthy and continue to be very active in key international and domestic markets. Looking at the performance and condition of the banking industry today, based on the third-quarter results, we can observe the following:

- Banks in all size and regional categories reported relatively high returns using a variety of earnings measures;
- Banks are active lenders in all major markets and continue to grow in key derivative markets; and
- Banks' capital ratios are high relative to historic standards.

At the same time, as we noted in our earlier condition reports, it is important to recognize that the operational environment for the industry over the next few years is likely to be different from what we have seen in the recent past. These changes are likely to affect the willingness of bank customers to borrow as well as their ability to repay loans.

Many industries, for example, are undergoing significant structural changes in response to the challenges presented by advances in information technology or from possible increased scale of production or other product or marketing synergies. Such changes inevitably will engender risks that may not have existed before, or that may not have existed to the same degree. And often these companies are customers of banks, either directly or indirectly.

We also see some reduction in the expected growth of some companies in part due to the slowdown in global demand for certain products and services. This in some cases may prompt a reconsideration or outright cancellation of expansion plans and possibly a reduction in staffing for some companies. We already have seen reports of such adjustments, which invariably will have regional or local economic repercussions for a variety of bank lending and servicing activities.

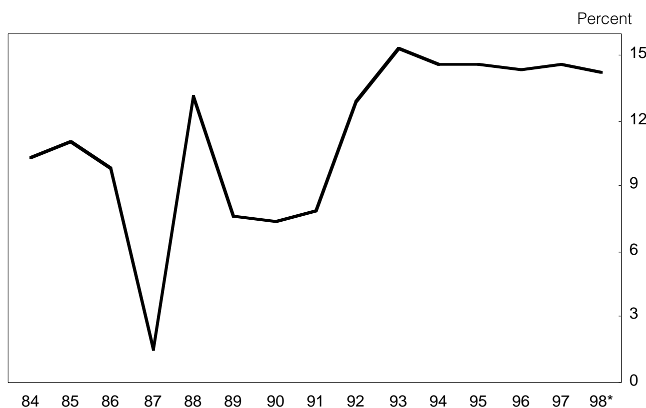
Third-Quarter Performance

With that in mind, it is useful to take a careful look at where we are in certain key bank performance areas—bank earnings, asset quality, lending activity, and fundamental condition measures. This then will provide a contextual framework for evaluating potential future developments for the industry.

Earnings

Looking at the major indicators, we see that bank earnings declined. Commercial banks earned $15 billion in the third quarter, down $1.1 billion from the second quarter. The annualized return on equity was 13.3 percent, a decline of 140 basis points from the second quarter and 107 basis points from a year ago. The return on assets was 1.15 percent, a decline of 10 basis points for the quarter and 2 basis points from a year ago.

Figure 1—Return on equity (commercial banks)



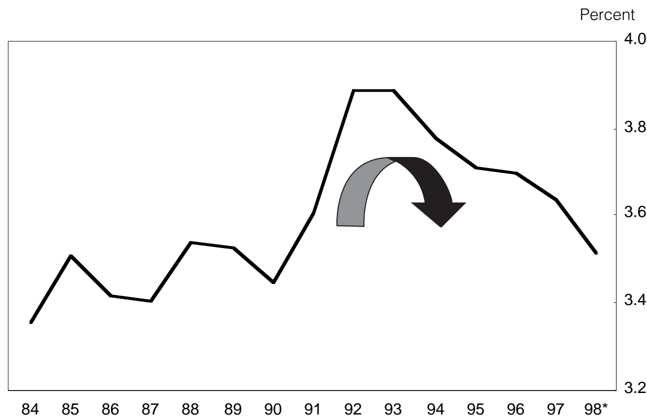
* 1998 data as of September 30, 1998. All other data as of year end.

Source: Integrated Banking Information System

While earnings were down, more banks also reported losses, showing that the decline is spread out across the industry. Year-to-year gains in earnings in the third quarter were reported by 57 percent of all banks, a decline from 65 percent a year ago. Meanwhile, the share of

banks reporting third-quarter losses also increased slightly, from 4.4 percent a year ago to 5.9 percent in the third quarter.

Figure 2—Net interest income to assets (commercial banks)



* 1998 data as of September 30, 1998. All other data as of year end.
Source: Integrated Banking Information System

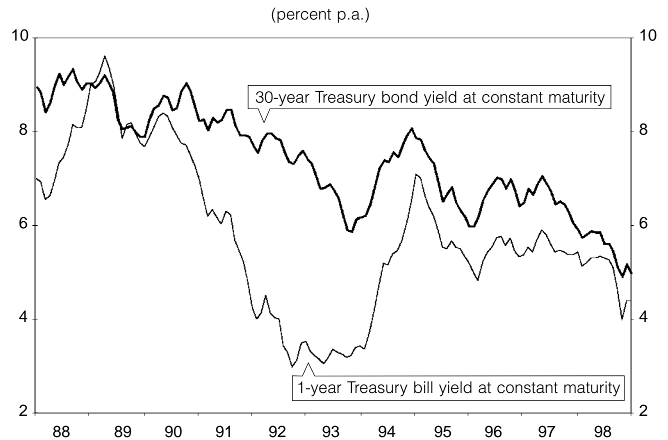
At first glance, it is tempting to attribute this reduction in earnings simply to trading losses from the turmoil in international markets. But this approach would miss some major developments in the underlying components of earnings, which deserve our attention. If we look at trends in interest income, noninterest income, and cost of operations, we can view a more complete picture of earnings performance.

Net interest income as a percent of assets has been declining significantly—from more than 3.9 percent in the early 1990s, to 3.5 percent as of the third quarter of 1998. The height of net interest income occurred in 1993.

Net interest income is determined by the volume of lending activity and the net interest yield on each loan. It is the reduction in the net yield on loans, not in the volume, that is the source of the present decline in net interest income. If, for example, we look at the interest rate difference between a 1-year Treasury as a measure of the cost of funds and a 30-year Treasury as a measure of the yield to long-term investments, the spread was 320 basis points in 1993. As of the third-quarter 1998, the spread on these risk-free instruments closed to only 40 basis points. The flattening of the yield curve, in other words, tells us that banks can expect a lower net return on each new loan they make.

Noninterest income, however, is a very different story. It is growing as a source of revenue. As a percent of assets, noninterest income increased to 2.3 percent from 2 percent five years ago. As we have noted in previous reports,

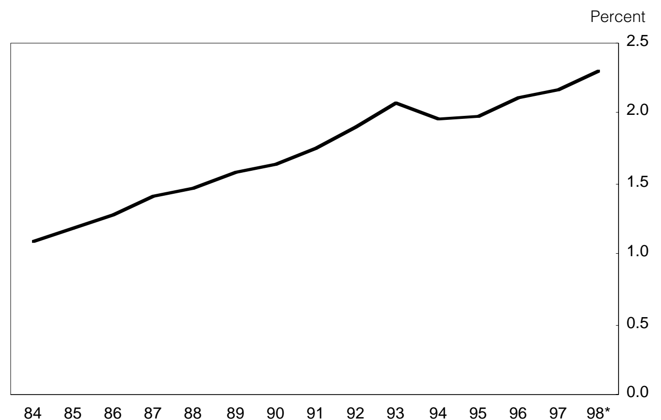
Figure 3—Comparison of yields



Source: Haver Analytics

its growing importance is quite clear and it is widespread in the banking industry. A large share of the noninterest component is attributed to fee income, which includes a variety of items such as service charges, commissions, and fees received for performing data-processing services for others. This increase suggests that we need to explore the types of fees that are increasing in volume and/or price, to better analyze their effects on banking, and the changing nature of the banking business.

Figure 4—Noninterest income to assets (commercial banks)



* 1998 data as of September 30, 1998. All other data as of year end.
Source: Integrated Banking Information System

As a percent of net operating revenue, noninterest income now represents a 39 percent share, with a significant increase in the rate of growth of this component over the last three years. Noninterest income in the third quarter grew 9 percent since last year. By comparison, net interest income grew 5 percent owing largely to

an increase in the volume of lending, even as margins declined. And again, this command performance by noninterest income is an increasingly important stream for banks in all asset size categories—this is not a large-bank phenomenon.

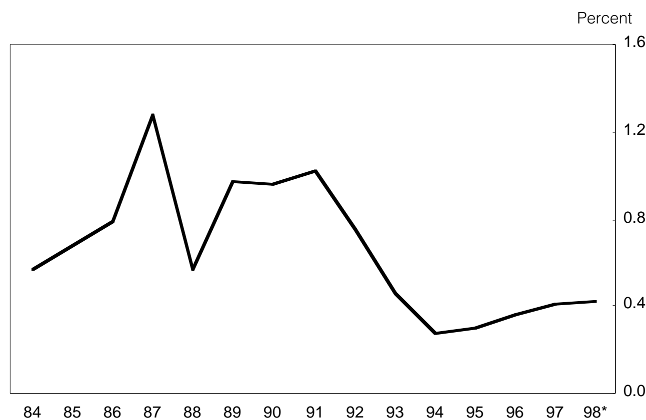
Figure 5—Noninterest income to net operating revenue (commercial banks)

* 1998 data as of September 30, 1998. All other data as of year end.
Source: Integrated Banking Information System

In sum, banks in all asset size groups are increasingly reliant on noninterest income components as a means of diversifying their income streams to maintain income levels as interest income falls. The gains in noninterest income now must be sufficiently robust to counterbalance reductions in earnings from interest-bearing assets.

Cost of operations also is increasing, as we see by the increase in noninterest expense to net operating revenue. Part of this may be related to expenses associated

Figure 6—Loss provision to assets (commercial banks)



* 1998 data as of September 30, 1998. All other data as of year end.
Source: Integrated Banking Information System

with adjustments for the year 2000 and conversions associated with the euro, both of which will continue throughout 1999 and possibly beyond.

So what does all this mean? The banking business is evolving. As we discussed, fee income is increasing, and lending margins are decreasing. These earnings trends coupled with other developments—shrinkage of net profit margins in key markets due to greater competition—provide some of the motivation for much of the merger activity we have seen over the last few years. As margins shrink, banks certainly will adopt new strategies to increase the geographic range of activity, promote cost reductions through scale of production, or seek product marketing synergies.

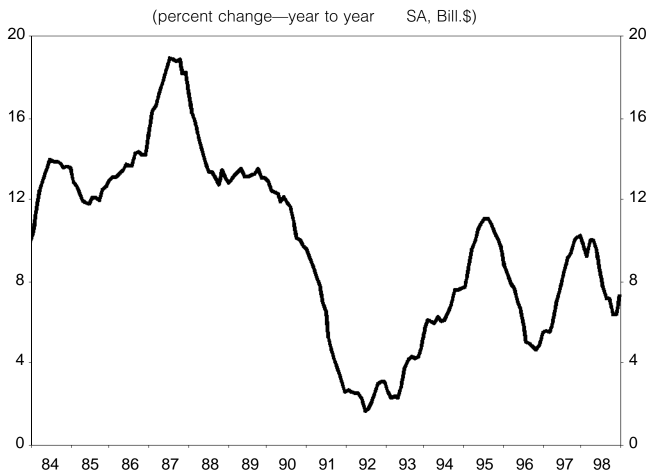
Banks basically have four strategies they can adopt in an effort to maintain earnings: 1) seek additional sources of earnings in new products or services, 2) move into new geographic markets, 3) reduce costs, or 4) increase risk. Clearly, given the slowdown in global economic activity and likelihood of some new stresses in local economies, such strategies may be appropriate. However, they must be evaluated carefully to ensure that the expectations are realistic and that the implementation is well handled so that the company does not incur inappropriate risks.

Managing these risks will be particularly challenging in light of the fast pace of lending reported by banks throughout 1998. Banks may be earning less in lending, but they are making more loans. *Overall loan growth* for banks in the third quarter was at a rate of 8.3 percent. This is down from 9 percent growth in the second quarter and 9.3 percent in the first. But it is certainly in concert with a continued strong growth in GDP. Loan growth for the first two months of the fourth quarter shot up again to 9.5 percent, a sure sign of the continued active participation of banks in major loan markets.

At the same time, *asset quality* for the banking industry remains quite high. The noncurrent loan ratio—those loans past due 90 days or on nonaccrual—was a mere 0.94 percent in the third quarter. However, the stresses associated with the curtailment of some business plans, layoffs, and adjustments to overcapacity in some major markets may mean that asset quality slides over the next year, with an associated increase in costs and draw on the loss provisions of banks.

Loss provisions are another source of potential increase in cost over the next year. The loss-provisions-to-assets ratio as of the third quarter stands at 0.5 percent. This compares to 0.28 percent near the beginning of this expansion and extraordinary series of bank earnings reports, a couple of years ago.

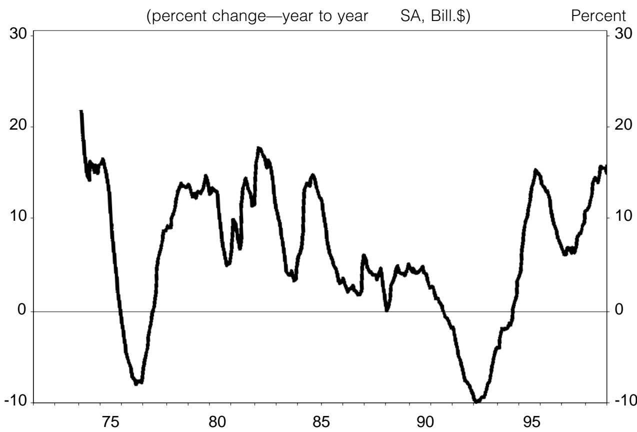
Figure 7—Real estate loans: domestically chartered banks



Source: Haver Analytics

Real estate loans grew 6.6 percent in the third quarter, a decline from 8.4 percent growth in the second quarter and 9.6 percent in the first. The steady decline is due to a falling growth rate in home equity lending, which slowed to 3.5 percent in the third quarter, down from 8 percent in the second and 14 percent in the first quarter. Other real estate lending grew at a fairly stable rate over this period.

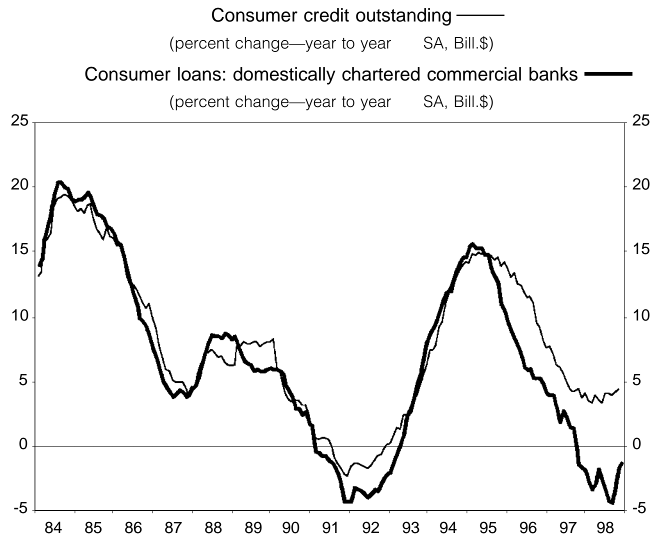
Figure 8—Commercial and industrial loans in bank credit: domestically chartered commercial banks



Source: Haver Analytics

Commercial and industrial loan activity grew 14 percent in the third quarter, a continuation of its performance in the first 6 months of the year. Commercial and industrial (C&I) lending has been climbing steadily since it stood at 8.6 percent growth in 1997. However, the various surveys conducted by regulatory agencies over the last year indicated that the quality of underwriting in the C&I area appeared to slip. A slippage in underwriting, together with the strong growth in lending, suggests that this is an area to watch.

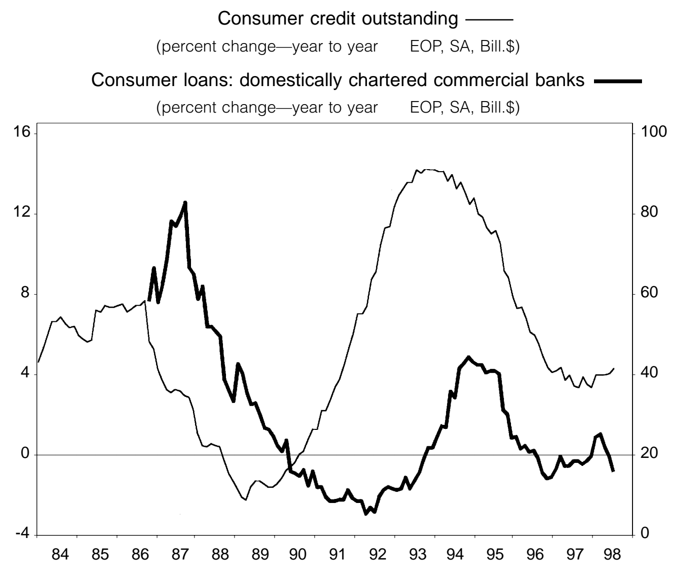
Figure 9—Consumer credit compared with consumer loans



Source: Haver Analytics

Consumer credit for the overall economy continued to grow at a 4.4 percent rate. Again to put this in context, the growth rate in 1997 was 4.3 percent; in 1996, 7.9

Figure 10—All consumer credit compared with securitized consumer credit

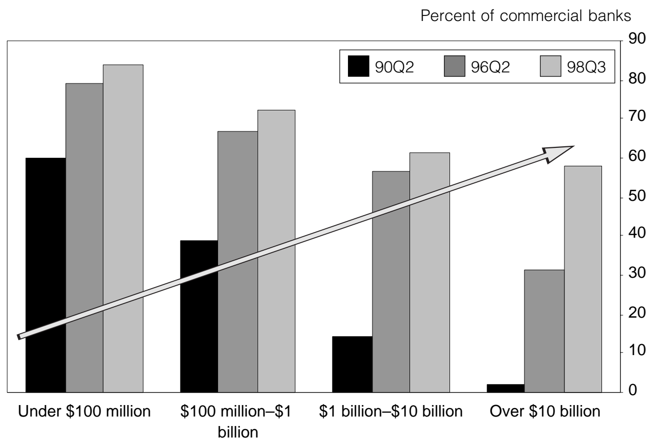


Source: Haver Analytics

percent; 14 percent in 1995; and 14.5 percent in 1994—the height of this expansion in consumer credit. The trend shows that commercial banks have been reducing their balance-sheet holdings of consumer credit: –3.9 percent growth in the third quarter, –2.5 percent in the second quarter, and –2.9 percent in the first, compared to 16 percent growth in commercial bank lending at the end of 1994.

Some of the reduction in bank holdings of consumer loans is associated with the securitization of these assets, which helps banks make more loans. The total pool of securitized consumer credit grew 44.8 percent in 1995, then 25.6 percent in 1996. After a brief respite we are seeing growth rates in the total asset pool of securitized consumer loans of 25.2 percent in the second quarter and 20 percent in the third. But there is a flip side to this securitization. While these loans generally are removed from the balance sheet for the respective bank, the associated risks may not be removed. For example, the participants have recourse back to the bank. Some of the risks may remain.

Figure 11—Banks with equity capital ratio over 8 percent



Source: Integrated Banking Information System

We also continue to watch the activities in the consumer credit market as a local credit issue. The concern—and one shared by many—is with the ability of some consumers to sustain their relatively high level of debt obligations in a more stressful economic environment, particularly in those areas likely to be hit by company layoffs.

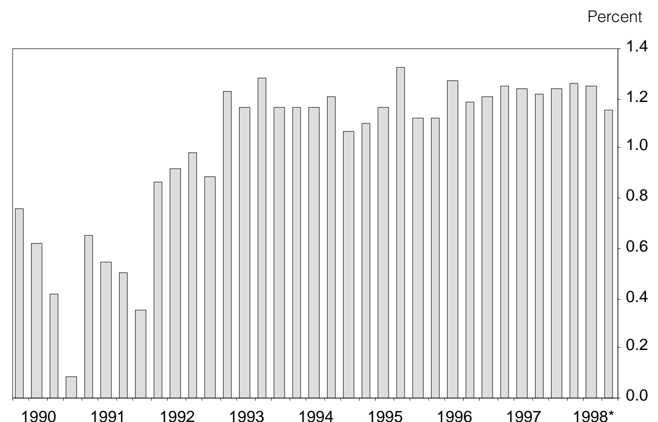
In addition to loans held on the balance sheet, banks have reported an increased level of activity in the off-balance-sheet areas. On a notional basis, *derivatives activity* increased by $4.5 trillion or 16 percent in the third quarter. The bulk of the activity was interest rate contracts and foreign exchange contracts. Credit derivatives increased 26 percent for the quarter, an area likely to continue to grow in volume and sophistication in future periods.

As we have discussed, the credit quality in some markets may slip over the next year. But it is important to recognize that the banking industry in the aggregate is relatively well positioned in the event of a slowdown in the economy.

Currently, 79 percent of all banks have an equity capital ratio greater than 8 percent. In the third quarter of 1990, 55 percent of the banking industry had a ratio greater than 8 percent. Banks in all asset size categories have increased their capital ratios, with capitalization of the larger banks clearly showing the most improvement.

Over half of the banks with assets over $10 billion now have an equity ratio greater than 8 percent, compared with just 2 percent eight years ago, and 32 percent two years ago. However, the banks' exposure is very different today. While they may be holding more capital, they also have more exposure, owing to off-balance-sheet activities. This greater amount of capital may be necessary, particularly when we consider these off-balance-sheet activities.

Figure 12—Return on assets, commercial banks



* Data as of third quarter, 1998.

Source: Integrated Banking Information System

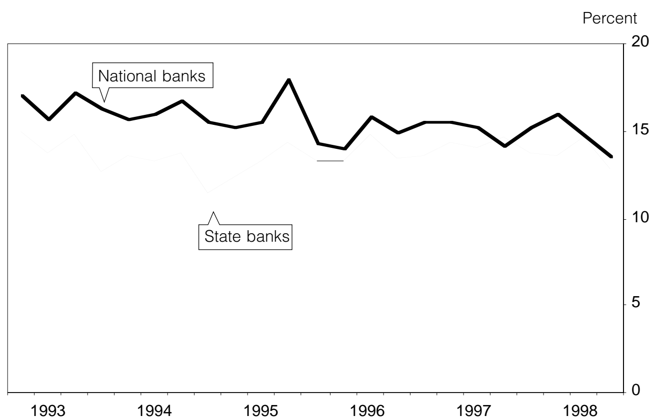
In sum, we have had a very heady period of reporting record-breaking earnings in the banking industry. We expect that the earnings performance for banks will continue to be quite healthy in an economic environment that remains healthy. But we must also recognize that the economic and financial environment over the next few

years will be changing as major companies realign their product-and-distribution mix and amend their structures. Inevitably, the challenges to banks and regulators will be different over the next few years. Our best course of action is to keep our hands on the wheel and handle these challenges effectively.

Other Trends

- Commercial banks earned $15 billion in the third quarter of 1998. This is a decline of about 7 percent from the second quarter, but an increase of 2 percent from the year-earlier figure. In line with income declines, return on assets declined from a second-quarter figure of 1.25 percent to 1.22 percent.
- As national banks' return on equity declined to 13.7 percent, the gap between them and state-chartered banks widened—state-chartered banks posted a third-quarter return on equity of 12.8 percent.

Figure 13—National and state-chartered banks' return on equity diverge

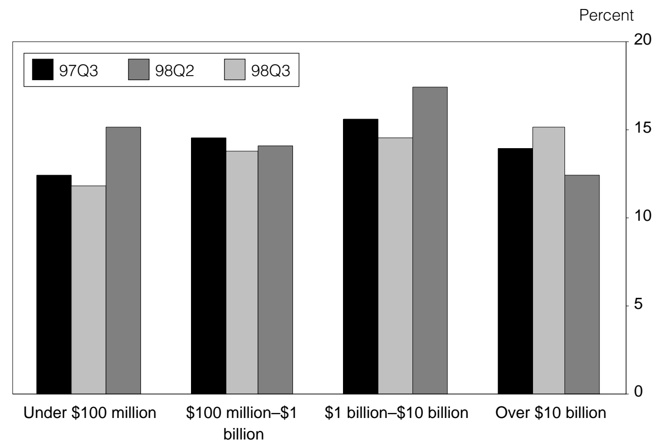


* Data as of third quarter, 1998.

Source: Integrated Banking Information System

- The decline in national bank ROE occurred in two of the four bank size groups—$100 million to $1 billion banks and banks over $10 billion experienced declines in their average ROE in the third quarter. Among state-chartered banks, only banks with assets between $1 billion and $10 billion increased their average ROE. This bank size group (for both state-chartered and national banks) is the one that does much of the credit-card-related business, so this alone may explain why it is an exception to the general decline in ROE.

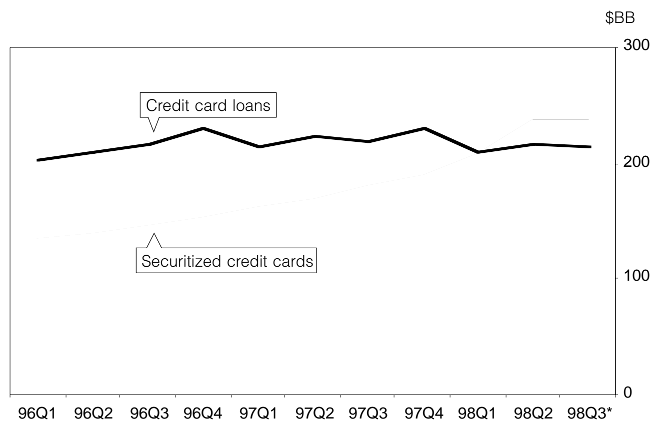
Figure 14—Quarterly return on equity by size (national banks)



Source: Integrated Banking Information System

- Among national banks, the regional pattern shows some differences. Fewer than 4 percent of banks in the OCC's Midwest and the Northeast districts were unprofitable and over 10 percent of the banks in both the West and Southeast districts were unprofitable. The higher fraction of unprofitable banks in these two districts is due largely to their disproportionate numbers of newly chartered banks. New businesses usually lose money; banks are no exception.
- Assets rose $400 billion (8 percent) compared to the third quarter 1997 figure and total loans and leases outstanding rose by $243 billion (8 percent).

Figure 15—Credit card loans outstanding and securitized credit cards



* Data as of third quarter, 1998.

Source: Integrated Banking Information System

- Credit card lending seems to have taken a breather in the third quarter as both on-balance-sheet and securitized-loan-portfolio size leveled off. This slower growth in a high margin business contributed to softness in net interest income.
- Unused credit card commitments have increased over the past year by about $413 billion (26 percent). This exposure is concentrated in larger banks. Commercial banks with assets under $100 million actually reduced unused credit card commitments by 60 percent over the course of the year.
- Similarly, derivative activity remains the province of large banks, with the 64 banks whose assets were over $10 billion dealing in virtually all (99.6 percent) of the derivative activity in the third quarter.

Key indicators, FDIC-insured national banks
Annual 1994–1997, year-to-date through September 30, 1998, third quarter 1997, and third quarter 1998
(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q3	Preliminary 1998Q3
Number of institutions reporting	3,075	2,858	2,726	2,597	2,519	2,625	2,519
Total employees (FTEs)	851,311	840,699	850,737	912,463	956,691	897,830	956,691
Selected income data ($)							
Net income	$26,803	$28,583	$30,497	$35,784	$28,971	$8,541	$9,174
Net interest income	83,958	87,080	94,564	106,641	82,380	26,497	27,638
Provision for loan losses	5,500	6,335	9,598	13,064	11,659	3,248	4,726
Noninterest income	45,906	51,080	56,100	65,429	58,738	16,756	20,166
Noninterest expense	83,941	87,591	93,690	104,681	87,050	26,518	29,814
Net operating income	27,027	28,540	30,096	34,995	27,421	8,480	8,846
Cash dividends declared	17,669	20,516	25,279	28,572	18,064	5,436	6,475
Net charge-offs to loan and lease reserve	5,994	6,459	9,968	12,661	10,880	3,195	4,096
Selected condition data ($)							
Total assets	2,256,008	2,401,017	2,528,057	2,893,910	3,048,935	2,760,453	3,048,935
Total loans and leases	1,382,855	1,522,677	1,641,464	1,840,485	1,962,827	1,773,139	1,962,827
Reserve for losses	30,990	31,142	31,992	34,864	37,056	34,630	37,056
Securities	414,264	390,549	380,615	452,119	495,814	424,932	495,814
Other real estate owned	5,709	3,396	2,761	2,112	1,948	2,312	1,948
Noncurrent loans and leases	17,852	17,595	17,223	17,878	18,011	17,275	18,011
Total deposits	1,630,171	1,695,817	1,801,043	2,004,866	2,034,043	1,908,003	2,034,043
Domestic deposits	1,350,658	1,406,312	1,525,565	1,685,316	1,698,586	1,610,598	1,698,586
Equity capital	172,655	189,714	207,167	244,967	271,195	242,914	271,195
Off-balance-sheet derivatives	7,570,283	7,914,818	7,488,663	8,704,481	11,585,255	8,686,394	11,585,255
Performance ratios (annualized %)							
Return on equity	15.99	15.76	15.28	15.00	14.82	14.23	13.66
Return on assets	1.24	1.24	1.25	1.29	1.29	1.25	1.21
Net interest income to assets	3.87	3.78	3.88	3.83	3.67	3.86	3.66
Loss provision to assets	0.25	0.27	0.39	0.47	0.52	0.47	0.63
Net operating income to assets	1.25	1.24	1.24	1.26	1.22	1.24	1.17
Noninterest income to assets	2.12	2.22	2.30	2.35	2.62	2.44	2.67
Noninterest expense to assets	3.87	3.80	3.85	3.76	3.88	3.87	3.95
Loss provision to loans and leases	0.42	0.44	0.61	0.73	0.81	0.73	0.97
Net charge-offs to loans and leases	0.46	0.45	0.63	0.71	0.76	0.72	0.84
Loss provision to net charge-offs	91.75	98.09	96.29	103.18	106.96	101.66	114.87
Performance ratios (%)							
Percent of institutions unprofitable	4.13	3.32	4.77	4.85	5.60	3.89	6.15
Percent of institutions with earnings gains	52.59	66.83	67.83	68.00	62.13	65.45	56.85
Noninterest income to net operating revenue	35.35	36.97	37.24	38.02	41.62	38.74	42.18
Noninterest expense to net operating revenue	64.64	63.40	62.18	60.84	61.69	61.31	62.37
Condition ratios (%)							
Nonperforming assets to assets	1.05	0.88	0.80	0.70	0.66	0.71	0.66
Noncurrent loans to loans	1.29	1.16	1.05	0.97	0.92	0.97	0.92
Loss reserve to noncurrent loans	173.59	176.99	185.75	195.01	205.74	200.46	205.74
Loss reserve to loans	2.24	2.05	1.95	1.89	1.89	1.95	1.89
Equity capital to assets	7.65	7.90	8.19	8.46	8.89	8.80	8.89
Leverage ratio	7.39	7.31	7.40	7.42	7.56	7.72	7.56
Risk-based capital ratio	12.47	12.09	11.97	11.87	11.86	12.05	11.86
Net loans and leases to assets	59.92	62.12	63.66	62.39	63.16	62.98	63.16
Securities to assets	18.36	16.27	15.06	15.62	16.26	15.39	16.26
Appreciation in securities (% of par)	–3.84	0.86	0.50	1.11	1.43	1.11	1.43
Residential mortgage assets to assets	20.43	20.13	19.81	20.10	20.54	20.16	20.54
Total deposits to assets	72.26	70.63	71.24	69.28	66.71	69.12	66.71
Core deposits to assets	55.16	53.28	54.08	51.59	49.27	51.64	49.27
Volatile liabilities to assets	29.90	30.29	29.83	31.42	32.15	31.35	32.15

Loan performance, FDIC-insured national banks
Annual 1994–1997, year-to-date through September 30, 1998, third quarter 1997, and third quarter 1998

(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q3	Preliminary 1998Q3
Percent of loans past due 30–89 days							
Total loans and leases	1.14	1.26	1.39	1.32	1.18	1.21	1.18
Loans secured by real estate (RE)	1.28	1.38	1.45	1.39	1.18	1.22	1.18
1–4 family residential mortgages	1.28	1.44	1.63	1.65	1.44	1.53	1.44
Home equity loans	0.87	1.19	1.04	0.93	0.85	0.84	0.85
Multifamily residential mortgages	1.45	1.15	1.28	1.33	0.76	0.66	0.76
Commercial RE loans	1.26	1.26	1.25	0.95	0.80	0.84	0.80
Construction RE loans	1.67	1.42	1.63	1.63	1.24	1.27	1.24
Commercial and industrial loans*	0.76	0.77	0.89	0.76	0.74	0.71	0.74
Loans to individuals	1.77	2.16	2.46	2.52	2.40	2.34	2.40
Credit cards	2.08	2.35	2.70	2.75	2.67	2.64	2.67
Installment loans	1.59	2.04	2.26	2.34	2.20	2.11	2.20
All other loans and leases	0.34	0.40	0.41	0.46	0.42	0.39	0.42
Percent of loans noncurrent							
Total loans and leases	1.29	1.16	1.05	0.97	0.92	0.97	0.92
Loans secured by real estate (RE)	1.83	1.46	1.27	1.07	0.99	1.12	0.99
1–4 family residential mortgages	0.96	0.90	1.10	1.01	0.95	1.02	0.95
Home equity loans	0.56	0.52	0.47	0.43	0.42	0.42	0.42
Multifamily residential mortgages	3.19	2.21	1.47	1.01	0.86	1.16	0.86
Commercial RE loans	2.81	2.18	1.71	1.27	1.09	1.43	1.09
Construction RE loans	4.93	3.17	1.31	1.00	0.83	0.93	0.83
Commercial and industrial loans*	1.04	1.06	0.87	0.78	0.81	0.83	0.81
Loans to individuals	1.01	1.18	1.34	1.49	1.41	1.27	1.41
Credit cards	1.09	1.34	1.70	2.03	1.82	1.68	1.82
Installment loans	0.97	1.06	1.04	1.04	1.09	0.96	1.09
All other loans and leases	0.47	0.32	0.25	0.27	0.27	0.33	0.27
Percent of loans charged-off, net							
Total loans and leases	0.46	0.45	0.63	0.71	0.76	0.72	0.84
Loans secured by real estate (RE)	0.29	0.13	0.09	0.06	0.05	0.07	0.06
1–4 family residential mortgages	0.14	0.10	0.08	0.08	0.07	0.08	0.07
Home equity loans	0.25	0.23	0.24	0.18	0.16	0.15	0.11
Multifamily residential mortgages	0.39	0.20	0.09	0.01	0.11	0.00	0.25
Commercial RE loans	0.47	0.18	0.02	–0.01	–0.05	0.03	–0.04
Construction RE loans	0.82	–0.01	0.16	–0.10	–0.01	–0.09	–0.03
Commercial and industrial loans*	0.16	0.10	0.22	0.27	0.33	0.33	0.42
Loans to individuals	1.49	1.80	2.45	2.86	3.01	2.87	2.96
Credit cards	3.06	3.40	4.25	4.95	5.31	5.12	5.26
Installment loans	0.59	0.76	1.04	1.20	1.17	1.14	1.14
All other loans and leases	–0.10	–0.09	0.11	0.10	0.46	0.13	0.95
Loans outstanding ($)							
Total loans and leases	$1,382,855	$1,522,677	$1,641,464	$1,840,485	$1,962,827	$1,773,139	$1,962,827
Loans secured by real estate (RE)	562,005	610,405	646,570	725,287	742,638	712,462	742,638
1–4 family residential mortgages	282,000	317,521	329,031	363,327	368,257	356,429	368,257
Home equity loans	46,044	48,836	55,022	67,670	66,262	65,321	66,262
Multifamily residential mortgages	17,081	18,161	20,480	23,346	23,189	22,450	23,189
Commercial RE loans	151,514	157,638	170,350	190,061	193,429	187,389	193,429
Construction RE loans	33,571	34,736	38,848	47,399	55,257	45,968	55,257
Farmland loans	8,310	8,734	9,046	10,177	10,605	10,141	10,605
RE loans from foreign offices	23,484	24,779	23,794	23,306	25,639	24,764	25,639
Commercial and industrial loans	370,094	405,630	425,148	508,564	572,664	482,937	572,664
Loans to individuals	291,799	320,009	356,067	371,516	373,213	358,179	373,213
Credit cards	111,109	131,228	161,104	168,257	163,771	154,126	163,771
Installment loans	180,690	188,781	194,963	203,258	209,441	204,053	209,441
All other loans and leases	162,135	189,490	216,194	237,330	276,440	221,843	276,440
Less: Unearned income	3,178	2,857	2,515	2,212	2,128	2,282	2,128

*Includes All other loans for institutions under $1 billion in asset size.

Key indicators, FDIC-insured national banks by asset size
Third quarter 1997 and third quarter 1998
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1997Q3	1998Q3	1997Q3	1998Q3	1997Q3	1998Q3	1997Q3	1998Q3
Number of institutions reporting	1,415	1,321	1,019	1,008	150	150	41	40
Total employees (FTEs)	37,229	33,816	113,124	111,755	158,267	165,179	589,210	645,941
Selected income data ($)								
Net income	$235	$277	$908	$902	$1,747	$2,235	$5,651	$5,759.
Net interest income	770	696	2,816	2,698	5,470	5,504	17,441	18,739
Provision for loan losses	44	41	228	205	1,251	1,226	1,724	3,255
Noninterest income	385	510	1,236	1,285	3,037	4,779	12,099	13,592
Noninterest expense	777	806	2,498	2,462	4,560	5,682	18,683	20,865
Net operating income	233	275	896	894	1,724	2,186	5,627	5,491
Cash dividends declared	101	490	421	417	1,043	2,115	3,871	3,453
Net charge-offs to loan and lease reserve	30	25	171	165	1,025	1,281	1,969	2,625
Selected condition data ($)								
Total assets	70,946	65,535	262,754	264,577	481,115	494,757	1,945,638	2,224,066
Total loans and leases	41,076	37,912	161,153	160,692	320,911	320,265	1,249,999	1,443,958
Reserve for losses	550	520	2,463	2,353	8,172	7,986	23,445	26,197
Securities	20,175	17,559	70,483	71,466	90,600	92,849	243,674	313,939
Other real estate owned	100	79	269	224	272	193	1,670	1,452
Noncurrent loans and leases	462	422	1,417	1,385	3,446	3,338	11,949	12,865
Total deposits	60,616	55,846	214,207	215,339	324,659	313,404	1,308,521	1,449,454
Domestic deposits	60,616	55,846	213,773	214,753	318,522	307,133	1,017,688	1,120,854
Equity capital	7,688	7,274	25,367	25,973	46,031	51,727	163,828	186,222
Off-balance-sheet derivatives	637	590	5,017	4,162	84,854	69,230	8,839,425	11,868,368
Performance ratios (annualized %)								
Return on equity	12.42	15.08	14.58	14.14	15.56	17.48	13.89	12.48
Return on assets	1.34	1.68	1.40	1.37	1.46	1.82	1.17	1.05
Net interest income to assets	4.38	4.21	4.33	4.11	4.58	4.48	3.60	3.41
Loss provision to assets	0.25	0.25	0.35	0.31	1.05	0.00	0.36	0.59
Net operating income to assets	1.33	1.67	1.38	1.36	1.44	1.78	1.16	1.00
Noninterest income to assets	2.19	3.08	1.90	1.96	2.54	3.89	2.50	2.47
Noninterest expense to assets	4.42	4.88	3.84	3.75	3.82	4.62	3.86	3.79
Loss provision to loans and leases	0.44	0.42	0.57	0.51	1.56	1.54	0.55	0.91
Net charge-offs to loans and leases	0.30	0.27	0.43	0.41	1.28	1.61	0.63	0.73
Loss provision to net charge-offs	146.97	159.76	133.61	124.45	122.12	95.69	87.56	123.14
Performance ratios (%)								
Percent of institutions unprofitable	5.80	9.08	1.86	2.78	0.67	3.33	0.00	5.00
Percent of institutions with earnings gains	59.79	49.58	72.72	64.38	68.00	66.00	70.73	72.50
Noninterest income to net operating revenue	33.33	42.26	30.49	32.26	35.70	46.48	40.96	42.04
Noninterest expense to net operating revenue	67.25	66.81	61.66	61.80	53.61	55.25	63.25	64.53
Condition ratios (%)								
Nonperforming assets to assets	0.79	0.77	0.64	0.61	0.77	0.72	0.70	0.65
Noncurrent loans to loans	1.13	1.11	0.88	0.86	1.07	1.04	0.96	0.89
Loss reserve to noncurrent loans	118.86	123.06	173.76	169.86	237.13	239.23	196.21	203.63
Loss reserve to loans	1.34	1.37	1.53	1.46	2.55	2.49	1.88	1.81
Equity capital to assets	10.84	11.10	9.65	9.82	9.57	10.46	8.42	8.37
Leverage ratio	10.64	10.62	9.30	9.27	8.59	8.78	7.17	6.99
Risk-based capital ratio	18.14	18.26	15.19	15.27	13.15	13.37	11.31	11.12
Net loans and leases to assets	57.12	57.06	60.40	59.85	65.00	63.12	63.04	63.75
Securities to assets	28.44	26.79	26.82	27.01	18.83	18.77	12.52	14.12
Appreciation in securities (% of par)	0.54	1.32	0.72	1.57	0.98	1.64	1.32	1.35
Residential mortgage assets to assets	22.61	22.03	26.24	25.65	23.74	23.66	18.36	19.20
Total deposits to assets	85.44	85.22	81.52	81.39	67.48	63.35	67.25	65.17
Core deposits to assets	74.74	73.85	70.91	70.06	58.20	54.32	46.57	44.95
Volatile liabilities to assets	12.73	12.82	16.99	16.59	25.90	28.15	35.31	35.46

Loan performance, FDIC-insured national banks by asset size
Third quarter 1997 and third quarter 1998

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1997Q3	1998Q3	1997Q3	1998Q3	1997Q3	1998Q3	1997Q3	1998Q3
Percent of loans past due 30–89 days								
Total loans and leases	1.45	1.44	1.22	1.22	1.64	1.63	1.08	1.07
Loans secured by real estate (RE)	1.25	1.25	0.97	0.95	1.20	1.17	1.28	1.23
1–4 family residential mortgages	1.58	1.57	1.15	1.15	1.30	1.23	1.68	1.54
Home equity loans	0.78	0.70	0.80	0.89	0.92	0.99	0.83	0.82
Multifamily residential mortgages	0.88	0.50	0.64	0.57	0.66	1.08	0.65	0.71
Commercial RE loans	0.93	0.94	0.75	0.72	1.06	0.97	0.79	0.77
Construction RE loans	1.19	1.30	1.11	1.03	1.73	1.71	1.15	1.14
Commercial and industrial loans*	2.28	2.56	1.55	1.74	1.27	1.26	0.53	0.58
Loans to individuals	2.35	2.04	2.02	1.97	2.61	2.48	2.25	2.42
Credit cards	3.77	2.45	2.87	2.94	2.88	2.63	2.47	2.69
Installment loans	2.24	2.02	1.80	1.75	2.24	2.22	2.11	2.26
All other loans and leases	N/A	N/A	N/A	N/A	0.86	1.13	0.35	0.37
Percent of loans noncurrent								
Total loans and leases	1.13	1.11	0.88	0.86	1.07	1.04	0.96	0.89
Loans secured by real estate (RE)	0.98	0.95	0.72	0.71	1.04	0.82	1.23	1.09
1–4 family residential mortgages	0.86	0.85	0.65	0.66	1.12	0.71	1.07	1.07
Home equity loans	0.45	0.44	0.31	0.32	0.41	0.54	0.43	0.40
Multifamily residential mortgages	0.70	0.46	0.82	0.46	0.94	0.64	1.33	1.03
Commercial RE loans	1.12	1.03	0.87	0.78	1.15	1.05	1.69	1.18
Construction RE loans	0.88	0.70	0.73	0.70	0.78	0.89	1.03	0.85
Commercial and industrial loans*	2.68	2.77	1.61	1.54	0.85	0.86	0.74	0.73
Loans to individuals	0.80	0.73	0.85	0.81	1.36	1.52	1.30	1.44
Credit cards	1.73	1.53	2.14	2.20	1.88	1.91	1.53	1.73
Installment loans	0.73	0.69	0.51	0.50	0.67	0.81	1.15	1.27
All other loans and leases	N/A	N/A	N/A	N/A	0.54	0.47	0.31	0.25
Percent of loans charged-off, net								
Total loans and leases	0.30	0.27	0.43	0.41	1.28	1.61	0.63	0.73
Loans secured by real estate (RE)	0.03	0.04	0.06	0.05	0.03	0.07	0.09	0.06
1–4 family residential mortgages	0.04	0.00	0.08	0.05	0.06	0.08	0.08	0.08
Home equity loans	–0.03	0.09	0.06	0.01	0.17	0.18	0.16	0.11
Multifamily residential mortgages	0.09	0.03	0.06	0.03	–0.01	–0.02	–0.01	0.38
Commercial RE loans	0.03	0.13	0.02	0.05	–0.05	0.12	0.05	–0.13
Construction RE loans	–0.01	0.04	0.00	0.06	–0.03	–0.14	–0.13	–0.02
Commercial and industrial loans*	0.82	0.72	0.47	0.51	0.27	0.27	0.32	0.43
Loans to individuals	0.90	0.79	1.73	1.70	3.74	4.37	2.66	2.49
Credit cards	3.53	3.16	5.28	6.45	5.74	6.26	4.71	4.40
Installment loans	0.69	0.65	0.77	0.62	0.99	0.92	1.27	1.30
All other loans and leases	N/A	N/A	N/A	N/A	0.06	0.33	0.15	1.06
Loans outstanding ($)								
Total loans and leases	$41,076	$37,912	$161,153	$160,692	$320,911	$320,265	$1,249,999	$1,443,958
Loans secured by real estate (RE)	23,033	21,278	96,055	95,353	133,812	127,286	459,561	498,720
1–4 family residential mortgages	11,672	10,506	46,958	44,933	66,729	64,268	231,070	248,551
Home equity loans	568	478	4,950	4,340	11,523	10,018	48,280	51,426
Multifamily residential mortgages	530	480	3,119	3,155	4,942	4,442	13,859	15,112
Commercial RE loans	6,253	5,943	30,642	31,600	38,862	35,892	111,633	119,994
Construction RE loans	1,564	1,499	6,980	7,546	9,852	10,826	27,572	35,385
Farmland loans	2,446	2,373	3,399	3,756	1,780	1,665	2,516	2,811
RE loans from foreign offices	0	0	8	24	124	175	24,631	25,440
Commercial and industrial loans	6,868	6,386	27,585	28,625	65,014	62,807	383,470	474,846
Loans to individuals	6,372	5,578	28,555	26,506	102,069	109,536	221,183	231,593
Credit cards	470	279	5,931	4,935	58,521	70,345	89,203	88,212
Installment loans	5,902	5,298	22,624	21,570	43,548	39,191	131,980	143,382
All other loans and leases	4,991	4,823	9,379	10,573	20,202	20,799	187,271	240,245
Less: Unearned income	188	153	420	365	186	163	1,487	1,446

*Includes All other loans for institutions under $1 billion in asset size.

Key indicators, FDIC-insured national banks by region
Third quarter 1998
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Number of institutions reporting	283	334	524	494	627	257	2,519
Total employees (FTEs)	262,837	243,107	147,776	75,953	73,858	153,160	956,691
Selected income data ($)							
Net income	$2,143	$2,990	$1,727	$914	$643	$757	$9,174
Net interest income	7,378	6,656	4,285	2,468	1,901	4,950	27,638
Provision for loan losses	1,703	583	376	397	111	1,555	4,726
Noninterest income	7,182	4,470	2,629	1,831	831	3,222	20,166
Noninterest expense	9,272	6,624	4,094	2,501	1,736	5,587	29,814
Net operating income	2,250	2,701	1,675	902	612	706	8,846
Cash dividends declared	1,497	1,241	1,153	1,163	302	1,120	6,475
Net charge-offs to loan and lease reserve	1,711	504	335	378	101	1,066	4,096
Selected condition data ($)							
Total assets	836,437	801,672	484,190	233,619	195,800	497,216	3,048,935
Total loans and leases	524,017	505,547	322,822	162,213	111,867	336,361	1,962,827
Reserve for losses	11,930	7,568	5,184	2,933	1,520	7,921	37,056
Securities	128,581	146,582	82,647	40,505	49,401	48,098	495,814
Other real estate owned	734	486	202	74	106	346	1,948
Noncurrent loans and leases	6,901	3,694	2,666	1,372	958	2,420	18,011
Total deposits	542,502	492,968	328,112	157,815	158,251	354,395	2,034,043
Domestic deposits	328,843	464,530	298,815	153,894	155,601	296,904	1,698,586
Equity capital	68,291	74,776	42,189	20,101	17,986	47,853	271,195
Off-balance-sheet derivatives	4,447,929	3,443,551	1,540,628	37,654	36,362	2,079,131	11,585,255
Performance ratios (annualized %)							
Return on equity	12.65	16.27	16.57	18.18	14.53	6.32	13.66
Return on assets	1.03	1.52	1.43	1.57	1.31	0.62	1.21
Net interest income to assets	3.54	3.39	3.55	4.25	3.88	4.02	3.66
Loss provision to assets	0.82	0.30	0.31	0.68	0.23	1.26	0.63
Net operating income to assets	1.08	1.38	1.39	1.55	1.25	0.57	1.17
Noninterest income to assets	3.45	2.28	2.18	3.15	1.70	2.62	2.67
Noninterest expense to assets	4.45	3.38	3.39	4.30	3.54	4.54	3.95
Loss provision to loans and leases	1.31	0.46	0.47	0.99	0.40	1.87	0.97
Net charge-offs to loans and leases	1.32	0.40	0.42	0.94	0.36	1.28	0.84
Loss provision to net charge-offs	98.48	115.72	112.22	105.10	109.34	145.90	114.87
Performance ratios (%)							
Percent of institutions unprofitable	3.53	10.48	4.20	3.85	6.86	10.12	6.15
Percent of institutions with earnings gains	57.24	57.78	59.92	53.64	56.46	56.03	56.85
Noninterest income to net operating revenue	49.33	40.18	38.03	42.59	30.43	39.43	42.18
Noninterest expense to net operating revenue	63.68	59.54	59.22	58.16	63.56	68.36	62.37
Condition ratios (%)							
Nonperforming assets to assets	0.93	0.52	0.59	0.62	0.54	0.56	0.66
Noncurrent loans to loans	1.32	0.73	0.83	0.85	0.86	0.72	0.92
Loss reserve to noncurrent loans	172.88	204.90	194.43	213.72	158.64	327.32	205.74
Loss reserve to loans	2.28	1.50	1.61	1.81	1.36	2.35	1.89
Equity capital to assets	8.16	9.33	8.71	8.60	9.19	9.62	8.89
Leverage ratio	7.33	7.44	7.69	7.97	8.02	7.66	7.56
Risk-based capital ratio	11.96	11.46	11.80	12.32	13.49	11.65	11.86
Net loans and leases to assets	61.22	62.12	65.60	68.18	56.36	66.06	63.16
Securities to assets	15.37	18.28	17.07	17.34	25.23	9.67	16.26
Appreciation in securities (% of par)	0.48	2.09	1.74	1.64	1.69	1.02	1.43
Residential mortgage assets to assets	15.83	27.06	21.09	23.23	22.53	15.37	20.54
Total deposits to assets	64.86	61.49	67.77	67.55	80.82	71.28	66.71
Core deposits to assets	34.02	51.27	54.16	60.28	69.56	53.76	49.27
Volatile liabilities to assets	45.12	31.11	28.40	21.50	18.18	26.17	32.15

Loan performance, FDIC-insured national banks by region
Third quarter 1998
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Percent of loans past due 30–89 days							
Total loans and leases	1.30	1.04	1.35	1.38	1.26	0.90	1.18
Loans secured by real estate (RE)	1.27	1.21	1.23	0.99	1.27	1.02	1.18
1–4 family residential mortgages	1.47	1.50	1.37	1.06	1.48	1.58	1.44
Home equity loans	1.04	0.64	1.09	0.71	0.73	0.76	0.85
Multifamily residential mortgages	0.68	0.69	1.02	1.03	0.57	0.56	0.76
Commercial RE loans	0.65	0.87	1.05	0.74	0.87	0.54	0.80
Construction RE loans	1.29	1.00	1.53	1.68	1.93	0.73	1.24
Commercial and industrial loans*	0.55	0.47	1.19	1.58	1.08	0.61	0.74
Loans to individuals	2.82	2.36	2.21	2.22	1.80	2.04	2.40
Credit cards	2.69	3.48	2.06	2.42	1.83	2.52	2.67
Installment loans	3.05	1.95	2.24	1.97	1.80	1.53	2.20
All other loans and leases	0.36	0.35	0.81	0.66	0.61	0.24	0.42
Percent of loans noncurrent							
Total loans and leases	1.32	0.73	0.83	0.85	0.86	0.72	0.92
Loans secured by real estate (RE)	1.43	0.95	0.85	0.66	0.96	0.87	0.99
1–4 family residential mortgages	1.08	1.06	0.82	0.61	0.84	0.92	0.95
Home equity loans	0.54	0.40	0.38	0.31	0.33	0.41	0.42
Multifamily residential mortgages	1.29	0.82	0.79	0.56	0.34	0.81	0.86
Commercial RE loans	1.64	0.93	1.09	0.63	1.18	1.03	1.09
Construction RE loans	1.27	0.79	0.77	0.98	0.71	0.74	0.83
Commercial and industrial loans*	0.90	0.57	0.91	1.04	1.15	0.72	0.81
Loans to individuals	2.29	0.91	0.85	1.19	0.53	1.04	1.41
Credit cards	1.94	2.11	1.40	1.52	0.92	1.73	1.82
Installment loans	2.92	0.48	0.72	0.78	0.51	0.31	1.09
All other loans and leases	0.28	0.14	0.48	0.43	0.29	0.22	0.27
Percent of loans charged-off, net							
Total loans and leases	1.32	0.40	0.42	0.94	0.36	1.28	0.84
Loans secured by real estate (RE)	0.08	0.05	0.08	0.04	0.03	0.04	0.06
1–4 family residential mortgages	0.10	0.06	0.06	0.12	0.05	0.07	0.07
Home equity loans	0.14	0.16	0.16	0.10	0.17	–0.02	0.11
Multifamily residential mortgages	–0.15	0.07	0.00	0.00	–0.03	1.53	0.25
Commercial RE loans	–0.22	0.02	0.10	–0.15	0.04	–0.16	–0.04
Construction RE loans	–0.19	–0.08	0.00	0.12	0.00	0.00	–0.03
Commercial and industrial loans*	0.33	0.36	0.30	0.58	0.35	0.72	0.42
Loans to individuals	4.14	1.83	1.48	3.24	1.17	3.79	2.96
Credit cards	5.42	4.12	4.09	5.18	3.13	6.34	5.26
Installment loans	1.78	0.93	0.87	0.92	1.00	1.22	1.14
All other loans and leases	1.02	0.17	0.30	0.31	0.05	2.32	0.95
Loans outstanding ($)							
Total loans and leases	$524,017	$505,547	$322,822	$162,213	$111,867	$336,361	$1,962,827
Loans secured by real estate (RE)	153,020	226,160	136,296	66,922	45,191	115,049	742,638
1–4 family residential mortgages	78,095	125,183	61,250	35,823	20,090	47,816	368,257
Home equity loans	11,885	19,460	15,615	3,698	753	14,851	66,262
Multifamily residential mortgages	5,066	5,647	4,882	2,131	1,319	4,143	23,189
Commercial RE loans	30,547	54,786	40,953	16,949	15,895	34,299	193,429
Construction RE loans	4,866	18,718	11,017	5,471	5,605	9,581	55,257
Farmland loans	435	2,035	2,563	2,850	1,528	1,195	10,605
RE loans from foreign offices	22,126	331	17	0	0	3,165	25,639
Commercial and industrial loans	165,957	146,758	90,584	37,523	32,074	99,767	572,664
Loans to individuals	131,268	68,712	58,535	38,125	22,957	53,616	373,213
Credit cards	84,508	18,313	11,251	20,956	1,158	27,585	163,771
Installment loans	46,760	50,398	47,283	17,169	21,800	26,032	209,441
All other loans and leases	74,914	64,175	37,639	19,674	11,884	68,153	276,440
Less: Unearned income	1,141	258	233	32	239	225	2,128

*Includes All other loans for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks
Annual 1994–1997, year-to-date through September 30, 1998, third quarter 1997, and third quarter 1998

(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q3	Preliminary 1998Q3
Number of institutions reporting	10,451	9,940	9,528	9,143	8,910	9,215	8,910
Total employees (FTEs)	1,489,171	1,484,421	1,489,193	1,538,416	1,597,787	1,524,060	1,597,787
Selected income data ($)							
Net income	$44,622	$48,746	$52,351	$59,165	$47,091	$14,723	$15,047
Net interest income	146,551	154,210	162,755	174,508	136,234	44,232	46,303
Provision for loan losses	10,965	12,602	16,286	19,846	16,720	4,974	6,585
Noninterest income	76,276	82,426	93,569	104,498	89,448	27,283	29,717
Noninterest expense	144,234	149,729	160,699	169,982	139,616	43,790	47,418
Net operating income	45,029	48,397	51,510	57,937	45,284	14,541	14,658
Cash dividends declared	28,089	31,053	38,787	42,514	28,465	8,579	10,107
Net charge-offs to loan and lease reserve	11,248	12,202	15,500	18,314	15,282	4,755	5,670
Selected condition data ($)							
Total assets	4,010,517	4,312,677	4,578,321	5,014,964	5,269,220	4,869,295	5,269,220
Total loans and leases	2,358,212	2,602,963	2,811,282	2,970,760	3,145,788	2,902,944	3,145,788
Reserve for losses	52,132	52,837	53,458	54,683	57,263	54,923	57,263
Securities	823,024	810,872	800,648	871,865	923,072	835,546	923,072
Other real estate owned	9,567	6,063	4,780	3,794	3,431	4,133	3,431
Noncurrent loans and leases	30,708	30,351	29,130	28,546	29,523	28,684	29,523
Total deposits	2,874,439	3,027,574	3,197,139	3,421,740	3,506,900	3,304,927	3,506,900
Domestic deposits	2,442,523	2,573,480	2,723,559	2,895,545	2,952,178	2,797,878	2,952,178
Equity capital	312,089	349,575	375,278	417,961	457,430	415,435	457,430
Off-balance-sheet derivatives	15,773,018	16,860,614	20,035,444	25,063,799	32,640,859	25,028,258	32,640,859
Performance ratios (annualized %)							
Return on equity	14.61	14.66	14.45	14.69	14.30	14.38	13.31
Return on assets	1.15	1.17	1.19	1.23	1.22	1.22	1.15
Net interest income to assets	3.78	3.71	3.70	3.64	3.52	3.67	3.54
Loss provision to assets	0.28	0.30	0.37	0.41	0.43	0.41	0.50
Net operating income to assets	1.16	1.16	1.17	1.21	1.17	1.21	1.12
Noninterest income to assets	1.97	1.98	2.13	2.18	2.31	2.26	2.27
Noninterest expense to assets	3.72	3.60	3.65	3.54	3.61	3.63	3.63
Loss provision to loans and leases	0.49	0.51	0.61	0.69	0.73	0.69	0.84
Net charge-offs to loans and leases	0.50	0.49	0.58	0.64	0.66	0.66	0.73
Loss provision to net charge-offs	97.48	103.28	105.07	108.36	106.89	104.61	111.33
Performance ratios (%)							
Percent of institutions unprofitable	3.98	3.55	4.29	4.81	5.15	4.38	5.90
Percent of institutions with earnings gains	53.99	67.54	70.74	68.45	62.57	65.14	57.21
Noninterest income to net operating revenue	34.23	34.83	36.50	37.45	39.63	38.15	39.09
Noninterest expense to net operating revenue	64.73	63.27	62.69	60.92	61.86	61.23	62.37
Condition ratios (%)							
Nonperforming assets to assets	1.01	0.85	0.75	0.66	0.65	0.68	0.65
Noncurrent loans to loans	1.30	1.17	1.04	0.96	0.94	0.99	0.94
Loss reserve to noncurrent loans	169.77	174.09	183.51	191.56	193.96	191.48	193.96
Loss reserve to loans	2.21	2.03	1.90	1.84	1.82	1.89	1.82
Equity capital to assets	7.78	8.11	8.20	8.33	8.68	8.53	8.68
Leverage ratio	7.64	7.61	7.64	7.56	7.70	7.78	7.70
Risk-based capital ratio	13.01	12.68	12.54	12.26	12.36	12.43	12.36
Net loans and leases to assets	57.50	59.13	60.24	58.15	58.61	58.49	58.61
Securities to assets	20.52	18.80	17.49	17.39	17.52	17.16	17.52
Appreciation in securities (% of par)	–3.42	1.01	0.51	1.10	1.64	1.07	1.64
Residential mortgage assets to assets	20.45	20.31	19.79	20.03	20.42	19.97	20.42
Total deposits to assets	71.67	70.20	69.83	68.23	66.55	67.87	66.55
Core deposits to assets	55.31	53.47	52.45	50.06	48.43	49.77	48.43
Volatile liabilities to assets	29.28	29.68	30.71	31.92	32.27	32.45	32.27

Loan performance, FDIC-insured commercial banks
Annual 1994–1997, year-to-date through September 30, 1998, third quarter 1997, and third quarter 1998
(Dollar figures in millions)

	1994	1995	1996	1997	Preliminary 1998YTD	1997Q3	Preliminary 1998Q3
Percent of loans past due 30–89 days							
Total loans and leases	1.19	1.29	1.37	1.31	1.20	1.22	1.20
Loans secured by real estate (RE)	1.31	1.38	1.41	1.33	1.17	1.18	1.17
1–4 family residential mortgages	1.33	1.53	1.57	1.59	1.38	1.45	1.38
Home equity loans	0.85	1.09	1.06	0.96	0.86	0.86	0.86
Multifamily residential mortgages	1.65	0.99	1.19	1.11	0.71	0.75	0.71
Commercial RE loans	1.27	1.21	1.24	0.97	0.87	0.86	0.87
Construction RE loans	1.64	1.41	1.58	1.42	1.26	1.22	1.26
Commercial and industrial loans*	0.89	0.86	0.95	0.83	0.84	0.80	0.84
Loans to individuals	1.82	2.21	2.50	2.50	2.40	2.38	2.40
Credit cards	2.08	2.40	2.76	2.73	2.74	2.72	2.74
Installment loans	1.66	2.08	2.31	2.33	2.19	2.15	2.19
All other loans and leases	0.30	0.37	0.37	0.51	0.46	0.43	0.46
Percent of loans noncurrent							
Total loans and leases	1.30	1.17	1.04	0.96	0.94	0.99	0.94
Loans secured by real estate (RE)	1.70	1.39	1.20	1.01	0.94	1.06	0.94
1–4 family residential mortgages	0.91	0.88	0.99	0.94	0.89	0.94	0.89
Home equity loans	0.54	0.52	0.48	0.44	0.43	0.42	0.43
Multifamily residential mortgages	2.73	1.99	1.35	0.95	0.82	1.08	0.82
Commercial RE loans	2.61	2.02	1.61	1.21	1.02	1.35	1.02
Construction RE loans	4.14	2.75	1.38	0.97	0.90	1.05	0.90
Commercial and industrial loans*	1.27	1.19	0.98	0.85	0.96	0.92	0.96
Loans to individuals	1.01	1.22	1.36	1.47	1.42	1.36	1.42
Credit cards	1.23	1.58	1.91	2.17	2.04	2.00	2.04
Installment loans	0.87	0.97	0.97	0.98	1.02	0.94	1.02
All other loans and leases	0.46	0.30	0.22	0.25	0.27	0.29	0.27
Percent of loans charged-off, net							
Total loans and leases	0.50	0.49	0.58	0.64	0.66	0.66	0.73
Loans secured by real estate (RE)	0.32	0.18	0.10	0.06	0.04	0.06	0.05
1–4 family residential mortgages	0.14	0.11	0.08	0.08	0.06	0.07	0.07
Home equity loans	0.21	0.20	0.20	0.16	0.14	0.13	0.11
Multifamily residential mortgages	0.51	0.32	0.15	0.04	0.07	0.03	0.17
Commercial RE loans	0.53	0.32	0.09	0.01	–0.02	0.02	–0.01
Construction RE loans	0.87	0.22	0.19	–0.02	0.00	–0.03	0.00
Commercial and industrial loans*	0.27	0.25	0.26	0.28	0.34	0.34	0.40
Loans to individuals	1.43	1.73	2.28	2.70	2.74	2.75	2.73
Credit cards	3.00	3.40	4.35	5.11	5.37	5.37	5.35
Installment loans	0.50	0.66	0.89	1.04	1.01	1.01	1.03
All other loans and leases	0.14	–0.02	0.08	0.11	0.45	0.11	0.85
Loans outstanding ($)							
Total loans and leases	$2,358,212	$2,602,963	$2,811,282	$2,970,760	$3,145,788	$2,902,944	$3,145,788
Loans secured by real estate (RE)	997,704	1,080,116	1,139,020	1,244,023	1,300,378	1,226,869	1,300,378
1–4 family residential mortgages	493,137	546,808	570,124	620,601	642,390	612,133	642,390
Home equity loans	75,818	79,182	85,300	98,164	96,889	96,090	96,889
Multifamily residential mortgages	31,928	35,788	38,162	41,232	42,453	39,908	42,453
Commercial RE loans	283,208	298,533	315,989	340,551	357,524	336,120	357,524
Construction RE loans	64,506	68,696	76,399	88,248	102,467	86,112	102,467
Farmland loans	22,649	23,907	24,964	27,070	28,777	26,888	28,777
RE loans from foreign offices	26,457	27,202	28,083	28,157	29,878	29,618	29,878
Commercial and industrial loans	589,090	661,417	709,600	795,923	873,935	765,212	873,935
Loans to individuals	487,104	535,348	562,291	561,437	555,298	554,549	555,298
Credit cards	186,755	216,016	231,664	231,174	216,106	220,387	216,106
Installment loans	300,348	319,332	330,627	330,263	339,192	334,161	339,192
All other loans and leases	290,659	331,934	405,678	373,902	420,370	361,064	420,370
Less: Unearned income	6,344	5,853	5,308	4,525	4,193	4,750	4,193

*Includes All other loans for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks by asset size
Third quarter 1997 and third quarter 1998

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1997Q3	1998Q3	1997Q3	1998Q3	1997Q3	1998Q3	1997Q3	1998Q3
Number of institutions reporting	5,978	5,580	2,874	2,947	297	319	66	64
Total employees (FTEs)	132,019	121,650	309,861	306,989	296,353	313,531	785,827	855,617
Selected income data ($)								
Net income	$879	$816	$2,517	$2,407	$3,105	$3,839	$8,222	$7,984
Net interest income	2,952	2,706	7,656	7,636	9,755	10,130	23,869	25,831
Provision for loan losses	158	160	496	597	1,917	1,710	2,403	4,118
Noninterest income	877	985	2,806	2,969	5,339	7,046	18,261	18,717
Noninterest expense	2,428	2,423	6,282	6,544	8,387	9,675	26,692	28,777
Net operating income	873	820	2,487	2,376	3,057	3,751	8,123	7,710
Cash dividends declared	321	709	1,242	1,119	1,821	3,416	5,194	4,863
Net charge-offs to loan and lease reserve	103	148	369	399	1,627	1,692	2,655	3,431
Selected condition data ($)								
Total assets	272,267	257,424	711,057	730,945	899,758	956,796	2,986,213	3,324,055
Total loans and leases	161,581	153,314	440,475	450,237	597,023	619,131	1,703,865	1,923,106
Reserve for losses	2,348	2,223	6,690	6,827	13,072	12,997	32,812	35,216
Securities	76,355	67,601	187,926	192,752	180,811	197,205	390,455	465,515
Other real estate owned	384	308	927	760	720	576	2,103	1,787
Noncurrent loans and leases	1,709	1,652	4,099	3,973	6,694	6,441	16,181	17,456
Total deposits	233,171	219,372	587,678	601,574	615,944	641,431	1,868,133	2,044,523
Domestic deposits	233,117	219,320	585,286	599,512	595,865	624,537	1,383,611	1,508,809
Equity capital	29,850	28,748	68,903	71,656	83,991	93,940	232,692	263,086
Off-balance-sheet derivatives	849	943	8,957	10,064	140,197	132,030	25,529,243	33,305,788
Performance ratios (annualized %)								
Return on equity	11.96	11.46	14.87	13.67	15.19	16.54	14.26	12.26
Return on assets	1.31	1.28	1.43	1.33	1.40	1.62	1.11	0.97
Net interest income to assets	4.39	4.23	4.36	4.22	4.38	4.27	3.22	3.13
Loss provision to assets	0.23	0.25	0.28	0.33	0.86	0.72	0.32	0.50
Net operating income to assets	1.30	1.28	1.41	1.31	1.37	1.58	1.10	0.93
Noninterest income to assets	1.30	1.54	1.60	1.64	2.40	2.97	2.47	2.27
Noninterest expense to assets	3.61	3.79	3.57	3.62	3.77	4.08	3.61	3.48
Loss provision to loans and leases	0.40	0.42	0.46	0.54	1.30	1.11	0.56	0.86
Net charge-offs to loans and leases	0.26	0.39	0.34	0.36	1.10	1.10	0.62	0.72
Loss provision to net charge-offs	153.72	107.48	134.36	149.87	117.81	100.85	90.49	112.14
Performance ratios (%)								
Percent of institutions unprofitable	5.97	7.74	1.39	2.65	2.36	4.08	0.00	4.69
Percent of institutions with earnings gains	60.51	52.11	74.04	65.42	70.71	67.40	72.73	71.88
Noninterest income to net operating revenue	22.91	26.68	26.82	28.00	35.37	41.02	43.34	42.02
Noninterest expense to net operating revenue	63.42	65.64	60.05	61.71	55.56	56.33	63.36	64.60
Condition ratios (%)								
Nonperforming assets to assets	0.77	0.76	0.71	0.65	0.82	0.74	0.62	0.61
Noncurrent loans to loans	1.06	1.08	0.93	0.88	1.12	1.04	0.95	0.91
Loss reserve to noncurrent loans	137.38	134.50	163.22	171.83	195.27	201.78	202.78	201.75
Loss reserve to loans	1.45	1.45	1.52	1.52	2.19	2.10	1.93	1.83
Equity capital to assets	10.96	11.17	9.69	9.80	9.33	9.82	7.79	7.91
Leverage ratio	10.82	10.84	9.33	9.31	8.56	8.57	6.88	6.83
Risk-based capital ratio	18.15	18.02	15.13	15.07	13.16	13.20	11.29	11.32
Net loans and leases to assets	58.48	58.69	61.01	60.66	64.90	63.35	55.96	56.79
Securities to assets	28.04	26.26	26.43	26.37	20.10	20.61	13.08	14.00
Appreciation in securities (% of par)	0.55	1.35	0.79	1.63	0.85	1.56	1.41	1.73
Residential mortgage assets to assets	21.99	21.34	24.74	24.22	25.01	25.60	17.13	18.02
Total deposits to assets	85.64	85.22	82.65	82.30	68.46	67.04	62.56	61.51
Core deposits to assets	74.91	74.01	71.63	70.71	56.88	56.03	40.12	39.37
Volatile liabilities to assets	12.53	12.61	16.29	16.05	27.14	26.53	39.72	39.01

Loan performance, FDIC-insured commercial banks by asset size
Third quarter 1997 and third quarter 1998

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1996Q3	1997Q3	1996Q3	1997Q3	1996Q3	1997Q3	1996Q3	1997Q3
Percent of loans past due 30–89 days								
Total loans and leases	1.52	1.54	1.25	1.27	1.55	1.53	1.07	1.05
Loans secured by real estate (RE)	1.34	1.34	1.02	1.01	1.16	1.16	1.25	1.21
1–4 family residential mortgages	1.69	1.68	1.24	1.23	1.28	1.26	1.57	1.45
Home equity loans	0.87	0.85	0.84	0.87	0.90	0.95	0.85	0.83
Multifamily residential mortgages	0.83	0.66	0.70	0.57	0.97	0.79	0.63	0.74
Commercial RE loans	1.04	1.07	0.78	0.78	1.02	1.02	0.81	0.81
Construction RE loans	1.16	1.23	1.09	1.11	1.36	1.45	1.23	1.26
Commercial and industrial loans*	1.40	1.52	1.32	1.41	1.15	1.18	0.53	0.58
Loans to individuals	2.39	2.32	2.04	2.11	2.60	2.50	2.33	2.42
Credit cards	3.43	2.92	2.82	3.38	2.89	2.70	2.58	2.71
Installment loans	2.33	2.30	1.90	1.89	2.29	2.27	2.15	2.23
All other loans and leases	N/A	N/A	N/A	N/A	1.05	1.15	0.37	0.41
Percent of loans noncurrent								
Total loans and leases	1.06	1.08	0.93	0.88	1.12	1.04	0.95	0.91
Loans secured by real estate (RE)	0.91	0.90	0.82	0.76	1.07	0.87	1.19	1.04
1–4 family residential mortgages	0.82	0.83	0.73	0.70	1.01	0.80	1.01	1.00
Home equity loans	0.44	0.52	0.40	0.38	0.41	0.50	0.43	0.41
Multifamily residential mortgages	0.88	0.70	0.92	0.68	1.05	0.79	1.20	0.91
Commercial RE loans	1.03	0.91	0.97	0.82	1.30	1.05	1.69	1.15
Construction RE loans	0.79	0.70	0.81	0.87	1.13	0.91	1.21	0.95
Commercial and industrial loans*	1.40	1.47	1.33	1.26	0.92	0.96	0.75	0.81
Loans to individuals	0.91	0.93	0.77	0.76	1.52	1.52	1.45	1.55
Credit cards	2.12	1.85	1.76	1.77	2.10	1.96	1.95	2.13
Installment loans	0.84	0.89	0.58	0.59	0.90	1.03	1.09	1.17
All other loans and leases	N/A	N/A	N/A	N/A	0.49	0.49	0.28	0.24
Percent of loans charged-off, net								
Total loans and leases	0.26	0.39	0.34	0.36	1.10	1.10	0.62	0.72
Loans secured by real estate (RE)	0.03	0.05	0.05	0.05	0.05	0.07	0.07	0.05
1–4 family residential mortgages	0.04	0.05	0.07	0.06	0.07	0.06	0.08	0.08
Home equity loans	0.01	0.36	0.07	0.04	0.13	0.15	0.14	0.11
Multifamily residential mortgages	–0.03	0.17	0.06	0.05	0.09	0.02	0.00	0.32
Commercial RE loans	0.02	0.06	0.04	0.03	0.00	0.11	0.01	–0.11
Construction RE loans	0.02	0.05	0.02	0.03	0.00	–0.07	–0.10	0.02
Commercial and industrial loans*	0.40	0.41	0.39	0.41	0.32	0.36	0.30	0.37
Loans to individuals	0.82	1.63	1.37	1.58	3.55	3.56	2.79	2.59
Credit cards	4.08	9.34	4.58	6.62	6.01	5.95	5.01	4.76
Installment loans	0.62	1.25	0.78	0.73	0.91	0.87	1.18	1.17
All other loans and leases	N/A	N/A	N/A	N/A	0.17	0.45	0.10	1.01
Loans outstanding ($)								
Total loans and leases	$161,581	$153,314	$440,475	$450,237	$597,023	$619,131	$1,703,865	$1,923,106
Loans secured by real estate (RE)	90,392	85,587	271,507	277,892	264,794	283,053	600,177	653,846
1–4 family residential mortgages	45,273	41,630	123,120	122,094	131,532	138,481	312,209	340,186
Home equity loans	2,158	1,931	13,400	12,760	20,807	19,679	59,725	62,518
Multifamily residential mortgages	1,984	1,824	8,893	9,146	10,647	11,776	18,384	19,707
Commercial RE loans	23,783	23,080	92,626	96,702	77,049	83,706	142,662	154,036
Construction RE loans	6,305	6,287	23,549	26,163	21,331	25,518	34,927	44,498
Farmland loans	10,881	10,824	9,857	10,982	3,182	3,542	2,967	3,428
RE loans from foreign offices	7	10	62	45	246	350	29,302	29,472
Commercial and industrial loans	26,147	25,279	76,667	81,435	125,612	127,774	536,787	639,447
Loans to individuals	24,457	22,172	69,526	65,716	165,676	167,663	294,890	299,747
Credit cards	1,361	1,009	10,784	9,640	85,136	87,947	123,106	117,510
Installment loans	23,096	21,162	58,742	56,076	80,539	79,716	171,784	182,237
All other loans and leases	21,247	20,826	24,112	26,314	41,875	41,386	273,830	331,844
Less: Unearned income	661	550	1,337	1,120	933	745	1,819	1,777

*Includes All other loans for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks by region
Third quarter 1998
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Number of institutions reporting	697	1,466	1,941	2,295	1,549	962	8,910
Total employees (FTEs)	471,857	385,223	266,895	127,621	120,862	225,329	1,597,787
Selected income data ($)							
Net income	$4,301	$4,155	$2,876	$1,344	$947	$1,423	$15,047
Net interest income	14,309	10,173	7,477	3,823	3,000	7,521	46,303
Provision for loan losses	2,451	878	624	505	218	1,909	6,585
Noninterest income	12,101	6,188	3,969	2,283	1,128	4,047	29,717
Noninterest expense	17,052	9,825	6,738	3,604	2,619	7,580	47,418
Net operating income	4,387	3,854	2,806	1,328	908	1,375	14,658
Cash dividends declared	2,941	2,128	1,767	1,396	434	1,442	10,107
Net charge-offs to loan and lease reserve	2,376	722	580	454	154	1,385	5,670
Selected condition data ($)							
Total assets	1,917,831	1,148,573	835,223	363,046	301,478	703,069	5,269,220
Total loans and leases	972,334	735,371	552,265	246,195	169,558	470,065	3,145,788
Reserve for losses	20,523	10,902	8,577	4,297	2,370	10,594	57,263
Securities	293,234	223,759	160,287	73,013	83,188	89,592	923,072
Other real estate owned	1,147	849	394	196	234	609	3,431
Noncurrent loans and leases	11,972	5,440	4,495	2,141	1,543	3,932	29,523
Total deposits	1,142,496	751,246	584,912	266,043	246,860	515,342	3,506,900
Domestic deposits	728,080	719,181	546,644	262,122	244,210	451,941	2,952,178
Equity capital	146,637	107,478	73,607	33,088	28,224	68,396	457,430
Off-balance-sheet derivatives	25,378,641	3,490,082	1,602,780	38,506	36,875	2,093,975	32,640,859
Performance ratios (annualized %)							
Return on equity	11.87	15.67	15.87	16.37	13.64	8.35	13.31
Return on assets	0.90	1.47	1.38	1.49	1.26	0.82	1.15
Net interest income to assets	2.99	3.61	3.59	4.25	3.99	4.33	3.54
Loss provision to assets	0.51	0.31	0.30	0.56	0.29	1.10	0.50
Net operating income to assets	0.92	1.37	1.35	1.48	1.21	0.79	1.12
Noninterest income to assets	2.53	2.19	1.91	2.54	1.50	2.33	2.27
Noninterest expense to assets	3.56	3.48	3.24	4.01	3.49	4.36	3.63
Loss provision to loans and leases	1.01	0.48	0.46	0.83	0.52	1.64	0.84
Net charge-offs to loans and leases	0.98	0.40	0.42	0.75	0.37	1.19	0.73
Loss provision to net charge-offs	93.65	121.60	106.96	111.23	141.78	137.86	111.33
Performance ratios (%)							
Percent of institutions unprofitable	7.75	8.32	4.69	3.27	5.29	10.60	5.90
Percent of institutions with earnings gains	62.41	56.55	58.94	54.68	55.78	59.25	57.21
Noninterest income to net operating revenue	45.82	37.82	34.68	37.39	27.32	34.98	39.09
Noninterest expense to net operating revenue	64.56	60.05	58.86	59.02	63.45	65.52	62.37
Condition ratios (%)							
Nonperforming assets to assets	0.74	0.55	0.59	0.64	0.59	0.65	0.65
Noncurrent loans to loans	1.23	0.74	0.81	0.87	0.91	0.84	0.94
Loss reserve to noncurrent loans	171.42	200.42	190.82	200.67	153.58	269.44	193.96
Loss reserve to loans	2.11	1.48	1.55	1.75	1.40	2.25	1.82
Equity capital to assets	7.65	9.36	8.81	9.11	9.36	9.73	8.68
Leverage ratio	7.02	7.85	8.01	8.58	8.42	8.19	7.70
Risk-based capital ratio	12.29	12.05	12.21	13.21	14.21	12.16	12.36
Net loans and leases to assets	49.63	63.08	65.09	66.63	55.46	65.35	58.61
Securities to assets	15.29	19.48	19.19	20.11	27.59	12.74	17.52
Appreciation in securities (% of par)	1.13	2.53	1.69	1.57	1.48	1.27	1.64
Residential mortgage assets to assets	16.21	27.32	22.45	22.20	23.59	15.96	20.42
Total deposits to assets	59.57	65.41	70.03	73.28	81.88	73.30	66.55
Core deposits to assets	31.30	54.96	57.00	65.53	69.82	56.35	48.43
Volatile liabilities to assets	44.85	27.85	26.49	18.14	17.95	25.46	32.27

Loan performance, FDIC-insured commercial banks by region
Third quarter 1998
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Percent of loans past due 30–89 days							
Total loans and leases	1.21	1.15	1.35	1.36	1.34	0.96	1.20
Loans secured by real estate (RE)	1.24	1.19	1.21	1.05	1.27	0.97	1.17
1–4 family residential mortgages	1.35	1.46	1.33	1.20	1.53	1.42	1.38
Home equity loans	0.96	0.68	1.10	0.76	0.76	0.76	0.86
Multifamily residential mortgages	0.52	0.88	0.97	0.94	0.57	0.47	0.71
Commercial RE loans	0.94	0.88	1.00	0.78	0.95	0.64	0.87
Construction RE loans	1.28	1.06	1.61	1.61	1.52	0.97	1.26
Commercial and industrial loans*	0.57	0.66	1.24	1.74	1.31	0.76	0.84
Loans to individuals	2.81	2.32	2.24	2.28	1.87	1.97	2.40
Credit cards	2.84	3.30	2.41	2.73	1.85	2.28	2.74
Installment loans	2.76	1.99	2.20	1.89	1.87	1.63	2.19
All other loans and leases	0.39	0.39	0.95	0.46	0.59	0.26	0.46
Percent of loans noncurrent							
Total loans and leases	1.23	0.74	0.81	0.87	0.91	0.84	0.94
Loans secured by real estate (RE)	1.25	0.85	0.80	0.69	0.92	0.91	0.94
1–4 family residential mortgages	0.99	0.94	0.74	0.61	0.84	0.96	0.89
Home equity loans	0.56	0.36	0.40	0.32	0.35	0.44	0.43
Multifamily residential mortgages	0.92	0.96	0.73	0.58	0.38	0.81	0.82
Commercial RE loans	1.50	0.82	0.98	0.64	1.06	0.99	1.02
Construction RE loans	1.57	0.73	0.91	0.92	0.69	0.93	0.90
Commercial and industrial loans*	1.06	0.63	0.93	1.33	1.36	0.91	0.96
Loans to individuals	2.23	0.95	0.91	1.19	0.59	1.11	1.42
Credit cards	2.32	1.97	1.77	1.72	0.98	1.73	2.04
Installment loans	2.12	0.60	0.68	0.72	0.57	0.41	1.02
All other loans and leases	0.26	0.16	0.42	0.30	0.28	0.25	0.27
Percent of loans charged-off, net							
Total loans and leases	0.98	0.40	0.42	0.75	0.37	1.19	0.73
Loans secured by real estate (RE)	0.06	0.05	0.07	0.03	0.04	0.05	0.05
1–4 family residential mortgages	0.08	0.06	0.05	0.09	0.06	0.11	0.07
Home equity loans	0.12	0.14	0.18	0.09	0.21	–0.01	0.11
Multifamily residential mortgages	–0.02	0.04	0.12	0.03	–0.03	0.81	0.17
Commercial RE loans	–0.09	0.02	0.10	–0.08	0.04	–0.07	–0.01
Construction RE loans	–0.07	–0.02	0.04	0.09	0.01	–0.01	0.00
Commercial and industrial loans*	0.26	0.35	0.32	0.54	0.44	0.78	0.40
Loans to individuals	3.54	1.76	1.70	2.97	1.06	3.82	2.73
Credit cards	5.54	4.24	4.41	5.47	3.26	6.17	5.35
Installment loans	1.24	0.85	0.99	0.77	0.90	1.26	1.03
All other loans and leases	0.99	0.17	0.30	0.20	0.19	2.12	0.85
Loans outstanding ($)							
Total loans and leases	$972,334	$735,371	$552,265	$246,195	$169,558	$470,065	$3,145,788.
Loans secured by real estate (RE)	311,698	364,838	251,865	111,233	75,844	184,900	1,300,378
1–4 family residential mortgages	172,373	192,757	119,031	55,302	33,273	69,654	642,390
Home equity loans	21,061	28,790	23,349	4,842	907	17,940	96,889
Multifamily residential mortgages	11,618	9,134	8,594	3,357	2,118	7,632	42,453
Commercial RE loans	68,784	93,588	73,768	29,050	26,912	65,423	357,524
Construction RE loans	11,097	35,110	19,903	9,164	9,493	17,700	102,467
Farmland loans	1,124	5,127	7,202	9,518	3,141	2,665	28,777
RE loans from foreign offices	25,642	331	19	0	0	3,886	29,878
Commercial and industrial loans	306,810	185,548	152,925	51,706	44,271	132,674	873,935
Loans to individuals	197,757	110,103	87,542	49,318	33,561	77,017	555,298
Credit cards	104,122	28,103	18,312	23,179	1,594	40,797	216,106
Installment loans	93,635	82,001	69,230	26,139	31,967	36,220	339,192
All other loans and leases	157,921	75,561	60,418	34,015	16,411	76,045	420,370
Less: Unearned income	1,852	680	485	76	529	571	4,193

*Includes All other loans for institutions under $1 billion in asset size.

Glossary

Data Sources

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

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

Computation Methodology

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

Definitions

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

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

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

IBIS—OCC's Integrated Banking Information System.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Status of OCC Year-2000 Examinations

The Office of the Comptroller of the Currency (OCC) conducts year-2000 readiness examinations of national banks, federal branches, uninsured trust banks, independent data centers, affiliated bank data centers and multiregional data processing servicers, and software vendors. The OCC plans call for two additional year-2000 readiness examinations at each institution we supervise. These examinations began in the third quarter of 1999. The first set of these examinations will be completed early in the first quarter of 1999 and the second set will be completed early in the third quarter of 1999. These examinations focus on banks' testing processes and contingency plans. In addition, the OCC will monitor quarterly the year-2000 remediation progress in all national banking institutions through the first quarter of 2000.

Based on examinations to date, the majority of these institutions have shown good faith efforts to address year-2000 issues, and most are on schedule with their remediation efforts. As of September 30, 1998, 97 percent of institutions are rated "satisfactory" in their progress toward year-2000 readiness. About 3 percent are rated "needs improvement" and only seven institutions are rated "unsatisfactory" in their progress. These third-quarter ratings are similar to the second-quarter ratings, in which 96 percent of institutions were rated "satisfactory," 4 percent were rated "needs improvement," and eight institutions were rated "unsatisfactory" in their progress toward year-2000 readiness.

To date, the OCC has found that institutions that were rated "less than satisfactory" demonstrated a number of common problems and deficiencies including:

- Incomplete testing plans
- Insufficient allocation of financial resources to complete necessary tasks
- Failure to meet scheduled deadlines
- Ineffective management oversight of year-2000 efforts, and
- Ineffective year-2000 risk management processes

Financial institutions have begun to test and validate their systems. By the end of the third quarter 1998, about 40 percent of banks moved into the validation (and testing) phase, up from 25 percent in June. As national banks move through the testing phase, the OCC will become better able to determine whether institutions will complete their year-2000 project plans in time and whether their efforts will minimize risks. In reviewing the ratings to date, it is important to note that the OCC's year-2000 ratings are no more than a point-in-time snapshot of the industry's progress and cannot necessarily predict the ultimate success of the industry's year-2000 remediation efforts.

When necessary, the OCC has taken enforcement action against institutions that have fallen behind. The OCC is using a variety of enforcement tools to effect prompt remedial action by financial institutions that are rated "less than satisfactory."

Through September 30, 1998, the OCC initiated 11 formal enforcement actions and 303 informal enforcement actions. Of the 314 total actions, 209 have been terminated because of corrective measures taken by the institutions. The OCC takes more aggressive enforcement action when an institution receives an "unsatisfactory" year-2000 summary rating. The OCC initiates formal enforcement action whenever informal measures are inadequate or ineffective in securing prompt remediation of the year-2000-related problems. The OCC's enforcement policy is determined largely by:

1) The institution's year-2000 summary evaluation
2) Progress made in complying with any previously issued supervisory directive or other informal or formal enforcement action
3) The cooperation, responsiveness, and capability of the institution's management and board of directors; and
4) The time remaining prior to the year 2000

Year-2000 examination reports of individual institutions are confidential and the property of the OCC. Financial institutions may not disclose their year-2000 supervisory ratings and the contents of the examination reports or make statements that indicate or imply that their year-2000 plan or actual year-2000 readiness has been approved or certified by a supervisory agency.

Special Studies on Technology and Banking

Banking over the Internet

by Kori L. Egland, Karen Furst, Daniel E. Nolle, and Douglas Robertson[1]

Banking over the Internet is attracting a great deal of attention in the banking and regulatory communities, and developments in this new delivery channel are the subject of numerous articles in the banking press. Despite widespread interest in and concerns about this subject, there is little systematic information on how many banks offer personal computer (PC) banking over the Internet, and on the nature of the services offered. To address this deficiency, the Special Studies staff at the Office of the Comptroller of the Currency (OCC) has undertaken a comprehensive review of Web sites of banks offering transactional Internet banking. We define "transactional" Internet banking as providing customers the ability to access their accounts and, at a minimum, transfer funds between accounts. This report provides new and unique information on the dimensions of transactional Internet banking, both in the commercial banking industry in total and for national banks.

Our key findings are as follows:

- Very few banks offered customers the ability to access their accounts and perform at least simple money transactions. As of June 30, 1998, less than 5 percent of commercial banks and less than 7 percent of national banks had such transactional Web sites. While some Internet-based financial services, particularly discount brokerage, are having a dramatic impact on the market, Internet banking at this point is a relatively small factor in the banking industry.
- Because of the relatively high number of large banks offering Internet banking, Internet-accessible banks account for almost 40 percent of commercial bank and over 60 percent of national bank assets.
- Large banks are more likely to offer transactional Internet banking than smaller banks, but some small and mid-size banks also offer customers the ability to bank via the Internet. Currently, the fixed costs of offering Internet banking do not appear to be prohibitive for small institutions.
- Banks offering transactional banking over the Internet appear to be more likely to include a privacy statement on their Web sites as compared to banks with Web sites and no transactional capabilities. The majority of large banks have adopted Web site privacy statements. While there has been growth in adoption, most small and mid-size banks with transactional Internet banking do not yet have on-line privacy statements. Our analysis does not assess the quality of the on-line privacy information offered.
- During 1998, we estimate that the number of commercial bank transactional Web sites more than tripled, although the growth rate slowed in the second half of the year. Announcements by third-party Internet software vendors of new contracts with banks suggest that strong growth is likely in the number of transactional Web sites in early 1999.
- While use of the Internet for banking transactions is relatively small, the projected growth in Web sites means that a very large share of all banking customers will have access to this service. The critical factor for future use will be the development of products that provide higher value relative to traditional channels, and that provide adequate security, privacy, and other consumer protections. The introduction this year of electronic bill presentment may generate a substantial boost to customer usage of Internet banking.

Key Characteristics of Banks Offering Transactional Internet Banking

Advancements in information technology have made it possible for banks to use the Internet as a delivery channel for banking services. By using the Internet, as compared to previously available "proprietary" or "dial-up" PC banking, banks have the potential to reach a large number of customers at a low incremental cost. Proprietary PC banking has been used by some banks for more than two decades, but despite claims about its potential to revolutionize the delivery of banking services, its use has never become extensive.[2]

[1] The authors thank Cindi Bonnette for her generous help and Tanya Lee and Mark Ferrandino for their excellent research assistance.

[2] Both proprietary PC banking and Internet PC banking are two forms of "remote" banking. Telephone call centers and automated teller machines (ATMs) are two other widely used forms of remote banking. Though it is not yet standard procedure in the banking press, industry studies, and common usage to specify which form of PC banking one means, it is worthwhile making the distinction between the two. They are different from a technological point of view. For example, although not yet widespread, devices other than PCs could be used for Internet banking such as "palmtop" (or hand-held) personal computers, kiosks, and Web television. It is also likely that there are differences in the levels and types of risk exposures related to these forms of remote and PC banking.

Table 1—Banks offering transactional banking via the Internet[1]
(as of June 30, 1998)

	All banks	National banks
Transactional Web sites for commercial banks and banking companies	223	88
Banks offering transactional Internet banking[2]	374	161
Banks offering both transactional Internet banking and proprietary PC banking	68	32
Banks with transactional Internet banking as a percent of all banks, by charter type	4.2	6.3
Assets in banks with transactional Internet banking as a percent of all bank assets, by charter type	39.6	61.0

Memorandum: There were 8,983 commercial banks and 2,546 national banks as of June 30, 1998.

Source: Office of the Comptroller of the Currency using information from banks' Web sites and from FFIEC *Reports of Condition and Income*.

Notes:

[1] "Transactional" Internet banking includes any of the following activities: access accounts for balance inquiry and account history; transfer funds between accounts; electronic bill payment; download data to software; open an account; apply for a loan; apply for a line of credit; purchase financial instruments (e.g., certificates of deposit, mutual funds); purchase insurance.

[2] The number of banks offering transactional Internet banking is greater than the number of transactional Web sites, because the bank subsidiaries of some banking companies are accessible from a single Web site.

There are a number of reasons to believe that there is great potential for Internet banking despite the lackluster experience of proprietary systems. In recent years, we have the seen the development of an electronic and communications infrastructure that could facilitate the adoption of Internet banking. The most important factor is the astounding growth in the Internet. According to one survey, the number of Internet users over the age of 16 increased from 58 million at the third quarter of 1997 to 79 million at the end of the second quarter of 1998.[3] Perhaps more importantly, a recent study indicates that 40 percent of Internet users are willing to conduct a financial transaction on-line.[4] In addition, innovations in technology hold great promise for improving the quality and functionality of on-line services. Moreover, the openness of the Internet allows banks to avoid the problems associated with the distribution of software and updates that are found in proprietary PC banking.

Our Database

Our information on the nature and extent of transactional Internet banking comes from our review of Web sites for the entire banking and thrift industries. We found almost 1,800 banking and thrift Web sites as of June 30, 1998, of which 258 were transactional, the rest being information-only sites. Of the 258 transactional Web sites, 223 belonged to individual commercial banks or multi-bank holding companies, as Table 1 shows. The Web sites of some multi-bank holding companies are used by more than one bank in the holding company, and we ascertained that the 223 banking Web sites covered 374 commercial banks.[5] We scrutinized each transactional Web site to determine the range of services each offered. On a bank-by-bank basis we matched our Internet banking data with the OCC's database of standard banking variables. The result is a unique set of information that allows us to describe the structure and performance of banks offering transactional Internet banking, and to compare these technological "early-adopter" banks with the remainder of the banking industry.

Few Banks Offer Transactional Internet Banking

Very few banks offer transactional Internet banking. Table 1 shows that 4.2 percent of the 8,983 commercial banks offered transactional Internet banking as of June 30, 1998. National banks were slightly more likely to offer transactional Internet banking than state banks; even so, only 6.3 percent of national banks did. Nevertheless, Table 1 also shows that the small group of banks offering transactional Internet banking accounted for almost 40 percent of all commercial bank assets. Transactional Internet banks with a national charter accounted for 61 percent of national banking system assets.

Producing a comprehensive "count" of proprietary PC banking is another story. Because banks are not required to report the fact that they offer proprietary PC banking and because there is no publicly available information on all proprietary PC banking, our count is based on data we could collect from Web sites. As Table 1 shows, we were able to ascertain that 68 of the 374 banks offering transactional Internet banking also offered proprietary banking; 32 of the banks offering both Internet and proprietary PC banking were national banks.

[3] The CommerceNet/Nielsen Internet Demographic Survey of North American Internet users over the age of 16.

[4] As reported by Piper Jaffray Research, *Online Brokerage*, October 1998, using data from GVU Internet surveys 1995–1998.

[5] In so doing, we took a fairly conservative approach, including multiple subsidiary banks only if a given Web site contained a statement that it was applicable to multiple banks, or if it contained other information strongly indicating this. As a consequence, our bank "count" may somewhat understate the total number of banks covered by the 223 Web sites.

Table 2—Banks offering transactional PC banking via the Internet: size distribution
(as of June 30, 1998)

Asset size	Number of banks	Percent of all banks	Number of national banks	Percent of all national banks
Less than $100 million	72	1.3	26	2.0
$100 million to $1 billion	210	7.1	74	7.2
$1 billion to $10 billion	65	21.0	40	27.2
Greater than $10 billion	27	42.2	21	52.5

Memorandum:

National banks as a percent of all banks: 28.3

National banks offering transactional Internet banking as a percent of all banks offering transactional Internet banking: 43

Source: Office of the Comptroller of the Currency using information from banks' Web sites and FFIEC *Reports of Condition and Income*.

Table 3—Structure characteristics of banks offering transactional banking via the Internet
(as of June 30, 1998)

	Banks with transactional Internet banking	Banks without transactional Internet banking
Number of banks	374	8,609
Structure characteristics (*averages*)		
Assets (in millions)	$5,481	$364
Deposits (in millions)	$3,711	$246
Number of branches	61	5
Number of employees	1,676	112

Source: Office of the Comptroller of the Currency using information from banks' Web sites and from FFIEC *Reports of Condition and Income.*

Banks Offering Transactional Internet Banking Are Larger on Average than Other Banks

The different impressions one gets from considering the small number of transactional Internet banks on the one hand, and the large proportion of banking system assets for which these banks account on the other hand, is explained by the fact that a relatively high proportion of large banks offered this delivery channel, when compared with the proportion of large banks in the whole banking industry. Table 2 shows that 27 large banks, accounting for 42 percent of all commercial banks in the over-$10-billion-in-assets size category, offered transactional Internet banking; 21 of these were national banks. By comparison, the 72 small banks offering transactional Internet banking accounted for only 1.3 percent of all banks in the under-$100-million-in-assets size category.

Measured by assets or deposits, transactional Internet banks as a group were about 15 times larger on average than the 8,609 banks which did not offer transactional Internet banking, as Table 3 indicates. The size differential is apparent in the comparison of the average number of branches and employees per banks as well. However, 75 percent of the transactional Internet banks were under $1 billion in assets, indicating that the cost of offering Internet banking is not prohibitive for small banks.

We also compared the performance of transactional Internet banks with other banks in order to ascertain if there are distinct characteristics of these early adopters. We did not find obvious differences between the groups in profitability, efficiency, or credit quality.[6] The relative similarity of the performance of the two groups held across size categories, leading us to the conclusion that transactional Internet banks differ from other banks primarily by size.

Key Internet Banking Characteristics

Virtually all banks with transactional Internet banking offered customers the ability to check their account balances and history, and transfer moneys between their accounts, as Table 4 shows.[7] Three-fourths of banks with transactional Internet capabilities offered customers an electronic bill payment service; almost 80 percent of national banks with transactional Internet banking offered

[6] Anecdotal evidence suggests that most bankers do not believe they are receiving a significant boost to net revenue from their customers' use of Internet banking capabilities. We did not conduct any formal statistical analysis to ascertain if offering Internet banking may be a factor in determining bank performance. Such analysis is likely to be more fruitful as the use of Internet banking spreads and matures.

[7] A small number of Web sites did not contain information about one or more of the attributes displayed in Table 4. In building our data set we took a conservative approach, inserting "missing values" into these fields. Subsequently, we calculated the percentages in Table 4 using as the denominator 374, the total number of banks offering transactional Internet banking, rather than excluding the missing values (which varied across attributes) from the denominator, and then calculating percentages. This approach makes very little quantitative difference and no qualitative difference in the results displayed in Table 4, though it seems highly likely that in fact 100 percent of banks offering transactional Internet banking offer at least balance inquiry and funds transfer.

Table 4—Banks offering transactional banking via the Internet: key services
(as of June 30, 1998)

Type of service offered	Services offered (percent of transactional Internet banks)[1]	
	All banks	National banks
Balance inquiry and funds transfer	98.1	98.1
Electronic bill payment	75.4	80.7
Business Internet banking	24.1	39.1
Open an account	19.5	24.8
Apply for loan	12.8	17.4
Transactional Internet banking and proprietary PC banking	18.2	19.9

Source: Office of the Comptroller of the Currency using information from banks' Web sites.

Notes:

[1] For a small number of institutions it was not possible to ascertain the nature of the Internet banking services offered. For purposes of the calculations in this table, missing values were treated as if the service was not offered.

this service (Table 4). Electronic bill payment allows the bank's customers to instruct the bank to make payments electronically. The bank then either sends an automated clearing house (ACH) payment or a paper check. In either case, the customer's account is debited for the amount of the payment. Customer use of electronic bill payment is not yet widespread, but many observers believe there is likely to be a sudden, large increase in customer demand for this technology. Electronic bill presentment, due to be offered by a number of banks early in 1999, has the potential, in combination with electronic bill payment, to "electronify" the entire billing and payment process.[8]

Although transactional Internet banking is commonly viewed as a service offered to individuals, among banks offering transactional Internet banking, a sizeable minority offered an Internet-based service tailored to businesses. Table 4 shows that almost a quarter of commercial banks with transactional Internet Web sites, and almost 40 percent of national banks, offered transactional Internet services aimed at business customers. Some industry observers believe that access to Internet banking services is likely to become increasingly important to small and medium-size businesses. We know of no precise analysis measuring the demand for such a service by businesses, but some observers suggest that, in general, both small and large banks have stepped up efforts to gain more small- and medium-size-business customers.

Table 4 shows that fewer than 20 percent of banks' transactional Web sites allowed customers and potential customers to open an account on-line. Even fewer had provisions for applying for a loan on-line. These lower percentages may in part be due to uncertainty about the validity of alternatives to handwritten signatures. It is unclear how the use and acceptance of electronic authentication will affect these activities, particularly the ability to open an account on-line, and a banks' ability to know a customer on-line without in-person identification.

Privacy Statements and Transactional Internet Banking

Technological developments have introduced tremendous changes in the ability of financial and nonfinancial firms to efficiently collect, store, use, and sell information about their customers. This has heightened concerns about the potential for violations of personal privacy. In a report to Congress this past summer, the Federal Trade Commission (FTC) stated that industry efforts to encourage voluntary adoption of the most basic privacy protection—notice[9]—have fallen short of what is needed to protect consumers. The FTC conducted an on-line survey in March of 1998 and found that only 14 percent of all Web sites and 17 percent of financial Web sites posted a notice describing the collection and use of information.[10]

Our analysis of transactional bank Internet Web sites provides additional information on the extent of on-line privacy statements. As displayed in Table 5a, in June 1998 slightly over 40 percent of all transactional banking Web sites included a privacy statement that at a minimum indicated what information is collected by the bank on-line, and how it is to be used. The corresponding percentage for national bank transactional Web sites was slightly higher at 41 percent. It is important to note that we have

[8] This point is explored further in Furst, Karen, Daniel E. Nolle, and William W. Lang, "Technological Innovation in Banking and Payments: Industry Trends and Implications for Banks," *Quarterly Journal*, Vol. 17, No. 3, Office of the Comptroller of the Currency, September 1998; and in Radecki, Lawrence J., and John Wenninger, "Paying Electronic Bills Electronically," *Current Issues in Economics and Finance,* Vol. 5, No. 1, Federal Reserve Bank of New York, January 1999. For a recent description of the perspectives of current and possible future participants in the market for electronic bill presentment and payment, see O'Sullivan, Orla, "Banks Begin to Present Bills On Line," *USBanker,* Vol. 108, No. 12, December 1998, pp. 64–70.

[9] Notice includes telling customers what information is to be collected about them, and the intended use of that information.

[10] The FTC sample included 125 Web sites of banks, credit unions, mortgage companies, real estate firms, security and stock brokerage, and other financial services firms.

Table 5a—Privacy statements and transactional Internet banking[1]

	June 30, 1998		November 30, 1998		Percent increase in privacy coverage	
	All banks	National banks	All banks	National banks	All banks	National banks
Percent of transactional Web sites with on-line privacy statement	40.4	40.9	51.6	54.5	27.8	33.3

Table 5b—Transactional Web sites with on-line privacy statement as a percent of all transactional Web sites, by asset size category

	June 30, 1998		November 30, 1998	
Asset size	All banks	National banks	All banks	National banks
Less than $100 million	30.4	21.4	37.0	35.7
$100 million to $1 billion	37.4	32.6	48.9	41.3
$1 billion to $10 billion	36.4	37.5	52.6	62.5
Greater than $10 billion	74.1	75.0	88.9	95.0

Source: Office of the Comptroller of the Currency using information from banks' Web sites.

Notes:

[1] To qualify as having a privacy statement, a Web site had to indicate what information is collected and how it is used.

made no qualitative assessment of these on-line privacy statements, which may vary widely in the nature of the information they provide to customers.

We examined these same sites for privacy statements as of November 30, 1998. Over that five-month period, the percentage of sites with on-line privacy statements grew to almost 52 percent, an increase of almost 28 percent. The growth at national bank Web sites was somewhat higher at 33 percent.

A distinct pattern emerges when we look at privacy statements for banks of different sizes. Table 5b reveals that large banks are much more likely to have an on-line privacy statement. In June 1998, three-fourths of banks with greater than $10 billion in assets had on-line privacy statements, and by November 30 this had increased to almost 90 percent. The corresponding level was even higher for large national banks with transactional Internet banking: 95 percent of national banks with greater than $10 billion in assets included privacy statements on their transactional Web sites.

Among the largest 10 banks, six offered transactional Internet banking in June 1998, but one of those banks did not have an on-line privacy statement, a situation that was remedied by the time we re-examined Web sites at the end of November. By that time, seven of the top 10 banks had transactional Internet banking Web sites, and all of these had on-line privacy statements. In addition, for the three without transactional Web sites, one had an on-line privacy statement on its non-transactional Web site.

Small banks, particularly those in the smallest size category with less than $100 million in assets, were much less likely to have on-line privacy statements. In June 1998, only 30 percent of Web sites for this group of banks included a privacy statement. Coverage increased to 37 percent by November. These figures show that despite progress in addressing on-line privacy, the majority of small banks still do not have an on-line privacy statement.

Growth of Transactional Internet Banking

Data of the same scope and quality as our data for transactional Internet banking as of midyear 1998 do not exist for other points in time, so it is not possible to describe with precision the growth of transactional Internet banking. However, based on information from the Federal Deposit Insurance Corporation (FDIC), from a widely used industry publication, and from recent press reports, it is possible to estimate roughly the recent growth trend in banks offering transactional Internet banking.

Some observers have said that the transactional Internet banking "era" is approximately three years old.[11] Figure 1 shows that by year-end 1997 (i.e., at the end of the second year of the Internet banking era) there were only 103 transactional banking and thrift Web sites.[12] However, the number of transactional banking Web sites increased to 258 over the first six months of 1998, an annual growth rate of over 300 percent. Our estimates of the number of transactional banking and thrift Web sites for the end of the third quarter and the end of November of 1998 indicate a slowdown in that pace, but still show steady growth.

There are indications that growth in the number of transactional Web sites will accelerate in early 1999. In late 1998 and early 1999, we reviewed numerous Web sites and press releases of major vendors announcing

[11] For example, see the article in *The Charlotte Observer*, October 24, 1998.

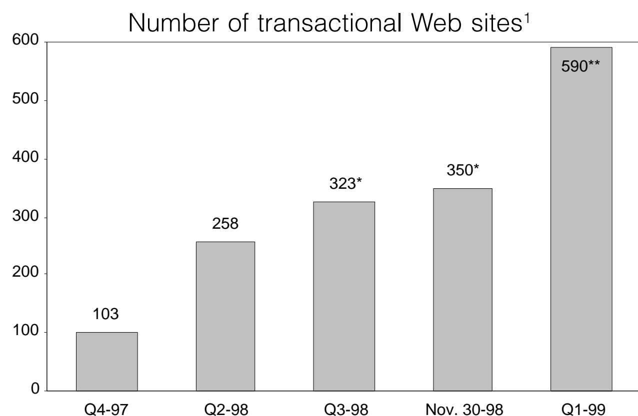
[12] The few other "counts" of Internet banking that exist do not distinguish between banks and thrifts. Though most of this report deals with commercial bank Web sites, we compiled information on thrift Web sites as well, and so are able to put our figures for June 30, 1998 on the same basis as other data bases we have used.

new contracts with banks and thrifts to build and/or service Web sites.[13] Based on this information, we calculate that at least 240 new bank and thrift transactional Web sites will come on-line within the next several months, bringing total transactional bank and thrift Web sites to 590 by the end of the first quarter of this year, as displayed in Figure 1. At a pace of 240 new Web sites per quarter, there would be about 1,300 transactional bank and thrift Web sites by the end of 1999, covering perhaps 10 to 15 percent of all commercial banks.[14]

It is more difficult to gauge the extent and growth of customer usage of transactional Internet banking. Industry estimates vary widely and generally lack precision, but most estimates suggest that usage is not widespread. Based on a recent estimate of "on-line" banking usage, roughly 4 percent of households currently bank on-line.[15] However, the 374 commercial banks currently offering Internet banking account for 41 percent of all small deposits at commercial banks. Even without taking into account the likely growth in Internet banking Web sites, the infrastructure already in place provides considerable potential for expansion in Internet banking activity.

It is impossible to predict whether such expansion in usage will occur, but the possibility should not be discounted. Such dramatic shifts in market acceptance are not unusual in the world of electronic commerce. For example, starting from virtually zero three years ago, on-line brokerage activity now accounts for almost one quarter of all individual brokerage activity.[16] Moreover, bill presentment is expected to become operational during 1999. Many industry experts believe that the introduction of bill presentment could greatly accelerate the already rapid growth in the use of bill payment through on-line banking.

Figure 1—Transactional Internet banking Web sites: strong growth in 1998, possible surge in early 1999



[1] Bank and thrift Web sites
* estimated
** extrapolated

Source: Office of the Comptroller of Currency using data from the FDIC, bank and thrift Web sites, *On-line Banking Report,* and selected vendor Web sites and press releases.

Summary and Conclusions

Few banks offer transactional Internet banking, though the relatively high proportion of large banks in this group means that a significant share of industry assets and deposits are accounted for by these banks. The significant number of small and mid-size banks offering Internet banking suggests that the fixed costs of offering Internet banking do not appear to be prohibitive for small institutions. In terms of performance characteristics, we found no evidence of major differences in the performance of the group of banks offering transactional Internet banking compared to those that do not.[17]

The majority of large banks are adopting Web site privacy statements. While there has been growth in adoption, most small and mid-size banks with transactional Internet banking do not yet have on-line privacy statements. We did not assess the quality of the on-line privacy information offered.

Growth in the number of banks offering transactional Internet banking has been strong recently. However, even if recent growth trends accelerate somewhat, that would still result in a relatively small percentage of banks offering transactional Internet banking by the end of 1999. Nevertheless, it is likely that the majority of large banks will offer transactional Internet banking by the end of 1999.

Usage of Internet banking is still a relatively small factor in the banking industry. However, it is likely that over half of existing depositors will have deposit accounts at banks with Internet banking sites by the end of 1999. A change in consumer demand for Internet banking services could potentially generate a rapid expansion in the importance of Internet banking activity for the industry. Such shifts in customer preferences may become a hallmark in the world of electronic commerce.

[13] Based on our conversations with several vendors, we estimate that over 90 percent of the new Web sites will be transactional.

[14] Our intent is to determine what sort of "baseline" growth rate results from extrapolating from known information, rather than to attempt to forecast future growth in transactional Internet banking. We also caution that our baseline may be somewhat conservative. It is possible, for example, that as banks complete their Y2K readiness programs during 1999 they may be able to focus more resources on technology upgrades, including transactional Internet banking. In addition, it is worth mentioning that many of the 1,500 or so banks that had an Internet site without transactional capabilities at mid-year 1998 may have viewed establishing an Internet presence as a prerequisite to offering transactional banking in 1999. If so, past growth rates are likely to understate this sort of "evolutionary" move to transactional Internet banking.

[15] PSI Global, as illustrated in "Delivering the Goods," special section of the *American Banker*, December 1, 1998.

[16] Calculations based on Deutsche Bank Research and Piper Jaffray Equity Research.

[17] Our external approach to the data does not allow us to make any judgments about transactional risk exposure, including security risk.

Recent Corporate Decisions

The Washington-Directed Licensing Division contributes summaries of selected corporate decisions to every issue of the *Quarterly Journal*. In addition, decisions that represent a new or changed policy, or present issues of general interest to the public or the banking industry, are published monthly in the OCC publication, *Interpretations and Actions*. In the third quarter of 1998, the following corporate decisions were of particular importance because they were precedent-setting or otherwise represented issues of importance. The decision documents may be found in *Interpretations and Actions* if a reference number is provided in brackets. If the decision has not been published, the application control number is provided.

Operating Subsidiaries

On August 14, 1998, the OCC granted conditional approval for Wells Fargo Bank, NA, San Francisco, California, to expand the activities of an existing operating subsidiary to acquire a noncontrolling investment in a Nevada limited liability company that would originate and support automated teller machines to serve casino customers. [Conditional Approval No. 285]

On August 18, 1998, the OCC granted approval for Mellon Bank, NA, Pittsburgh, Pennsylvania, to expand the activities of its mortgage reinsurance operating subsidiary to include reinsuring a portion of the mortgage loans that it or certain affiliates service. This represents the first time the OCC permitted a bank to reinsure serviced loans that were not originated or purchased by the bank or an affiliate. [Corporate Decision No. 98–40]

On September 4, 1998, the OCC granted conditional approval for Bank of America, NT& SA, San Francisco, California, to expand the activities of an existing operating subsidiary, and thereby make a noncontrolling, minority investment in a Delaware limited liability company that would provide credit and debit card transaction processing services and check guaranty and verification services to casinos and other similar establishments. [Conditional Approval No. 286]

Interstate Mergers

On September 16, 1998, the OCC granted approval for The First National Bank of Maryland, Baltimore, Maryland, to merge with two affiliated Pennsylvania banks pursuant to 12 USC 215–a and 1831u. The target banks are Dauphin Deposit Bank and Trust Company, Harrisburg, Pennsylvania, and The York Bank and Trust Company, York, Pennsylvania. The resulting bank was also authorized to retain and operate the offices of the merging banks under 12 USC 36(d) and 1831u(d)(1). [Application Control No. 98–SE–02–0030]

On September 18, 1998, the OCC approved the application filed by NationsBank, NA, Charlotte, North Carolina, to acquire Barnett Bank, NA, Jacksonville, Florida, and Community Bank of the Islands, Sanibel, Florida. The OCC investigated the various comments received from the public and community organizations, including those comments relating to NationsBank's CRA performance in Florida that were received by the Federal Reserve in connection with the application to merge BankAmerica Corporation and NationsBank Corporation. The results of that investigation are detailed in the OCC's decision statement. The OCC's investigation found no basis for denying or conditionally approving the application. [Corporate Decision No. 98–44]

On September 30, 1998, the OCC granted conditional approval to merge Magna Bank, N.A., St. Louis, Missouri, with and into Union Planters Bank, N.A., Memphis, Tennessee. Union Planters Bank, N.A., has two years from the date the merger is consummated to establish the legal permissibility of Magna Insurance Agency Inc. and InBank Insurance Agency, Inc., or restructure the activities to bring them into compliance with national banking law. [Conditional Approval No. 288]

Interstate Branch

On August 21, 1998, the OCC granted approval for One Valley Bank–East, N.A., Martinsburg, West Virginia, to establish an interstate branch in Winchester, Virginia, pursuant to 12 USC 36(g); subsequently purchase and assume certain Virginia-based assets and liabilities of an affiliated bank, One Valley Bank–Central, N.A., Lynchburg, Virginia; and finally establish a second branch in Winchester, Virginia, pursuant to 12 USC 36(c). One Valley Bank–Central, N.A., Lynchburg, Virginia, continued to operate after this partial purchase and assumption transaction. The effect of the transaction was to give One Valley Bank–East, N.A., Martinsburg, West Virginia, a Virginia presence near the West Virginia border. [Application Control Nos. 98–SE–05–0121, 98–SE–02–0039]

On September 4, 1998, the OCC granted approval for Nara Bank, National Association, Los Angeles, California, to purchase the assets and assume the liabilities of the Flushing, New York, branch of the Korean Exchange Bank, Seoul, South Korea, pursuant to 12 USC 24(Seventh), 36(d) and 1831u. Nara Bank will retain and operate this state licensed foreign branches as an interstate branch located in Flushing, New York. [Corporate Decision No. 98–42]

Appeals Process

Appeal 1—Appeal of "Needs to Improve" CRA Rating

Background

A bank filed an appeal of their Community Reinvestment Act (CRA) rating of "needs to improve" (NTI) assigned by the supervisory office. The Public Evaluation (PE) stated that the bank's loan-to-deposit (L/D) ratio was less than reasonable, considering seasonal variations, given the bank's size, financial condition, capacity to lend and assessment area credit needs.

The appeal indicated that the board of directors believe the CRA rating should have been "outstanding" or at least "satisfactory" based on the following:

- The NTI resulted from a "litmus test" of the L/D ratio and that the federal act imposed no such legalistic test.
- The bank's officers and directors had already considered many of the suggestions in the report of examination to improve the rating.
- The particular circumstances of FNB and the economic conditions of the surrounding community supported a higher rating.
- There was no evidence of discrimination, self-dealing, or insider abuse.

Discussion

The analysis of the appeal included a review of the issues highlighted in the bank's letter, the PE and all supporting documentation, discussions with OCC personnel, and an on-site visit to the bank.

While the community where the bank is located is experiencing stagnant population growth, its designated assessment area is the whole county which includes the six other communities. The bank has made the majority of its loans within the assessment area, and the banker's familiarity with the county was evidenced during the community tour. The PE noted that the distribution of loans reflected a reasonable penetration among individuals of different income levels and businesses of different sizes.

The CRA regulation performance standards' criteria for evaluating a small bank's record of helping to meet the credit needs of its community include an evaluation of the bank's L/D ratio adjusted for seasonal variation. The reasonableness of the ratio is assessed given the bank's size, financial condition, and assessment area credit needs. This ratio is a clear indicator of a bank's ability or willingness to help meet the assessment area's credit needs.

The bank's 21 percent L/D ratio at the quarter-end of the evaluation period was significantly lower than similarly situated institutions. There are six other commercial banks serving the assessment area, three are locally owned and three are branches of community banks headquartered outside of the county. The three locally owned banks all had L/D ratios which far exceeded the bank's, ranging from 59 percent to 80 percent at the same quarter-end. The bank's average L/D ratio during the CRA assessment period was 17 percent compared to the other three banks' average of 62 percent. Although there is strong competition in the assessment area, the board and management's lending practices are the primary reasons for the bank's low L/D ratio.

Conclusion

The OCC recognizes that every bank is unique in its own right, and evaluates each bank's CRA performance based on the context in which it operates. This bank was atypical in that its loan portfolio was less than its total capital, indicating new lending opportunities could be explored in a safe and sound manner. The ombudsman is not advocating relaxation of credit standards, but rather a program to increase lending slowly and gradually, and most importantly, safely. The absence of evidence of discrimination, self-dealing, or insider abuse are not significant factors in the assignment of an overall CRA rating.

The ombudsman concurred with the "needs to improve" rating.

Appeal 2—Appeal of Composite CAMELS Rating of 3 and Other Examination Conclusions

The board of directors (the board) appealed, on behalf of the bank, several matters in the Report of Examination (ROE). The appeal centered on three "loss" loan classifications that were directed for charge-off retroactive to year end. The bank disagreed with both the timing and the charge-off of these loans. The bank also appealed the following related matters:

- The composite rating and the component ratings for capital, asset quality, management, and earnings;
- The restatement of the year-end call report;
- Four resulting violations of law—three violations of 12 USC 84 and one violation of 12 USC 60(b);
- The assessments for credit, compliance, strategic, and reputation risks; and
- The proposed formal agreement.

The loans were carryover agricultural debt. To evaluate the credit quality of the three loan classifications challenged in the appeal, consideration was given to information available during the examination and the supplemental information provided by bank management, when warranted. This supplemental information consisted of current collateral valuations. Additionally, the Office of the Ombudsman (ombudsman) discussed the operating status of the three credits with bank management. Finally, the guidance in "Examining Circular 222: Agricultural Loan Classification" regarding carryover debt was also considered in reaching the conclusions in this appeal.

Classification of Credits

Borrower 1
(ROE Classification: $114 Thousand—Loss)

Background and Discussion

The first borrower had a history of poor operating performance. Over the last six years the borrower generated $150 thousand in carryover debt and paid only $36 thousand toward the reduction of carryover balances resulting in outstanding debt of $114 thousand. Bank management did not fund the current year's operating expenses, but the borrower was being financed by another institution. The borrower's cash flow projections reflected profitable operations for the current season after servicing all debt, including a portion of the bank's carryover debt and accrued interest. However, the borrower had a poor history of meeting projections. Bank management used more conservative estimates in their projections that reflected a small shortfall in the borrower's ability to meet all debt service requirements.

Equipment securing the loan was not supported by an independent valuation and, therefore, not given consideration during the examination. Subsequently, management obtained an independent auctioneer's valuation of the equipment, totaling $89 thousand. Also, $8 thousand in notes receivable were assigned to the bank. The total value of the collateral securing the carryover debt was $97 thousand compared to an outstanding balance of $114 thousand.

Conclusion

The ombudsman determined a doubtful classification was appropriate for borrower. The loans were appropriately placed on nonaccrual as of year end 1997 because full payment of principal and interest was in doubt. Classifying the credit doubtful recognized that, while bank management did not increase their exposure, they could benefit from the borrower's 1998 crop, as reflected in the two cashflow projections.

The ombudsman decided a dollar amount equal to the unsecured portion of this credit should be specifically allocated for in the allowance for loan and lease losses (ALLL) and the secured portion of the debt should have allocations based on the bank's formula for this risk category. Any payments received were to be applied to the oldest carryover balances.

If the borrower has another unsuccessful year of operation and is unable to meet debt service requirements, the debt should be charged-off. This should occur no later than March 31, 1999.

Borrower 2
(ROE Classification: $67 Thousand—Loss)

Background and Discussion

The second borrower was no longer actively farming because of unprofitable farm operations and had been making payments from liquidation of the farm equipment that serves as collateral on the carryover debt. The borrower's payment history revealed that the last principal reduction occurred seven months prior to the examination. During the examination, payments totaling $10 thousand were made, which management applied to interest. While the supervisory office considered the principal reduction, they were unaware payments had been made during the supervisory activity.

During the examination, bank management inspected the equipment and estimated its value at $75 thousand and the hay at $8 thousand, although the hay is not collateral for the bank's debt. The borrower's estimate of value for the same equipment list totaled $151 thousand. Subsequent to the examination, management received a written cash offer of $25 thousand for a portion of the collateral, compared to the borrower's value of $74 thousand for the same equipment. The offer included an additional $3 thousand for the hay.

The borrower has unencumbered real estate that is available for sale. The borrower had expressed, in writing, his intent to apply the proceeds from the sale of the real estate to his bank debt. He had received a verbal offer on one parcel for $32 thousand; however, this included a portion of the equipment (irrigation-related) in the cash offer discussed above.

Conclusion

The ombudsman determined a split classification of substandard ($28 thousand) and doubtful ($29 thousand) appropriately recognized the risk associated with this credit. The loans should have been placed on nonaccrual as of year end because full payment of principal and interest was in doubt. The $10 thousand of interest payments made during the examination was inappropriate. The ombudsman directed bank management reverse the interest and apply the payments to principal. The classification was based on:

- The borrower's demonstrated willingness to repay his debt from the liquidation of the collateral, evidenced by the payments made in 1998;
- The bank's written cash offer of $28 thousand for a portion of the equipment and hay;
- The value of the remaining collateral is questionable; and
- Although other assets are available, the bank has no collateral interest in them.

The substandard classification represents the cash offer for a portion of the equipment. The doubtful portion of the credit recognizes the difference in value between the cash offer and the outstanding balance after the reversal of interest payments. This also considered bank management's position, that the borrower will apply proceeds from the sale of the remaining equipment and/or real estate. Land sales are best realized during the non-growing season from late November to March. Management was informed to make ALLL allocations according to the bank's formula for these risk categories. If the loans are not repaid by March 31, 1999, they should be charged off and appropriate recovery methods instituted.

Borrower 3
(ROE Classification: $65 Thousand—Loss)

Background and Discussion

On the third borrower the bank had a lien on irrigation equipment valued by the borrower in January 1993 at $109 thousand. As the equipment is attached to the land, management had demonstrated a reluctance to initiate repossession procedures. The borrower was uncooperative, with extremely past-due debt that had a questionable repayment source and lacked a current collateral valuation.

Conclusion

Based on the above, the ombudsman's office agreed with the examiners that the debt was a loss. The undeterminable collateral values and protracted collection period made the loans of such little value that their continuance as bankable assets was not warranted.

Effect of loan classification changes. The ombudsman requested appropriate members of the bank's management team and members from the OCC's supervisory office meet to determine the impact of the reclassification of two of the three credits on the violations of law and the bank's balance sheet. The ombudsman asked that a written summary of any changes be provided to his office.

Risk Assessment System Conclusions

There was agreement on several risk categories; therefore, the ombudsman only addressed the four risk categories in which the board expressed a difference from the assessment in the ROE. Those risk categories were credit, compliance, reputation, and strategic. The following comments provide the basis for the decisions on those risk categories.

Credit Risk

Credit risk was assessed as *high and stable* at the time of the examination. The appeal stated that it should be *moderate and stable*. The volume of problem credits was significant and the trend was increasing. Credit-related losses necessitated abnormally high provisions to the ALLL to cover inherent losses. Significant concentrations of credit exist in the form of agricultural and unsecured loans. Credit analyses were not comprehensive and there were weaknesses in collateral controls. The ombudsman determined that, collectively, these characteristics were indicators of a high level of credit risk.

Compliance Risk

Compliance risk was assessed as *high and increasing* at the time of the examination. The appeal stated that it should be *moderate and stable*. The bank's history of violations since 1990 was low, consisting of a few consumer protection and Bank Secrecy Act citations. The volume of violations at the examination under appeal was centered in one area (lending) and dependent on three loan classifications. However, these violations were more substantial and representative of moderate compliance risk. The bank's overall compliance program had been effective in the past in detecting, correcting, and preventing frequent violations. Based on this, the ombudsman decided the direction of compliance risk was stable.

Reputation Risk

Reputation risk was assessed as *moderate and stable* at the time of the examination. The appeal stated that it should be *low and stable*. Considering the potential negative public response or perception from the large volume of loan losses and related recovery actions, the ombudsman determined reputation risk was moderate.

Strategic Risk

Strategic risk was assessed as *moderate and increasing* at the time of the examination. The appeal stated that it should be *moderate and stable*. There was no evidence to suggest the bank's strategic initiatives would alter business plans or that they were inconsistent with the existing line of business. Therefore, the direction for strategic risk was determined to be stable.

Component and Composite Ratings Conclusions

Capital Rating

Capital was rated 3 in the ROE. The appeal stated that it should be rated 2. The bank's level of capital did not provide the necessary base to support its current lending activities. Management is forced to sell participations on large agricultural borrowers because of the reduced legal lending limit. Earnings have not been sufficient to provide for adequate capital accretion because of the large provision expense required to replenish the ALLL. In addition, the volume of problem assets continued to strain the bank's level of capital. Based on these factors, the bank's capital was less than satisfactory for its risk profile and warranted a 3 rating.

Asset Quality Rating

Asset quality was rated 3 in the ROE. The appeal stated that it should be rated 2. The bank's credit quality had deteriorated, evidenced by the increasing trend in problem assets. While the bank operates in an agricultural-based economy that can be affected by the weather, ineffective credit administration practices had contributed to the deterioration in credit quality. There was a need to improve credit administration practices in the following areas:

- Developing action plans for problem borrowers;
- Using comparative analysis on borrowers' performance to projections; and
- More detailed analysis to support borrowers' credit worthiness for unsecured lending.

The current level of problem loans, deteriorating trends in asset quality, and weaknesses in credit administration practices provided support for the 3 rating assigned to asset quality.

Management Rating

Management was rated 3 in the ROE. The appeal stated that it should be rated 2. Safety and soundness ROEs from 1994, 1995, and 1996 revealed management had made progress in several areas where there was supervisory concern. However, there was a need to improve credit administration practices and reverse the increasing trend in problem assets. The weaknesses in the bank's credit culture and processes continued to plague the overall performance of the bank with significant loan losses, high provision expenses, erratic earnings fluctuations, and minimum capital accretion. Given the nature and significance of the loan portfolio to the overall performance of the bank, the administrative weaknesses associated with lending supported a 3-rated management component.

Earnings Rating

The earnings component was rated 4 in the ROE. The appeal stated that it should be rated 3. Earnings performance in the bank had been erratic. Excluding the results of the examination under appeal, the bank recorded a net loss in two of the last five years. In addition, loan losses exceeded net income in three of the last five years. After adjusting for the changes in classifications discussed above, losses would still exceed net income. The significant provisions to the ALLL have prevented earnings from adequately increasing the level of capital in the bank. The unsustained earnings performance, erratic fluctuations in net income and insufficient accretion of capital are characteristics of a 4-rated earnings component.

Composite Rating

A composite rating of 3 was assigned as a result of the examination. The appeal stated that the rating should be 2. At the time of the examination, the bank exhibited a significant degree of supervisory concern because of the lack of effective management and board supervision, which negatively affected the quality of the bank's loan portfolio and earnings stream. Given these weaknesses, the level of capital in the institution was strained, which lessens the ability of the bank to withstand business fluctuations that are common to banks in an agricultural-based economy. Therefore, a composite 3 rating appropriately reflected the condition of the bank.

Formal Agreement and Summary

Enforcement Actions are not appealable matters. As discussed in "OCC Bulletin 96-18: National Bank Appeals Process," when the primary supervisory office determines and notifies a national bank of its intention to pursue available remedies under applicable statues or published enforcement-related policies of the OCC, the decision becomes unappealable. Recognizing communication as an essential part of the supervisory process, the ombudsman encouraged the board to discuss the issues in the ROE with the supervisory office and specifically outline their course of action and the designated time frames for completing implementation of those actions. However, the bank was reminded that the final determination on enforcement action decisions rests with the supervisory office.

Appeal 3—Appeal of Composite CAMELS Rating of 3 and Other Examination Conclusions

A bank formally appealed its composite rating, all component rating, bank information systems rating / year 2000 assessment (BIS/Y2K), and all risk assessment system (RAS) determinations. The assigned ratings were 4/344433 for the composite/CAMELS component ratings, respectively. BIS was rated 3 and Y2K was assigned a "needs to improve." RAS ratings were: strategic risk—high and increasing; reputation risk—high and increasing; credit risk—high and increasing; compliance risk—high and increasing; liquidity risk—moderate and increasing; transaction risk—moderate and increasing; and interest rate risk—moderate and increasing. The Board believed the Report of Examination (ROE) presented a very distorted picture of the bank in an effort to justify certain results intended to be achieved by the supervisory office.

Capital

Background

The appeal stated the bank was a well-capitalized institution under any benchmark of the OCC, FDIC, or the Board of Governors of the Federal Reserve and to say otherwise smacks of credulity. The appeal stated that the bank has increased capital every year for the past 50 years through its conservative nature, which is why the bank can weather the current credit problems. The ROE requests the bank adopt a capital plan. The appeal stated the bank had a capital plan in place for years and has always provided it to the examiners. The most recent plan was revised in August 1997.

Discussion and Conclusion

The ROE stated that capital is fair based on the high and increasing credit risk, poor earnings, and ineffective control structures of the bank. Capital ratios at the time of the examination were above the requirements for the well-capitalized category; however, for the last two years capital ratios had decreased. The rate of asset growth out-paced capital accretion. The supervisory office was concerned that capital adequacy was threatened by the bank's increasing risk profile. During 1997, the board approved the formation of a holding company subsidiary to hold and sell the bank's other assets acquired from debts previously contracted. In order to capitalize the subsidiary, the bank issued a $3 million dividend to the holding company, which also contributed to the assigned capital rating.

The Office of the Ombudsman (ombudsman) determined that at the time of the examination, asset quality deterioration had affected capital. Extraordinary provisions to the allowance for loan and lease losses (ALLL) eliminated earnings for the year and, therefore, earnings did not contribute to the accretion of capital. The majority of the actual capital decline in 1997 resulted from the decision to capitalize the holding company subsidiary to hold the bank's problem assets. While capital declined, this also removed, to some extent, some of the riskier assets from the bank's books. The level of identified risk and problem assets did not pose an immediate threat to the viability of the bank because of the capital base. The ombudsman's office further analyzed capital levels and determined the bank's capital base could absorb significant losses. Therefore, at the time of the examination, the ombudsman determined that a 2 rating more appropriately described the bank's capital position.

Asset Quality

Background

The appeal attributed the problems in asset quality to two officers that perpetrated fraudulent and unsound lending activities despite established underwriting guidelines. The appeal also pointed out that the circumvention of underwriting guidelines did not go unnoticed, but was uncovered by internal controls, specifically through delinquency reports. Loan review and audit reported exceptions to the executive officer responsible for lending who delayed responding to "cover his own tracks." The bank also noted that since the departure of the officer, asset quality trends had improved, and loan review and audit had been strengthened and refocused. Lending policies had been revised and the ALLL calculation improved.

Discussion and Conclusion

The ROE stated asset quality is unsatisfactory based on continued declining trends, severe credit administration deficiencies, the lack of sound underwriting policies, and weak control mechanisms. Further the ROE asserted, the high level of risk and problem assets were significant and expose the bank to continued credit losses. The supervisory office also noted the ALLL methodology was flawed, which resulted in questionable coverage for the inherent risks presented in the portfolio.

The ombudsman recognized that at the time of the examination, the increase in problem assets, the high level of past-due loans, and significant credit losses adversely affected asset quality and resulted in elevated credit risk. Board oversight and senior management supervision of lending activities and credit administration practices was poor. After examination charge-offs, 99 percent of classified assets were in the substandard category, indicating collateral provided some level of protection from losses. However, it was difficult to determine the true magnitude of the credit-oriented problems that confronted the bank. A significant level of underwriting exceptions occurred throughout 1997, and

the majority of these credits were unseasoned. These credits possessed characteristics that mirrored the problem portfolios that had negatively affected the bank's financial performance. However, the level of identified risk and problem assets did not immediately threaten the viability of the bank because of the bank's capital position. The ombudsman determined that an asset quality rating of 3 was more reflective of the position that existed at the time of the examination.

Management

Background

The appeal stated that the board and senior management had successfully managed the bank for years, as supported by previous OCC comments, despite a local economy that had experienced difficulties. They made a mistake, by trusting an experienced executive officer. The appeal noted that the board recognized the limited depth of resources with the discharge of two loan officers, and had redirected personnel focus from corporate to bank matters. In addition the appeal asserted lending experience, however, remained considerable.

Discussion and Conclusion

The ROE stated management and board oversight was deficient, given the lack of management expertise and the limited depth of resources to address the significant risks threatening the safety and soundness of the bank.

The ombudsman determined, through discussion with bank representatives and the supervisory office, that management and the board did not exercise control over the bank's lending activities, which negatively affected earnings and capital at the time of the examination. The amount of resources dedicated to managing the level of risk and resolving the problems in the loan portfolio was inadequate. The loan portfolio represented the largest portion of the bank's balance sheet and the largest contributor to the income statement. Losses encountered in 1997 provide evidence the loan portfolio is significant to the bank's financial performance. Therefore, the ombudsman concluded a 4 rating was appropriate considering the deficiencies noted in overall board and management supervision of the bank's affairs.

Earnings

Background

The appeal noted earnings last year were more than adequate to support operations before increasing the ALLL to the level required by the OCC. Because all indirect loans had been credit scored, the board and senior management believed the greatest bulk of loss had been identified and appropriately reserved in the ALLL. The appeal recognized the bank's net interest margin had been declining and attributed it to competition and the rising costs of funds.

Discussion and Conclusion

The ROE stated earnings were unsatisfactory, insufficient to support operations, allow for appropriate capital accretion, and maintain adequate allowance levels. Future earnings streams were at-risk, given asset quality problems, the questionable adequacy of the ALLL, and strained net interest margin (NIM).

The ombudsman recognized that earnings were generated through traditional means with no extraordinary income sources. The bank relied almost entirely on the NIM coupled with low overhead and low ALLL provision expense to support its historically solid earnings. The NIM was relatively low and declining faster than for banks of similar size and characteristics over the last several years. Thus, it was important to control overhead costs and provision expenses to support net income levels. The bank's historical rate of return was not going to be recognized because of the material problems in the lending area. The capital growth would be significantly less than the bank had experienced in the past. The ombudsman determined the rapid declining NIM, the substantive drop in earnings experienced at fiscal year end, and the anticipated significant decrease in recurring earnings for the subsequent year provided support for the 4 rating assigned to the bank's earnings component.

Liquidity and Sensitivity to Market Risk

Background

The appeal stated the criticism of liquidity and sensitivity is lacking and further lends credence to the board's belief that the examiners needed to reach certain scoring criteria to arrive at predetermined composite rating. The bank had used a fairly detailed interest rate risk model for a number of years. To improve this risk assessment, the bank began working with a nationally recognized model, using standard assumptions until bank staff is more familiar with the model. The interest rate risk program has been complemented by the OCC in the past. In addition, the appeal noted the bank's liquidity was very strong at the date of the ROE and even stronger as of the submission of the appeal. The ROE was critical of the bank's liquidity largely on what might happen in the future. The bank's liquidity policy had never been criticized in past OCC examinations.

Discussion and Conclusion

The ROE assessed liquidity and sensitivity to market risk as "fair." The supervisory office noted that while funds management policies and processes had been established, management remained in the development stage with monitoring and reporting mechanisms. Further, the

current financial stress on the bank, the uncertainty of 1998 earnings performance, and management's response to such trends expose the bank to increasing liquidity and interest rate risk. The bank also lacked a formal liquidity contingency plan.

The ombudsman review determined the bank had a stable core deposit base and an adequate liquidity position. The amount of liquidity and the bank's policies and practices were sufficient to ensure adequate liquidity to meet funding needs. Almost 9 percent of total assets were in federal funds sold, with an additional 11 percent in unpledged investment securities. Supervision was adequate regarding liquidity and funds management practices. Based on these facts the ombudsman determined a 2 rating was more appropriate for the bank's liquidity position.

The level of interest rate risk (IRR) at the time of the examination was low and well within policy limits. In addition, the bank measured equity at risk, which also was within the bank's policy limit. Adequate risk management processes were in place to monitor sensitivity to market risk. The ombudsman concluded a 2 rating was appropriate at the time of the examination.

Bank Information Systems Rating/Year-2000 Assessment

Background

The appeal stated the board and senior management addressed the data processing needs, as well as Year-2000 (Y2K) compliance prior to the examination, and were clearly focused on the problem. They were committed to staying on schedule. Initial input received from OCC examiners was that the new system was a good choice and they were pleased with Y2K progress.

The appeal noted that OCC rated liquidity "fair" because of events that might occur in the future, and yet rated bank information systems (BIS) "less than satisfactory" with no regard or credit given for the near future event of a complete management information systems (MIS) changeover. The bank stated this jaundiced grading lacks credibility and should be wholly discounted in the appeal.

Discussion and Conclusion

The reasons provided in the ROE for the "less than satisfactory" rating for BIS and Y2K compliance were:

- Deficient board and management rating;
- Distressed financial condition of the bank; and
- Management's commitment to address significant asset quality issues.

While it was true that asset quality deterioration had significantly affected the bank's earnings and overall condition, there was no evidence to suggest this would materially affect BIS activities and Y2K compliance and remediation efforts. At the time of the examination, the bank's efforts were in compliance with the established time line for the system conversion. During the processing of the appeal it was determined that bank management remained on schedule. Based on the information reviewed, the bank's Y2K compliance efforts were satisfactory and the information systems department met the *FFIEC Information Systems Handbook* (1996) definition of a 2-rated department.

Risk Assessment System

A risk assessment system (RAS) comparison is presented on the following chart, followed by a detailed discussion of the factors contributing to the ombudsman's decision.

Risks	Supervisory Office	Ombudsman's Office
Strategic	High/increasing	High/increasing
Reputation	High/increasing	High/increasing
Credit	High/increasing	High/increasing
Interest rate	Moderate/increasing	Moderate/stable
Liquidity	Moderate/increasing	Low/increasing
Transaction	Moderate/increasing	Moderate/increasing
Compliance	Moderate/increasing	Moderate/stable

Strategic Risk

The board's strategic implementation of the conversion to a new computer system and Y2K had been very thorough and continued to proceed with little or no glitches. During the ombudsman's visit with the board, they discussed the bank's extensive experience in out-of-territory lending, with minimum losses. However very different from its history, the bank encountered rapid growth originated by relatively new officers that assured the board appropriate steps were being taken to address potential problems and protect the bank. A high-risk assessment considers the impact that problems in indirect lending and the shortage of resources in the bank to resolve these issues had on the franchise value in 1997. The need to re-engineer the lending area, the level of unidentified risk in the indirect lending portfolio, and the negative impact indirect lending was expected to have on 1998 earnings caused strategic risk to be increasing.

Reputation Risk

The bank's vulnerability to negative market perception in light of the large losses in 1997, the volume of repossessed marine craft, and the number of accounts affected by fraudulent activities support a high-risk assessment. The determination that reputation risk was

increasing captured the uncertainty of not knowing how the community would respond to issues associated with the board's inadequate control over indirect lending and competitors' ability to use these problems in their marketing efforts.

Credit Risk

Credit-related losses had necessitated abnormally high ALLL provisions to cover inherent losses. Exposure to earnings from credit risk was substantial, evidenced by the losses in 1997 and the budgeted ALLL provisions for 1998. At the time of the examination, the department lacked the necessary resources to work through problems within a reasonable time frame. In addition, the nature of the repossessed collateral could extend the time needed to resolve the credit problems. Based on these factors credit risk was high and increasing.

Interest Rate Risk

The bank had a low level of earnings exposure to interest rate risk (IRR), moderate exposure in terms of equity at risk, and satisfactory IRR measurement and monitoring. Because of the interrelationship between IRR, liquidity, and funds management practices, and because of the bank's higher volume of longer-term fixed-rate assets, moderate risk was appropriate. With improved modeling and reporting capabilities, management should be able to better monitor and control the bank's IRR exposure.

Liquidity Risk

The bank had a high level of balance sheet liquidity, a solid core deposit base, sufficient off- balance-sheet sources, and adequate measuring systems in place, indicating low liquidity risk. However, there was the potential of a negative impact on liquidity at the time of the examination based on reputation risk. The issues facing the bank and the inevitable publicity that follows in a small community, caused liquidity risk to be increasing.

Transaction Risk

The bank was planning a major system conversion for the third quarter of 1998. A major conversion can and usually does increase a bank's transaction risk profile. The bank had to migrate and reconcile two sources (mainframe and PC-based) to the new system. In addition, the bank's time frame was aggressive. Therefore, transaction risk was increasing.

Compliance Risk

Management used automated tools to assist them in minimizing compliance exposure. Compliance management systems had been adequate to avoid significant or frequent violations. The moderate assessment represents an increase in compliance risk since the December 1996 compliance examination. Although at the examination, several violations of Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O) were identified, the bank had no history of violating this regulation. The limited compliance scope of the examination did not support a change from the stable assessment.

Composite Rating and Summary

At the time of the examination the bank exhibited a significant degree of supervisory concern because of the lack of effective management and board supervision, which negatively affected the quality of the bank's loan portfolio and earnings stream. The level of capital support at the time mitigated a more severe composite rating. Therefore, the ombudsman determined that a 3 composite rating was more reflective of the condition of the bank at that time.

However, the ombudsman was concerned with the adverse trends that had continued to develop during the processing of the appeal. The condition of the bank deteriorated further and provided sufficient evidence to justify a higher level of supervisory concern. Asset quality problems continued to deplete earnings and trends had not reversed. A full year had expired since the problems first surfaced and the depth of the asset quality problems were still not quantified. The level of nonperforming assets was exceptionally high and there had been no comprehensive, independent evaluation of the loan portfolio to identify the full magnitude of the problem. The condition of the bank was more characteristic of a 4 composite rating, primarily because of management and the board's lack of effective steps to control the continued deterioration in asset quality and impact on the bank's earnings stream and capital base. Therefore, the ombudsman did not change the bank's overall composite rating, nor its capital or asset quality component ratings, in the OCC's official supervisory record.

Appeal 4—Appeal of Community Reinvestment Act Rating

Background

A formal appeal was filed concerning a rating of "substantial non-compliance record of meeting community credit needs" received during the Community Reinvestment Act (CRA) examination.

The OCC's CRA Performance Evaluation (PE) listed the following factors in support of the bank's rating:

- Lending patterns show conspicuous gaps in lending in low- and moderate-income (LMI) geographies which are predominately African-American and Hispanic neighborhoods;

- The geographic distribution of loans originated show very poor lending penetration in LMI geographies; and
- Lending levels reflect very poor responsiveness to assessment area credit needs.

The PE designated the performance ratings as "substantial non-compliance" for the Lending Test and "low satisfactory" for the Investment and Service Tests. The PE also noted, consistent with the CRA regulation, that the Lending Test is weighted more heavily than the Investment and Service Tests when arriving at a composite CRA rating.

The bank believed that each of the three performance ratings should have been higher than assigned during the examination, and that the overall rating should have been "satisfactory record of meeting community credit needs."

Discussion

The evaluation of a bank's CRA activities requires a full understanding of the performance context in which it operates. The performance context considers the economic condition and demographics of the assessment area, competition, and the types of products and services offered by the bank. While the CRA activities of other similarly situated financial institutions are considered, bank-by-bank comparisons are not a component of the overall rating process.

The ombudsman's analysis included a review of the issues highlighted in the bank's appeal letter, the Report of Examination, the PE, and all supporting documentation. Additionally, extensive discussions were held with appropriate bank management and OCC supervisory personnel.

The Lending Test

The Lending Test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) through its lending activities by considering a bank's home mortgage, small business, small farm, and community development lending. Based upon the ombudsman's analysis of the bank's lending performance during this evaluation period, it was clear that there were conspicuous gaps in lending, particularly, in LMI geographies. The lending gaps identified during the examination were inclusive of small business, home mortgage, home improvement, and community development loans. Further review of the Home Mortgage Disclosure Act (HMDA) data indicated that lending opportunities did exist within these same geographies. The bank's limited offering of HMDA products and a lack of marketing efforts had affected its ability to effectively compete with other lenders within these geographies. Therefore, because of the significance of a potential SNC rating, the ombudsman expanded the analysis to include retail (non-HMDA) lending products for the same evaluation period.

The ombudsman carefully reviewed the Lending Test analyses, related information contained in the examiners' working papers, and the additional data provided by the bank. In considering all loan products, the ombudsman found that the volume of the bank's lending within its assessment area to LMI geographies essentially mirrored the examination findings. The inclusion of retail (non-HMDA) products was not a significant factor. Some material conspicuous gaps in both lending and in the origination of loan applications remained, particularly in LMI geographies.

Comparing all findings with the Lending Test rating guidelines and after a detailed and extensive assessment of all the facts and circumstances, the ombudsman concluded that the bank's performance under the Lending Test, was more appropriately reflective of a "needs to improve" rating and not the "substantial non-compliance" rating as assigned in the PE.

The Investment Test

The Investment Test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) through qualified investments that benefit its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s).

The ombudsman performed a detailed review of the examiners' findings, supporting working papers and information contained in the appeal and provided by the bank. Most notable was the bank's investment in and support of two local community development corporations. Qualified investments in these types of organizations are consistent with the CRA. The regulation further encourages banks to make investments that are innovative, complex, and not routinely provided by the private sector. While the bank had some participation in qualified investments, the ombudsman determined that the bank's investment activity did not represent innovative and/or complex transactions or investments that are not routinely provided by private investors. As a result of a detailed analysis of all documentation, and the application of the CRA Investment Test rating guidelines, the ombudsman concluded that the "low satisfactory" rating assigned in the PE was appropriate.

The Service Test

The Service Test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) by analyzing both the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services.

The ombudsman performed a detailed review of the examiners' findings, supporting working papers and information contained in the appeal and provided by the bank. The ombudsman recognized and considered the other efforts the bank has made relative to the service test including alternative product delivery systems, the introduction of debit cards, and the opening of a new branch in a moderate-income geography. However, as a result of a detailed analysis of all documentation, and application of the CRA Service Test rating guidelines, the ombudsman concluded that the "low satisfactory" rating assigned in the PE was appropriate.

Conclusion

The intent of CRA is to encourage banks to help provide credit products and services throughout its assessment area, including LMI geographies and individuals. While the ombudsman recognized the bank's efforts in general, its overall performance was poor, specifically under the Lending Test.

Owing to the heavier weighting of the Lending Test in the overall rating process, the "needs to improve" Lending Test rating consequently changed the bank's overall CRA rating from the "substantial non-compliance record of meeting community credit needs" to a "needs to improve record of meeting community credit needs." A revised CRA PE was prepared to reflect these changes and forwarded to the bank by the supervisory office.

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Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the National Black Chamber of Commerce, on improving business prosperity for black entrepreneurs, Baltimore, Maryland, July 10, 1998

It is a pleasure to join you at your annual convention and it's an honor to salute the National Black Chamber of Commerce and the work of its 180 local chapters, representing 62,000 black-owned businesses all across our nation.

Let me first commend you on the insight expressed in the theme chosen for this year's convention. As you say, the face of entrepreneurship in America *is* changing today—changing in ways that increasingly reflect our nation's racial, ethnic, and gender diversity. Look at the numbers. Between 1987 and 1992—the most recent period for which these statistics exist—there was a 62 percent increase in the total of minority-owned business; a 43 percent increase in women-owned firms; a 46 percent increase in the total of black-owned businesses; and comparable increases in revenue growth in all these firms. When the Department of Commerce publishes the results of its latest Survey of Minority Business Enterprises later this year, I believe it will show continued steady progress in making the face of entrepreneurship an even more representative reflection of America.

> This is all promising. But there is much work still to be done. So, having mentioned the progress we've made so far, let's now talk about the progress we can and must make if we are to accomplish the goal of full economic opportunity for all.

We are not there yet, and the numbers unfortunately reflect that, too. African-Americans make up 12.6 percent of the population and yet own only four percent of all businesses. Moreover, although no segment of the black-owned business community has grown faster than the one with revenues of over $1 million annually, black-owned businesses still tend to generate lower revenues and profits than the average small business. According to the Commerce Department data, over the period studied, African-American-owned firms on average generated annual revenues of less than $52,000—compared to $193,000 for all firms generally—and employed only half as many workers. That disparity can be explained in large part by the fact that black business owners were nearly twice as likely as all small business owners to operate in the retail and personal services field—traditionally, the smallest and least profitable of all business segments. Clearly, not all small business opportunities are equal.

When we ask *why* blacks are over-represented in these emphatically worthy but generally less remunerative fields, a clear answer emerges. Capital—human and financial—is the key to small business prosperity. Education, training, and finance—together, they make small businesses work. What the national banking system can do to help advance that goal is what I would like to discuss with you this morning.

Unlike large firms that can raise capital directly from the money markets, small business must rely on personal resources and institutional intermediaries for their financing needs. Although many kinds of financial institutions supply credit and related services to small business, commercial banks remain the most important source of small business funding today. Between 1989 and 1994, small business loans by commercial banks grew from $71 billion to $99 billion annually, and 87 percent of small business owners reported that they had purchased financial products and services from banks. Indeed, for small businesses, funding obtained from banks, whether in the form of direct small business loans, second mortgages, or unsecured credit, exceeds the next three sources of small business finance—family, friends, and former business owners—combined.

Bank loans are especially important to the minority small business person because in minority communities, family net worth—the second most important source of small business funding overall—tends to be lower than for the population at large. For most would-be minority entrepreneurs, then, the choices are limited. Without a bank loan, the dream of business ownership may never be reached. We know that when entrepreneurs proceed without adequate financing, the odds that they will survive beyond the first year or two, if they get off the ground at all, drop precipitously.

And even though more black businesspeople are getting bank loans than ever before, the evidence clearly shows that black entrepreneurs lag significantly behind other minority groups and the population as a whole both in their ability to obtain bank loans and in the size of the loans that they do obtain. Shortfalls in bank financing may help to explain why blacks tend to be over-represented in the personal service and retail fields, primarily serving local markets, and under-represented in the potentially more lucrative, broader-market, but more capital intensive fields

of construction, finance and insurance, wholesaling, and manufacturing. And that, in turn, explains why black-owned businesses tend to generate fewer jobs than nonminority small businesses.

So what stands between black entrepreneurs and the bank financing that is so crucial to their success? Whenever one asks that question, the possibility of discrimination must be addressed. Certainly a widespread perception exists among female and minority entrepreneurs that, despite the provisions of the Equal Credit Opportunity Act, some financial institutions unlawfully discriminate in underwriting applications for small business credit. In addition, academic studies have shown that female and minority business owners do in fact face unfair obstacles in obtaining business-related credit.

In addition to vigorous enforcement responses throughout the government, another important thing we can do to obtain better compliance with anti-discrimination laws is to gather better and more timely data about the loans that are being made. As part of the OCC-encouraged reforms of the Community Reinvestment Act, we instituted a system to collect small business loan origination data. This is information that we can use to track where small business loans are going—and, just as importantly, where they are not going. But these data reveal only where loans are going geographically by census tract; they don't tell us the race, gender, or national origin of the *recipients* of the loans. In fact, lenders are currently forbidden by the Federal Reserve Board's Regulation B from inquiring about the race, color, sex, religion, or national origin of an applicant for a non-mortgage loan. The OCC and other federal agencies, including the Department of the Treasury, Justice, HUD, the Federal Trade Commission, and the Small Business Administration, have urged the Federal Reserve Board to change Regulation B so that creditors could collect such information, on a voluntary basis. Such a change would permit bankers and regulators to better monitor small business lending patterns and would materially assists us in the fight against discrimination in the small business market. As such, we believe this change would improve access to credit. It is not too late for you to express your views to the Federal Reserve Board, and I would encourage you to join us in supporting this change to Reg. B.

Lending discrimination undoubtedly still exists, and where it does, I promise you that we will do whatever we can to root it out. But another—and more pervasive—obstacle to the consummation of mutually profitable relationships between bankers and minority entrepreneurs today is unfamiliarity and misunderstanding. The communications gap that keeps bankers and minority entrepreneurs apart is a gap that we must begin to close if *both* sectors are to use each other to achieve their full potential for growth. Banks and minority small businesses need one another.

To help bring them together, the OCC launched a project called Banking on Minority Business. Harry, you were there, in a meeting with Comptroller Gene Ludwig in January of last year, when the idea was conceived. With the good advice he got from you and others at that meeting, Gene visited eight cities across the country and met with hundreds of national bankers, minority small business owners, and local business development officials to discuss access to credit and financial services for minority-owned small businesses. I have continued these meetings in additional cities. We learned a great deal, and next week we will be issuing an OCC advisory to share what we learned with bankers, bank examiners, and the rest of the financial and regulatory world. But I thought I would take just a few moments to give you an advance look at what we will be saying.

We learned that—fundamentally—the difference between successful minority small business loan programs and less successful ones can often be summed up in one word: *attitude*. A positive attitude is the hallmark of the banker who sees minority small business lending not as a legal "compliance" or political responsibility, but as a business opportunity waiting to be seized upon. In other words, bankers who are successful treat minority small business loans as a profit center, not as a compliance cost.

Success, we have found, requires targeted research and outreach. Some bankers cultivate business contacts in the minority community, as the banks' own suppliers and contractors. This can actually prove to be a win-win-win situation. Banks receive quality work and products from motivated entrepreneurs. Minority businesses obtain business opportunities. And, importantly, banks gain relationships and perspectives on the minority small business community in their areas that can help bankers to better understand the needs of minority entrepreneurs and the opportunities that exist in that community.

Other bankers staff their minority small business lending sections with seasoned loan officers who speak the language of their ethnic clients and have the authority to tailor loan products to fit their customers' distinctive needs—more flexible loan products like small business lines of credit accessed by check drafts or loans that are principally underwritten on a cash-flow basis with nontraditional approaches to secondary sources of repayment.

The right attitude on the bankers' part means taking the time to explain loan requirements and credit criteria, working with denied applicants to improve their creditworthiness, and preparing written materials in the language of the applicant. It may mean providing counsel-

ing to applicants who lack extensive experience in running a small business—for some would-be entrepreneurs need training as much as they need capital. Many banks work in partnership with nonprofit organizations and with SBA-sponsored Small Business Development Centers, which provide loan application preparation and management assistance to businesses that banks cannot provide themselves. Some offer instruction in starting and operating a small business and provide continuing assistance after the business is up and running.

All these activities are well established, but they take extra effort. However, for the bank, the payoff comes in the form of expedited approvals, solidly performing loans, and lifelong and growing banking relationships.

Banks with successful minority small business programs also often take advantage of loan guarantees extended by the SBA, U.S. Department of Agriculture, and other federal, state, and local agencies. The best banks use these programs strategically to mitigate risks in some loans and expand lending to minority small businesses. These guarantees may allow a bank to focus more on cash flow than collateral. Subordinated debt may shore up an otherwise undercapitalized, minority small business borrower. In addition, the portion of a loan guaranteed by the SBA is likely to be more saleable on the secondary market.

Some national banks have also formed subsidiaries—banks within banks—which specialize in forming partnerships with businesses located in low- and moderate-income census tracts, disadvantaged businesses, minority- and women-owned business, and worker ownership arrangements. Sometimes they make traditional loans; other banks, using the OCC's Part 24 rule, provide equity financing, either directly, or, when dealing with very small or start-up businesses, through third-party organizations, including Small Business Investment Companies, community development corporations, and minority-owned financial institutions specializing in lending to minority businesses. By working through these third-party intermediaries, banks in effect become "partner's partners"—pooling their risks while providing both loans and equity capital to businesses that have generally had limited access to the financial mainstream.

Now, of course, a positive attitude cannot be a one-way street, so I need to mention that misconceptions on the borrower's part can be just as damaging to the banking relationship as insensitivity on the banker's. The borrower has to understand that the banker is a business person, and must be mindful of the bank's fundamentals—both in terms of the basics of a loan application and the bank's bottom line. Moreover, the banker, even at the most senior levels, has both a board of directors and government regulators to answer to in case things go wrong.

Let me close by emphasizing the need to work together. The businesses you head may be small, but, together, your impact on our national economy is and will remain very large. *Your* success is crucial to the continued success of our nation's economy and to the health of our nation's communities. The potential is nowhere richer than in the minority community. More than ever before, America's commercial banks are positioned to become your partners in this endeavor. We at the OCC will do our best to make sure that this promise is realized.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the Robert Morris Associates, Consumer Risk Management Conference, on risks of easing underwriting standards in the home equity market, Chicago, Illinois, July 13, 1998

It's a pleasure to be with you for what looks like yet another fine and very timely RMA [Robert Morris Associates] conference. For nearly a century, RMA has been a focal point for education, exchange of ideas, and exploration of new issues affecting the lending business of our nation's banks.

During that time, the banking industry has obviously changed greatly, and has faced many different challenges. Some challenges, such as maintaining sound loan underwriting standards in an evolving economic environment are not new, but they manifest themselves in new ways with changing times. It is this challenge that I want to talk about this afternoon.

The OCC has also been doing its job for a long time, too. Since 1863, we have worked toward a safe, sound, and vital national banking system. We too have faced many challenges—as a supervisor and regulator. And, our responsibilities have always included the critically important but never pleasant task of calling attention to problems developing within the banking system—problems that, if left unchecked, could undermine the system's long-term safety and soundness. Frequently it happens that these warnings must be sounded when standard indicators of banking health are positive—as most are today. We do this not because we take any pleasure in pulling the punchbowl from the table in the midst of the party, but because 135 years of experience has taught us that the best way to ensure the continued health of the banking system is for bankers—and regulators—to exercise vigilance and foresight early on.

For the OCC in the current economic cycle, "early on" was three years ago, when, in response to reports of slippage in credit quality and credit terms in both the wholesale and retail loan markets, we formed a National Credit Committee composed of some of OCC's most experienced credit specialists. To get below the surface of the generally rosy aggregate industry statistics and to assess the nature and extent of the problems we were hearing about, the Committee conducted a survey of examiners-in-charge at a sample of our largest banks, and published its findings in November 1995. After that, at roughly yearly intervals, we released two more underwriting surveys, and we have now completed the fourth in the series, to be released later this summer.

We now have the results of this latest effort, and they are unsettling. On the retail side, the picture is mixed. Last year, we were able to report that many national banks, in the face of mounting charge-offs, were reassessing their underwriting standards for credit cards, and tightening those standards where appropriate. That trend continues, with 10 times as many examiners reporting in the current survey that their banks had tightened credit card and consumer leasing policies as had eased them.

But we now find that some of this risk has merely been shifted into other categories of consumer lending. The increase in the number of surveyed banks reported to have tightened credit card standards was nearly matched by the number of banks that had *eased* underwriting standards in the issuance of home equity loans and home equity lines of credit. This reflects not only the boom in the home equity market generally and an increase in competition among lenders who participate in it, but also the decision of some banks to pursue opportunities in two fast growing segments of that market, the subprime and high loan-to-value (LTV) segments.

There is nothing inherently wrong with these non-traditional home equity loans. Properly underwritten and administered, they can work well for borrowers and lenders. Consumers with a history of financial reverses can use these loans to rebuild their credit and then qualify for better rates on subsequent loans. They can use the proceeds for education, home improvement, or small business formation—uses that can improve the borrower's long term financial prospects and help them join the financial mainstream. All borrowers deserve the same opportunity to use the equity built up in their homes to reduce their overall credit costs.

But the home equity markets, including subprime and high LTV products, also suffer from abusive practices and irresponsibility on both sides of the transaction. Predatory lending, loans made without full disclosure of terms, and loans that cannot possibly be supported by the borrower's cash flow are poor business for both borrowers and lenders over the long run. When loans become financial straitjackets and stop becoming gateways to financial opportunity, neither party benefits. Borrowers run the risk of losing their most important and valuable asset—their home. Lenders expose themselves to loan losses and damage to their credibility.

Some believe that the entry of regulated commercial banks into the subprime and high LTV market will curb abusive lending practices by supplanting certain un-

scrupulous lenders who prey on the poor and unsophisticated. But competitive pressures must not lead commercial banks to cutthroat, lowest common denominator lending. If bankers are to become successful in these markets, they must be attentive to the peculiar challenges—both social and financial—that they pose. They must understand that subprime and high LTV loans are separate products requiring separate marketing, account management, and collections techniques to manage credit exposure. Banks that make and service subprime and high LTV loans as though they were no different from each other and no different from conventional home equity loans are putting their reputations—as well as their consumer loan portfolios—at risk.

On the commercial side, the picture is even more disturbing. For the fourth year in a row, commercial underwriting standards have slipped. We see this slippage in every category except international lending, where the Asian crisis has prompted lenders to be more cautious. Elsewhere the pattern is consistent. More and more syndicated and middle market loans are becoming leveraged deals. In all categories, heavy competition and a push to increase loan volume has led some lenders to compromise their underwriting standards.

The logic of lending is quite simple: the lender accepts a limited return in exchange for manageable downside risk. Unfortunately, more and more lenders are behaving like investors on the downside—that is, accepting greater risk of loss—without commensurate potential upside return to compensate for the level of risk assumed. For comparable loans on similar terms, fees and spreads are down. And the downside risk in the commercial loan market seems to be increasing. Across the board, banks are granting broader and more generous concessions to business borrowers. Provisions governing covenants, guarantors, and tenors have become less rigorous for borrowers. Collateral requirements have been relaxed.

Even as banks have increased their exposure to risk, they have also reduced their ability to cover potential losses out of existing reserves. Call report data shows a steady drop in the percentage of loan loss reserves to gross loans and leases over the past 22 quarters. Thus, as we approach a record eighth year of economic expansion, a time when banks should be shoring up their balance sheets, banks seem instead to be increasing their downside exposure in the commercial and consumer loan market.

In October of 1997, when we unveiled the results of the last underwriting survey, we also took several steps to respond to the trends we found. We instructed all OCC examiners-in-charge to discuss the results of that survey with senior bank management, with particular emphasis on the relevance of our findings for each specific bank. Furthermore, we instructed examiners to continue to review credit underwriting standards, including sampling new loans, and to discuss the results with senior management of the bank. We began a system-wide study of the capability of national banks to deal with an increase in the volume of problem loans. We accelerated efforts to finalize new interagency guidance governing classification and charge-off policies on retail credit. Finally, we announced the impending release of OCC guidance on loan portfolio management techniques.

In the months since we announced this program, we have seen some positive responses. A number of community banks have revised their loan policies. Others have beefed up their collection capabilities, and developed contingency plans to deal with the decline in asset quality that is sure to occur in the event that the economy deteriorates. The OCC's loan portfolio management handbook has been widely hailed as an important contribution in assisting bankers and bank examiners to understand the interrelationships among loans, the importance of analyzing risk across different boundaries, and how the portfolio concept can be used to aid in the management of overall credit risk before it jeopardizes bank solvency.

For all that, the disclosures contained in our latest underwriting survey indicate that our previous actions and admonitions have not had the full impact we hoped to achieve. Because banks have not shifted gears to the extent we believe the situation requires, we are shifting gears ourselves to enhance our focus on credit risk issues.

In our portfolio management handbook, we emphasized that "the identification and management of risk among groups of loans may be at least as important as the risk inherent in individual loans." Yet our guidance also recognizes that the portfolio is no stronger than the sum of its parts. Where the underwriting and approval processes are flawed, bad loans will result, endangering the whole portfolio. Therefore, we have already begun to supplement our examinations by doing more "drilling down" to assess the adequacy of and adherence to the bank's own underwriting standards, especially in banks with higher risk profiles. We have published or will soon publish new handbooks on large bank supervision, small bank supervision, internal controls, and lending areas, that reflect this emphasis.

And we will soon take several new steps that will help focus on credit risk at the individual bank level. In the coming weeks, we will be asking our examiners to identify and report to bank CEOs and boards of directors, as appropriate, when, in the course of their examination, they identify specific loans with structural weaknesses that may jeopardize repayment and/or orderly liquidation of the loan at a future date. By "structural

weakness" we mean loans underwritten in ways that do not adequately reflect the purpose of the loan, the type of loan, or the source of repayment. These structural weaknesses are most commonly evidenced by inappropriate maturities or amortization schedules, ineffective covenants, and inadequate collateral or guarantor support. This type of lending warrants special attention by bank management and examiners alike.

We will also ask our examiners, in the Report of Examination, or other appropriate supervisory communication, to comment on several specific questions. First is the extent to which underwriting practices are deviating from formal underwriting policies. When loans are made as exceptions to policy, are they so recognized by the bank? Does the bank have systems in place to identify, report, and manage the additional risk associated with those loans? And what are the implications of this category of loans for the bank's overall risk profile?

Second, we will ask our examiners to comment on the volume of and trends in loans upon which repayment prospects are heavily dependent upon the realization of projected cash flows, asset values, equity values, and a borrower's so-called "enterprise value." Finally, we will ask our examiners to identify any adverse credit risk trends within category of credits rated as "pass."

The purpose of these new steps is not to be punitive. Rather, our objective is to enhance our focus on the quality and quantity of credit risk at the individual bank level and to give bankers the opportunity to make appropriate risk management adjustments.

Some will say that the optimistic assumptions underlying much of the lending we see today have never been more warranted. We certainly hope that to be the case. But there are warning signals to the contrary that I would urge you to heed.

The problems we are seeing in the banking system today are serious. They could presage the same kinds of problems that afflicted the industry nearly a decade ago. But history does not have to repeat itself. Bankers have the opportunity to take the steps necessary to better contain their credit risk going forward. The time for that action is now.

Statement of Julie L. Williams, Acting Comptroller of the Currency, before the Subcommittee on Financial Institutions and Consumer Credit of the U.S. House Committee on Banking and Financial Services, on the draft Financial Institution Regulatory Streamlining Act of 1998, Washington, D.C., July 16, 1998

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

I. Introduction

Madam Chairwoman and members of the subcommittee, I appreciate this opportunity to discuss continuing efforts to reduce the regulatory burden on the banking industry, and specifically to offer the views of the Office of the Comptroller of the Currency on the subcommittee's draft of the Financial Institution Regulatory Streamlining Act of 1998. I commend you for your leadership in crafting a bill that builds on prior successful efforts to provide prudent and effective regulatory relief for the banking industry.

Effective bank supervision necessarily imposes a degree of regulatory burden to maintain the safety and soundness of the industry, ensure that the credit needs of the public are served, and protect the interests of banking customers. However, it is our mutual responsibility to identify and eliminate unnecessary regulatory and supervisory burden. Excess burden makes banking unnecessarily more costly, inhibits banks' ability to serve their customers, and thereby saps their long-term safety and soundness.

Since 1993, the Office of the Comptroller of the Currency (OCC) has undertaken three major initiatives aimed at reducing unnecessary regulatory burden and improving the efficiency of supervision. We designed each program to ensure that the OCC focuses its regulations and supervisory resources on those bank activities and products that present the greatest risks to safety and soundness and the OCC's other regulatory responsibilities. First, we undertook our Regulation Review Program, which involved reviewing all of the OCC's rules and eliminating or revising provisions that did not contribute significantly to maintaining the safety and soundness of national banks, facilitate equitable access to banking services for all consumers, or accomplish the OCC's other statutory responsibilities. Following completion of the Regulation Review Program, we conducted an evaluation of the results of our work primarily by convening focus groups across the country including bankers, private sector banking lawyers, community group representatives, and our own examiners and supervisory staff. The vast majority of those who participated in our evaluation effort thought the program was beneficial; they noted a reduction in regulatory burden and no discernible negative impact on the safety and soundness of the industry, or in the ability of national banks to address community needs and consumer issues. I am happy to say that our final report on this evaluation effort, "Measuring the Effectiveness of the OCC's Regulation Review Program," has just been released. I have attached a copy as an appendix to this testimony.

A second initiative aimed at reducing burden and promoting efficiency was the implementation of a new supervisory approach, supervision by risk. This approach deploys our examiners in the most efficient manner possible by focusing their attention on those issues facing a bank that have the greatest effect on the nature and extent of risks in an individual institution. Having identified the risks for an individual bank, examiners then form an overall conclusion about the institution's risk profile, which serves as the basis on which they structure supervisory plans and actions.

Our third major initiative in this area has been a reduction in direct regulatory costs. After reviewing our assessments and corporate fees, we reduced charges for national banks to more accurately reflect the actual costs of supervision. The total reduction in fees and assessments instituted by the OCC between 1995 and 1997 will save national banks $88 million annually.

Congress can be proud of the leadership it has shown over the last five years in the effort to reduce unnecessary regulatory burdens for the banking industry, while not compromising either the safety and soundness or the community and customer responsibilities of banks. And there are still opportunities to do more. The OCC therefore supports the subcommittee's efforts to provide regulatory relief and promote economic efficiency in the banking industry.

Madam Chairwoman, in the remainder of my statement I will address the questions raised in your invitation letter. I will also provide comments on several specific provisions in the draft bill and recommend changes that I believe are appropriate. Appendix 1 contains the OCC's detailed comments on the draft bill. Appendix 2 contains the report, "Measuring the Effectiveness of the OCC's Regulation Review Program." We also have additional suggestions for regulatory burden relief that we would be happy to share with the subcommittee at your convenience.

II. Comments on the Financial Institution Regulatory Streamlining Act of 1998

Removal of Restrictions on Interest Payments (Sections 101 and 102)

In your invitation letter, you requested that the OCC comment on two of the draft bill's most significant provisions, which would amend the Federal Reserve Act to allow the Federal Reserve Board to pay interest on required and excess reserves and lift the prohibition on depository institutions paying interest on demand deposits.

Interest on reserves. As you know, the question of paying interest on sterile reserves has been under debate for many years. On one side, the prohibition on payment of interest on required reserves has caused banks to create mechanisms to minimize required reserves.[1] The practical result of these measures has been the shrinkage of the reserve base.[2] Recently, the Federal Reserve Board has expressed concern over this shrinkage and the possibility that this could hinder its implementation of monetary policy. On the other side, permitting the payment of interest on these reserves would reduce revenue that the Federal Reserve Board currently turns over to the Treasury. This provision thus has a budgetary impact, and would appear to require some offsetting budget adjustments. Not knowing what those might be and given the range of programs that could be detrimentally affected, it is difficult to conclude that, on balance, this change is desirable at this time. The Treasury Department has offered its analysis and comment on this proposal and we defer to those views for a more detailed reaction.

Interest on demand deposits. The draft bill also removes the statutory prohibitions that prevent depository institutions from offering interest-bearing negotiable order of withdrawal (NOW) accounts to businesses and paying interest on demand deposits. In a 1996 interagency report[3] the OCC and other federal banking regulatory agencies concluded that the statutory prohibition against the payment of interest on demand deposits no longer serves a useful public purpose. The OCC continues to believe the prohibition is outdated in the modern financial services environment. While banks might incur a cost from paying interest on demand accounts, the long-term effects of removing this regulatory distortion and encouraging increased competition and efficiency in the banking industry are likely to be beneficial. Further, we do not believe that the repeal of this prohibition would raise any longer-term supervisory concerns.

We recognize, however, that it may be appropriate to provide a period during which financial institutions could make necessary changes in their funding sources and pricing to accommodate the repeal of the prohibition. This is particularly the case now, as institutions face unique challenges readying themselves for the year 2000. Combining the first two provisions of the alternative section 102 in the draft bill, which (1) authorize 24 transfers per month from any interest-bearing account to another account of the owner in the same institution, and (2) permit the payment of interest on all demand deposits as of October 1, 2004, provides a generous period in which to accomplish this transition. In fact, the proposed six-year transition period could well be shorter. We would recommend, however, that it at least extend for a period that allows institutions to complete their adjustment to the millennium date change, *e.g.,* at least into 2001.

Financing Corporation Payments (Section 103)

Section 103 of the draft bill amends the Federal Home Loan Bank Act to provide, indirectly, refunds from the deposit insurance funds to insured financial institutions. This refund would be provided only when the Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF) have "excess net income,"[4] in which case the FDIC would make a payment to the Financing Corporation[5] (FICO) in an amount not to exceed 25

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[1] For example, the development of sweep accounts has proliferated. Under these arrangements, funds in corporate checking accounts are transferred, or "swept," into interest-bearing investment vehicles, usually overnight, to be returned to the demand account the next day. This has had two significant effects from the bank's perspective. First, sweep arrangements reduce the level of transaction deposits, thereby reducing the amount of sterile reserves that a bank must hold and increasing the funds available to lend or invest. Second, sweep accounts enable corporate checking account customers to earn interest on their transaction balances by temporarily placing these funds in interest-bearing accounts. Thus, banks can attract and maintain corporate deposits, funds which could otherwise be placed in nonbank financial institutions that do not face the payment of interest restriction. These deposits, in turn, provide funds that the bank may use to make loans and investments.

[2] According to the February 25, 1998 *American Banker* article, "Fed Raps Plan to Get Around Ban on Corporate Checking Interest," the growth in sweep accounts has coincided with a $14 billion drop in reserve balances from December 1994 to November 1997 (p. 4).

[3] *Joint Report: Streamlining of Regulatory Requirements*, September 23, 1996, p. I-47.

[4] The fund has "excess net income" when the reserve ratio is above 1.35 percent of the estimated deposits of the fund *after* making any appropriate refunds to BIF members, *and* so long as the fund's balance is not less than what it was at the beginning of the calendar year.

[5] The Financing Corporation was established in 1987 to recapitalize the Federal Savings and Loan Insurance Corporation. FICO makes assessments on SAIF members for payment of interest and custodial costs on its bonds. The Economic Growth and Regulatory Paperwork Reduction Act of 1996 provided that, beginning with semiannual periods after December 31, 1996, FICO assessments would be shared among all insured depository institutions, including insured national banks.

percent of the FICO assessments. Any such payments made to the FICO would reduce proportionately the FICO assessment imposed on each member of the insurance fund from which the payments were made.

As this section involves issues related to management of the federal deposit insurance funds, the Federal Deposit Insurance Corporation's analysis and comments on this section are most pertinent. In general, however, particularly in light of evolving international economic trends, the year-2000 challenge faced by the bank and thrift industry, and the undesirable trends in credit underwriting standards about which all the bank regulatory agencies have expressed concern, we would be very reluctant to see income diverted from the BIF or the SAIF absent a very thorough analysis of developing industry trends and the potential long-term needs of the affected funds.

Corporate Governance Provisions (Sections 201 and 203)

Authority to allow more directors. The draft bill contains important, burden-reducing provisions that would simply streamline and modernize aspects of the corporate governance of national banks. Section 201, for example, would permit the OCC to allow a national bank to have more than 25 directors. Permitting this increase would provide the bank with more flexibility to determine the composition of its board of directors in a manner that best suits its particular needs. For example, a larger board of directors may be more appropriate for banks resulting from a merger or consolidation and would permit better local representation on the board of directors of interstate banks.

The OCC also believes that along with the expansion of the size of the board of directors, it would be appropriate to allow banks the flexibility to stagger the election process of members of their boards of directors. Currently, national bank directors may hold office for only one year and must be elected annually. Conducting an election for an entire board every year can be somewhat disruptive to business operations. There are sound public policy reasons for allowing banks to choose a staggered election process. In particular, it can help ensure that a board will, at all times, include experienced members, which can enhance banks' safety and soundness. Such a change would be consistent with the Model Business Corporation Act and with many state corporate codes, including Delaware's General Corporation Law. If both of these changes are made, they will provide banks with more stability in connection with changing the composition of a bank's board, coupled with the flexibility to determine the membership of the board to reflect the bank's lines of business and the markets in which it operates.

Expedited procedures. Section 203 expedites the procedure by which a national bank may reorganize to become a subsidiary of a holding company. Currently, a national bank that wishes to reorganize into a subsidiary of a bank holding company must go through a cumbersome multi-step process because there are no provisions in current law that permit a national bank to reorganize as a subsidiary of a bank holding company in one direct transaction. The OCC supports this provision because it would make it easier for banks to create a holding company, if they choose that structural form of organization, in a manner that reduces unnecessary burdens and costs.

Provisions Affecting Supervisory Agencies (Sections 302, 303, 311, 501, and 502)

Call report simplification. You asked us to comment on the advisability of the call report simplification mandate outlined in section 302. The OCC and the other federal banking agencies are completing the implementation of Section 307 of the Riegle Community Development and Regulatory Improvement Act of 1994, which among other provisions required the banking agencies to jointly adopt a single form for the filing of core information that supervised institutions are required to submit, and to permit institutions to file call reports electronically. Although the OCC supports simplifying the processes through which banks provide supervisory information, given the demands on computer systems associated with year-2000 compliance, we do not favor a renewed requirement that would place demands on banks to reprogram their computer systems until after the industry has remediated its mission critical systems. Year-2000 compliance currently requires the full attention of information systems experts and contractors at banks and the federal banking agencies.

Purchased mortgage servicing rights. Section 303 amends the Federal Deposit Insurance Act to allow the federal banking agencies to jointly adjust or eliminate the 10 percent "haircut" on the valuation of purchased mortgage servicing rights and originated mortgage servicing rights, if they find that such valuation would not have an adverse effect on the deposit insurance funds or the safety and soundness of the depository institution. The OCC prefers this provision, which we jointly suggested with the other federal banking agencies, over any proposal that would repeal this "haircut" altogether.

Insider credit extensions. The OCC believes that the subcommittee should proceed cautiously with the relaxation of insider lending limits proposed in section 311. As a whole, these insider lending limits provide important safeguards including protections against valuation issues arising with collateral provided in transactions by bank insiders. Over time there has been a series of reductions in these limits and we urge the subcommittee to examine the cumulative effect of earlier liberalization in this area.

Bank Examination Report Protection Act. The OCC supports the Bank Examination Report Protection Act contained in sections 501 and 502 of the draft bill. These sections establish a bank supervisory privilege to protect confidential supervisory information, such as depository institution examination reports and other documents relating to the examination. First, codifying and strengthening the examination privilege will help preserve the cooperative exchange of information by supervised institutions with their examiners and the candid internal analysis of examiners. Second, these sections will buttress existing, uniform procedures for handling and accessing supervisory information by requiring third-party litigants to seek supervisory information directly from the supervisory agencies rather than indirectly from the supervised institution. Third, these sections will address the supervised institutions' concerns that their privileges will be waived if they voluntarily permit the supervisory agencies to have access to privileged information that can be valuable to an examiner's assessment of safety and soundness. These sections favorably resolve many of the unsettled issues regarding the handling of access to supervisory information, while preserving a process, including judicial review, by which third parties may seek access to supervisory information.

Community and Consumer-Related Provisions (Sections 310 and 402)

Elimination of certain merger filings. Under current law, a holding company seeking to merge or consolidate its bank subsidiaries must seek approval from the appropriate bank regulator under the Bank Merger Act. If a bank merger or consolidation is part of a larger transaction involving the merger or acquisition of another holding company, the acquiring holding company must also seek approval from the Federal Reserve Board under the Bank Holding Company Act. Section 310 would exempt *all* mergers of depository institution subsidiaries of the same bank holding company from the Bank Merger Act. Specifically, the amendment replaces the Bank Merger Act application process with a 10-day prior notice for these transactions, unless the reviewing agency requires a full-scale application within this 10-day period.

We understand that this amendment is intended to eliminate redundancies in the merger approval process. The antitrust review, convenience and needs analysis, public notice, and Community Reinvestment Act (CRA) review that the responsible agency undertakes pursuant to the Bank Merger Act in acting on an application to merge the depository institution subsidiaries are similar to procedures that the Federal Reserve Board follows pursuant to the Bank Holding Company Act in acting on an application to merge the parent holding companies. The OCC, however, does not support this amendment. It would impede the ability of the responsible agency to review these transactions for safety and soundness, have the effect of unnecessarily reducing the role of the public in the affiliate bank merger process, and hamper effective review of community-oriented issues including compliance with the CRA.

These problems arise because the amendment would cover transactions that are not subject to review under the Bank Holding Company Act, *e.g.,* a merger of affiliate banks owned by the same holding company that did not involve an acquisition of an additional bank or a merger with another holding company. There could be no convenience and needs analysis, public notice, or CRA review, unless the responsible agency required a full-scale application under the Bank Merger Act during the 10-day prior notice period.[6]

In addition, we believe that the 10-day review period provided in this section does not provide adequate time to review these transactions for safety and soundness. In the case of a merger involving both a national bank and a state bank, the OCC must contact and receive information from the appropriate state bank supervisor. A 10-day period would not always allow the OCC to receive and effectively evaluate this information, nor would it provide adequate time for the OCC to fulfill its statutory responsibility under national banking law to approve any merger or consolidation in which the resulting bank is a national bank. Further, the amendment provides no uniform criteria to guide the responsible agencies in determining whether to require a full-scale application.

Nonetheless, we are committed to eliminating unnecessary delays in the review process for corporate applications. To the extent permissible under the Bank Merger Act, the OCC, as well as the other banking agencies, and the Department of Justice (DOJ) have worked together to expedite review and approval of certain mergers that are competitively neutral, *e.g.,* mergers of affiliated institutions that are more than 50 percent owned by the same bank holding company. In 1992, DOJ agreed that this type of transaction can be consummated under the Bank Merger Act 31 days after DOJ receives notice of the OCC's preliminary approval of the application. This has the practical effect of eliminating the waiting time that would otherwise be required for a DOJ review of the proposed merger's competitive effects. This agreement has reduced burden and shortened the waiting period under the Bank Merger Act while preserving the respon-

[6] While the OCC would still retain the authority under the National Bank Merger and Consolidation Act to approve all merger transactions in which a national bank is the resulting bank, that act does not duplicate the statutory convenience and needs test, the CRA review, or the public notice requirements that apply if a transaction is approved under the Bank Merger Act.

sible supervisory agency's authority to require public notice of a transaction and to consider the applicants' CRA performance.

Amendments to TILA. Section 402 proposes amendments to the Truth in Lending Act (TILA) that would eliminate current requirements for disclosure of key credit terms. Specifically, the section eliminates the number of installments and the period of repayment as terms that, if disclosed by the lender, trigger additional disclosures regarding down payment, terms of repayment, and annual percentage rate (APR) in all advertisements of closed end credit. In addition, in radio and television advertisements for open-end, home-secured loans, this section eliminates the disclosure of loan fees, highest possible APR, and balloon payment requirements. We believe that these amendments deprive consumers of information that is key to making informed credit decisions, particularly in the case of home equity loans. Accordingly, we do not support this change.

III. Conclusion

The OCC remains committed to the reduction of unnecessary regulatory and supervisory burden. But we must do so without compromising either the safety and soundness or the community and consumer responsibilities of insured depository institutions. We applaud the subcommittee for its efforts, and support a majority of provisions in the draft bill.

[Appendixes 1 and 2 follow]

Appendix 1

Financial Institution Regulatory Streamlining Act of 1998 (June 19, 1998 Draft)— Draft Summary and Comments of the Office of the Comptroller of the Currency

Title I—Improving Monetary Policy

Sec. 101. Payment of Interest on Reserves at Federal Reserve Banks

Summary: In general, section 19(b) of the Federal Reserve Act (FRA) requires depository institutions to maintain reserves against their transaction accounts and nonpersonal time deposits ("sterile reserves"). This section amends section 19(b) to permit the Federal Reserve Board (Fed) to pay interest on all reserve balances, both required and excess, on at least a quarterly basis at a rate not to exceed the general level of short-term interest rates. The Fed would have authority to issue regulations regarding the payment, distribution, and crediting of interest pursuant to this section. In addition, this section permits depository institutions to place their reserves in either Federal Reserve Banks or banks that maintain reserves in a Federal Reserve Bank.

OCC Comment: This provision has budgetary impact, and would appear to require some offsetting budget adjustments. Not knowing what those might be, it is difficult to conclude that this change is desirable at this time. The Treasury Department has previously offered its analysis and comment on this proposal and we defer to those views for a more detailed reaction.

Sec. 102. Amendments Relating to Savings and Demand Deposit Accounts at Depository Institutions

Summary: Section 1832 of Title 12 prohibits depository institutions from offering interest- bearing NOW accounts to businesses. Section 19(i) of the FRA (12 USC 371a), section 5(b)(1)(B) of the Home Owners' Loan Act (HOLA) (12 USC 1464(b)(1)(B)), and section 18 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1828) prohibit member banks, thrifts, and nonmember banks, respectively, from paying interest on demand deposits. Section 102 proposes two alternatives. The first alternative, removes these prohibitions. The second alternative: (1) effective as of amendment, authorizes depository institutions to permit the owner of any interest-bearing deposit or account to make up to 24 transfers per month to another account of the owner in the same institution, (2) permits depository institutions to offer interest-bearing NOW accounts to businesses and to pay interest on demand deposits as in the first alternative, but with an effective date of October 1, 2004 (thereby providing a six-year transition period); and (3) permits the Fed to lower or eliminate the reserve requirement.

OCC Comment: In a joint report submitted to the Congress in September 1996, the OCC, along with the other Federal banking agencies, concluded that the statutory prohibition against the payment of interest on demand deposits no longer serves a useful public purpose. *See Joint Report: Streamlining of Regulatory Requirements* (September 23, 1996). The OCC continues to believe that the prohibition on paying interest on business checking accounts is outdated in the modern financial services environment. While banks might incur a cost from paying interest on demand accounts, the long-term effects of removing this regulatory distortion and encouraging increased competition and efficiency in the banking industry are likely to be beneficial. Further, we do not believe that the repeal of this prohibition would result in any long-term supervisory concerns. We recognize, however, that it may be appropriate to provide a period during which financial institutions could make necessary changes in their funding sources and pricing to accommodate the repeal of the prohibition. Combining the first two provisions of the alternative section 102 provides a generous transition period in which to accomplish this. In fact, the proposed six-year transition period could well be shorter. We would recommend, however, that it at least extend for a period that allows institutions to complete their adjustment to the millennium date change, *e.g.,* at least into 2001. The OCC defers to Treasury on the amendment to give the Fed more flexibility in reducing the reserve requirement.

Sec. 103. Financing Corporation Payments

Summary: The Economic Growth and Regulatory Paperwork Reduction Act, P.L. 104–208 (EGRPRA) provides that beginning with the semiannual periods after December 31, 1996, assessments to pay the approximately $800 million in interest on the obligations issued by the Financing Corporation (FICO) will be shared among all insured depository institutions, including insured national banks, instead of only Savings Association Insurance Fund (SAIF) members. For purposes of the assessments to pay the interest on the FICO bonds, Bank Insurance Fund (BIF) assessable deposits will be assessed at a rate of 20 percent of the assessment rate applicable to SAIF-assessable deposits until December 31, 1999. After the earlier of December 31, 1999 or the date that the last savings association ceases to exist, full pro-rata sharing of FICO assessments will begin.

EGRPRA also establishes a SAIF Special Reserve as of January 1, 1999 that will consist of the excess in the SAIF

over the designated reserve ratio as of that date (1.25 percent). While the amount in the SAIF Special Reserve cannot be used to calculate any future designated reserve ratio and cannot be used for refunds from the SAIF, it would be available for emergency purposes if the reserve ratio of the SAIF is less than 50 percent of its designated reserve ratio for a sustained period of time.

In addition, EGRPRA requires the FDIC on such basis as it deems appropriate to refund any premiums in excess of the designated reserve ratio to BIF members. There are no provisions for refunds to SAIF members. A member cannot, however, receive any refund for any semiannual assessment period that exceeds the assessment paid during that period. Institutions that are not well capitalized or that have other weaknesses are not eligible for refunds. Currently, BIF has reached its designated reserve ratio, and therefore, pursuant to section 7(b) of the FDI Act (12 USC 1817(b)), banks are not paying premiums to BIF. Meanwhile, interest is accruing on the funds in BIF, resulting in a balance in excess of the designated reserve ratio. However, the FDIC cannot technically refund any of this excess amount because banks are not paying premiums to BIF at this time.

This section amends section 21(f) of the Federal Home Loan Bank Act (FHLB Act) (12 USC 1441(f)) in order to provide, indirectly, refunds to banks from BIF as a result of their FICO payments. Specifically, this section provides that if the BIF or the SAIF have excess net income for a semiannual period, the Federal Deposit Insurance Corporation (FDIC) must make a payment to the FICO from the insurance fund in an amount equal to the excess net income. In turn, any payments made to the FICO from an insurance fund will result in the assessment imposed on each member of that fund by the FICO pursuant to section 21(f)(2) of the FHLB Act to be reduced by a set percentage. The amendment further provides that the total amount of such payments may not exceed 25 percent of the aggregate assessments in a calender year imposed by the FICO on the members of the fund. Also, such payment may not cause the reserve ratio of the insurance fund to be less than 1.35 percent of the estimated insured deposits of the fund, or the balance of the fund to be less than the balance of the fund at the end of the preceding calender year. A deposit insurance fund has “excess net income” if, at the beginning of a semiannual period, the fund has achieved a reserve ratio that is not less than 1.35 percent of the estimated deposits of the fund and, at the end of the period, after making any appropriate refunds from the BIF to BIF members, the fund has achieved a reserve ratio that exceeds 1.35 percent of the estimated insured deposits of the fund and has a balance that is not less than the balance of the fund at the beginning of the period. “Excess net income” is also defined in the amendment. This section will apply to the semiannual period beginning on or after January 1, 1999. Therefore, this amendment does not affect the FICO payment schedule, which, as described above, provides that banks be assessed at a rate of 20 percent of the assessment rate applicable to SAIF-assessable deposits until December 31, 1999.

It should be noted that saving associations will not necessarily benefit from this amendment. Because current law requires all amounts in SAIF in excess of the designated reserve ratio of 1.25 percent to be transferred to the SAIF Special Reserve, SAIF would never reach the 1.35 percent reserve ratio required for the FICO transfer. Therefore, savings associations would not receive any refunds for their FICO payments under this amendment as currently drafted. In order for savings associations to receive these refunds, the SAIF Special Reserve must be abolished.

OCC Comment: As this section involves issues related to management of the Federal deposit insurance funds, the Federal Deposit Insurance Corporation’s analysis and comments on this section are most pertinent. In general, however, we would be reluctant to see income diverted from the BIF or the SAIF absent a very thorough analysis of developing industry trends and the potential long-term needs of the affected funds.

Title II—Improving Financial Institutions Management Practices

Subtitle A—National Banks

Sec. 201. Authority to Allow More than 25 Directors

Summary: Section 31 of the Banking Act of 1933 (12 USC 71a) requires the board of directors of every national bank and State member bank to consist of at least 5 and no more than 25 members. This section permits the OCC, by order or regulation, to allow a national bank to have more than 25 directors.

OCC Comment: The OCC supports this change. Permitting a national bank to have more than 25 directors, with the approval of the OCC, would provide the bank with flexibility to determine the composition of its board of directors in a manner that best suits its particular needs. For example, a larger board of directors may be more appropriate for banks resulting from a merger or consolidation, and would permit greater geographic representation on the board of directors of interstate banks.

The OCC also believes that along with the expansion of the size of the board of directors, it would be appropriate to allow banks the flexibility to stagger the election process of members of their boards of directors. Currently, national bank directors may hold office for only

one year and must be elected annually. Conducting an election process for an entire board every year can be disruptive to business operations. Allowing banks to choose a staggered election process can help ensure that a board will at all times include experienced members which can enhance banks' safety and soundness. Such a change would be consistent with the Model Business Corporation Act and with many State corporate codes, including Delaware's General Corporation Law. If both of these changes are made, they will provide banks with the flexibility to ensure the highest-quality boards, thereby enhancing the board's oversight of the bank's activities and the bank's overall safety and soundness.

Sec. 202. Loans On or Purchases by Bank of Its Own Stock

Summary: Section 5201 of the Revised Statutes (12 USC 83) prohibits a national bank from making any loan or discount on, or owning or holding, its own stock unless the stock is acquired to prevent loss on a debt previously contracted (DPC) and sold or disposed of within six months. The purpose of section 5201 is to prevent the impairment of a bank's capital resources. *See Deitrick* v. *Greaney,* 309 U.S. 190 (1940). This amendment would repeal this section's prohibition on a bank owning or holding its own stock but retain the prohibition on making loans or discounts on the security of the bank's own shares. This section also makes the same change to section 18 of the FDI Act so that it applies to all insured depository institutions.

OCC Comment: The OCC supports this amendment. The OCC has interpreted section 83 to permit a national bank to acquire its own stock for certain legitimate corporate purposes, and as long as the acquisition is not for speculative purposes. (*See* 12 CFR 7.2020.) This amendment codifies this OCC interpretation and will eliminate any confusion about the authority of a national bank to purchase its own shares for legitimate corporate purposes, *e.g.,* holding stock for purposes of offering stock in connection with an officer or employee stock option or bonus plan, or to sell to a potential director in circumstances where a director is required to own qualifying shares, or when conducting a reverse stock split to reorganize as a Subchapter S corporation, which may involve decreasing the number of shareholders of the bank.

However, we do note that a technical change needs to be made to this amendment. The word "previously" should be added before the word "contracted" on page 15, line 2, and again on page 15, line 16.

To be consistent with the OCC's interpretations of section 83 and for safety and soundness reasons, we suggest that the legislative history accompanying this provision makes clear that a bank's acquisition of its own stock may not be for speculative purposes.

Sec. 203. Expedited Procedures for Certain Reorganizations

Summary: This section amends the National Bank Consolidation and Merger Act (12 USC 215 *et seq.*) to expedite the procedure by which a national bank reorganizes to become a subsidiary of a holding company. Pursuant to regulations issued by the OCC, national banks would be permitted, with the approval of two-thirds of the shareholders of the bank and the approval of the OCC, to reorganize into a subsidiary of a bank holding company directly. Under this section, the shareholder approval requirements and dissenters' rights that apply under current law to these transaction would not change, and the requirements of the Bank Holding Company Act (BHC Act) would still apply. This section also states that it is unlawful for a company to become a bank holding company or for a bank to become a subsidiary of a bank holding company without the prior approval of the Fed pursuant to section 3 of the BHC Act.

OCC Comment: The OCC supports this provision because it would make it easier for banks to create a holding company, if they choose that structural form of organization, in a manner that reduces unnecessary burdens and costs. Under current law, a national bank that wishes to reorganize into a subsidiary of a bank holding company must go through a cumbersome multistep process because there are no provisions in current law that permit a national bank to reorganize as a subsidiary of a bank holding company in one direct transaction. Under current law, the bank first forms a "phantom bank" that is owned by a bank holding company. The bank then merges into this phantom bank to become the subsidiary of the bank holding company. Upon the consummation of this transaction, shares of the existing bank are exchanged for shares of the holding company or other compensation is provided to the shareholders, and the holding company owns all of the shares of the resulting bank. The resulting bank typically is indistinguishable in name, location, and balance sheet from the preexisting bank, with the only difference being the ownership of its stock. However, because the "phantom bank" must be chartered as any other bank with its attendant procedures and costs, this procedure can be expensive and time-consuming, and imposes needless burdens. We note that this amendment does not affect the application of the Community Reinvestment Act (CRA) to these transactions or the application of the BHC Act.

Subtitle B—Savings Associations

Sec. 211. Noncontrolling Investments by Savings and Loan Holding Companies

Summary: This section amends section 10(e)(1)(A)(iii) of HOLA (12 USC 1467a(e)(1)(A)(iii)) to give the Director of

OTS the discretion to permit a savings and loan holding company to acquire or retain more than 5 percent of the voting shares of a savings association or another savings and loan holding company that is not a subsidiary. However, this section specifically prohibits the OTS from permitting a multiple savings and loan holding company to acquire more than 5 percent of a company not a subsidiary engaged in any activities, other than certain exempt activities. Current law prohibits the acquisition unless the transaction is subject to an exception, *e.g.,* the shares are acquired in a fiduciary capacity or acquired pursuant to a debt previously contracted. While the Director has the discretion to permit a savings and loan holding company to acquire "control" of a savings association or another savings and loan holding company (control is generally triggered if 25 percent of the voting stock is acquired), the Director does not have the discretion under current law to permit noncontrolling ownership of stock of over 5 percent.

OCC Comment: The OCC defers to the comments of the OTS on this provision.

Sec. 212. Streamlining Thrift Service Company Investment Requirements

Summary: Under current section 5(c)(4)(B) of HOLA (12 USC 1464(c)(4)(B)), a Federal savings association may invest in the stock of any corporation organized under the laws of the State in which the association has its home office if the stock of the corporation is owned only by savings associations chartered by that State and Federal savings associations having their home office in that State. Current OTS regulations further provide that Federal savings associations may apply to engage in activities through a service corporation, other than those that are preapproved, that are "reasonably related" to the activities of financial institutions. 12 CFR 559.3(e)(2). This section repeals the geographic limitations on where a service company must be chartered and where its owners must be located. This section also permits service corporations to be organized as limited liability companies.

OCC Comment: The OCC defers to the comments of the OTS on this provision.

Sec. 213. Repeal of Dividend Notice Requirement

Summary: Section 10(f) of HOLA (12 USC 1467a(f)) requires savings association subsidiaries of savings and loan holding companies to give 30 days advance notice to the OTS before declaring any dividends. Section 213 of this legislation repeals the notice requirement in section 10(f) of HOLA.

OCC Comment: The OCC defers to the comments of the OTS on this provision.

Sec. 214. Updating of Authority for Thrift Community Development Investments

Summary: Currently, section 5(c)(3)(A) of HOLA (12 USC 1464(c)(3)(A)) authorizes a Federal savings association to invest in real estate (or loans secured by real estate) located in areas receiving "concentrated development assistance" under the Community Development Block Grant program. The aggregate amount of real estate investments made under this provision may not exceed 2 percent of assets, and the aggregate real estate investments plus loans made under this provision may not exceed 5 percent of assets.

Section 214 of this legislation replaces the outdated language referring to the Community Development Block Grant program with the same language that currently authorizes community development investments by national banks and State member banks. This section also replaces the current 2 percent/5 percent asset investment limit with the same investment limit that applies to national banks, specifically, the sum of 5 percent of capital and surplus, with a higher amount permitted up to the sum of 10 percent of capital and surplus if the Director of the OTS determines that this higher amount will pose no significant risk to the deposit insurance fund and the savings association is adequately capitalized. *See* 12 USC 24(Eleventh) and 338a.

OCC Comment: The OCC defers to the comments of the OTS on this provision.

Subtitle C—Other Institutions

Sec. 221. Business Purpose Credit Extensions (Business Credit Cards)

Summary: This section adds a provision to section 4 of the BHC Act (12 USC 1843) authorizing CEBA credit card banks and nonbank banks to provide credit card accounts for business purposes.

OCC Comment: The OCC does not object to this amendment, as long as this authority is not extended to nonbank banks that have chosen to retain their exemption from the BHC Act by not making business loans while accepting retail deposits.

Sec. 222. Divestiture Requirement

Summary: This section amends section 4(f)(4) of the BHC Act (12 USC 1843(f)(4)), which requires companies controlling a grandfathered nonbank bank to divest the nonbank bank if the company: (i) acquires control of an additional bank or an insured institution, (ii) acquires more than 5 percent of the shares of an additional bank or a savings association, or (iii) fails to comply with the restrictions contained in paragraph (3) of section 4(f).

Under current law, it must divest control of the nonbank bank within 180 days or conform to the limitations in the BHC Act within that period. Section 222 provides that the company does not have to divest the nonbank bank if it corrects the condition or ceases the activity that violated the exemptions or submits a plan to the Fed to correct the condition or cease the activity within 1 year, and the company implements procedures that are reasonably adapted to avoid the reoccurrence of the offending condition or activity. In addition, section 222 requires the company to notify the Fed immediately upon failing to qualify for the exemption.

OCC Comment: The OCC takes no position on this provision.

Title III—Streamlining Federal Banking Agency Requirements and Elimination of Unnecessary or Outdated Requirements

Sec. 301. "Plain English" Requirement for Federal Banking Agency Rules

Summary: This section requires each Federal banking agency to use plain language in all proposed and final rulemakings published in the *Federal Register* after January 1, 1999. In addition, each Federal banking agency must submit a report to Congress by March 1, 1999 that describes how the agency has complied with this requirement. This section is similar to a recent Executive Memorandum issued June 1, 1998 by President Clinton.

OCC Comment: The OCC supports the objective of this section. However, we suggest that the term "plain language" be defined as provided in President Clinton's Executive Memorandum. (This memorandum states that "plain language" documents have logical orientation, easy-to-read design features, and use: (1) common everyday words (except for necessary technical terms), (2) "you" and other pronouns, (3) the active voice, and (4) short sentences.) In addition, to be meaningful, the report to Congress on compliance with this section should cover a period longer than 2 months.

Sec. 302. Call Report Simplification

Summary: This section requires the Federal banking agencies to jointly develop a system under which insured depository institutions and their affiliates may file call reports, savings association financial reports, and bank holding company consolidated and parent-only financial statements electronically, and make these reports and statements available to the public electronically. The agencies must report to Congress one year after enactment with legislative recommendations that would enhance efficiency for filers and users of these call reports and statements. In addition, the Federal banking agencies would be required to jointly adopt a single form for the filing of core information that is required to be submitted to all Federal banking agencies in these reports and statements, and to simplify, and establish, an index for the instructions for these reports and statements. Finally, each Federal banking agency would be required to review the information required by schedules supplementing this core information and eliminate requirements that are not necessary for safety and soundness or other public purposes.

OCC Comment: This section has already been enacted by Congress, and the Federal banking agencies are in the process of implementing its requirements. *See* section 307 of P.L. 103–325, the Riegle Community Development and Regulatory Improvement Act of 1994. Although the OCC supports simplifying the processes through which banks provide supervisory information, given the demands on computer systems associated with Year 2000 compliance, we do not favor a renewed requirement that would place demands on banks to reprogram their computer systems until after the industry has remediated its mission critical systems. Year 2000 compliance currently requires the full attention of information systems experts and contractors at banks and the Federal banking agencies.

Sec. 303. Purchased Mortgage Servicing Rights

Summary: This section amends section 475(a) of the FDI Act (12 USC 1828 note), which provides that purchased mortgage servicing rights (PMSR) may be included in calculating risk-based capital if, among other things, the servicing rights are valued at not more than 90 percent of their fair market value (10 percent haircut). Specifically, this section permits the appropriate Federal banking agencies to adjust or eliminate this haircut by permitting PMSRs to be valued at more than 90 percent of their fair market value, up to 100 percent, if they jointly find that such valuation would not have an adverse affect on the deposit insurance funds or on the safety and soundness of insured depository institutions.

OCC Comment: The OCC prefers this provision, which we jointly suggested with the other Federal banking agencies, over any proposal that would repeal this "haircut" altogether.

Sec. 304. Judicial Review of Receivership Appointments

Summary: Pursuant to section 11(c)(7) of the FDI Act (12 USC 1821(c)(7)), insured State depository institutions must bring suit against the FDIC for its decision to appoint the FDIC as conservator or receiver of the institution within 30 days of the appointment. Section 5(d)(2)(B) of HOLA (12 USC 1464(d)(2)(B)) also provides a 30-day statute of limitations for the challenge of the appointment by the Director of the OTS of a receiver or conservator of a thrift,

and section 203(b) of the Bank Conservation Act (BCA) (12 USC 203(b)) provides a 20 day statute of limitations for the appointment by the OCC of a conservator for a national bank. However, current law does not expressly provide a statute of limitations for a decision by the OCC to appoint a receiver of an insured or uninsured national bank. As a result, the general six-year statute of limitations for actions against the U.S. applies to these appointments, *see James Madison, Limited* v. *Ludwig,* 82 F.3d 1085 (1996).

Section 304 amends section 2 of the National Bank Receivership Act (12 USC 191) to make it consistent with the FDI Act, HOLA, and the BCA by imposing a 30-day statute of limitation on a national bank's challenge to the Comptroller's decision to place the bank in receivership. In addition, this section amends section 11(c)(7) of the FDI Act to place a 30-day statute of limitations for challenges to the appointment of the FDIC as receiver or conservator pursuant to other statutory authority.

OCC Comment: The OCC supports this section.

Sec. 305. Elimination of Outdated Statutory Minimum Capital Requirements

Summary: This section repeals section 5138 of the Revised Statutes (12 USC 51), which imposes minimum capital requirements for national banks ranging from $50,000 to $200,000, depending on where the bank is located. Section 5138 was first enacted in 1864 and last amended in 1935 and does not reflect current minimum capital ratio requirements that have been adopted pursuant to the authority in section 38 of FDI Act (12 USC 1831o) and section 908 of the International Lending Supervision Act (ILSA) (12 USC 3907). Section 908 of ILSA was enacted by Congress in 1983 and expressly requires the Federal banking agencies to establish adequate minimum capital requirements for banking institutions. Section 38 of FDI Act was enacted in 1991 and establishes a system of prompt corrective action based on capital levels.

OCC Comment: The OCC supports this section. Section 5138 is outdated and unnecessary in light of current law and should be repealed to avoid any confusion.

Sec. 306. Elimination of Individual Branch Capital Requirements

Summary: Section 5155 of the Revised Statutes (12 USC 36(c)) requires a national bank, in order to establish an intrastate branch in a State, to meet the capital requirements imposed by the State on State banks seeking to establish intrastate branches. Section 306 of this legislation would repeal this requirement.

OCC Comment: The OCC supports this repeal. The branch-by-branch capital requirement is obsolete and not necessary for safety and soundness. Moreover, under prompt corrective action, troubled banks are already subject to branching limitations. See 12 USC 1831o(e).

Sec. 307. Amendment Relating to Shareholder Notice Provisions Relating to Consolidations and Mergers

Summary: This section eliminates the requirement in 12 USC 214a, 215, and 215a that shareholder notice for meetings involving a consolidation or merger vote must be made by "certified or registered" mail. National banks still would be required to provide notice of the meeting to each shareholder of record by regular mail, and to publish notice in a newspaper of general circulation in the place where the bank is located.

OCC Comment: The OCC supports this section. Requiring the mailed notice to be certified or registered imposes unnecessary costs and burdens on national banks, without any significant offsetting benefit.

Sec. 308. Payment of Interest in Receiverships with Surplus Funds

Summary: This section amends section 11(d)(10) of FDI Act (12 USC 1821(d)(10)) to provide the FDIC with express rulemaking authority, with respect to receivership estates of insured depository institutions, to pay post-insolvency interest to creditors and to establish an interest rate on those payments following satisfaction of the principal amount of all creditor claims.

OCC Comment: The OCC defers to the comments of the FDIC on this provision.

Sec. 309. Repeal of Deposit Broker Notification and Recordkeeping Requirement

Summary: This section repeals section 29A of the FDI Act (12 USC 1831f–1), which requires a deposit broker to file a written notice with the FDIC before soliciting or placing any deposit with an insured depository institution. The FDIC has no enforcement power over deposit brokers, who are part of a generally unregulated industry.

OCC Comment: The OCC defers to the comments of the FDIC and Treasury on this provision.

Sec. 310. Elimination of Bank Merger Act Filing for Mergers of Institutions Within Bank Holding Company

Summary: A holding company seeking to merge or consolidate its bank subsidiaries must seek approval under the Bank Merger Act (section 18(c) of the FDI Act, codified at 12 USC 1828(c)). In addition, if the transaction involves an interstate bank merger, the transaction must comply with additional requirements pursuant to section 44 of the FDI Act (12 USC 1831u). Among other

things, the Bank Merger Act requires prior approval of the transaction by the appropriate Federal banking agency, following public notice of the transaction, and requires the agency in its review of the application to consider the financial and managerial resources of the institution and the "convenience and needs of the communities" affected by the merger. Under the BMA, the responsible agency must request a report on any likely competitive implications of the merger from the Attorney General and the other financial institution regulatory agencies. Unless an emergency exists, the agencies and the Attorney General have 30 days to submit the report. If the banking agency approves the merger transaction, it must notify the Attorney General. Generally, the merger transaction may not, however, be consummated for 30 days after the date of approval and an antitrust challenge to the merger must be initiated during that 30-day post-approval waiting period or not at all. If an emergency exists, the 30-day post-approval waiting period may be reduced. This waiting period is required by statute to allow the Justice Department time to file an objection if it so chooses. Furthermore, the CRA also applies to transactions requiring approval under the Bank Merger Act. Finally, if the transaction involves the merger or consolidation of banks resulting in a national bank, the transaction must be approved by the OCC pursuant to sections 2, 3, and 4 of the National Bank Merger and Consolidation Act (12 USC 215, 215a, 215a–1). These provisions also require notice of the shareholder meeting to vote on the proposed merger to be published in a newspaper of general circulation for four consecutive weeks prior to the meeting. This notice may be waived by a unanimous vote of the shareholders. OCC regulations require that only one application must be filed with the OCC for a "business combination," such as a bank merger and, thus, one application would satisfy the requirements of both the Bank Merger Act and national banking law. *See* 12 CFR 5.33.

Under the amendment made by section 310, mergers, consolidations, and acquisitions of assets or assumption of liabilities involving insured depository institutions that are subsidiaries of the same holding company are exempt from the Bank Merger Act if: (1) the responsible agency would not be prohibited from approving the transaction under section 44 of the FDI Act (interstate bank mergers), (2) the acquiring, assuming, or resulting institution complies with all applicable requirements of section 44 as if the transaction were approved under this section; (3) the acquiring, assuming or resulting institution provides its appropriate Federal banking agency written notification of the transaction 10 days prior to consummation, and (4) the agency does not require a Bank Merger Act application within this 10-day period.

OCC Comment: The OCC does not support this amendment as currently drafted because it is unnecessarily broad, unnecessarily reduces the role of the public in the affiliate bank merger process, reduces effective review of community-oriented issues including compliance with the CRA, and impedes the ability of the responsible agency to review the transaction for safety and soundness.

The amendment exempts all mergers of depository institution subsidiaries of the same bank holding company from the Bank Merger Act. The reason given for the proposal is that the antitrust review, convenience and needs analysis, public notice, and CRA review that the responsible agency considers under the Bank Merger Act in acting on an application to merge the depository institution subsidiaries are the same issues the Fed considers under the BHC Act in acting on the application to merge the parent holding companies. As drafted, however, the amendment covers other transactions for which there is no regulatory overlap. The amendment exempts all mergers of depository institution subsidiaries of the same bank holding company, including mergers that did not require BHC Act approval, *e.g.,* a corporate reorganization that does not involve an acquisition of an additional bank or a merger with another holding company. These transactions are only subject to the approval requirements of the Bank Merger Act. As a result of the amendment, however, these transactions will be totally exempt and will not be subject to any convenience and needs analysis, public notice, or CRA review, unless the responsible agency requires an application under the Bank Merger Act.[1]

In addition, we believe that the 10-day review period provided in this section does not provide adequate time to review the transaction for safety and soundness. For example, in the case of a merger involving a national and State bank, the OCC must contact and receive information from the appropriate State bank supervisor. A 10-day period would not always allow the OCC to receive and effectively evaluate this information. Also, the 10-day period will not provide adequate time for the OCC to fulfill its statutory responsibility under national banking law to approve any merger or consolidation in which a national bank is the resulting bank. In addition, the amendment provides no uniform criteria to guide the responsible agencies in determining whether to require an application.

Finally, the provisions in the amendment relating to interstate transactions that are subject to section 44 of the FDI Act are confusing. Specifically, it is unclear whether interstate transactions are covered by the amendment.

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[1] While the OCC would still retain the authority under the National Bank Merger and Consolidation Act to approve all merger transactions in which a national bank is the resulting bank, that Act does not duplicate the convenience and needs test, the CRA review, or the public notice requirements that apply if a transaction is approved under the Bank Merger Act.

As an alternative approach to streamline the merger process in the case of proposed transactions to merge or consolidate affiliated institutions, the Bank Merger Act application process could be retained, but modified to eliminate unnecessary delays in consummating transactions that are competitively neutral. Under this approach, these transactions would still be reviewed by the appropriate Federal banking agency under the Bank Merger Act, and CRA issues could still be considered in approving the transaction.

Sec 311. Allowances for Certain Extensions of Credit to Executive Officers

Summary: This section provides a specific statutory exemption to the insider lending rules by amending section 22(g) of the FRA (12 U.S.C. 375a) to permit executive officers to obtain home equity lines of credit up to $100,000 and loans secured by readily marketable assets with a fair market value that is not less than twice the amount of credit extended.

OCC Comment: The OCC believes that the Subcommittee should proceed cautiously with the relaxation of insider lending limits proposed in section 311. As a whole, these insider lending limits provide important safeguards including protections against valuation issues arising with collateral provided in transactions by bank insiders. Over time there has been a series of reductions in these limits and we urge the Subcommittee to examine the cumulative effect of earlier liberalization in this area.

Sec. 312. Repeal of Federal Reserve Act Lending Limit

Summary: This section repeals section 11(m) of the FRA (12 USC 248(m)), which prohibits a member bank from making loans secured by stocks or bonds to one borrower in excess of 15 percent of the bank's unimpaired capital and surplus.

OCC Comment: The OCC supports repealing this obsolete provision. Section 11(m), as enacted, set a limit of 10 percent (raised to 15 percent in 1994), which at the time corresponded to the 10 percent lending limit applicable to national banks under 12 USC 84. In 1982, Congress raised the lending limit in section 84 to 25 percent of unimpaired capital and surplus (not more than 15 percent of which may be unsecured), but did not raise the corresponding limit in section 11(m). This produces anomalous results. For example, if a bank has loaned to one borrower an amount equal to 10 percent of its unimpaired capital and surplus, and those loans are secured by stocks or bonds, section 84 allows that bank to lend an additional 15 percent of its unimpaired capital and surplus on an unsecured basis to that borrower. However, if the borrower does not qualify for an unsecured loan under the bank's credit criteria, section 11(m) prohibits that bank from making a loan secured with stocks or bonds in excess of 15 percent, even though the borrower has this additional collateral available. Section 11(m) thus hinders a bank's ability to collateralize its loans to the maximum extent possible and, thus, is inconsistent with safety and soundness.

Sec. 313. Repeal of Bank Holding Company Act Provision Limiting Savings Bank Life Insurance

Summary: Section 313 repeals section 3(f) of the BHC Act (12 USC 1842(f)). Section 3(f) provides that a qualified savings bank (a savings bank organized prior to March 5, 1987) that is a subsidiary of a bank holding company may engage directly or through a subsidiary in any activity permissible under State law notwithstanding any other provision of the BHC Act (except for the restrictions in section 3(f)). However, section 3(f) also provides that the insurance activities of qualified savings banks are limited to those permissible for nonbank affiliates of bank holding companies under section 4(c)(8) of the BHC Act *(i.e.,* credit-related activities or agency activities conducted in a place with a population of under 5,000) unless the qualified savings bank is located in Connecticut, Massachusetts, or New York and was permitted under State law to engage in the sale or underwriting of savings bank life insurance as of March 5, 1987. In addition, section 3(f) provides that the grandfathered authority to engage in savings bank life insurance will terminate if the savings bank is acquired by a company which is not a savings bank or a savings bank holding company, unless the activity is otherwise authorized under the BHC Act.

OCC Comment: The OCC does not object to the repeal of section 3(f). We recommend that the legislative history for this provision point out that section 3(f) is no longer needed in light of subsequent judicial clarifications of the BHC Act, and legislation subsequently enacted by Congress, notably section 24 of the FDI Act.

Title IV—Disclosure Simplification

Sec. 401. Alternative Disclosure for Variable Rate, Open-Ended Home Secured Credit

Summary: This section amends section 127A(a)(2) of the Truth in Lending Act (TILA) (15 USC 1637(a)(2)) to allow a creditor to provide a statement that "periodic payment may increase or decrease" in lieu of the 15-year historical table currently required for a variable-rate, open-end, consumer credit plan secured by the consumer's principal dwelling. Section 127A(a)(2) continues to require a creditor to provide the maximum APR and the associated minimum payment. (Section 2105 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 amended TILA to provide a similar change for closed-end, variable-rate loans.)

OCC Comment: The OCC takes no position on the substance of this section. However, we note that the Mortgage Reform Task Force, formed pursuant to the requirement in section 2101 of the EGRPRA that HUD and the Fed unify RESPA and TILA disclosures, is examining the issue of annual percentage rate disclosure generally.

Sec. 402. Alternative Compliance Methods for Advertising Credit Terms

Summary: Subsection (a) of this section amends section 144(d) of TILA (15 USC 1664(d)) to eliminate: (1) the number of installments, and (2) the period of repayment, as terms that, if disclosed by a lender, trigger additional disclosure regarding the down payment, terms of repayment, and APR in closed-end credit advertisements.

Subsection (b) adds a new section 148 to TILA (15 USC 1661 *et seq.)* to provide an alternate disclosure method for radio and television advertisements. The disclosures that currently apply to radio and television advertisements under TILA are found in sections 143, 144(d), and 147(a) and (e) (15 USC 1663, 1664, and 1665b, respectively). Section 143, which applies to open-end plans, requires disclosure of any minimum or fixed amount, the periodic rates expressed as an APR (if periodic rates may be applied), and any other term required by the Fed's regulations (currently, 12 CFR 226.16(b)(3) requires disclosure of any membership or participation fee). As indicated above, section 144(d), which applies to closed-end plans, requires disclosure of the down payment, the terms of repayment, and the finance charge expressed as an APR if certain triggering terms are used in the advertisement. Section 147(a), which applies to open-end, home-secured plans, requires disclosure of loan fees and opening cost estimates, the periodic rates expressed as an APR (if periodic rates may be applied), the highest annual percentage, and any other information required by the Fed's regulations (currently none) if the advertisement states specific terms of the plan. Section 147(e) requires the disclosure of any required balloon payments in the case of open-end, home-secured loans if the advertisement mentions a minimum monthly payment.

Section 402 of this legislation provides that a radio or television advertisement meets the disclosure requirements of sections 143, 144(d), and 147(a) and (e) if it clearly and conspicuously discloses: (1) the APR of any finance charge (and, with respect to an open-end plan, the simple interest rate or the periodic rate); (2) whether the interest rate may vary; (3) if the advertisement states an introductory rate, the period during which any introductory rate is in effect and the APR that will be in effect after any introductory period, with equal prominence; (4) the annual fee, with respect to an open-end plan; (5) a toll-free telephone number from which a consumer may obtain additional information; and (6) a statement that the consumer may use the telephone number to obtain further details about the terms and cost of the credit. The telephone number must be available beginning not later than the date of first broadcast and ending no earlier than 10 days after the final broadcast, and the creditor must provide all information otherwise required by TILA orally by telephone or, if requested, in writing.

OCC Comment: The OCC is concerned that these changes to TILA may deprive consumers of material terms (such as the amount of any down payment, repayment terms, highest possible APR, and balloon payment requirements) that are key to making informed credit decisions, particularly in the case of home equity loans.

Title V—Bank Examination Report Protection Act

Sec. 501. Amendment to the Federal Deposit Insurance Act

Summary: This section adds a new section 45 to the FDI Act as set forth at 12 USC 1811 *et seq.* to establish a bank supervisory privilege to protect confidential supervisory information, such as depository institution examination reports or supervisory correspondence or other documents relating to an examination. Recent court decisions have weakened the confidential status of supervisory information, which is the foundation for the supervisory process.[2]

Specifically, new section 45 provides that all confidential supervisory information is the property of the Federal banking agency that created or requested it and is privileged from disclosure to any other person. Persons in possession of this information are prohibited from disclosing it without prior authorization of that Federal banking agency, with certain exceptions. In addition, this section provides that when a depository institution submits any information to a Federal, State or foreign banking agency or authority, the institution has not waived, destroyed, or otherwise affected any privilege it may claim with respect to that information under Federal or State law. This section also provides that the same privilege created by this section exists, in any court proceeding to compel production or disclosure, for information or documents prepared

[2] *See, e.g., In re Bankers Trust,* 61 F.3d 465, 470 (6th Cir. 1995) (holding that litigants seeking information from the Federal Reserve Board (FRB) need not subpoena the FRB for the information and instead may obtain the FRB's confidential information from a defendant bank); *Schreiber* v. *Society for Savings Bancorp,* 11 F.3d 217, 220 (D.C. Cir. 1993) (holding that the bank examination privilege protects only agency opinion from disclosure and does not protect factual information about an institution); *Frankford Trust Co.* v. *Advest Inc.,* 1995 U.S. Dist. Lexis 11825 (E.D. Penn, Aug. 25, 1995) (not reported) (holding that the work product privilege is waived by disclosure of privileged information to a bank regulatory agency).

by a State bank supervisor or foreign bank regulatory or supervisory authority.

However, the privilege created by section 45 does not prevent duly authorized committees of the United States Congress or the Comptroller General of the United States from obtaining access to this information. In addition, the Federal banking agencies may waive this privilege, in whole or in part, at their discretion, and may authorize access to confidential supervisory information for any appropriate governmental, law enforcement, or public purpose in accordance with agency regulations and orders without waiving any privilege.

This section also establishes specific procedures for obtaining confidential supervisory information from the originating Federal banking agency. It also provides definitions for "confidential supervisory information," "supervisory process," and "financial institution" Finally, this section authorizes each Federal banking agency, after consultation with the other Federal banking agencies and the National Credit Union Administration (NCUA), to issue regulations that implement this section.

OCC Comment: The OCC supports this section. In a letter to Rep. McCollum dated September 17, 1997, the OCC, along with the other Federal banking agencies and the NCUA, expressed their support for this legislation. Specifically, this section will help preserve the cooperative, non-adversarial exchange of information by supervised institutions with their examiners and the candid internal analysis of examiners, by codifying and strengthening the examination privilege. Second, the proposed legislation will enforce existing, nationwide uniform procedures for handling and accessing supervisory information, requiring third party litigants to seek supervisory information directly from the Agencies and not indirectly from the supervised institutions. Third, the proposed legislation will resolve the supervised institutions' concerns that their privileges will be waived if they voluntarily permit the Agencies to have access to privileged information that is otherwise valuable to an examiner's assessment of safety and soundness. The proposed legislation favorably resolves many of the unsettled issues regarding the handling of and access to supervisory information, while preserving a process, including judicial review, by which third parties may seek access to supervisory information in appropriate circumstances.

Sec. 502. Amendment to Federal Credit Union Act

Summary: This section adds a new section 215 to Title II of the Federal Credit Union Act (12 USC 1781 *et seq.)* to establish a credit union supervisory privilege and the procedures for obtaining confidential supervisory information in the case of Federal credit unions and the NCUA. This privilege and these procedures are essentially identical to the privileges and procedures established by section 501 that apply to the Federal banking agencies and depository institutions.

OCC Comment: The OCC supports this section, for the same reasons provided in our comments to section 501.

Title VI—Technical Corrections

Sec. 601. Technical Correction Relating to Deposit Insurance Funds

Summary: This section amends an incorrect citation in section 2707 of the Deposit Insurance Funds Act of 1996 (P.L. 104–208, 110 Stat. 3009).

OCC Comment: The OCC supports this technical correction.

Sec. 602. Rules for Continuation of Deposit Insurance for Member Banks Converting Charters (Technical Error in Section 8(o) of FDI Act)

Summary: This section amends an incorrect citation in section 8(o) of FDI Act (12 USC 1818(o)).

OCC Comment: The OCC supports this technical correction.

Sec. 603. Waiver of Citizenship Requirement for National Bank Directors

Summary: Section 5146 of the Revised Statutes (12 USC 72) requires that the directors of a national bank must be citizens of the United States and that a majority of the directors must live in the same State where the bank is located, or within 100 miles of an office of the bank. The Comptroller may waive the State residency requirement, pursuant to section 2241 of P.L. 104–208, the Economic Growth and Regulatory Paperwork Reduction Act of 1996. As drafted, however, section 2241 inadvertently deleted the long-standing authority of the Comptroller to waive the citizenship requirement for up to a minority of directors of national banks that are subsidiaries or affiliates of foreign banks. In a colloquy on the Senate floor at the time P.L. 104–208 was being considered for final passage, Sens. Mack, D'Amato, and Graham stated that deleting the citizenship waiver authority was a technical drafting error and directed the OCC to treat the authority as unchanged until Congress could correct the error.

This section corrects this technical error. In addition, this section gives the Comptroller the authority to waive the citizenship requirement for up to a minority of directors for any national bank, whether or not affiliated with a foreign bank. This change would parallel the authority the Comptroller has to waive the residency requirement for directors of any national bank.

OCC Comment: The OCC supports this section.

Sec. 604. Technical Correction to Prohibition on Comptroller Interests in National Banks

Summary: Section 329 of the Revised Statutes (12 USC 11) prohibits the Comptroller and Deputy Comptroller from having an interest in any association issuing national currency. This section amends 12 USC 11 to reflect the fact that national banks no longer issue national currency. The section, however, maintains the purpose of the original provision and it prohibits the Comptroller and Deputy Comptroller from owning interests in the national banks they regulate.

OCC Comment: The OCC supports this section.

Appendix 2

Measuring the Effectiveness of the OCC's Regulation Review Program (July 1998)

This report, "Measuring the Effectiveness of the OCC's Regulation Review Program," is submitted to Acting Comptroller Julie L. Williams and the members of the Executive Committee by the Regulation Review Effectiveness Measures Team.

The Measures Team is led by Karen Solomon, director, Legislative and Regulatory Activities Division. Its members are: Rusty Thompson, district accountant, Southwestern District; Cindy Petitt, director, Organizational Effectiveness Division; Joanna Hadley, attorney, Legislative and Regulatory Activities Division; and Nancy Jones, executive assistant to the Comptroller.

The Measures Team wishes to thank Bill Grant, Joanne Buck, Mark Tenhundfeld, Karen Proctor, and all of the focus group participants for their contributions to our work.

I. Introduction

One of the OCC's major objectives in 1997 was to implement effectiveness measures for OCC programs, processes, and projects. The OCC's Regulation Review Program was one of the first areas of the OCC's operations to be evaluated using effectiveness measures. The program was evaluated on how well it reduced regulatory burden, promoted competition, improved the clarity of the OCC's rules, produced risk-focused and results-oriented regulations, and encouraged public participation in OCC rulemaking. During 1997, the staff team assigned to measure the program's effectiveness (referred to in this report as the Reg Review Measures Team or simply the Measures Team) convened 14 focus groups to help with the evaluation. Each group was homogeneous, comprising either bankers, private sector banking lawyers, community group representatives, or OCC staff.

In general, the tone of the sessions was positive. Most groups thought that the Regulation Review Program was a positive step toward reducing burden; they saw meaningful improvement in the OCC's rules. They gave the agency credit for trying to modernize its rules to keep up with developments in the financial services business. Participants in all of the groups appreciated the opportunity to provide their views on the program. The measures effort has thus had the secondary benefit of reinforcing the OCC's accessibility and interest in understanding the practical consequences of its programs.

All of the bankers who commented favorably on the OCC's rules praised something specific. For example, many thought that the new streamlined corporate application process cuts costs and produces quicker results. Many applauded the new suspicious activity reporting system implemented jointly by the OCC and other agencies because it greatly reduces the number of required filings. Thus, there is no question about which changes bankers appreciated most: the ones that saved the most time, that saved the most money, that granted the most promising new powers.

Nearly everyone who evaluated the program also spoke of things the OCC should do better or differently. These suggestions,[1] which make up much of this report, will help senior OCC management to view the OCC's priorities in the light of what bankers, OCC staff, and others think they should be.

The OCC is already addressing some of most common concerns that were mentioned. For instance:

- Some examiners said that they would like additional training in new products and services so that they can better supervise a changing industry. Continuing education is now one of the OCC's top priorities. The Continuing Education Division has undertaken a number of initiatives intended to enhance the agency's training programs. These include the implementation of a Senior Examiner Training Program, which will be expanded to all OCC employees in 1998.
- The frequency with which the subject of the Community Reinvestment Act (CRA) arose suggested that the OCC should continue to look at ways to refine CRA implementation. In fact, we are. This year, for example, the OCC is pilot testing (in six large banks) ways to improve large-bank CRA exams. Moreover, the OCC is working with the other federal banking agencies to make more uniform the agencies' approaches to CRA exams and CRA ratings.

[1] Not all of the suggestions were targeted with precision to issues that the program was intended to address, however. The focus group format is designed to stimulate discussion among the participants. Conversation in the sessions sometimes turned to topics beyond the scope of the Regulation Review Program, and some of the concerns raised went beyond what the program was intended to achieve. This material is included in our summaries nonetheless because the Measures Team thought that the credibility of the project depended on our willingness to present what we had heard in a reasonably transparent way and because we thought OCC senior management would be interested in knowing what issues were most on the minds of the participants even if those issues went beyond the parameters that the OCC had established for the program.

Such work will be the foundation for the initiatives that follow from the Measures Project.

Section II summarizes the perspectives of each type of focus group. Section III is a detailed description of participants' comments and is arranged by topic. Section IV describes the Measures Team's method. Appendix A presents the results quantitatively by focus group. Appendix B is an annotated list of regulations commonly praised or criticized by participants.

II. Summary of Findings

Set forth below are the principal findings that resulted from discussions in the focus groups, presented by category of participant.

The Perspective of Bankers and Private-Sector Banking Lawyers

Bankers assess their relationship with the OCC primarily on examinations and their interaction with examiners rather than the regulations we issue. That relationship has improved significantly over the past several years, and bankers attribute the improvement to the favorable climate that the OCC has created, in part, through its Regulation Review Program. Bankers tend to withhold judgment about regulatory initiatives until they have experience with the way the new initiatives are implemented.

The new regulations that most favorably impressed bankers tended to be the ones that had the most direct and immediate impact on banks' day-to-day operations and near-term business planning. Banker groups, as well as most others, singled out the OCC's streamlining of its application process in 12 CFR 5 (part 5) for special favorable mention. Many bankers not only commented favorably on the new framework for applications processing contained in part 5 but also reported their experience that the new process is working well. Most groups, especially banking lawyers, urged the OCC to eliminate more types of applications and rely on after-the-fact notices for more types of activities.

A number of bankers and banking lawyers also reacted positively to the revisions of the CRA regulations. They generally agree that the new CRA rules cut paperwork and shift the emphasis to performance. Some banking lawyers, however, believe that the OCC missed an opportunity to achieve even greater burden reduction when it revised the CRA rules. Some bankers said that CRA should be eliminated altogether.

Bankers—and most other groups—identify the operating subsidiary (op sub) provisions of the new part 5 as the OCC's single most important contribution to promoting banks' ability to compete. Even some banks that don't currently intend to file op sub applications under part 5 nonetheless believe that the potential it offers for expanded activities will strengthen the national bank charter. The larger banks and their lawyers are anxious for prompt implementation; they want to see new activities approved quickly. But opinion is split between large and small banks. Some smaller banks worry that the new part 5 will result in a loss of their business to larger banks better positioned to provide a broader array of financial services.

Regardless of size, banks are worried about their ability to stay competitive. Bankers believe they are disadvantaged when competing with such firms as finance companies that are regulated lightly or not at all and with others that enjoy special benefits not available to national banks. For example, bankers cited as anti-competitive the tax benefits granted to credit unions. Some community bankers believe that their organization has no long-term future because it will not be able to withstand competitive pressures.

Bankers say they get too much information and that they don't have time to read much of what they get. Bankers and their lawyers want the OCC to help them manage the information they get. The way information is organized and transmitted is important to them.

Community Group Perspective

The process used to revise the CRA rules was, in the opinion of the community group representatives, a good example of how the OCC should obtain community input. These participants thought the OCC's processes fell short in other areas, however. In particular, some said that the OCC's outreach in connection with the revisions to part 5 was too little, too late.

Community group representatives think that national banks still fall short in their service to low- and moderate-income communities. National banks, they say, are content with involvement in projects that will bring CRA credit. They are not seeking to develop low- and moderate-income markets by providing a full range of products and services to these consumers.

The OCC should do better in making information available to the public. For example, the community group representatives want better access to all of the materials that accompany regulations, such as examiner guidance and interpretive letters. They also thought the OCC should provide more and better information about how its rules are being used—for example, about the volume and types of applications the OCC has received under the new part 5. Finally, they thought the OCC should take better account of the resource limitations of public interest groups—for example, by lengthening the com-

ment period on proposed regulations and improving its community contacts database.

OCC Staff Perspective

Like bankers, the OCC's examiners believe the banker–examiner relationship is much better today than it was five years ago, and they, too, attribute improved relations to the favorable climate that the OCC has worked to establish through initiatives like the Regulation Review Program. Examiners believe that building good working relationships with key people in the banks they supervise is essential to effective supervision. Examiners also believe that those relationships reflect greater mutual trust than in the past and, as a result of this increased trust, that they can supervise banks in a less adversarial way.

Examiners believe that the OCC has been especially effective in adding value to the national bank franchise. They attribute this added value to the reduction in assessments and corporate fees, the potential for banks to pursue new, innovative business opportunities that is implicit in the part 5 operating subsidiary provisions, and the progress the OCC has made in areas such as national bank insurance powers.

At the same time, examiners express concern about keeping pace with the evolution of products and services in the national banking system. They understand that banks, especially the smaller and less sophisticated banks, look to the OCC for guidance on evaluating the risks posed by some new business lines and identifying ways of managing those risks appropriately. They believe the OCC's field staff should be positioned to step into that role, and they are eager to participate in training that helps them stay current with developments in the industry. Some examiners would also like to see field staff have more influence on OCC policy and decisions on applications.

The OCC's examiners believe they're not always getting the right kind of information to do their jobs. Examiners would like additional training on the OCC's new rules. They want help in understanding precisely how new regulatory requirements differ from the old so that they can more effectively apply the new requirements and advise bankers about how to apply them. They want help in understanding why the OCC has changed regulations so that their judgment on the particular matters they handle can be informed by an understanding of the OCC's broader objectives.

Examiners say that they simply do not have enough time to read all the paper the OCC sends them. The format of our regulations makes them difficult for examiners to use; they would prefer summaries (like those that the trade organizations put out for their bank members), examples, and information presented in a question-and-answer format like the CRA questions and answers that the banking agencies published and revise from time to time.

III. Focus Group Participants' Comments by Topic

This section presents a more detailed summary of the comments made by focus group participants. In addition to forming the basis for the grade the participants gave the Regulation Review Program (grades are on a four-point scale), the OCC's standards for developing regulations provided a useful framework for the discussion. The discussions of certain standards, especially reducing regulatory burden, touched on other standards as well.

A. Reducing Burden

The combined score given the program by both external and internal focus group participants and by survey respondents in the area of regulatory burden reduction was 2.9 [appendix A]. Those who answered the written survey questions gave the lowest grade for burden reduction—2.3; lawyers at the Cleveland outreach session gave the highest—3.6.

1. Positives

The clearest positive theme to emerge from the discussion with bankers and banking lawyers about burden reduction is that bankers assess their relationship with the OCC based on examinations and their interaction with examiners and that the relationship has improved noticeably. These groups were aware of the Regulation Review Program, understood generally what the OCC was trying to accomplish, and could usually cite particular areas where they thought the OCC had done well in rewriting its rules or, conversely, where there was still room for improvement. But given an opportunity to "talk back" to the OCC, nearly all external focus group participants wanted to discuss the examination process at their (or their client's) bank and their organization's relationship with the OCC's examiners. Thus, bankers experience regulatory burden, or liberation from burden, most directly at the examiner level.

For the most part, both bankers and OCC staff report that the banker–examiner relationship has improved significantly in the past five years. Bankers generally thought there was better communication between their bank and OCC staff today than previously. Participants at the Independent Bankers Association of America (IBAA) meeting saw OCC staff as having a more positive attitude than before, and they thought that staff members were more willing to consider the circumstances unique to each bank. American Bankers Association (ABA) participants saw an improvement in OCC staff members'

understanding of the regulations and an increase in staff responsiveness to questions.

Similar points were made by OCC staff members in the Central, Southwestern, and Southeastern districts. Staff saw a good working relationship between examiner and banker as essential to successful supervision, and they believed that their relationship with bankers is more positive now than previously. They thought that communication between bankers and examiners had improved and that banks are less likely now than before to view the OCC as an adversary. They attributed these positive developments, in part, to the more open, positive supervisory approach exemplified by the Regulation Review Program. Some credited former Comptroller Ludwig personally for the agency's efforts to improve communications with banks and for the generally positive perception that the OCC is willing to take positions that enhance the national bank charter.

Bankers and examiners also generally agreed about which of the program's changes were the best and most important. They tended to single out for favorable mention the rules that had an immediate effect on banks' day-to-day operations and near-term business planning. The rules most frequently mentioned were the revisions to the corporate application processes in part 5 (ATM and branching applications were mentioned often) and the shift in emphasis from paperwork to performance in the revised CRA regulations. Banking lawyers also generally praised the new application procedures in part 5, but thought that the OCC could reduce the time for applications processing even more. According to some participants, the OCC's program had the added benefit of spurring other agencies to try to reduce burden as well. Most bankers thought it was important for the OCC to continue to work with other agencies to produce uniform regulations whenever possible so that similar charters are regulated in the same way.

2. Areas for Improvement

While participants in every group praised the OCC for the tenor and direction of its regulatory changes, most groups complained about the burden resulting from the large quantity of new information associated not only with comprehensive regulatory change pursuant to the program (and other OCC initiatives such as supervision by risk) but also with running a business in a heavily regulated industry.

In this regard, bankers, banking lawyers, and examiners all cited circumstances in which national banks, or banks generally, are regulated more heavily than their competitors. Most frequently mentioned were compliance rules, especially the CRA. Many banker and examiner participants agreed that the CRA revisions, undertaken jointly by the OCC and the other federal banking agencies, succeeded in shifting the regulatory emphasis from paperwork to performance and that the new rules are a substantial improvement over the old. But they pointed out that other types of financial institutions are not subject to the increased cost and burden of CRA. Some community bankers thought CRA unnecessary as a substantive matter because it's simply the business of community banks to lend to their communities. Some participants in nearly every group advocated that the CRA be eliminated.

Some examiners raised concerns about the implementation of the new CRA rules, saying that the rating process is frustrating for field staff because the rules are not always consistently interpreted at the examiner, district, and headquarters levels. Similarly, community group representatives thought that the CRA rules are not consistently implemented from one geographic district to another.

Bankers believe that they get too much information from regulators and that they are required to provide too much information to regulators. They complain that the OCC sends them much more paper than they have time to read. This is a problem particularly for smaller banks that do not have large in-house legal or compliance staffs. As for the information that banks are required to provide, bankers urged the OCC to do more to reduce the number of applications that must be filed and the amount of information that must be included in the applications they do file. The message was, "Go further, do more."

Similarly, OCC staff thought that the program had changed the rules enough for a while and that the OCC should let banks catch up and digest the new rules before embarking on another series of changes. They, too, get more information than they can assimilate. In addition, OCC examiners said they want information that helps them implement the new regulation changes and answer questions from bankers. One examiner cited the final changes to 12 CFR 1 (part 1), the OCC's investment securities rule, as an instance in which the OCC communicated more effectively with bankers than with examiners.

Moreover, many district staff members believe that the OCC needs to do more "to help the field help the bank." Their suggestions included providing training (including the use of technologies like teleconferencing, training videos, and the Internet) to examiners about new regulations and the supervision of new lines of business. In addition, they want more help from the rule-writers in understanding quickly how the new rules differ from the old. They would like plain-language versions of rules that, from their perspective, are still written in "legalese."

Other suggestions for improving the OCC's regulations included: making the quarterly lending limit calculation

optional so banks could take advantage of mid-term increases in capital and making the 18-month examination schedule optional for certain small institutions. Some community bankers said they would prefer for examiners to come to their bank more often but stay for less time. Finally, participants in a number of the OCC staff groups thought that the OCC's regulations would be improved if front-line examination staff had direct input during their development.

B. Promoting Competition

The program achieved a 3.1 rating on promoting competition from external respondents and a 3.3 from internal respondents. The Internet survey respondents, the Cleveland lawyers, and the Central District staff gave the program the highest ratings in this category—3.7, 3.6, and 3.5, respectively. The ABA gave it the lowest rating—a 2.6.

1. Positives

By far the program initiative most frequently mentioned as a positive for promoting competition was the revision of the operating subsidiary provisions in part 5. Bankers, banking lawyers, and OCC staff all thought that the potential for expanded business opportunities presented by these provisions was significant and welcome. Participants also cited the OCC's reduction of assessments and fees and its work (and litigation successes) on national bank insurance powers as furthering national banks' ability to compete. More generally, bankers, banking lawyers, and OCC staff praised the OCC's "can-do" attitude and willingness to entertain new business ideas as beneficial to competitiveness.

2. Areas for Improvement

While the respondents' reaction to the operating subsidiary provisions of part 5 was generally enthusiastic and positive, some participants expressed reservations. Some community bank participants thought that part 5 might be "too progressive," that it would favor large, multi-state banks, and could ultimately cause more harm than good. On the other hand, the banking lawyers' groups were concerned that part 5 would not be implemented quickly enough or that the OCC would not go far enough in approving new activities in operating subsidiaries.

A common theme in the discussions about national bank competitiveness was that it is constrained in ways that the OCC does not control. For example, many participants believe that Congress does not fully understand or appreciate the competitive pressures on national banks and urged the OCC to take the lead in educating members of Congress about the importance of true modernization in the financial services industry.

Frequent mention was made of the inequities in the rules that apply to national banks as compared with their competitors. Some participants pointed to the tax advantages enjoyed by credit unions. And, as mentioned in the discussion on reducing regulatory burden, others focused on the fact that CRA does not apply to all lenders that compete with national banks. Still others noted that even when the same rules apply (*e.g.*, the Real Estate Settlement Procedures Act applies to finance companies), competitors not subject to on-site examination and regular supervision can "get away with" violations and thus lack the same incentive to comply. Some participants said that the delays and other burdens on consumers resulting from a bank's compliance with regulatory requirements cause them to lose business. Many participants thought that the disclosures required by some laws—Truth in Lending and Truth in Savings, for example—were unnecessary and that customers did not particularly need or want them.

C. Clarity

"Clarity" is the shorthand term that the Measures Team used for the standard calling for rules that can be understood by reasonably knowledgeable users. Under this heading, focus group participants also frequently discussed the accessibility of the information that the OCC maintains. Of the six standards, clarity was rated the lowest with a 2.8 grade point average overall—2.7 from the internal groups and 2.9 from the external groups. The grades ranged from a low of 2.3 (Central District) to a high of 3.3 (Cleveland lawyers).

Most participants in most focus groups admitted that they do not actually read the OCC's rules, or that they read them only when the exact phrasing is central to resolving the issue at hand. Predictably, lawyers are the most frequent and regular users of the OCC's rules, and therefore it is perhaps encouraging that attorneys gave clarity the highest grade (3.2). On the other hand, clarity got low scores from examiners (2.6) and community group representatives (2.4).

1. Positives

Bank counsel, as well as OCC lawyers, thought the revised rules were clearer and easier to read than before. Private sector lawyers in one session thought the improvements had reduced their clients' need to seek interpretations from the agency. Participants in several groups found that the preambles provided helpful explanations of the regulation text.

In most groups, discussions about the clarity of the OCC's rules tended to expand to include access to the information that the OCC maintains. Many participants liked the fact that the OCC's regulations are now available on our Web site on the Internet.

Many participants indicated that uniform interagency guidance is very useful. The interagency guidance helps

eliminate interagency differences. A participant at the ABA focus group suggested that one agency be designated as the lead for each regulation. Other agencies would then follow the lead agency's interpretations.

2. Areas for Improvement

Examiners said they continue to find the OCC's regulations difficult to read. This difficulty is primarily due to the way regulations are structured *(i.e.,* many numbered paragraphs, subparagraphs, and clauses) and the writing style (long sentences written in "legalese"). Many examiners thought that a variety of other formats—including executive summaries of regulations like those provided by industry trade groups, bullet-point explanations, questions and answers, and examples of how the regulation applies—would be better for communicating the OCC's standards both to bankers and examination staff than the format we currently use.

Several participants recommended putting *all* regulations and interpretations on the Internet. Community group representatives stressed that they cannot evaluate how the OCC regulates without access to the materials that accompany or interpret regulations. These representatives urged the OCC to provide better access to all the guidance materials that the OCC uses in its supervision. They suggested that the OCC should consult with users of new technologies in general and community groups in particular as we design new information delivery systems so that the systems are as helpful as the OCC intends. They specifically mentioned that the OCC's Web site, which some find difficult to use, could benefit from suggestions from users.

Most participants said that the ability to search quickly through all of the regulations and interpretations electronically to find the applicable cites would be very helpful. Participants in the OCC staff groups were optimistic that the OCC's Internet would be helpful in giving them better access not only to regulations but also to preambles and interpretive letters. The consensus among all participants was that the OCC should make more information available electronically in searchable form. Examiners did point out that they continue to have problems with access even with increased use of electronic communication because they may not have Internet access at the banks they examine.

Participants in some groups also talked about the effectiveness of the OCC's other means for communicating policies and standards. Participants in two of the lawyers' groups thought that the differences in weight and enforceability between regulations and other types of issuances, such as bulletins and handbooks, are not always recognized by examiners. Reaction to the new, bound version of the *Comptroller's Handbook* was mixed. Some participants—mostly bankers—like the new handbook, saying it is more direct and easier to use than the OCC's regulations. Others—mostly lawyers—said they prefer the old, loose-leaf version because it included a subject index.

D. Risk-Focused and Results-Oriented Regulations

This standard advocates efficient regulations. The objectives are for the OCC to choose subjects for regulation that are important, rather than trivial, and to design regulation so that national banks are required to achieve a result rather than to complete paperwork or compliance steps. Participants gave the OCC an overall score of 2.8 on this measure—2.9 for internal focus groups and 2.8 for external groups.

1. Positives

Overall, bankers and examiners are seeing a change in attitude that is resulting in a more reasoned and risk-focused approach to supervision. Bankers cited several examples of regulatory changes that reflect OCC's objectives of focusing on the results we are trying to achieve and areas where risks are greatest. These examples include: performance-based CRA, flexibility under 12 CFR 9 (part 9), the op sub provisions of part 5, 12 CFR 7 (part 7), and recently issued guidance in risk areas such as interest rate risk.

2. Areas for Improvement

Bankers and examiners felt that there was still significant opportunity to make regulations more risk-focused, and bankers were particularly concerned about how examiners would practice supervision by risk. Bankers, attorneys, and examiners thought that a number of regulations continue to be too focused on areas that pose insignificant risk. Where there is risk, they felt that the OCC should offer banks broader flexibility in the management of those risks. The consumer regulations were cited most often as requiring banks to demonstrate compliance with a series of steps that did not necessarily produce the intended or desired regulatory objective. The Bank Secrecy Act (BSA) requirements were cited several times as an example of where the benefits of regulations are unclear. Those mentioning BSA said that, despite the significant cost of collecting and reporting the required information, there is no indication that the information ever leads to prosecution.

Banker concerns about supervision by risk centered on several issues:

- How risk ratings will be used and whether they will be publicly disclosed (and how a bank's disagreement with its examiner over the appropriate risk rating will be resolved);

- Whether front line examiners fully understand supervision by risk; and
- The OCC's need to better focus its examinations on lines of business that present increased risk whether the activity is conducted in the bank itself or elsewhere in the bank's organizational structure.

E. Public Participation

1. Positives

The community group representatives were the group best able to evaluate whether the OCC effectively invites and uses public input in its rulemaking processes. The community group representatives cited the development of the revised CRA regulations, which included a series of public interagency hearings across the nation and two separate opportunities for comment on proposed regulations, as a good example of how the OCC can successfully obtain community input.

2. Areas for Improvement

At the same time, the groups believed that the OCC can and should do more to generate public participation, and they recommended several strategies, including more outreach to community groups, outreach on more topics than those that are traditionally considered the groups' areas of interest, and outreach "beyond the Beltway" to groups with important constituencies that do not necessarily have a Washington presence.

The community group representatives also urged the OCC to do what it can to address the problems created by the scarcity of resources from which many groups typically suffer. For example, they thought that a 60-day comment period is usually too short for their meaningful review and comment and that 90-day or, preferably, 120-day comment periods would more likely allow for meaningful input by community groups. Similarly, the groups found advance notices of proposed rulemaking particularly useful to enable their staffs to become acquainted with issues before a proposed rule is released.

IV. Method

The OCC initiated a review of all of its regulations pursuant to the Regulation Review Program in mid-1993. The program was completed in December 1996, when the last of the rules that the OCC revised was published. During the course of the program, the agency revised 28 regulations covering virtually every subject area of significance in the supervision of national banks. Because the program was comprehensive in scope, it has affected every bank we supervise in some way. Similarly, the changes in our rules and in the regulatory philosophy that shapes them have affected the way OCC staff examine and supervise national banks. This makes for a large and diverse group of users, and potential evaluators, of the Regulation Review Program. Those in a position to evaluate the program's effectiveness include banks of all sizes pursuing a wide range of business strategies, banks' compliance officers, banking lawyers, community group representatives, as well as OCC staff supervising all sizes and types of banks.

The Reg Review Measures Team's first step was to decide what measures to use to evaluate the program's effectiveness. The purpose and objectives of the program had been publicly articulated early on in articles and other materials prepared by the Chief Counsel and law department staff.[2] By the time the program concluded, the OCC had decided that the standards used for regulation review should apply to all of the rules that the OCC writes. In January 1997, the OCC issued a bulletin setting out the six standards it will apply to the development of all regulations.[3] The Measures Team adopted these standards, the first four of which are the same as the standards established specifically for the Regulation Review Program, as the effectiveness measures for the program. The standards are as follows:

- The OCC's regulations eliminate unnecessary burden and minimize the burden resulting from the requirements that are necessary for the effective supervision of national banks.
- The OCC's regulations promote national banks' competitiveness and allow industry innovation.
- The OCC's regulations are risk-focused and results-oriented.
- The OCC's regulations are written so that they can be understood by a reasonably knowledgeable person. The OCC uses the regulatory approach best suited to the subject matter.
- The OCC maximizes the opportunity for national bank and public participation in its rulemakings and sets the effective dates of its regulations to facilitate national banks' planning processes.
- The OCC encourages continual reevaluation of its rules.

A. Focus Groups

To take account of the large number and diverse perspectives of potential respondents, the Measures Team's primary strategy was to gather information through focus groups. We convened a total of 14 focus groups, eight

[2] *See* Julie L. Williams and Mark P. Jacobsen, "A New Approach for Risk-Focused, Efficient Regulation: The OCC's Regulation Review Program," *ABA Bank Compliance Journal* (Spring 1995).

[3] OCC Bulletin 97-8, "Standards for Developing Regulations" (January 17, 1997).

groups of external respondents and six groups of internal respondents.

The groups held between nine and 21 respondents who shared a perspective on the OCC's regulations. Of the eight external groups, four held bank executives or officers; three were private-sector banking lawyers; and one was representatives of community groups. Of the six internal groups, three held examiners; two were field supervisory staff; and one was OCC staff lawyers. This last group—the OCC's district counsel and other managers from the law department—was the one on which we initially pilot-tested our focus group protocol.

Combined attendance at all focus group sessions was 166—90 participants in external groups and 76 participants in OCC staff groups. Bankers and banking lawyers represented 27 states. The OCC examiners and supervisory staff represented five of the OCC's six geographical districts. The following table outlines the composition, timing, and location of the focus groups.

Group/Organization	Description of Participants	Date	Location
OCC Law Department Managers and District Counsel	OCC lawyers—all six districts and Washington managers represented (16 participants)	April 18, 1997	Washington, DC
OCC Central District Field Managers	OCC supervisory staff—Central District (11 participants)	April 28, 1997	Chicago, IL
Independent Bankers Association of American (IBAA)	Bank executives—States represented: CO, FL, ID, IL, KS, LA, ND, NE, PA, NY, SC, TX, WA (16 participants)	May 5, 1997	Washington, DC
Bank Administration Institute (BAI)	Bank compliance officers—States represented: DE, IL, MA, NC, RI (nine participants)	May 8, 1997	Washington, DC
Bankers' Roundtable—Lawyers Council	Banking lawyers—States represented: CA, LA, MI, MA, NC, NY, OH, PA, RI, TN (12 participants)	May 30, 1997	Washington, DC
OCC Southwestern District Field Managers	OCC supervisory staff—Southwestern District (21 participants)	June 4, 1997	Dallas, TX
American Bankers Association (ABA)	Bank compliance officers—States represented: CA, CO, FL, HI, NY, ND, NJ, OH, WI (12 participants)	June 11, 1997	Washington, DC
Lawyers' Outreach Meeting	Banking lawyers—States represented: OH, PA (11 participants)	June 12, 1997	Cleveland, OH
OCC Northeastern District Staff Conference	OCC examiners—Northeastern District (nine participants)	October 20, 1997	Arlington, VA
OCC Western District Staff Conference	OCC examiners—Western District (10 participants)	October 30, 1997	Seattle, WA
OCC Southeastern District Staff Conference	OCC examiners—Southeastern District (nine participants)	November 3, 1997	Tampa, FL
Bankers' Outreach Meeting	Bankers—States represented: LA, OK, TX (10 participants)	November 6, 1997	New Orleans, LA

Group/Organization	Description of Participants	Date	Location
Lawyers' Outreach Meeting	Banking lawyers— States represented: AL, MS, OK, TN, TX (11 participants)	November 6, 1997	New Orleans, LA
Community Group Representatives Meeting	Community Group Representatives (nine participants)	November 13, 1997	Washington, DC

In most cases, a focus group was held in connection with a previously scheduled meeting of the organization or group. The Measures Team worked with the OCC's Banking Relations Division to have an OCC focus group included on the agenda for national conferences already scheduled by the ABA, the IBAA, and the BAI. Similarly, the OCC staff focus groups were held in conjunction with pre-arranged meetings or district staff conferences. This approach was helpful because it allowed us to bypass a time-consuming process for selecting and inviting participants and, in the case of the private-sector participants, enabled us to obtain a better geographic diversity than would otherwise have been possible without holding many more sessions. For the external groups, the group sponsoring the larger meeting usually invited the participants. In the case of the community group representatives, OCC staff extended invitations directly to the community organization. For the OCC employee groups, the focus group was on the agenda of the scheduled managers' meeting.

The protocol for the focus group sessions was to ask the participants to grade the OCC's success in achieving each of the first three or four measures on the list of six.[4] Discussion then focused on the reasons why participants graded the OCC as they did, with emphasis on the specific things that participants thought we had done well and the specific areas where they thought we had missed the mark or saw opportunities for us to do better. For example, it was typical for the focus group facilitator to ask participants to list the changes resulting from the Regulation Review Program that they appreciated the most and then to ask what more the OCC should have done, or what the agency should have done differently, in order to earn the highest grade on the scale. An attachment to this report [appendix B] lists in chart form the regulations that were singled out for favor or as rules that we could improve.

[4] The Measures Team quickly discovered that six standards were too many to discuss fully in the time allocated for the sessions, which lasted, on average, about 1½ hours. Therefore, we selected the three or four of the standards that would likely generate the most helpful discussion or interest that particular group. For example, we sometimes eliminated the risk-focused/results-oriented standard because the comments often duplicated the ones on reducing regulatory burden. In our discussion with the community group representatives, we focused on the public participation standard. In some groups, participants graded the program on all of the standards even if there was insufficient time to discuss them all.

B. Informal Surveys

To supplement what it learned from focus groups, the Measures Team experimented with informal surveys distributed electronically and in hard copy to get feedback on the Regulation Review Program. We prepared a short, informal survey asking respondents to evaluate the program using the standards described above and made it available in two ways. First, the survey appear[ed] in electronic form on the OCC's home page on the World Wide Web. Second, the survey was distributed as a handout at outreach and state banker association meetings that bankers and banking lawyers attend with the Comptroller or the chief counsel.

The survey worked the same way in both formats. Respondents were invited to grade the OCC on all six effectiveness measures described above and to comment in writing on any aspect of the program they wish. In addition, respondents could provide their names and telephone numbers if they are willing to be called by an OCC staff member for a follow-up conversation about the program. Being available for telephone follow-up was optional—respondents could answer the survey questions whether they were willing to be called or not.

We received only 14 responses to the survey—11 from outreach meetings, three over the Internet. Of these, 10 respondents (all bankers) indicated that they were willing to be contacted by an OCC staff member, and we spoke to each person by telephone. We have tabulated the survey responses along with our focus group results, but we note as a separate matter that the sparseness of the Internet responses suggests that, in order to get maximum benefit from its Web site, the OCC may need to emphasize the availability of the Internet as a means of communicating with us and find ways to encourage bankers and others to use it.

Appendix A: Quantitative Results

This section shows how bankers, banking lawyers, community group representatives, and OCC staff graded the program for effectiveness. The grades are computed on a four-point scale; 4 is the highest grade. Overall, the program earned a 3.0, or B, average from both internal and external respondents. Banking lawyers attending an outreach meeting in Cleveland gave the program the highest score (3.5); participants in the IBAA group gave it the lowest (2.7).

Regulation Review Program
Internal and External Focus Groups
Grade Point Average
(on a 4.0 scale)

	Internal Focus Groups	External Focus Groups	Combined
Reduce burden	2.9	2.9	2.9
Foster competition	3.3	3.1	3.2
Risk-focused/results-oriented	2.9	2.8	2.9
Clarity	2.7	2.9	2.8
National bank and public participation	2.9	3.1	3.0
Continual reevaluation of rules	2.9	3.2	3.1
Overall	3.0	3.0	3.0
Participants:			
OCC employees	76	0	76
Bankers		57	57
Community group reps/others		10	10
Bank attorneys		34	34
Number of participants	76	104	180

Regulation Review Program
Internal Focus Groups
Grade Point Average
(on a 4.0 scale)

	Law Dept Mgrs	Central District Field Mgrs	SW District Field Mgrs	NE District Examiners	WE District Examiners	SE District Examiners	Combined
Reduce burden	2.9	3.2	2.8	2.7	2.7	2.9	2.9
Foster competition	3.5	3.5	3.2	3.4	2.9	3.3	3.3
Risk-focused/results-oriented	3.1	2.8			2.9	2.9	2.9
Clarity	3.3	2.3	2.5	2.6	2.7	2.9	2.7
National bank and public participation					2.8	3.0	2.9
Continual reevaluation of rules					2.9	2.9	2.9
Overall	3.2	3.0	2.8	2.9	2.8	3.0	3.0
Participants:							
OCC employees	16	11	21	9	10	9	76
Bankers							0
Community group reps/others							0
Bank attorneys							0
Number of participants	16	11	21	9	10	9	76

Regulation Review Program
External Focus Groups
Grade Point Average
(on a 4.0 scale)

	IBAA	BAI	Bankers Roundtable —Lawyers' Council	ABA	Cleveland Lawyers Outreach	New Orleans Lawyers Outreach	New Orleans Bankers Outreach	Community Group Participants	Handouts at State Banker Meetings	Internet	Combined
Reduce burden	2.9	2.9	2.8	2.8	3.6	3.0	2.9	3.0	2.3	2.7	2.9
Foster competition	2.8	2.8	3.5	2.6	3.6	2.7	3.0	2.9	3.4	3.7	3.1
Risk-focused/ results-oriented	2.5					2.3	3.2		2.8	3.3	2.8
Clarity	2.5		3.2	3.1	3.3	3.0	2.8	2.4	2.5	3.0	2.9
National bank and public participation						3.4	3.0	2.7	2.7	3.7	3.1
Continual reevaluation of rules						2.8	3.3	3.3	3.0	3.7	3.2
Overall	2.7	2.9	3.2	2.8	3.5	2.9	3.0	2.9	2.8	3.4	3.0
Participants:											
OCC employees										0	
Bankers	16	8		9			10		11	3	57
Community group reps/ others		1						9			10
Bank attorneys			12	3	11	11					37
Number of participants	16	9	12	12	11	11	10	9	11	3	104

Appendix B: OCC Regulations Specifically Mentioned by Focus Group Participants

This list identifies regulations revised under the Regulation Review Program that were specifically mentioned by focus group participants. Any explanatory comments offered by the participants are mentioned parenthetically.

Favorable Mention

Part 1 (Investment Securities)

Parts 1, 5, 7, 9 (well written)

Part 5 (Rules, Policies and Procedures for Corporate Activities) (improvements in applications process, especially for branches and ATMs, laundry list of activities eligible for streamlined procedures, procedures for dealing with CRA protests, easy procedures for low-risk activities, flexibility about new activities)

Part 7 (Interpretive Rulings) (corporate governance, dual employee provisions)

Part 8 (Assessment of Fees) (fee reductions)

Part 9 (Fiduciary Activities of National Banks)

Part 12 (Recordkeeping and Confirmation Requirements for Securities Transactions)

Part 21 (Minimum Security Devices and Procedures, etc.) (changes in reporting thresholds, ease of new reporting system)

Part 23 (Leasing) (a rule that just implements the statute)

Part 25 (CRA) (results-oriented, performance-based)

Part 32 (Lending Limits)

In general (adoption of consistent definitions)

Unfavorable Mention/Suggested Improvements

Part 2 (Credit Life Insurance) (some terms unclear)

Part 4 (18-Month Exam Schedule) (keep the cycle at 12 months: come more often, but stay less time)

Part 5 (Rules, Policies and Procedures for Corporate Activities) (cut processing time even more, make more

activities eligible for after-the-fact notice, *e.g.,* investments in bank premises and internal bank restructurings, approve activities quickly under the operating subsidiary provisions, approve combinations of eligible banks on an expedited basis)

Part 7 (Interpretive Rulings) (provision on debt cancellation contracts conflicts with unpublished interpretations)

Part 8 (Assessment of Fees) (reduce fees more)

Part 9 (Fiduciary Activities of National Banks) (repeal advertising prohibition)

Part 24 (Community Development Corporations, etc.) (rule may not be necessary, too many restrictions on what qualifies as a community development investment, CRA protest provisions)

Part 25 (CRA) (waste of time for community banks—they lend to their communities anyway)

Part 32 (Lending Limits) (some banks want flexibility to compute lending limit more often than quarterly)

Statement of Julie L. Williams, Acting Comptroller of the Currency, before the U.S. House Committee on Banking and Financial Services, on protecting consumer privacy, Washington, D.C., July 28, 1998

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

Mr. Chairman, Ranking Member LaFalce, and members of the committee, I appreciate this opportunity to appear before you today to testify on issues regarding the proper handling and safeguarding of customer financial information and the protection of consumer privacy. The Office of the Comptroller of the Currency (OCC) applauds the chairman's leadership working to curb information broker abuses that victimize both banks and their customers. And, we also commend Congressman LaFalce for identifying and bringing to the committee's attention other timely privacy concerns that have been heightened by recent changes in the marketplace, particularly mega-mergers and the growing customer databases of the companies that result from those transactions.

The financial services industry has had longstanding experience in handling and safeguarding sensitive customer information and protecting consumer privacy. Access to and use of financial information is the lifeblood of the financial services industry—ensuring that institutions make appropriate credit determinations, provide proper investment guidance, extend insurance wisely, as well as identify new market opportunities. Information also assists financial institutions in properly identifying their customers in order to prevent fraud and in knowing their customers to guard against money laundering.

It is thus essential that financial institutions maintain customers' trust and confidence in their handling of personal information to ensure the continued flow of this information. Failure to properly safeguard information, or the handling of information contrary to customers' reasonable privacy expectations, can result in loss of business opportunities and could also present safety and soundness risks in the form of potential liability and damage to banks' reputations.

Recent developments, primarily technological advances and the rapidly changing structure of the financial services industry, have presented new opportunities for the financial services industry while, at the same time, heightening the public's concern about financial privacy. Advances in electronic banking and communications technology have enabled banks and other businesses to gather, analyze, and disseminate customer information in a more expedient and efficient manner. Use of on-line computer software facilitates the transfer of information almost instantly.

Proposed bank mega-mergers and the emergence of financial services conglomerates will result in immense databases of customer information. Pending financial modernization legislation would further facilitate the creation of diversified, potentially very large, financial entities that will be able to amass vast amounts of information about customers' credit and investment habits, deposit accounts, and insurance transactions. Companies will likely use and manipulate this data to target customers for increasing arrays of products and services tailored to meet a customer's particular needs and financial circumstances. Accordingly, this information can result in increased business opportunities for industry and improved products and services for consumers.

However, these advances in corporate structure and technological capabilities raise pressing issues about how banks will safeguard and use the expanding base of consumer data. Surveys indicate that consumers are becoming increasingly anxious about how their personal information is being handled by the different companies with which they do business and about their lack of control over its dissemination. In some cases, consumers are kept deliberately ill-informed about the information practices of these companies. Without sufficient information, consumers cannot make informed choices about how and to what extent companies should be able to use their data beyond the purposes for which it was provided. Moreover, an increasing number of news stories have reminded the public about the limits of confidentiality, the ease with which determined crooks can evade protections designed to safeguard data, and the nightmarish consequences that befall individuals victimized by so-called identity theft.

Thus, the parameters of the privacy debate can be defined as the tension between the potential economic benefits for businesses and consumers through the development of enhanced information assets on the one hand and the public's increasing concern over privacy on the other hand. The challenge for financial institutions is to use this wealth of customer information responsibly, to safeguard it against improper access, and to build consumer confidence in the knowledge that both are occurring.

Shortly after I became Acting Comptroller, I formed a Privacy Working Group (PWG) within the OCC to focus on the challenges banks face in addressing emerging consumer privacy issues. The PWG has already begun work to look into the areas of safeguarding bank customer information, Web site disclosures of bank privacy policies, and the adequacy of information-sharing notices furnished by banks to their customers under the Fair Credit Reporting Act (FCRA). Our goal in these areas is to articulate guidance on "effective practices" for Web site and FCRA disclosures, as well as to consider issuing guidance to banks on safeguarding sensitive customer data. I will discuss each of these initiatives in the testimony.

Based on our work to date, key privacy issues today seem generally to fall into three areas: safeguarding/security of customer information; privacy-related disclosures; and the role of regulators. The discussion that follows is organized around these three areas. The first issue area—safeguarding customer information—will include a discussion of the OCC's views on the chairman's bill, the Financial Information Privacy Act of 1998.

I. Safeguarding/Security of Customer Information

Safeguarding sensitive customer information is essential to a bank's maintaining the trust of its customers and, ultimately, to the bank's safe and sound operations. Banks currently take a number of steps to preserve the integrity of customer data. Banks often use personal identification numbers, passwords, or other unique identifiers in conjunction with other identifying information, such as name, address, mother's maiden name, and account number or account activity, to ensure they are appropriately disclosing information only to their customers. Financial institutions also are exploring the use of biometrics and are using encryption to safeguard customer information that is electronically transmitted. In addition, the OCC routinely examines banks for internal controls to ensure that access to customer data is limited to bank employees who need the data to properly perform their duties. The agency also examines the banks' data processing systems using the Federal Financial Institutions Examination Council's exam procedures to evaluate information systems. Further, the OCC has published additional guidance for examiners and bankers on data security.

Despite these precautions, however, some banks and their customers have been the victims of scams involving the unauthorized procurement of customer data for legal or illegal financial gain. This problem is exacerbated by the fact that consumer information that used to be confidential is increasingly in the public domain, account numbers are sometimes retrievable from trash cans, and passwords and personal identification numbers (PINs) are not always closely guarded by consumers. Two growing and alarming practices that are thriving on this ready access to consumer information have come to be known in the public arena as account information brokering and identity theft. Mr. Chairman, your bill focuses on a significant abuse in this area, and the OCC strongly supports your efforts.

Account Information Brokering

As I have explained, there is a tremendous demand for information about individuals' and businesses' financial information. For example, attorneys, debt collectors, and private investigators use bank account information in lawsuits and other proceedings. This demand for account information, combined with the availability of free advertising on the Internet, has led to a dramatic increase in the number of account information brokers.

These brokers gather confidential financial information, including specific account numbers and balances, from various public sources and from nonpublic sources, such as banks, using a technique known as "pretext telephone calling." Brokers who engage in this practice call banks and use surreptitious or fraudulent means to try to coerce bank employees into providing a customer's account information. For example, a broker armed with an individual's social security number may pose as a bank customer who has misplaced an account number, and repeatedly call the bank until the broker finds a bank employee willing to provide the information. The broker then sells this information to anyone who is willing to pay for it, including identity thieves, who may use account information to engage in check and credit card fraud, and other criminal acts.

The use of surreptitious or fraudulent means to obtain a customer's account information may violate state and federal laws prohibiting unfair and/or deceptive practices. It also may violate the federal wire fraud statute, 18 USC 1343, although the loss to the individual may not be of sufficient magnitude to result in prosecution under the statute. However, the existing statute prohibiting false statements to financial institutions, 18 USC 1014, does not apply to account information brokering because it is limited to statements made in connection with applications, loans, advances, commitments, or similar transactions, and not with procuring information. There is no federal law that directly prohibits the procurement of customer account information from financial institutions under false pretenses.

Financial Information Privacy Act of 1998

The OCC supports Chairman Leach's bill, the Financial Information Privacy Act of 1998 (FIPA), which is aimed at stopping the practice of obtaining customer account

information from financial institutions under false pretenses. Its important to note here that in our experience banks take this issue very seriously, and have traditionally done a good job protecting customer information. But now, more is required. The FIPA addresses an area of growing concern and fills in gaps in federal law.

To summarize, FIPA prohibits persons from obtaining, or causing to be disclosed, customer information held by a financial institution by: (1) knowingly making a false statement to a financial institution's officer, employee, or agent; (2) knowingly making a false statement to a financial institution's customer; or (3) knowingly providing any document to an officer, employee, or agent of a financial institution that is forged, counterfeit, lost, stolen, or otherwise fraudulently obtained. FIPA also prohibits any person from receiving financial institution customer information that the person knows or has reason to know was obtained in the manner described above. These prohibitions would be enforced by the Federal Trade Commission (FTC) for information brokers, by the federal financial supervisory agencies for financial institutions, and by the states. The bill also provides for criminal penalties for violations of the prohibitions, with fines pursuant to Title 18 of the U.S. Code and/or imprisonment up to 10 years. The bill preempts state laws only to the extent they are inconsistent with the statute. It requires the Comptroller General to report to Congress within 18 months after enactment on the adequacy of the act's remedies, and to make recommendations for additional legislative or regulatory action to address threats to the privacy of financial information.

The provisions of this bill appear to us to be a focused and efficient approach to an emerging problem. We support the FIPA and welcome the opportunity to work with the committee on this initiative.

Agency Advisory

The OCC has been working with the other banking agencies, the Federal Bureau of Investigation, Internal Revenue Service, Secret Service, and FTC and other agencies to develop guidance for the financial services industry about information-brokering practices employing pretext phone calling. We expect that our guidance in this area will alert financial institutions to this practice; enhance their awareness of issues surrounding the confidentiality and sensitivity of customer information generally; and suggest appropriate measures for the protection of customer data from unwitting disclosures. We plan to provide specific guidance to banks about the need to ensure proper employee training regarding appropriate security measures, as well as the adoption of policies addressing financial privacy, and the desirability of strong controls to decrease the likelihood of improper or illegal disclosure. Because of the importance of this area, we expect to issue this guidance in the near future, and we are hopeful this can be done by the other agencies as well.

Identity Theft

Identity theft is the practice whereby a person obtains personal information on an individual, such as a social security number, and fraudulently uses that information to impersonate the individual in cashing checks, obtaining and using credit cards, or obtaining loans, all with the intention of stealing the funds obtained. It may take a week, a month, or longer to detect the initial fraud, particularly if the crook has the credit card or other bills sent to an address that is not the victim's. These thieves also often strike repeatedly. In the end, the victim is left having to repudiate the debts incurred by the thief. It can take years for the victim to repair a tarnished credit record.

A report released by the General Accounting Office in May found that cases of identity theft are increasing. The American Bankers Association has informed consumers that identity theft is one of the fastest growing types of financial fraud.

For these reasons, the OCC supports S. 512, the "Identity Theft and Assumption Deterrence Act of 1998," and its House counterpart, H.R. 4151. These bills make it a crime to knowingly and unlawfully possess, transfer, or use a means of identification of another person with the intent to commit or facilitate any unlawful activity. They provide for restitution to victims of the offense. And they require the FTC to establish a centralized complaint and consumer education service for victims of identity theft, and to refer victims to appropriate entities, including consumer reporting and law enforcement agencies.

The OCC's Privacy Working Group is currently looking into the practices and procedures that banks employ to guard against identity theft. It is clear that banks must have sufficient measures in place to properly identify their customers, but these measures cannot be so intrusive or burdensome that they alienate bank customers attempting to conduct routine business. Depending on our findings, we will consider issuing guidance later this year to assist banks in avoiding situations that put their customers' identity and finances in jeopardy.

II. Adequacy of Privacy-Related Disclosures

The financial services industry, among others, routinely collects sensitive data from individuals in the course of performing routine business. Yet relatively few industries inform their customers about what they do with this information and whether they furnish it to others for purposes unrelated to its initial use. We learned in our work on the Consumer Electronic Payments Task Force

(Task Force)[1] that consumers want to be better informed about the use of their personal data and they want more control over its ultimate disposition. We found, generally, that consumers want adequate disclosures about a company's information collection and use policies. They do not want to reveal more information than is needed for a transaction. And, consumers are concerned about possible secondary uses of their information beyond that needed for the original transaction. These and other concerns about data security are heightened when consumers are asked to furnish personal information in an on-line environment.

Yet there are no privacy laws that afford consumers comprehensive protection in the private sector uses of their personal information, or even in the disclosure of the uses of that information.[2] Instead, the Task Force, government agencies, and the White House have urged industries to adopt meaningful self-regulatory measures in the privacy area, particularly with respect to Internet data collection. Where privacy protections have been enacted, they have been on a sectoral basis, such as recent amendments to the Fair Credit Reporting Act that provide consumers with disclosures about certain types of information sharing and an opportunity to "opt out" of such sharing.

Self-Regulatory Measures for On-Line Data Collection

In June 1998, the FTC released a report to Congress containing the results of a survey of 1,400 Web sites, including financial service providers, to determine whether and to what extent these sites posted privacy policies. The FTC also examined the content of these privacy policies to discern whether they addressed four fair information practices: (1) notice of information practices; (2) consumer choice as to how that information is to be used beyond the purpose for which the information was provided; (3) consumers' access to their information and an opportunity to correct it for inaccuracies; and (4) reasonable steps to keep the information secure. The commission found that over 85 percent of these Web sites collected personal information, but that only 14 percent provided any notice about information practices, and that only 2 percent provided notice by means of a comprehensive privacy policy. The survey shows that financial service providers fared no better or worse than any other industry in posting privacy policies.

The OCC takes the results of this survey seriously and believes that financial institutions that have Web sites should be posting meaningful privacy policies on their Web sites. The OCC's Privacy Working Group is currently meeting with interested industry representatives and privacy advocates about effective Web site privacy disclosures. We are researching what banks now are doing in this area and expect to issue guidance about what constitutes "effective practices" in Web page privacy policies disclosure. I should also note that we have an excellent working relationship with the Federal Trade Commission on these and other related projects.

Fair Credit Reporting Act

Recent amendments to the Fair Credit Reporting Act (FCRA) permit affiliated companies to share customer information, free of the restrictions placed on credit bureaus, provided that these companies clearly and conspicuously disclose this fact to consumers and provide consumers with an opportunity to direct that the information not be shared.[3] This affiliate-sharing provision provides new opportunities for both industry and consumers. It allows industry to expand its customer databases and it also affords consumers the opportunity to make informed privacy choices. The ability of consumers to make such informed decisions, however, turns on just how meaningful, clear, and conspicuous these notices are.

What we have found, however, are inconsistencies in how the opt-out notice process is being implemented.

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[1] To ensure that consumer concerns arising from new electronic payment technologies receive appropriate consideration, the Secretary of the Treasury, Robert E. Rubin, established the Consumer Electronic Payments Task Force ("Task Force") in the fall of 1996. Eugene A. Ludwig, Comptroller of the Currency, chaired the Task Force which included Richard L. Gregg, Commissioner of the Financial Management Service; Jack Guynn, President of the Federal Reserve Bank of Atlanta; Andrew C. Hove Jr., Chairman of the Federal Deposit Insurance Corporation; Edward W. Kelley Jr., Member of the Board of Governors of the Federal Reserve System; Robert Pitofsky, Chairman of the Federal Trade Commission; and Ellen Seidman, Director of the Office of Thrift Supervision.

The Task Force established as its mission to identify, in partnership with the industry and the public, consumer issues raised by emerging electronic money technologies and to explore the extent to which innovative responses are being developed that are consistent with the needs of this developing market.

[2] Privacy protections are essentially evolutionary in the United States, and there is little precedent for comprehensive government established privacy protections. Unlike the nations of Western Europe, the United States does not have universal or omnibus privacy laws. Privacy protections in the United States have evolved on a sectoral basis reflecting in part how federal and state legislatures address competing policy objectives, including the prevention and prosecution of criminal acts.

Attached to the testimony is an excerpt from "The Report of the Consumer Electronic Payments Task Force" (April 1998, pp. 21–36), which contains a discussion of federal and state privacy laws.

[3] Specifically, the FCRA allows any company to share within its corporate family or to sell to third parties the company's "transaction and experience" information that it possesses on its own customers. 15 USC 1681a(d)(2)(a)(I) and (ii). Such sharing or selling does not trigger any notice or opt-out requirements. If affiliated companies share any other type of information that would constitute a consumer report if sold outside the corporate family, the affiliate must give a consumer notice of the intent to share the information and an opportunity to opt out. *Id.* at §1681a(d)(2)(a)(iii).

Unfortunately, some affiliate information-sharing opt-out disclosures are buried in the middle or near the end of a multi-page account agreement. For existing accounts, some institutions have been known to reduce the opt-out disclosures to the fine print along with a long list of other required disclosures. Under these circumstances, few consumers will even notice the opt-out disclosures, let alone take the time to write the required opt-out letter.

On the other hand, I have seen evidence of responsible consumer notification and opportunity to opt out. In one case, the bank sent its customers a separate letter informing them of the benefits by way of greater product and service availability that resulted from the sharing of customer information among affiliates; but also providing a detachable form for its customers to use if they want to opt out. This type of simple, straightforward disclosure, and convenient approach for the consumer to opt out should be embraced by the banking industry.

The OCC is now working on developing guidance on effective practices for opt-out notices. As in the area of Web site disclosures, the PWG is meeting with and seeking input from the industry, privacy group representatives, and the FTC in identifying these effective practices. We are also discussing these issues with the other bank regulators. We expect to put out guidance on opt-out notices sometime this fall.

III. The Role of Regulators

In this emerging privacy area, the extent of actions taken by the OCC and other regulators will be significantly influenced by the success of the banking industry in adopting meaningful self-regulatory policies and in adhering to the limited laws that are now in place. Self-regulation clearly offers banks the ability to shape their own policies, rather than having a one-size-fits-all approach that could be mandated by law. To be meaningful, the OCC believes that self-regulation must respond to consumers' privacy concerns, provide adequate disclosures about privacy policies, accord consumers meaningful control over the use of the information they furnish, include reasonable steps to protect the security and integrity of that information, and offer some compliance assurance mechanisms.

Laudably, the major banking and thrift trade groups, ABA, ACB, TBR, CBA, and IBAA have endorsed a set of privacy principles adopted by the Banking Industry Technology Secretariat—BITS—of The Bankers Roundtable.[4] It is unclear, however, how many individual banks are adopting and adhering to these principles. Failure to adopt more widespread self-regulatory measures may well result in the OCC's stepping up activities in this area.

With respect to the Fair Credit Reporting Act, as I have said, the OCC already has some initiatives under way. In addition to the guidance on effective opt-out notices, the OCC very shortly will be issuing an advisory to banks and bank examiners about the agency's ability to examine banks for compliance with FCRA. The 1996 amendments to the FCRA greatly expanded the duties of banks in the areas of data accuracy and privacy, as well as provided banks new opportunities for gathering and using information on their customers. At the same time, these amendments cut back on the ability of the bank regulators to examine institutions for compliance with the statute. The revised FCRA permits the bank regulators to

[4] In September 1997, the American Bankers Association (ABA), The Bankers Roundtable (TBR) and its division, the Banking Industry Technology Secretariat (BITS), the Consumer Bankers Association (CBA), and the Independent Bankers Association of America (IBAA) endorsed a common set of privacy principles ("Banking Industry Principles"). America's Community Bankers (ACB) subsequently also endorsed the principles. These principles provide that subscribing financial institutions should:

(1) recognize a consumer's expectation of privacy by making available privacy guidelines and/or providing a series of questions and answers about financial privacy to their customers;

(2) only collect, retain, and use individual customer information where it would be useful (and allowed by law) to administer that organization's business and to provide products, services, and other opportunities to its customers;

(3) establish procedures to ensure customer information is accurate, current, and complete in accordance with reasonable commercial standards, including responding to requests to correct inaccuracies in a timely manner;

(4) limit employee access to personally identifiable information to those with a business reason for knowing such information, educate employees so that they will understand the importance of confidentiality and customer privacy, and take appropriate disciplinary measures to enforce employee privacy responsibilities;

(5) maintain appropriate security standards and procedures regarding unauthorized access to customer information;

(6) not reveal specific information about customer accounts or other personally identifiable information to unaffiliated third parties for their independent use, except for the exchange of information with reputable information-reporting agencies to maximize the accuracy and security of such information or in the performance of bona fide corporate due diligence, unless 1) the information is provided to help complete a customer-initiated transaction, 2) the customer requests it, 3) the disclosure is required by/or allowed by law (e.g., subpoena, investigation of fraudulent activity), or 4) the customer has been informed about the possibility of such disclosure for marketing or similar purposes through a prior communication and is given the opportunity to decline (i.e., "opt-out");

(7) if personally identifiable information is given to a third party, the financial institution should insist that the third party adhere to similar privacy principles that provide for keeping such information confidential; [and]

(8) devise methods of providing a customer with an understanding of their privacy principles.

examine institutions for FCRA compliance only in response to a complaint or if the agency "otherwise has knowledge" of a violation of the statute. 15 USC 1681s (d). There is no other consumer protection statute that we enforce that similarly limits our ability to examine banks for compliance.

On this score, I should also note, however, that the OCC has recently reprogrammed its new customer assistance complaint database to specifically capture privacy-focused consumer complaints. This will provide us with a more meaningful way to assess and investigate consumers' concerns, and also should help us identify consumer complaints that may involve a violation of FCRA—a trigger for our examination authority.

Conclusion

I will close by again commending the chairman, Ranking Member LaFalce, and this committee for considering and addressing the issue of consumer privacy. We look forward to working with the committee so that banks and other financial services providers meet the many challenges emerging in the consumer privacy arena.

[Attachment follows]

Attachment

(Excerpt from "The Report of the Consumer Electronic Payments Task Force," April 1998, pp. 21–36)

Privacy

Consumers are becoming increasingly concerned about how personally identifiable information is being used. This concern, if unaddressed, could have the potential to act as an impediment to widespread consumer acceptance of e-money.

Summary of Comments

Several commenters stated that a significant barrier to the widespread usage of e-money will be lack of consumer trust or confidence in the privacy of the new payment systems. These commenters suggested that both fair information practices and anonymous payments will help build that trust.[65] Other commenters stated the belief that systems should be developed to ensure consumer privacy and security, rather than having to add privacy protections later in response to demonstrated problems. Several commenters stated that the appropriate role for government is to set basic privacy principles to guide businesses as they build consumer privacy and security into their systems.

Many commenters expressed concern that the increase in data collection efficiency associated with e-money could provide merchants and other system participants with an increased ability to obtain personally identifiable consumer information. Similarly, other commenters stated that the diversity, quality, and quantity of information that is collected and the fact that there are multiple places it can be captured and stored, increase the privacy concerns that could arise with electronic money.

Several commenters noted that the trend toward electronic money may eventually reduce a consumer's ability to use cash or other anonymous payment methods, whereas other commenters believed that the new technology could promote anonymous payment methods.[66] Similarly, several industry commenters noted that the use of encryption can enhance the technical security of products and provide greater privacy protection for consumers.[67]

Some commenters noted that the number of parties involved in new payment methods, including issuers, distributors and processors, could result in more people having access to consumer information. Other commenters noted that the potential for privacy invasions may be greater as cards become multifunctional because more information could be collected and stored in one place.

Many commenters were also concerned that consumers may not receive adequate disclosure of what personal data is being collected, who will receive that data, and how the data will be used.[68] Some commenters worried that information consumers voluntarily reveal to the issuer and information about their transactions with merchants would be transferred to the issuer's affiliates and to other parties.[69] Several commenters asserted that self-regulatory actions, such as industry guidelines and privacy policies, do not provide any meaningful protections for consumers because they are largely unenforceable. Additionally, some commenters were concerned that the personal information collected through these new electronic payment methods may not be secure from illegal or unauthorized access and use.

Other commenters stated that most consumers do not understand and will not be informed of the privacy implications of choosing different payment methods. These commenters stressed that there must be significant efforts to educate the public about information security and to seek fair information practices. Some commenters suggested that the government should work with consumer organizations to help educate consumers about privacy considerations related to e-money. Other

[65] *See* Remarks and Prepared Statement of Mary J. Culnan, Commissioner, President's Commission on Critical Infrastructure Protection, Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues.

[66] *See* Demonstration and Remarks of David Chaum, Founder and Chief Technology Officer, DigiCash, Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues.

[67] Remarks and Prepared Statement of Paul Lampru, Strategic Marketing, VeriFone, Task Force Public Meeting (July 17, 1997), Panel on Security Issues; Remarks and Prepared Statement of Elliot C. McEntee, President and CEO, National Automated Clearing House Association (NACHA), Task Force Public Meeting (July 17, 1997), Panel on Security Issues; Remarks and Prepared Statement of Russell B. Stevensen, Jr., General Counsel, CyberCash, Task Force Public Meeting (July 17, 1997), Panel on Security Issues; and Demonstration and Prepared Statement of Thomas Smedinghoff, Esq., McBride, Baker, & Coles, Task Force Public Meeting (July 17, 1997), Panel on Security Issues.

[68] Remarks and Prepared Statement of Dierdre K. Mulligan, Staff Counsel, Center for Democracy and Technology, Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues (expressing the view that most e-money issuers presently do not provide adequate disclosures).

[69] *See* Culnan Remarks and Statement, *supra. See also* Mulligan Remarks and Remarks and Prepared Statement of Susan Grant, Vice President for Public Policy, National Consumers League, Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues.

commenters suggested that the government should establish model disclosures and vocabulary to help consumers understand these products.

Several commenters expressed concerns that e-money would give the government greater access to consumers' financial information by eliminating their ability to make payments anonymously. These commenters noted that consumers may believe that auditable e-money systems will increase the government's ability to gain access to financial information.

Industry commenters expressed the belief that it is premature to prescribe a particular form of consumer disclosure about privacy, particularly when stored value products are in such an early stage of development and implementation.[70] These industry commenters also stated that they currently require their third party servicers or contractors to agree to provisions limiting their use of information.[71] Several commenters also noted that statutory and common law restricts third party access to many types of information.[72] Some commenters noted that they currently provide consumers with general information about what information is being collected and the use of that information.[73]

Representatives of law enforcement expressed concerns that some of the new payment methods will diminish the government's ability to identify participants in financial transactions. These commenters stated that the use of encryption in e-money systems might make it more difficult for law enforcement authorities to identify, apprehend, and prosecute criminals who use encryption systems to facilitate money-laundering and counterfeiting.[74] These commenters also stressed that existing constitutional and statutory provisions place many restrictions on governmental access to confidential information. Other commenters noted that requiring that e-money issuers maintain detailed transaction records to facilitate law enforcement could chill product innovation and increase issuer costs, possibly hindering market acceptance of new payment products.[75]

Assessment of Consumer Concerns

Consumer concerns about the privacy of their financial information extend beyond privacy in e-money transactions, and are varied and complex. Some consumers are extremely protective of their privacy and view any collection or use of personally identifiable information as an intrusion, while others are far less concerned about privacy-related matters. Although consumers' privacy thresholds are not uniform, consumers generally share certain key privacy concerns. First, consumers want to receive adequate information about an entity's information collection and use policies. Consumers also appear to be concerned about secondary use of information—the use of information for purposes other than the original transaction, either by the information collector or by a third-party to whom the information is sold or transferred *(e.g.,* a third party processor).[76]

The potential for privacy intrusions seems to be at its greatest in these cases, where consumers may not be aware that their personal information is being put to new uses or have any control over those uses.[77] Obtaining knowledge of an issuer's information use policies would allow consumers choice, *i.e.,* so that they can make an informed decision about what e-money product is appropriate for their privacy needs. Additionally, disclosures could provide consumers with rights of redress should the

[70] *See* Remarks and Prepared Statement of Janet Koehler, Senior Manager, AT&T Universal Card Services, on behalf of SmartCard Forum, Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues.

[71] *See* Remarks and Prepared Statement of Marcia Z. Sullivan, Director of Government Relations, Consumer Bankers Association, Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues.

[72] *See* Remarks and Prepared Statement of Peter Toren, Trial Attorney, Computer Crime and Intellectual Property Section, Department of Justice, Task Force Public Meeting (July 17, 1997), Panel on Security Issues.

[73] *See* Koehler Statement and Remarks, Sullivan Statement and Remarks, *supra.*

[74] On the other hand, encryption techniques can also serve as a deterrent to counterfeiting and other criminal attacks on e-money systems. *See* Security of Electronic Money, BIS, 1996.

[75] *See* Remarks and Prepared Statement of Pamela J. Johnson, Counselor to the Director, Department of the Treasury, Financial Crimes Enforcement Network (FinCEN), Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues and Toren, Statement and Remarks, *supra.*

[76] Some commenters noted that consumers are less concerned about primary uses of information because consumers may, in effect, bargain to a desired privacy outcome by either paying a "premium" for fair information practices addressing notice, choice, access, verification, and remedy or look for benefits in exchange for allowing a vendor to collect and use information. *See* Remarks and Prepared Statement of Marc Rotenberg, Director, Electronic Privacy Information Center, Task Force Public Meeting (July 17, 1997), Panel on Privacy Issues.

[77] This latter element—control over how information is put to use—appears to be especially important. Mary Culnan of Georgetown University argues that business practices are less likely to appear invasive when the consumer has a relationship with the business, only relevant information is collected, and the consumer is able to control the use of the information. Culnan, Mary J., *How Did They Get My Name: An Exploratory Investigation of Consumer Attitudes Toward Secondary Information Use,* MIS Quarterly, Vol. 17, No. 3, September 1993, pp. 341–363. Even consumers who do not object to how the information is put to use raise privacy objections if they have no control over secondary use. Culnan, Mary J. and Pamela K. Armstrong, *Information Privacy Concerns and Procedural Fairness: An Empirical Investigation,* Paper presented at INFORMS National Meeting, May 1996.

issuer misuse their personal information in a way that is inconsistent with the disclosures or violated public policy.[78]

Privacy Protections in Law

Existing laws may limit access to, and use of, consumers' e-money information by issuers and third parties. However, unlike the nations of Western Europe, the United States does not have universal or omnibus privacy laws.[79] A consumer's right to financial privacy has not been established as a fundamental right by the United States Supreme Court.[80] Privacy protections in the United States, have evolved on a sectoral basis (applying to certain sectors of society, *e.g.,* banking industry or the public sector), reflecting in part how federal and state legislatures address competing policy objectives, including the prevention and prosecution of criminal acts. This report discusses several existing privacy laws that may or may not apply to e-money.

Laws Requiring Disclosure of Privacy Practices

Many commenters expressed concern that consumers would not receive adequate information about an issuer's information practices. Some issuers will provide these disclosures, in an effort to distinguish their products from those of their competitors; however, market incentives may be insufficient to ensure that all consumers receive disclosures about an issuer's information policies. Moreover, existing legal requirements for disclosure of information policies may be inapplicable to most forms of e-money presently in the marketplace.[81]

The Electronic Fund Transfer Act ("EFTA") and its implementing regulation, the Federal Reserve Board's Regulation E, establish the rights and liabilities of consumers who maintain an account[82] at a financial institution and use electronic funds transfers ("EFTs") into or out of the account.[83] Among other things, Regulation E requires financial institutions to document EFTs in writing and to disclose certain information to their customers.[84] Among the disclosures financial institutions must provide to consumers is a description of the circumstances in the institution's "ordinary course of business" in which it will disclose information about the consumer's account to third parties.[85] As discussed in greater detail in the Consumer Protections and Disclosures section of this Report, however, the Federal Reserve Board has not yet determined to what extent, if any, Regulation E applies to e-money systems.

Laws Limiting Access to Consumer Information

Under the Fair Credit Reporting Act ("FCRA"), 15 U.S.C. 1681 *et seq.,* a "consumer reporting agency" may furnish a "consumer report" only to a third party who has a "permissible purpose" for using the information.[86] The

[78] The Federal Trade Commission has studied online privacy issues since 1995. Through a series of public meetings convened as part of the Bureau of Consumer Protection's Consumer Privacy Initiative, the FTC has received extensive commentary on consumers' concerns regarding these issues. The testimony presented at these meetings demonstrates that consumers care deeply about the security and confidentiality of their personal information in the online environment. Of all the information that businesses collect about them, consumers are especially troubled by the potential for unauthorized disclosure of their financial information. Federal Trade Commission, *Staff Report: Consumer Privacy on the Global Information Infrastructure,* 12 (1996).

Research presented at the Commission's 1997 public workshop on Consumer Information Privacy shows that consumers have much less confidence in online companies with respect to the handling of their personal information than they have in many other institutions—including banks—doing business offline. Louis Harris & Associates and Alan F. Westin, *Commerce, Communication, and Privacy Online: A National Survey of Computer Users,* ix (conducted for *Privacy & American Business* 1997).

[79] *See* Fred Cate, Privacy in the Information Age (Brookings Institute 1997).

[80] For example, the U.S. Supreme Court has not considered whether the implied right of personal privacy extends to personal financial records. The Supreme Court has held, in the context of the Fourth Amendment, that no "reasonable expectation of privacy" exists in the bank records of individuals and that a bank customer "takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the government." *United States* v. *Miller,* 425 U.S. 435 (1976).

However, several state courts have found that a reasonable expectation of privacy exists in financial records. *See e.g., Charnes* v. *DiGiacomo,* 612 P.2d 1117 (Colo. 1980); *People* v. *Jackson,* 452 N.E.2d 85 (Ill. App. Ct. 1983); *Commonwealth* v. *DeJohn,* 403 A.2d 1283 (Pa. 1983); *Utah* v. *Thompson,* 810 P.2d 415 (Utah 1991).

[81] This brief survey of U.S. privacy laws is specifically limited to the nascent electronic money product. It would be inappropriate to apply this survey to assess the level of privacy protection in broader or more established financial services.

[82] An "account" for the purposes of the EFTA is defined as a demand deposit, savings deposit, or other consumer asset account held directly or indirectly by a financial institution, for personal, family, or household purposes. 15 U.S.C. 1693a(2); 12 C.F.R. 205.2(b)(1).

[83] Several states also have EFT laws requiring privacy-related disclosures. These laws either (1) require only that a financial institution disclose its electronic funds transfer information policies or (2) specifically create confidentiality obligations with respect to EFT transfers. *See, e.g.,* Ill. Ann. Stat. Ch. 17, 44(a)(9) (1981) (mandating disclosure of EFT information policies); Mich. Comp. Laws. Ann. 488.12 (1987); Minn. Stat. Ann. 47.49 (1988); NM Stat. Ann. 58–16–12 (Supp. 1984) (creating confidentiality requirements).

[84] *Id.* 1693d.

[85] *Id.* 1693c(a)(9); 12 C.F.R. 205.7(a)(9).

[86] A "consumer reporting agency" is defined as any person who regularly assembles or evaluates consumer information for the purpose of furnishing consumer reports to third parties. *Id.* 1681a(f). A "consumer report" is any communication, by a "consumer reporting agency," of any information that bears on a consumer's credit-worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living that is collected or used (or expected to be used) as a in factor establishing the consumer's eligibility for credit, insurance, employment, or any other purpose permissible under the Act. *Id.* 1681a(d)(1).

FCRA enumerates the permissible purposes for obtaining a consumer report, including: where the consumer has given his or her written permission; in connection with a credit transaction or insurance underwriting; for employment purposes; and, if there is a legitimate business need, in connection with a business transaction initiated by the consumer. Information solely about transactions or experiences between a consumer and an entity, however, may be shared generally by the entity.[87]

Recent amendments to the FCRA expand the scope of permissible information-sharing among affiliates. Affiliated persons and entities are now permitted to share and use consumer information—including consumer reports—among themselves without becoming consumer reporting agencies subject to the FCRA, provided the consumer receives notice and an opportunity before the consumer's information is shared to direct that the information not be shared ("opt-out").[88]

Businesses may communicate their own transactional information about a consumer to a consumer reporting agency without notice to the consumer. To ensure the accuracy of this information, however, the FCRA amendments require that persons who furnish information to a consumer reporting agency avoid furnishing knowingly inaccurate information, correct and update information reported, and notify the consumer reporting agency of disputes and account closures.[89]

It is uncertain whether consumer's e-money transaction information would fall under the protection of the FCRA for several reasons. First, e-money issuers may not be considered "consumer reporting agencies." Second, the data collected—information on the consumer's spending patterns—may not fall within the definition of a "consumer report," for example, if the information is considered to be experience information. However, e-money issuers that provided information to a consumer reporting agency would be subject to the requirements of the FCRA regarding furnishers, discussed above.

Laws Restricting Governmental Access to Information

Several federal statutes may limit the government's access to consumers' e-money information. The Privacy Act of 1974 ("Privacy Act") controls the federal government's collection, use, and disclosure of information on individuals. It does not apply to state government agencies or the private sector.[90] A federal agency may collect "only such information about an individual as is relevant and necessary" to accomplish a required agency function and the agency must provide a Privacy Act statement to each individual asked to supply information.[91] The Privacy Act prohibits, with limited exceptions, a federal agency from disclosing any such record to any person or to another agency unless the individual to whom the record pertains has either requested the disclosure or consented to it in writing.[92]

The Right to Financial Privacy Act ("RFPA") prohibits the federal government from accessing or obtaining information in a customer's financial records from a financial institution, and prohibits a financial institution from disclosing such information to the federal government, except pursuant to the customer's authorization, an administrative subpoena or summons, a search warrant, a judicial subpoena, or a formal written request.[93] The

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[87] This is because reports containing information solely about transactions or experiences between the consumer and the entity making the report are not "consumer reports" for purposes of the FCRA. *Id.* 1681a (d)(2)(A)(i), 1681a(f).

[88] *Id.* 1681a(d)(2)(A)(iii) (as amended by Pub. L. No. 104–208, tit. II, ch. 1, 2402(e)). The notice and opt-out requirements do not apply to the sharing of pure identification information, such as names and addresses, or"experience" information, which relates solely to an entity's own transactions or experiences with the customer.

[89] *Id.* 1681s–2 (as added by Pub. L. 104–208, tit. II, ch. 1, 2413(a)(2)). Several states have fair credit reporting laws that mirror the general scheme of the federal FCRA. Some of these laws provide stricter penalties, greater consumer rights to access, and more generous error correction procedures, as well as permit information sharing with affiliates. Cal. Civ. Code 1785.3(c). State fair credit reporting laws generally impose requirements on users of consumer reports similar to the FCRA. However, the revised FCRA preempts most state laws or regulations governing information sharing and use among affiliated companies whether limited to credit reporting or not. Most federal preemption provisions sunset on January 1, 2004. 15 U.S.C. 1681t(b)(2). State laws that were preempted by the FCRA do not automatically return in force after the sunset date. Each state must enact new legislation. 15 U.S.C. 1681t (d).

[90] The Privacy Act established a Privacy Protection Study Commission to study the data systems of governmental, regional, and private organizations and to make recommendations for the protection of personal information. *See* Pub. L. No. 93–579, 5 (amended June 1, 1977). The Commission's report, issued in 1977, recommended protection of individual records maintained by private sector record keepers in its provision of telecommunication services, but Congress has never done so. Privacy Protection Study Commission, Personal Privacy in an Information Society (USGPO Stock No. 052–003–00395–3) (1977).

[91] 5 U.S.C. 552a(e)(1) and (3). The Privacy Act applies only to personal information within "records" contained in a "system of records," as these terms are defined by the Act. *Id.* 552a(a)(4) and (5).

[92] *Id.* 552a(b). An individual may access and copy any information pertaining to himself that is maintained in an agency's system of records. *Id.* 552a(d).

[93] 12 U.S.C. 3404–3408. The government generally must notify the customer of the nature of the law enforcement inquiry and give the customer an opportunity to challenge the access *prior* to accessing a customer's records. *Id.* 3405–3408. The government generally must notify the customer of the nature of the law enforcement inquiry and give the customer an opportunity to challenge the access *prior* to accessing a customer's records. *Id.* 3405–3408.

RFPA defines a "financial institution" as any office of a bank, savings bank, credit card issuer, industrial loan company, trust company, savings association, building and loan, homestead association, credit union, or consumer finance institution.[94] The RFPA only covers "financial records," defined to include "information known to have been derived from" a record pertaining to a customer's relationship with a financial institution.[95]

It is uncertain whether the RFPA would apply to a consumer's e-money transaction information for several reasons. First, the scope of institutions subject to the RFPA is limited, although many current e-money issuers would most likely fall within the RFPA's definition of "financial institutions."[96] Second, a consumer's e-money transaction information may not, in all instances, be considered to be a "financial record" relating to an "account" for purposes of the RFPA.

Although the U.S. has various sectoral privacy laws protecting some consumer financial information, it is uncertain whether these protections would extend to e-money. Accordingly, existing laws may not address consumer concerns about the collection and use of their e-money information, require issuers to disclose how information will be collected and used, provide consumers with the ability to control whether unaffiliated third parties can obtain the information, or generally limit government access to the information. In sum, it is uncertain and untested whether consumer concerns about privacy in e-money transactions are addressed by existing law.

Many states also have financial privacy laws that impose similar restrictions to the federal RFPA, often only regulating disclosures to governmental agencies. Cal. Gov't Code 7460–7493 (1995 & 1997 Supp.); Nev. Rev. Stat. Ann. 239A.010–239A.190 (1996); N.H. Rev. Stat. Ann. ch. 359–C (1984 & 1996 Supp.); Or. Rev. Stat. 192.550–595 (1995). Other states have broader statutes that prohibit disclosures to "any person," which implies that private entities are also covered. *E.g.,* Conn. Gen. Stat. Ann. 36a–42 (1996); Me. Rev. Stat. Ann. tit. 9–B 162 (1997); Md. Ann. Code 1–302 (1996 Supp.). The types of financial institutions and records regulated by states also differs from the federal RFPA, ranging from only state-regulated financial institutions and financial records to any corporation organized under the state or federal law and any confidential information, financial or otherwise. *E.g.,* Nev. Rev. Stat. Ann. 239A.030 (1996) and Neb. Rev. Stat. 8–1401 (1996 Supp.). State laws, however, may more readily apply to e-money issuers and products. This is largely because some state financial privacy laws apply to both depository institutions and nonbanks and have more expansive financial definitions of "financial records." Overall, although a few states' laws may apply in this context, the majority may not.

[94] 12 U.S.C. 3401(1).

[95] *Id.* 3401(2).

[96] Issuers which do not otherwise fall within the definition of "financial institution," would probably not be considered a "financial institution" for the purposes of the RFPA based on their e-money activities alone. *See* 12 U.S.C. 3401(1).

Security of Consumers' Transaction Information

Federal laws prohibiting unauthorized access to electronic communications may be applicable to the security of e-money payment information.[97] The Electronic Communications Privacy Act ("ECPA") prohibits the unauthorized access or use of any facility through which an electronic communication service is provided or to intentionally exceed the authorization for accessing that facility.[98] "Electronic communications" is defined broadly and includes any transfer of signs, signals, writing, images, sounds, or intelligence of any nature transmitted by a wire, or electromagnetic or photo-electronic system, except electronic funds transfer information stored by a financial institution.[99] The ECPA also prohibits any person or entity from knowingly divulging to any person or entity the contents of an electronic communication while that communication is in transmission or in electronic storage.[100]

Again, it is unclear whether a consumer's e-money transaction information would fall within the ECPA's prohibition against disclosing electronic communications in transmission or storage.

Industry Responses

Information on consumers and their preferences has important economic value to businesses and consumers. It can help businesses better allocate their resources, improve product quality, and assist consumers

[97] Several states have also criminalized unauthorized access to electronic communications. *See, e.g.* N.J. S.A. 17:16K–2.

[98] 18 U.S.C. 2520. Although "electronic funds transfers" are exempt from the scope of the ECPA, it is unclear whether e-money products would be "electronic funds transfers."

[99] 18 U.S.C. 2510 (12). "Electronic communication system" is defined as any wire, electromagnetic, or photoelectric facilities for the transmission of electronic communications and any computer facilities or related electronic equipment for the electronic storage of such communications. 18 U.S.C. 2510(14).

[100] 18 U.S.C. 2701(a)(1). *Also see* S. Rep. No. 99–541, 99th Cong., 2d Sess. 1, 37 (1986). "Electronic storage" means (A) any temporary, intermediate storage of a wire or electronic communication incidental to the electronic transmission thereof; and (B) any storage of such communication by an electronic communication service for purposes of backup protection of such communication. 18 U.S.C. 2510(17).

There are several exceptions to the ECPA's general prohibition on disclosure. These include: disclosure to the addressees or intended recipients of the communication or their authorized agents; in response to a court order; and with the lawful consent of the sender, addressee, or intended recipient of such communication. 18 U.S.C. 2702(b)(1)–(4). Information may also be released to law enforcement agencies if the contents were inadvertently obtained by the communication service provider and the information pertains to the commission of a crime. 18 U.S.C. 2702(b)(6). However, none of these provisions is intended to affect any other provision of federal law that prohibits disclosure of information on the basis of the content of that information, such as the FCRA.

in product and service choice. Information can aid firms in the design and delivery of products and services, in marketing, and in inventory control.

Although some information, such as mailing lists or product purchase patterns, has always been used for marketing purposes, technological advances of recent years have made that information easier to develop and cheaper to replicate.[101] Consequently, firms are able to make better use of existing information and to lower the costs of developing new information sources. Information resources can also generate their own independent source of revenue when replicated, sorted, and sold. In some cases, the revenue from direct sale of information might make the provision of primary services profitable. The development and use of consumers' information, however, also raises important questions about consumers' privacy.

The heightened public debate in recent years about privacy and electronic technology has begun to make financial industry participants more sensitive to issues surrounding the collection and dissemination of customer information. As in the financial services sector more generally, industry responses that could be relevant to e-money are continuing to evolve. For example, many products can be purchased on an anonymous basis, such as through vending machines. Similarly, the development of more anonymous e-money products is, itself, one market response that has the potential to provide consumers with new ways to enhance their privacy in financial transactions. Industry responses based on new, more anonymous technologies may be constrained, however, by law enforcement concerns, which may constitute a significant barrier to the development of electronic money products with greater protections. Although it is too early to tell how many e-money products will ultimately develop, it is likely that more anonymous products will emerge if there is consumer demand for the products and law enforcement concerns can be accommodated. For example, consumer preferences might emerge for anonymous small dollar payments, which would not infringe on the important interests of government agencies to review suspicious large dollar transactions.

Current e-money technology is capable of delivering products with varying effects on privacy, ranging from fully anonymous, cash-like systems, in which no personally identifiable transaction records are created, to fully auditable systems that can identify and store every transaction conducted by every consumer. As the technology evolves, new products will be developed. The extent to which new products will incorporate privacy protections will be influenced by several factors, including consumer preferences, law enforcement needs, and industry perceptions of the value of information.

Consumers with a high degree of concern about the privacy of their transactions will likely favor cash or other cash-like payment products that preserve their anonymity. Other consumers are willing to surrender a degree of privacy in their consumer transactions in order to obtain consumer benefits available with auditable systems, such as convenience, error resolution, recovery of value for lost cards, purchase protection, and loyalty program awards.[102] The majority of stored value systems in existence today involve some trade-off between these types of consumer benefits and privacy. Some e-money issuers claim that it is possible to combine some consumer benefits of an auditable system with the anonymity of a cash-like system, decreasing the need for this trade-off.[103]

At the present time, whether consumers will demand e-money products that protect their privacy is uncertain. How widespread the existence of privacy protections will become may depend on the extent to which consumers tend to prefer products that offer these protections. Given the strong competing pressures from cash and other payment methods, issuers are more likely to face pressures to provide privacy protections, especially as consumer awareness over information collection and use rises and consumers increasingly seek such protections.[104] Issuers in such an environment might see offering privacy protection as a way to differentiate their product, competing for customers on the basis of the privacy protections offered.[105] Similarly, some issuers

[101] *See* Lawrence J. Redecki, John Wenninger and Daniel K. Orlow, *Industry Structure: Electronic Delivery's Potential Effects on Retail Banking,* 19 Journal of Retail Banking Services 57 (Winter 1997).

[102] *See* Laufer, R.S. and M. Wolfe, *Privacy as a Concept and a Social Issue: A Multidimensional Development Theory,* Journal of Social Issues (33:3), Summer 1977, pp. 22–42. Note, however, that even if consumers recognize the benefits of surrendering some privacy, privacy concerns can still arise if consumers are not aware that information is being collected and if more information is gathered than the transaction and associated protections required.

Alan Westin demonstrated this point by constructing a "willingness to trade-off" index, which measures an individual's willingness to trade consumer benefits for a relaxation of privacy interests. Westin, A.F., *Domestic and International Data Protection Issues,* Testimony before the Subcommittee on Government Information, Justice, and Agriculture, Committee on Government Relations, U.S. House of Representatives, U.S. GPO, WDC: 1991, pp. 54–68.

[103] One product developer, DigiCash, claims already to have done this.

[104] In markets without such competition, the incentives to provide privacy protections may not be as great. Lack of consumer awareness that information collection is taking place, or the absence of viable substitutes available to consumers for the service provided, could dampen private incentives to respond to privacy concerns of individuals.

[105] Although issuers, who market their product based on its privacy protections will disclose their information practices or other privacy-enhancing features, many others may not. In the latter cases, consumers will have to make judgements about whether to use the product, as they do with other payment methods today.

may then create a product for which consumers would, in effect, pay a premium in exchange for additional privacy protections. While there is reliable evidence that consumers are reluctant to commit to electronic commerce and e-money because of privacy concerns, a clear market demand for this "privacy premium" product has yet to emerge. Consumers that are not particularly concerned about the confidentiality of their purchases may not demand privacy protections or information about disclosure policies, as is currently the case for credit cards and similar payment vehicles.

Market developments may in some respects address consumer concerns about privacy. Moreover, even if individual consumers do not demand specific protections—due to lack of knowledge or otherwise—implementation of privacy protections by individual firms could increase consumer confidence overall and thereby foster development of the e-money market.

In addition, many financial industry participants, either individually or as part of industry groups, are exploring self-regulatory responses to consumer privacy concerns in the financial services industry more generally. As described more fully below, several groups have voluntarily established privacy policies or codes of fair information practices. Also, several industry groups are considering developing "Acceptance" or "Privacy" marks.[106]

- The SmartCard Forum's[107] Privacy Guidelines encourage their members to: respect the privacy expectations of consumers; ensure that the data are as current, accurate, and complete as possible; promptly honor consumers' requests for information that a company has about them; enable consumers to correct inaccurate personally identifiable information; limit the use, collection, and retention of customer information; and apply appropriate security measures to protect consumer data. The SmartCard Forum principles also encourage their members to provide consumers the opportunity to opt-out before personally identifiable consumer information is to be provided to unaffiliated third parties for marketing or similar purposes. Third parties receiving the information from SmartCard members are encouraged to adhere to equivalent privacy standards with respect to that information. Similarly, the guidelines suggest that service providers should implement policies and procedures to limit employee access to personally identifiable consumer information on a need-to-know basis, educate employees about the privacy guidelines and their responsibilities under the guidelines, and monitor employee compliance, taking appropriate disciplinary action where appropriate.[108]

- In September 1997, the American Bankers Association ("ABA"), The Bankers Roundtable and its division, the Bank Information Technology Secretariat ("BITS"), the Consumer Bankers Association (CBA), and the Independent Bankers Association of America ("IBAA"), endorsed a common set of privacy principles ("Banking Industry Principles"). These principles provide that subscribing financial institutions should:

  (1) recognize a consumer's expectation of privacy by making available privacy guidelines and/or providing a series of questions and answers about financial privacy to their customers;

  (2) only collect, retain and use individual customer information where it would be useful (and allowed by law) to administer that organization's business and to provide products, services, and other opportunities to its customers;

  (3) establish procedures to ensure customer information is accurate, current, and complete in accordance with reasonable commercial standards, including responding to requests to correct inaccuracies in a timely manner;

  (4) limit employee access to personally identifiable information to those with a business reason for knowing such information, educate employees so that they will understand the importance of confidentiality and customer privacy, and take appropriate disciplinary measures to enforce employee privacy responsibilities;

  (5) maintain appropriate security standards and procedures regarding unauthorized access to customer information;

  (6) not reveal specific information about customer accounts or other personally identifiable information to unaffiliated third parties for their independent use, except for the exchange of information with reputable information reporting agencies to maximize the accuracy and security of such information or in the performance of bona fide corporate due diligence,

[106] See Koehler Statement, *supra.*

[107] The Smart Card Forum was formed in 1993 to promote the widespread acceptance of smart cards that support multiple applications. Bringing together representatives from technology companies, the financial services industry and other interested parties from the public and private sector, the Forum participants focus on issues to advance interoperability across industries and applications. Currently, over 230 corporate and government entities from the U.S., Canada, South America and Europe are members of the Smart Card Forum.

[108] Smart Card Forum Privacy Guidelines.

unless 1) the information is provided to help complete a customer-initiated transaction, 2) the customer requests it, 3) the disclosure is required by/or allowed by law *(e.g.,* subpoena, investigation of fraudulent activity) or 4) the customer has been informed about the possibility of such disclosure for marketing or similar purposes through a prior communication and is given the opportunity to decline *(i.e.,* "opt-out");

(7) if personally identifiable information is given to a third party, the financial institution should insist that the third party adhere to similar privacy principles that provide for keeping such information confidential;

(8) devise methods of providing a customer with an understanding of their privacy principles.[109]

In conjunction with the privacy principles, BITS is in the process of developing a plan for implementing the principles. Thus far, the BITS Board of Directors, made up of the Chairs of the largest banks in the United States, as well as representatives of the ABA, IBAA, and Bankers Roundtable, have approved and endorsed the "Privacy Principles Implementation Plan." This plan states that: a plan for implementing the privacy principles will be approved at the level of the Board of Directors or the Office of the Chair of the bank; bank policies related to customer privacy will be communicated to bank customers; employees will be informed and educated about the bank's plan to implement the privacy principles; banks will obtain agreements from third-party vendors on a case-by-case basis to comply with the bank's privacy principles; where a bank provides information to unaffiliated third parties for their independent use for marketing or similar purposes, the bank will notify customers of their right to opt-out from the information sharing; banks will establish and maintain procedures by which customers can correct inaccurate information, and banks will establish internal policies to ensure compliance with and to address breaches of a bank's privacy policy.[110]

These principles are more likely to address consumers' privacy concerns in a meaningful and effective manner if they involve a means to assure adherence by industry participants.

Certain industry self-regulatory initiatives include a compliance assurance mechanism. For example, the members of the Individual Reference Services Group ("IRSG") have agreed to self-regulatory principles that require an annual review by a "reasonably qualified independent professional service" to assess whether the reference service is in compliance with the IRSG's principles.[111] The results of this review must be made public. Also signatories to the principles have agreed only to sell information to reference service companies in compliance with the principles.[112]

Separately, a company's failure to honor its own stated privacy policy may also constitute a deceptive practice prohibited by the Federal Trade Commission Act ("FTCA") and state law. Section 5 of the Federal Trade Commission Act prohibits any person or corporation from engaging in unfair and deceptive acts or practices in or affecting commerce.[113]

Even if any industry self-regulatory policies are not implemented through a formal mechanism for enforcement, the interplay of these practices with existing law may result in certain remedies being available to consumers.

First, a court may find that the consumer's reliance on an issuer's stated privacy policy gave rise to a contractual relationship between the consumer and the issuer concerning the terms of the privacy policy. Thus, the issuer's failure to follow the terms of the policy statement could constitute a breach of contract.[114] Second,

[109] Banking Industry Principles.

[110] *Id.*

[111] The FTC, in its Report on Individual Reference Services, discussed the pros and cons of the IRSG self-regulatory initiative. *Individual Reference Services: A Report to Congress,* December 1997.

[112] The FTC criticized the IRSG principles for not giving consumers access to the public information maintained about them and disseminated by the reference services. Under the IRSG principals, consumers thus would not be able to check for inaccuracies in information resulting from transcription or other errors that occur in the process of obtaining or compiling such information. *Id.*

[113] 15 U.S.C. 45(a)(i). Under Section 5 of the Federal Trade Commission Act, deception occurs if "there is a representation, omission or practice that is likely to mislead the consumer, acting reasonably in the circumstances, to the consumer's detriment." *Cliffdale Associates, Inc.,* 103 F.T.C. 110 (1994).

[114] The general doctrine of implied contract may also offer some, albeit limited, protections through an implied contract of confidentiality. As applied to financial privacy, a depository institution can be said to have an implied contract with its customers to keep their financial affairs confidential. Although several state courts have found such an implied contract in a financial institution's relationship with its customers, there is no uniformity among state courts in the doctrine. *E.g., Peterson* v. *Idaho First Nat'l Bank,* 367 P.2d 284 (Idaho 1961) (Bank liable for unauthorized disclosure of customer's ledger record to customer's employer). Many cases upholding such an implied contract involved disclosure of information in connection with investigations of alleged violations of law, rather than in connection with marketing or other ordinary business transactions. Whether this theory provides any meaningful protection for consumers is uncertain as a financial institution may expressly negate any duty of confidentiality in its contract. Because consumers are told of the issuer's disclosure practices, the consumer may also be construed to have given implicit consent to any uses set forth in the

a consumer may argue that the issuer's failure to follow its privacy statement was a breach of warranty.[115] Third, consumers may have actions in tort for negligent misrepresentation.[116]

Review of Existing Self-Regulatory Policies

Both the SmartCard Forum guidelines and the Banking Industry Principles appear to generally address many consumer privacy concerns. It remains to be seen, however, whether they will be sufficient to address the concerns expressed to the Task Force. Each set of guidelines appears to encourage practices that address certain concerns about the collection and use of information. However, neither set has yet developed a formal means to assure adherence by participants or other members of industry. The lack of a means to assure adherence may limit the effectiveness of these guidelines.

Conclusion

Several privacy concerns were brought to the Task Force's attention during the course of its proceedings. Commenters stated that consumers were concerned that e-money technology would enable issuers and merchants to obtain large amounts of information about them. Similarly, many commenters stated that consumers were concerned that they would not receive adequate disclosure about an issuer's information practices, and that issuers would be able to share a consumer's e-money transaction information with third parties without the consumer's consent.

The Task Force recognizes that the increased efficiency of data collection methods associated with e-money may increase the potential for privacy intrusions. However, the Task Force also recognizes that technology provides opportunities for increased privacy, and that different privacy policies and product characteristics may be appropriate for different consumers depending on their disparate individual preferences relating to privacy. Moreover, e-money is in an early stage of development, and there is not yet any indication that anonymous payment methods (such as cash or anonymous e-money products) will not remain available.

Additionally, existing laws and market responses may address some consumer concerns. Industry participants appear to have significant incentives to develop an e-money market for consumers especially concerned about privacy. Similarly, industry self-regulatory principles have the potential to address other concerns expressed to the Task Force. Industry groups are currently working to develop privacy practices. The Task Force encourages issuers to adopt self-regulatory initiatives that are meaningful and effective in that they both respond to consumers' privacy concerns and involve some means to assure adherence by individual participants. These means can involve a variety of flexible approaches.

Privacy protections are essentially evolutionary in the United States, and there is little precedent for comprehensive government established privacy protections. Until e-money has had more time to develop, it is premature to assess whether and the degree to which it will present threats to privacy that would warrant government action.

As the e-money industry changes and matures, the extent to which industry participants have effectively addressed consumer privacy interests through self-regulatory initiatives should be carefully monitored. The need for government action regarding privacy standards for e-money then can be reassessed based on the growth of e-money as a payment media and the success of e-money providers in implementing effective privacy principles and policies.

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agreement. This implicit consent may be converted to express consent if the issuer adds appropriate language to the EFT service contract and disclosure. Law of Electronic Funds Transfer, Donald I. Baker, Roland E. Brandel ∂ 19.02[2][a]. However, if the consumer relied on these privacy statements to the consumer's detriment the issuer may be estopped from withdrawing or altering the promise it made to the consumer.

[115] Warranties are assurances by one party to a contract of the existence of a fact upon which the other party may rely, which, if untrue, may give rise to an action for breach of contract and damages. In such instances, the consumer could argue that statements made by the issuer in the privacy statement were untrue.

The Magnuson Moss Warranty Act, 15 U.S.C. 2301 *et seq.* may also be applicable if e-money were found to be a product, rather than a service as it is generally viewed at present.

[116] Negligent misrepresentation usually requires a material misrepresentation made by a party who had a duty to provide accurate information to the party requesting the information, who suffered injury as a result of the misrepresentation. Parties who in the course of their business supply false information for the guidance of others in their business transactions may be subject to liability for pecuniary loss caused by justified reliance on the information if they did not use reasonable care when making the representation. Restatement (second) of Torts 552. In the case of e-money, a consumer could argue that an issuer misrepresented its privacy practices in order to cause the consumer to rely upon those practices and purchase the issuer's product.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the Interagency Conference, "Building Economic Self-Determination in Indian Communities," on banking and the Native American economy, Washington, D.C., August 6, 1998

It's an honor to share this podium with such a distinguished group of statesmen and women from the public and private sectors, united in our commitment to the economic progress of Indian people.

As head of the bureau of the Treasury Department responsible for chartering, supervising, and regulating national banks, I would like to discuss the role that banks fill in the Native American economy today, and what we can do to enhance the contributions that banks can make to the economic self-determination of Indian people in the future.

This is a matter of considerable importance. For no business is more fundamental to economic growth and prosperity than banking. Even so, I am sometimes surprised to discover that official visitors to our country, especially those representing emerging economies, are more interested in—and more impressed by—our dynamic banking system and our system of bank regulation than almost anything else about us. They recognize that effective mechanisms for mobilizing, distributing, and leveraging wealth—under the proper supervisory controls—are indispensable prerequisites to their own countries' economic success, as they have been to ours.

Bank supervision is something that we at the OCC should be good at, for we have been at for over 135 years. Today the basic job of the bank supervisor is much the same as it was back then. The OCC's primary responsibility is to safeguard the safety and soundness and vitality of the national banking system so that our national economy can function efficiently and productively. In recent years, however, we have come to view fair access to banking services as a positive right to which all Americans have a claim. We recognize that for many individual Americans the lack of access to banking services has been a formidable barrier to economic opportunity. Conversely, we understand better than ever that the availability of banking services can be of enormous assistance in overcoming the effects of years of economic discrimination and neglect. And, we have come to understand how important it is, if only as a matter of their long-term self-interest, that banks explore and serve the financial needs that exist among all underserved populations.

Banking in Indian country is a telling case in point. Native Americans have traditionally been among the most underserved banking populations in America. Just five years ago, the whole Navajo reservation—comprising some 200,000 people on 26,000 square miles—was served by a total of just three banking offices and two automated teller machines. And the Navajo were probably no worse off in that respect than the majority of Native Americans living on reservations throughout the country. Certainly, the absence of banking services in Indian country has been a contributing factor to the economic difficulties that have long beset many of the Indian nations.

That's why improving access to banking services in Indian country has been a special concern of the OCC's in recent years. I am proud to say that the OCC has been a leader among federal banking agencies in devising practical methods to advance the economic self-determination of the Native American nations. During his term of office, which ended in April, Comptroller Gene Ludwig and senior OCC officials visited Indian reservations and met with bankers and tribal leaders and others with an interest in bringing Native Americans and banks together. We've met with board members of the North American Native Bankers Association, a new organization that represents Native-controlled financial institutions. The OCC sponsored revisions in the Community Reinvestment Act's regulations to encourage banks to place new loans, new investments, and new banking facilities in Indian country. Just last year, the OCC and the Department of Justice co-sponsored a conference, titled "Banking in Indian Country," which drew over 500 tribal officials, bankers, attorneys, and economic development consultants. To coincide with the conference, the OCC released a guidebook to banks seeking to provide financial services to Native Americans living in Indian country and a companion piece providing advice on making home purchase loans on Indian reservations. In each case, we have strived to develop practical solutions that couple respect for Indian sovereignty with practical assistance drawn from our experiences.

We ourselves are learning from these experiences. We have discovered that the range of needs for banking services in Indian country is almost as diverse as the Indian nations themselves. Some tribes are primarily seeking basic deposit and check-cashing services for low-income tribal members. Other tribal officials would like to increase the number of conventional home mortgages available to moderate- and higher-income residents of Indian reservations. Still others seek to promote small business financing for small firms owned by or

operated for the benefit of tribal members. And tribal governments may be looking for financing for their governmental or commercial enterprises, such as hospitals, schools, or industrial developments.

Just as the financial needs of the Native American people are diverse, so are the options and creative solutions available to meet those needs. Among these options are targeted programs like HUD's 184 Indian Home Loan Guarantee Program, under which lenders, tribal authorities, and the federal government work in partnership to resolve the unique challenges of making mortgage loans in Indian country. A number of tribes—in Alaska, Arizona, California, and New Mexico—have obtained assistance from the Treasury Department's Community Development Financial Institutions fund, and are leveraging that assistance to build and support small businesses and microenterprises, farms and factories, and affordable housing. Other tribes are exploring the creation of Community Development Corporations authorized by the financial regulatory agencies for bank investors and Small Business Investment Companies, which are venture capital firms licensed by the Small Business Administration to support small business expansion through a combination of debt financing, equity investments, and management counseling.

Important as they are, these programs are perhaps best viewed as a means by which to jump-start the private economy. It has long been the OCC's belief that good, profitable, self-sustaining business relationships exist in currently underserved markets. While these markets may require greater tenacity or creativity to cultivate, they hold the potential to reward such efforts many times over. We are convinced that many sound opportunities exist to provide financial services critical to Native American people that will spur economic development and lead to greater self-determination.

The experiences of commercial banks in Indian country increasingly bear this out. For bankers too, doing business there has been a learning experience. Bankers have learned the importance of understanding tribal sovereignty and the culture and laws of the tribes they serve. They have found that real success in the Native American environment takes time—time to build the enduring relationships with customers and tribal leaders that ultimately breed trust. And they now appreciate the need for flexibility in how they deliver products and services that take this cultural diversity into account. For example, on Indian reservations that sprawl across tens of thousands of acres, some banks have sensibly chosen to replace or supplement fixed brick-and-mortar branches with mobile "offices on wheels" that deliver financial products and services directly to the customer in a customer-friendly manner. We strongly support this type of initiative, which can have a dramatic impact on the availability of banking products and services in Indian country.

Bankers who once wondered whether there was money to be made in the Native American market are having many of their doubts dispelled. They have found that success in providing financial products and services in Indian country does not necessarily require radical changes in how banks do business or in the products and services they provide. Rather, their experience shows that success comes to those who are diligent in adapting and applying the fundamentals of sound banking to doing business in Indian country. Their loans to tribal members are proving to be just as safe and just as profitable as loans to borrowers in better-served communities. In fact, some of the most profitable branches of large nationwide banking companies today are located on Indian reservations. And the message is getting out to the banking industry at large.

Among the most auspicious developments in this whole picture is the emergence of banks owned by Native Americans. At present, there are six national banks in which tribes hold a majority or controlling shareholder's interest. They include the Blackfeet, the Citizen Band Potowatomi Tribe, the Mille Lacs Band of the Ojibwe Indian Tribe, the Viejas Band of Kumeyaay Indians, the Agua Caliente Band of Cahuilla Indians, and the Eastern Shawnee Tribe of Oklahoma. Additionally, we know of at least two tribally owned state-chartered banks.

Again, diversity is the most striking feature of these tribally owned banks. They are located in relatively prosperous cities and towns and in isolated, relatively poorer ones. One has its main office on its reservation. Others seek to serve tribal members while marketing their products and services off the reservation. These tribally owned banks are, variously, specialists in small business or agricultural lending or consumer banking. Some are active participants in the government-sponsored programs I mentioned earlier; others are more inclined to go their own way. They are both wholly tribal-owned and in partnership with non-Indian interests. But these institutions all share many of the same market challenges and opportunities, the same legislative, regulatory, and legal concerns, and the same operational dilemmas common to banks of their size. And there's one other thing they have in common: for the tribes that own these banks, empowerment and self-determination are not merely slogans or ideals, but a reality taking shape every working day.

In light of the growing interest in Native American banking, I directed my staff to develop a guide to assist Native American tribes as they explore entry into the national banking system. The result is a new publication, titled "A Guide to Tribal Ownership of a National Bank" [August

1998]. You are the first to receive a copy of this guide, which is in your conference package and on the OCC Web site.

Most of the steps involved in organizing a new national bank or acquiring a existing national bank are no different for a tribal government than for any other group. Groups contemplating formation or acquisition of a national bank in Indian country can review the information conveniently contained within this handbook and reach a better decision as to whether a national bank charter is the right tool for them to use to achieve their economic objectives. For those who decide that it is, we will work with you and provide technical assistance even before you begin the licensing process. We will continue to provide technical assistance until the bank is ready to open. We will make certain that your questions are answered in a timely and accurate manner, that you receive full and fair reviews at every step along the way, and that you get off the ground with a good chance of success.

In addition, if tribally owned banks are to fulfill the expectations of their owners and communities and truly advance the cause of economic self-determination over the long term, it is essential that they receive effective ongoing supervision by their chartering authority. OCC examiners can often provide useful advice and specialized expertise during their on-site examinations—expertise that smaller banks especially sometimes lack on their own. But our examiners must also monitor the banks' safety and soundness and bring their expertise to bear to ensure that potential problems are addressed by bank management before they compromise the solvency of an institution. The guide explains how the OCC and the other federal banking regulators seek to accomplish these regulatory objectives without unduly imposing on tribal sovereign rights.

Our new guide also provides examples of innovative ways to resolve the logjams that sometimes arise in connection with tribal ownership of a national bank. Under federal law, banks are required to give notice of certain changes in control. This requirement would be triggered in the event that the tribal officials in whom control of a bank is vested were replaced in tribal elections. In our guide, we suggest two possible approaches by tribal bank organizers to reduce that potential regulatory burden: by creating a voting trust or a voting agreement, in which the tribe agrees to vote the bank's stock according to the direction of someone who is not subject to regular replacement. Under either arrangement, tribal officials could shift without necessitating bank regulatory change of control notifications. Again, our goal is to help make the process of organizing and operating a national bank simpler and more productive—without compromising bank safety and soundness and without disrupting tribal sovereignty.

Obviously, the formation of a national bank is not the answer for every Native American tribe. It takes a major investment of capital, energy, and expertise. But, as some tribes have already discovered, the national bank charter can be a potent instrument for economic progress. It has benefitted millions of Americans for over a century. Under the right circumstances, with the right commitment and the right discipline, a bank charter can be of great value in advancing the cause of economic self-determination for Native Americans, today and into the future. We at the OCC look forward to working with Indian tribes to help enhance their business relationships with existing national banks and, where appropriate, in exploring the possibility of their own national bank charter.

Thank you.

Statement of Julie Williams, Acting Comptroller of the Currency, before the U.S. House Committee on Banking and Financial Services, on the year-2000 date change, Washington, D.C., September 17, 1998

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

Introduction

Mr. Chairman, and members of the committee, I welcome this opportunity to report on the progress the Office of the Comptroller of the Currency (OCC) is making in its efforts to ensure that national banks address the problems associated with the century date change and to describe the challenges that remain.

The OCC is committed to vigorously addressing the challenges posed by the century date change. This means supervising national banks effectively to reduce the risks associated with the year-2000 problem, and working diligently to ensure that our own internal systems are year-2000 compliant. We have been aggressive in our examination efforts; enforcement actions; internal examiner training program; and educational outreach programs for bankers and other groups. In addition, we have actively participated in the coordinated efforts of the Federal Financial Institutions Examination Council (FFIEC) member agencies to develop policies, procedures, and guidance for all insured depository institutions.

The OCC's efforts will intensify during the balance of 1998 through the first quarter of the year 2000 as we review the banks' testing, renovation, and contingency planning efforts. In preparation for those activities, the OCC provided advanced, formal training to a large number of examiners and reallocated examiner resources to perform year-2000 reviews. We have also established a year-2000 hotline and formed a special team of technical experts to answer questions our examiners pose and to go onsite at national banks, if necessary.

The overwhelming majority of national banks have demonstrated good-faith efforts to address year-2000 issues, and most are on schedule in dealing with the issues. Nonetheless, some of the toughest work associated with year 2000 lies ahead. Correction of problems that banks identify during the testing phase may be time-consuming and expensive. In addition, correction of any problems found will need to be made quickly, just at the time when qualified programming specialists and consultants will be in high demand. Software vendors and systems providers may not be readily available, willing, or able to provide customized replacement software and hardware systems.

As we head toward 1999, the OCC is also evaluating how national banks could be affected by the year-2000 problems of critical bank customers, such as large corporate borrowers, as well as external entities providing vital infrastructure, such as telecommunications and utility companies. For many larger banks, another critical and complex issue of concern is their exposure to foreign governments and international companies. Banks can address the credit risk associated with domestic customers by implementing appropriate credit risk management controls. With respect to external infrastructure providers and foreign parties, institutions, and their supervisors, are making conscientious efforts, through interagency and international coordinating groups, to ascertain which external entities and international parties have year-2000 problems and what, if any, corrective action they are taking. However, U.S. financial regulators have no direct control, and limited indirect influence, over the corrective action of many of these external entities and international parties.

The discussion that follows briefly describes the year-2000 problem and its impact on the banking industry; provides an overview of the OCC's supervisory initiatives; highlights the significant year-2000 challenges going forward; discusses the remediation of OCC internal systems; and concludes with our response to the committee's request regarding suggested legislative remedies.

Year-2000 Problem and Its Impact on the Banking Industry

Because information technology is an integral part of almost everything we do, the year-2000 problem impacts virtually all businesses and their customers. Any automated, computerized system that uses dates as key data elements, including computer hardware and software of all types, other communications systems, transportation services, elevators, vaults, and security systems, is potentially subject to year-2000 risk.

As you are well aware, the crux of the year-2000 problem is that many computer systems currently in use were not programmed to recognize or process information with dates beyond December 31, 1999. To conserve computer

memory space, programmers used two digit codes for storing years rather than four digit codes. As a result, software programs and computer chips may interpret the year-2000 date code of "00" as "1900." Furthermore, many mainframe computers are programmed to read "99" as a code for setting up special files or storing or rejecting the data processed, so problems could arise three months before the year 2000 when, on September 9, 1999, the date and year fields might be read as "9/9/99." Also, some systems may not recognize the year 2000 as a leap year.

Obviously, the banking industry is highly dependent upon computer systems, and dates are an integral part of virtually all areas of bank operations, transactions, and record keeping. The banking system's readiness is especially important because banks are at the center of our payments systems and directly affect credit flows throughout the economy. Banks use computer systems to perform financial calculations, track deposits and loan payments, transfer funds, and make direct deposits. The failure of the banking industry to address and solve year-2000 problems thus could have serious repercussions throughout our economy.

Overview of OCC Supervisory Initiatives

As you know, the OCC has been working closely with other federal banking agencies under the auspices of the FFIEC to address the year-2000 problem. The FFIEC has adopted a program to ensure a consistent and effective approach among the FFIEC member agencies in supervising and examining depository institutions' year-2000 efforts. The six major FFIEC year-2000 initiatives now under way include coordinating policy; developing and issuing guidance for banks and service providers; conducting examinations of service providers and software vendors; developing examination procedures and training programs for examiners; developing regulatory contingency plans; and conducting outreach activities with trade associations.

The OCC is aggressively implementing the FFIEC program to ensure that national banks will be ready to handle the century date change. Although our focus is on the national banks and their vendors, our supervisory strategy also addresses external connections that banks rely upon to conduct business. Thus, we expect banks to test external telecommunication systems; interfaces with credit bureaus, the Internet, clearing houses, and business partners; and environmental systems such as vaults, heating/cooling systems, and security. We also expect banks to develop remediation contingency plans and business resumption contingency plans in case internal or external systems fail or are disrupted. I am pleased to report to the committee that, on the whole, the banking industry has vigorously attacked the year-2000 problem.

The OCC began to address year-2000 supervisory issues in 1996. We have an extensive monitoring program that tracks, at least quarterly, the progress of national banks and their vendors in making their systems year-2000 compliant. We met our target to complete by June 30, 1998, onsite examinations of every national bank and regional data center and assessed where they stand in their year-2000 efforts. We will follow up as needed with every institution with which we have supervisory concerns, and we will take prompt action if any fall behind schedule. In 1999, when testing is under way, our year-2000 examinations will include reviews of testing results and contingency planning efforts. The OCC also is working closely with the other members of the FFIEC to ensure that the third-party providers of bank data processing products and services have comprehensive year-2000 project management programs in place and that they successfully complete their remediation and testing efforts.

Status of examinations. As planned, we completed our initial year-2000 examinations of banks, federal branches and agencies, and service providers by June 30, 1998. As of that date, nearly 96 percent of the institutions examined by the OCC received a summary evaluation of satisfactory on their progress in addressing year-2000 problems, 4 percent of institutions were rated needs improvement, and eight institutions were rated unsatisfactory. These ratings are likely to fluctuate as we examine the banks' testing plans, testing results, and contingency plans. As we have done to date, the OCC will continue to take aggressive and comprehensive action to ensure that an institution rated "needs improvement" or "unsatisfactory" adequately addresses its year-2000 risks.

Because nearly 70 percent of banks rely, in part or wholly, on service providers and software vendors for their mission-critical data processing needs, regulators must be well informed about the year-2000 compliance of the services these firms provide to financial institutions. The OCC and the other FFIEC agencies, therefore, have divided up responsibility for examining the largest service providers and the largest software vendors. In the course of the OCC's first round of examinations, completed June 30 of this year, five out of the 109 service providers and software vendors that the OCC examined received less than satisfactory ratings on their progress. Of these five firms, four were rated needs improvement and one was rated unsatisfactory. The OCC has been working closely with these service providers to ensure that they take steps to address the deficiencies we identified.

Enforcement. Financial institutions must recognize that a failure to make adequate preparations for the year 2000 will have serious consequences—from both a business

and a regulatory perspective. Unlike other types of supervisory issues that may be addressed through regular procedures, the timing inflexibility of the year-2000 problem requires that national banks and their vendors focus on achieving year-2000 compliance without delay. In April 1998, the OCC adopted an enforcement policy specifically designed to address year-2000 concerns. In addition to the full range of enforcement actions already available to the OCC, we are employing a new informal enforcement action. This document, a Supervisory Directive, focuses directly on the actions that banks need to take to remedy year-2000 deficiencies. Our enforcement policy requires that we process year-2000 enforcement actions expeditiously. We are using Supervisory Directives and other enforcement tools whenever necessary to effect prompt remedial action by banks, independent service providers, and federal branches which are rated less than satisfactory.

The OCC's choice of supervisory response is determined largely by the institution's year-2000 summary evaluation; its progress in complying with any previously issued supervisory directive or other informal or formal enforcement action; the cooperation, responsiveness, and capability of the institution's management and board of directors; and the time remaining until the year 2000.[1]

[1] A Supervisory Directive is a written instruction from the OCC to bank management ordering the bank to take specific corrective actions necessary to effectively remediate a noted year-2000 deficiency. It is considered an informal enforcement action. A Commitment Letter and a Memorandum of Understanding are two-party agreements between the OCC and the bank that are used to reflect the bank's commitment to correct its problems. They are also considered informal enforcement actions. A Formal Agreement is an agreement between the OCC and the bank that the OCC uses to require the bank's commitment to correct deficiencies, and its violation can be used as the basis for a cease and desist order and result in the imposition of a civil money penalty (CMP). A Consent Order is a Cease and Desist Order issued with the consent of the institution. It is similar in content to a Formal Agreement but, in addition to the assessment of CMPs for violations, the order can be enforced through an action for injunctive relief in federal district court. A Safety and Soundness Order is similar in all aspects to a Consent Order, but it is imposed unilaterally by the agency following notice of failure to adhere to safety and soundness guidelines. Under 12 USC 1831p-1, the federal banking agencies may require a bank that violates safety and soundness guidelines or regulations to file an acceptable plan. Further, if the bank fails to submit or implement a plan, the agency may issue a "safety and soundness order." To implement section 1831p-1, the agencies issued in 1995 the "Interagency Guidelines Establishing Standards for Safety and Soundness." See 12 CFR Part 30, Appendix A. The OCC believes that national banks that fail to implement an adequate year-2000 remediation program violate these Guidelines and, accordingly, OCC has commenced actions under 12 USC 1831p-1 against such banks. The OCC and the other FFIEC agencies are exploring the further use of safety and soundness guidelines. Formal Agreements, Consent Orders, and Safety and Soundness Orders are public documents; Supervisory Directives, Commitment Letters, and Memorandums of Understanding are not.

The OCC's enforcement actions have been effective in improving year-2000 readiness. Of the 278 Supervisory Directives issued through September 15, 1998, 141 were terminated because the institutions made the necessary changes. As of September 15, 1998, the OCC had issued one Commitment Letter, four Memorandums of Understanding, four Formal Agreements, and one Consent Order. One bank and its affiliated data service provider are operating under an approved safety and soundness plan. We monitor compliance with all enforcement actions on a regular basis.

Outreach. The OCC is devoting substantial resources to the important task of sharing year-2000 information among members of the financial community. From May 1997 through August 1998, OCC representatives participated in 54 outreach meetings with various groups of financial institutions, service providers, and trade associations. Each of our six district offices has sponsored outreach programs for their local communities, and OCC district managers are participating in additional outreach meetings being sponsored by the FFIEC and state bankers associations. Starting in March of this year, over 9,000 bankers have participated in meetings held in 38 states. These meetings have fostered better communication among critical parties involved in the financial industry's year-2000 remediation efforts. Moreover, they have helped the OCC raise issues, such as common industry concerns, in a more timely and efficient manner.

Resource allocation, expertise, and training. The OCC's year-2000 bank examinations and related activities have resulted in unprecedented resource requirements. To meet our year-2000 supervisory responsibilities during the remainder of 1998 and 1999, the OCC reallocated significant planned resources from less crucial scheduled examination activities and other projects to year-2000 efforts. As a result of this reallocation, some of our regular onsite exams at small banks with low risk ratings were rescheduled for later dates. However, we did not alter our scheduled off-site safety and soundness quarterly reviews of national banks, and we continue to update all national banks' financial conditions and risk profiles quarterly.

Almost 600 examiners recently received intensive, specialized training to prepare them for year-2000 examinations and reviews. With the assistance of external information technology experts, the OCC expanded an FFIEC training course to better meet the needs of its examiners. Additional OCC follow-up training is being developed, with classes expected to begin during the first quarter of 1999.

To ensure that our examiners have a comprehensive understanding of year-2000 issues, in addition to periodic written guidance, the OCC developed training

videos and computer-based training packages; scheduled conference calls where examiners can raise questions as well as share valuable information on their findings; and set up a conference board for questions and answers allowing examiners to interact with year-2000 compliance experts.

While many staff members in our headquarters and district offices are devoting significant time to year-2000 activities, we are supplementing our examiners' expertise with support from technical experts, both within and outside the OCC. For example, the OCC formed a rapid response team of internal and contracted information technology experts to help examiners who request assistance on particular issues during examinations. This team will be particularly useful in assessing the impact of year-2000 problems identified during the testing phase, and will be available, when appropriate, for onsite assistance to examiners. This month, a team of examiners and year-2000 consultants is reviewing the testing plans of service providers and software vendors supervised by the OCC. This centralized review will provide consistent and timely analysis of testing plans, and will help us identify key issues and appropriate supervisory actions. The OCC also established a year-2000 "help desk" to respond to questions examiners raise in the course of their year-2000 examinations. Staff from our policy, operations, and information technology units will address these questions and post responses on the OCC's internal year-2000 Web page.

Remaining Year-2000 Challenges

The OCC's actions thus far have been effective; most of the institutions we supervise are making good progress on their year-2000 remediation programs. But important challenges remain.

Testing. Financial institutions are now entering perhaps the most critical phase of their year-2000 preparation process. As these institutions move through the testing phase, we will have a much clearer picture of whether they will be ready for the turn of the millennium. One of the OCC's particular concerns is that, since most testing will take place in the first quarter of 1999, there could be a significant supervisory challenge if a large number of banks have difficulties during that peak period of testing reviews and analysis. The testing phase, for most banks and service providers, will consume over 60 percent of the cost and time spent to address year-2000 problems.

Earlier this year, the bank supervisors developed a coordinated approach, through the FFIEC, called the Workprogram Phase II. This program consists of examination procedures that specifically address testing and contingency planning. The Workprogram Phase II procedures include a review of the bank's testing plans and evaluation of testing progress; an assessment of the bank's ability to successfully implement its testing program; a review of the bank's customer due diligence process; a review of the bank's responses to the Self-Assessment Survey previously distributed to all national banks; a discussion of the bank's progress in developing a customer awareness strategy; and a follow-up on any prior outstanding issues.

The OCC's supervisory strategy for completing the Workprogram Phase II procedures calls for completion of *two* additional onsite examinations for each national bank by June 1999. The first set of examinations, to be completed by year-end 1998, will ensure that each institution has an adequate testing *plan* in place *prior* to the beginning of testing. The second set of examinations, scheduled for the first half of 1999, will take place after institutions have tested their systems and will assess testing *results* and contingency planning efforts. We made the decision to conduct *two* onsite examinations related to testing within this time period in order to catch and help correct problems in banks' testing plans and testing efforts as soon as possible.

The OCC and the other FFIEC agencies are also taking steps, where appropriate, to encourage industry coordination of testing. We are working closely with the bank trade groups regarding their efforts to conduct bank-to-bank and bank-to-counterparty testing. Also, the supervisory agencies are monitoring the efforts of the Mortgage Bankers Association to coordinate testing of mortgage banks and mortgage-related, government-sponsored enterprises. The OCC is also actively participating in the President's Council on Year 2000 Conversion. The Council has been helping to encourage testing efforts. One such initiative involves proxy testing between representatives from the financial services industry and the telecommunications industry. The test process and accompanying results will be made available to interested parties and should provide other non-participant financial institutions a means to evaluate the readiness of its telecommunications providers.

Contingency planning. Regulators must develop contingency plans that outline steps to address problematic year-2000 situations. The OCC is involved in several interagency contingency planning efforts. We participated in an interagency working group that included representatives of the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (Fed), and the Office of Thrift Supervision (OTS), and addressed the issue of what conditions must exist for the appointment of a receiver for a financial institution that fails to remediate its year-2000 problems. The findings of the group yielded information that will be useful in the identification of

institutions with significant potential to fail because of year-2000 problems and that will be the foundation for more targeted interagency contingency planning in the future.

The OCC also is developing contingency plans to deal with the industry's capacity to absorb non-year-2000–ready institutions. As we examine bank data centers and nonbank service providers, we will also assess their capacity to service new clients experiencing year-2000 problems. The OCC and the other FFIEC agencies are beginning to compile a "bidders list" for year-2000 purposes that will include institutions that have a demonstrated, well-managed year-2000 program and the capability to acquire other institutions.

The OCC established an internal working group to develop regulatory options for addressing bank-specific and systemic risk concerns. This group will outline plans for dealing with local problems that might temporarily disable banks in particular areas (e.g., the failure of a local utility or telephone company). We are also working on contingency plans for dealing with year-2000 problems in individual national banks, such as a bank's failure to complete the remediation phase of mission-critical systems or its business resumption plan. Finally, the OCC's legal staff is finalizing a review of our legal authority to close banks due to year-2000 failures.

Addressing the year-2000 problem is consuming significant human and monetary resources of regulators, financial institutions, service providers, hardware and software vendors, and other affected businesses. The limited time frame in which to deal with the many, sometimes conflicting, demands for remediating all systems and applications presents additional challenges. However, we believe that the time table we have established for banks to meet specific requirements and our aggressive examination schedule represents the best approach to enable institutions—and, if necessary, regulators—to take corrective action if testing plans, results, and contingency planning efforts prove inadequate.

Public confidence. Educating bank customers about the year-2000 problem is critical to minimizing unnecessary public alarm, which could cause serious problems for financial institutions and their customers. The OCC and the other FFIEC agencies have issued guidance instructing financial institutions to provide complete and accurate responses to questions and concerns raised by their customers. The OCC asked each national bank to develop a customer awareness program by September 30, 1998. This program should include appropriate communications channels to effectively respond to customer inquiries. The program also should address how the bank will respond to its customers should unfavorable events occur, whether those events are caused by internal bank problems (e.g., system breakdown) or external (e.g., adverse media coverage of year-2000 computer problems elsewhere). The OCC and FFIEC will continue to consider further efforts to encourage banks to educate their customers about the year-2000 problem.

Credit risk. The efforts bank customers, particularly large corporate borrowers, take to prepare for the year 2000 will affect banks directly. Banks' credit portfolios will weaken if loan customers are unable to meet their obligations to the banks because of the borrowers' own year-2000 malfunctions. The examinations we have conducted to date show that most large banks have implemented year-2000 credit risk management controls, but the sophistication of those controls differs widely. Also, while community banks are generally aware of this issue, they are not as far along in their preparations as large banks. National banks were to have in place a due diligence process to control the year-2000 risks posed by their customers by June 30, 1998. At the conclusion of the third quarter of 1998, our examiners will be able to confirm whether the institutions they supervise did, in fact, put in place adequate controls to address customers' year-2000–related credit risk.

The OCC continues to gather information on how institutions are addressing the credit risk aspects of the year-2000 problem from the shared national credit review, which we conducted in the second quarter of 1998. A second quarter survey of 45 large national banks and federal branches and agencies revealed that about 80 percent of those banks have a process in place to evaluate their customers' year-2000 readiness, and all banks expect to complete their assessment of that readiness by the end of this month. Generally speaking, these banks use the size of their relationship with a customer as a ranking factor in identifying their most critical customers. They are also using a given customer's reliance on technology to determine that customer's year-2000 risk. Banks are training loan officers to perform basic assessments of year-2000 customer risk and to determine which aspect of that customer's financial condition would most likely be affected. Some banks are also adopting risk control measures, such as developing covenants on adequate resources to achieve year-2000 compliance, increasing reserves to the allowance for loan and lease losses (ALLL), reducing credit lines, and shortening credit maturities.

Currently, credit markets are sufficiently liquid so that many borrowers can readily obtain funding without year-2000 restrictions. Therefore, in assessing their customers, most banks have been viewing the year-2000 problem as one additional credit factor to be considered along with other, more traditional factors. We anticipate

that this factor will increase in weight from the bankers' perspective as the century date change approaches.

International remediation efforts. Awareness of the year-2000 problem is increasing around the world, but unfortunately, some countries are just now initiating year-2000 awareness programs encompassing their financial markets, clearing and settlement systems, and important infrastructure platforms. Therefore, we are concerned about the global state of year-2000 preparedness and the potential adverse impact that year-2000 problems could have on international financial markets, clearing and payments systems, financial institution liquidity, and overall economic performance. Global financial market participants are intricately connected through automated linkages with correspondent banks and customers through the global clearing and payments systems. Operational breakdowns caused by insufficient year-2000 preparations by any major clearing organization, settlement agent, or securities depository in these systems could cause significant liquidity pressures for market participants. In addition, possible overreaction by market participants and the general public to their perceptions of year-2000 risk could precipitate instability in the global financial markets.

If year-2000 issues are not addressed properly, public confidence in banks and other financial institutions around the world could be undermined, particularly if the global media sensationalizes the potential problems that could develop. Thus, it is critical for foreign countries to make progress on their year-2000 preparations and build market confidence in those efforts.

U.S. bankers have found it difficult to ascertain the year-2000 status of some foreign countries for a number of reasons. First, many developing countries are preoccupied with domestic economic troubles and thus are unable to focus adequately on the problem. Often, these countries lack public and private sector organizations that could provide the market with reliable information on their year-2000 efforts. Second, some developed countries have stated publicly that the year-2000 problem is not a serious issue, further alarming bankers who recognize, based on first-hand experience, that the year-2000 risks in those countries are significant. Third, it is not clear how extensively countries preparing for the introduction of the euro have been able to also fully address the year-2000 issue at the same time.

OCC examiners assigned to our largest and most internationally active national banks report that these institutions are working diligently, as FFIEC guidance directs, to develop appropriate contingency plans to mitigate risks to those foreign agencies, customers, and counterparties that are not testing their year-2000 readiness thoroughly or successfully. Although U.S. banks' contingency plans for global year-2000 risk are not yet completed, the next phase of our year-2000 examination program will focus on banks' efforts to develop appropriate contingency plans for potential problems arising from year-2000–induced failures.

Several international year-2000 groups, particularly the Global 2000 Coordinating Group[2] and the Joint Year 2000 Council,[3] are helping countries focus on the many aspects of the year-2000 preparation process that will require careful, effective cross-border coordination of initiatives. Through these multilateral groups of international financial market regulatory authorities, the OCC is working with foreign bank supervisors to encourage more information sharing on regulatory year-2000 strategies, discuss contingency measures, establish linkages with national and international private sector initiatives, and promote more aggressive international year-2000 remedial action.

The OCC is collecting global year-2000 readiness information through a series of outreach activities with market participants and domestic and foreign financial industry regulators. We also established within the OCC a Global Banking Coordinator's office staffed by full-time, senior, large-bank examiners with responsibility for researching and maintaining data on year-2000 risk in foreign countries and assessing market perceptions of risk and potential market reactions. This unit is building a Global Year 2000 Risk Analysis database to support our supervisory efforts and will help the OCC identify potential problem areas as well as market perceptions regarding global year-2000 readiness. The database will include regional and country specific information on foreign public- and private-sector year-2000 preparations and will help the OCC identify and assess consensus market perceptions regarding the year-2000 progress of key foreign governments, financial systems, clearing and settlement systems, and infrastructure that could have an impact on the operations of U.S. banks.

Infrastructure. Both in the U.S. and abroad, another source of potential year-2000 risk is the infrastructure

[2] The Global 2000 Coordinating Group includes representatives from financial services firms that are located in and operate across multiple markets (including banking, securities, and insurance markets) and jurisdictions. The group is hosted by the Swiss Bank Corporation, and it currently consists of 77 institutions and associations representing 18 countries. The U.S. Steering Committee members are Bankers Trust, Citibank, Chase, J.P. Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley Dean Witter, Salomon Smith Barney, and the Securities Industry Association.

[3] The Joint Year 2000 Council is a multilateral group of international financial market regulatory authorities that is focusing on increasing information sharing on regulatory and supervisory year-2000 strategies, discussing possible contingency measures, and establishing linkages with national and international private sector initiatives.

upon which the public, private, and government sectors rely. Hence, it is important to ascertain the status of telecommunication and power companies, in particular, and to make sure they are making adequate progress.

Earlier this year, many banks expressed concerns that telecommunications and power companies were not disclosing sufficient information on their year-2000 remediation efforts. In response, the OCC and the other FFIEC agencies began meeting with government officials to discuss infrastructure concerns. Through our participation in the President's Council on Year 2000 Conversion, telecommunications and power companies have been urged to share information on the readiness of these critical industries.

Over the past quarter, national banks and federal branches and agencies indicate that they have received increased information on the year-2000 readiness efforts of telecommunications providers, and many national banks and federal branches and agencies report that their telecommunications providers appear to be making adequate progress towards remediating and testing telecommunications networks. Bankers are telling the OCC that less information has been forthcoming from power companies, however.

Our most immediate concern at this time is that many companies providing critical infrastructure will not be ready for external testing until well into 1999. For some, we understand that testing with their customers may not begin until the second or third quarter of 1999. Such a time schedule increases the risks to the banking system because it provides only limited time to remedy problems that surface during testing.

The OCC will continue to remind national banks and federal branches and agencies to gather information and assess year-2000 readiness efforts of all mission-critical service providers, including telecommunications providers and power companies. When we identify problems, we will work diligently to address them.

Let me now turn to the other issues you asked me to address in your letter of invitation. First, I will describe the status of the OCC's internal remediation process; then I will discuss our views on proposed legislative measures to facilitate progress on the year-2000 phases that lie ahead.

Remediation of OCC Internal Systems

The OCC has pursued an aggressive strategy for year-2000 remediation of its own internal systems. We expect our total outlay for this effort to be approximately $8 million.

The OCC identified 13 mission-critical information technology (IT) systems that support the key business functions of the agency. Of these systems, one will be retired, nine have been renovated, validated, and implemented, and the remaining three have been renovated, with implementation to occur shortly. This is well in advance of the Treasury Department deadline of December 31, 1998.

We also reviewed mission-critical non-IT systems. Mission-critical non-IT systems are those systems that are located at primary OCC sites and directly support the continuous operations of the building infrastructure as well as the life and safety of OCC personnel. We identified and assessed 29 of these mission-critical non-IT systems, six owned directly by the OCC with the remaining 23 being leased from other parties. Of these systems, 17 were compliant, eight were noncompliant, and four are currently being assessed. One of the noncompliant systems has already been repaired, two are awaiting repair, and five will be replaced. The OCC is updating its Business Continuity Plan to ensure we are adequately prepared for all eventualities.

Testing. Agency testing of our internal systems has been successful to date. Testing of renovated program code, particularly mission-critical systems, has demonstrated that those systems are year-2000 compliant, and generally in need of little further revision. We are scheduled to complete the testing and implementation of all mission-critical IT systems, non-mission-critical IT systems, commercial off-the-shelf packages, and telecommunications equipment by October 31, 1998.

Contingency planning. To ensure that we will be able to continue operations in the event of mishaps affecting our internal systems, the OCC developed contingency plans for all mission-critical and non-mission-critical systems and applications, as well as for internal and external data exchange partners. All of the OCC's mission-critical IT system contingency plans will be tested in the first quarter of 1999.

Independent validation and verification. The OCC also developed an independent validation and verification program, which consists of three steps. First, OCC's application systems scheduled to be renovated will be reviewed and assessed by a team including contractors and OCC programmers. Second, after this team's work is complete, a separate test team of contractors and OCC personnel will independently validate and verify the systems' year-2000 compliance. As a third check, an implementation team consisting of system user representatives will validate and confirm the operation of the system at the end of the implementation phase.

Certification. The final phase of OCC's year-2000 internal compliance process is certification. Each phase of the year-2000 compliance process creates documentation and an audit record of compliance activities. The OCC's

certification process entails reviewing this documentation, conducting spot checks of systems to verify reported results, and interviewing participants to ensure process compliance. This added process will ensure that all planned compliance steps were completed.

Legislative Remedies

You specifically asked, Mr. Chairman, for our views on year-2000 liability and whether any legislative remedies are needed to facilitate our year-2000 efforts.

Year-2000 liability issues for banks. The Administration's year-2000 disclosure bill, the "Good Samaritan" bill (H.R. 4355 and S. 2392), is intended to encourage the disclosure and exchange of information on year-2000 issues. Under the bill, to recover in a civil suit based on an allegedly false or misleading year-2000 statement, a claimant must establish certain specific elements, including knowledge that the statement was false, inaccurate, or misleading and that there was an intent to mislead or deceive. The OCC believes that this legislation will encourage voluntary disclosure and a meaningful exchange of information on year-2000 remediation activities, such as information exchanges among power and telecommunications companies and the financial institutions they serve.

Additional year-2000 legislative remedies. We also recommend that the Bank Service Company Act (BSCA) be amended to clarify that, under current law, when a bank causes an entity to provide services to it that are covered by the BSCA, under contract or otherwise, the entity is subject to enforcement actions with respect to the performance of those services to the same extent as if the services were performed by the bank on its own premises. Such an amendment would clarify that the appropriate federal banking agency that has examination authority for a bank, or a subsidiary or affiliate of that bank also has the authority under the BSCA to bring an enforcement action under 12 USC 1818 against the entity that is providing such services under contract or otherwise to the bank or its subsidiary or affiliate. The appropriate federal banking agency's ability to bring such an action could encourage a service provider to take the necessary actions to achieve year-2000 readiness.

The Examination Parity and Year 2000 Readiness for Financial Institutions Act, enacted earlier this year, gave the Office of Thrift Supervision (OTS) and National Credit Union Administration (NCUA) authority to take enforcement action against service providers. Although this authority was designed to parallel the current authority of the banking agencies under the BSCA, the different format and terminology used in that act have resulted in a clearer, more direct statement of enforcement authority being made available to the thrift and credit union regulators, making it desirable to clarify again that all of the banking agencies have comparable authority to take such actions on an ongoing basis. We have prepared draft legislative language which we would be happy to share with the committee for your consideration.

Conclusion

The OCC is committed to vigorous action to address the challenges posed by the century date change. We have devoted significant resources to supervising national banks to ensure that they are ready for the year 2000, and we are working diligently to ensure that our internal systems are year-2000 compliant. Throughout the remainder of 1998 and through the first quarter of the year 2000, when we review the national banks' testing, renovation, and contingency planning efforts of year-2000 problems and solutions, we will intensify our efforts significantly.

We also recognize that banks have exposures to external entities, including telecommunications and utility companies, and, in particular, foreign governments and international companies over which we have no direct control and, in many cases, limited indirect influence. Banks could also be affected by the year-2000 problems of large corporate borrowers. We are participating in interagency and international groups to help address these concerns. Importantly, the institutions we supervise are making conscientious efforts to ascertain which external entities and international parties have year-2000 problems and what, if any, corrective action they are taking.

The attention you, Mr. Chairman, and this committee, have focused on the year-2000 problems contributes to the effort to ensure that our nation's financial system will function smoothly when we reach the year 2000. I appreciate the opportunity to keep you apprised of our efforts to support that goal.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before The Bankers Roundtable, on credit underwriting, Washington, D.C., September 18, 1998

Thank you and good morning. It is always a pleasure to be with The Bankers Roundtable to discuss the most important issues of the day facing the financial services industry.

Many of you will remember the time when banking issues were essentially of interest to bankers and bankers alone, and we could assume that most of what we said and did would not be reported beyond the financial press. For better or worse, that is no longer the case.

The fact is that banking issues have never been more central to the health and prosperity of our nation and the whole global economy than they are today.

The nations whose economic difficulties now dominate the headlines differ in most respects. They are advanced nations like Japan, developing nations like Indonesia and Thailand, and reorganizing nations like Russia. Their cultures and histories vary widely. But they all share at least one thing in common: a troubled banking sector.

The recent misfortunes of these countries illustrate two important points: that national economies are little or no stronger than their banking systems, and that systemic weaknesses in the financial sector can foil even the most carefully crafted efforts to achieve economic recovery and reform.

What does it take to build the sound and competitive banks that are so essential to economic opportunity and growth in this country? I believe that it takes the right symmetry of inward *and* outward focus. By inward focus, I mean paying attention to the bank's internal fundamentals: the strength of its underwriting standards, the adequacy of its internal controls, and of course, its readiness to operate in the year 2000 and beyond.

Outward focus means thinking about your customers—current and potential—and what products and services—current and potential—to offer and how best to offer them. This means utilizing the powers of your bank creatively to provide new products and services, recognizing evolving customer expectations, treating customers in ways *they* regard as fair, and learning to serve—profitably serve—currently untapped or underserved customers and markets.

When the balance of these elements goes awry, the future stability—and viability—of a bank's business may be imperiled. Losing sight of customers' needs and expectations is one of the surest ways of withering a franchise, even though it may start with a sound internal footing. And lagging too far behind the competition in terms of product and service offerings, convenience, and price, usually produces the same unhappy result.

This morning I would like to talk about one of those internal fundamentals that I mentioned—one which, today, appears to be under much stress.

For some time now, I and other banking regulators, economic policy makers, and some of our most distinguished bankers have been pointing to weakening discipline and slipping standards in commercial and retail lending.

This past summer, in a speech before a credit conference in Chicago, I announced the preliminary findings of the OCC's latest annual survey of national bank underwriting standards. As you may recall, we found continued slippage in commercial lending practices: broader and more generous concessions to business borrowers, relaxed collateral requirements, and less rigorous provisions governing covenants, guarantors, and tenors. And bankers were not getting paid for assuming this additional risk—pricing has been very tight. We found this deterioration occurring in virtually every commercial line of business, with standards tightening only in international lending. And we found bankers who were well aware of their own increasing credit risk and regretted it, and yet felt pressures to continue so as not to lose critical market share. We released the final 1998 underwriting survey to the industry and to the public just yesterday, and a copy will be sent to all national banks. It is not a pretty picture.

The reaction to my Chicago speech—and to other warnings by the OCC and other agencies on the same subject that preceded it—has been mixed. On the one hand, many bankers expressed strong support for our efforts to highlight and reverse these trends. They indicated that our regulatory admonitions and the supervisory measures that accompanied them were proving to be of assistance to them in resisting internal pressures for more lending at any cost. On the other hand, some bankers insisted that it was "the other guy"—not *their* bank—that was responsible for driving underwriting standards down.

But, in addition, in my recent discussions with industry representatives—including some of you in this room today—I heard it suggested again and again that one of the most effective things we could do to encourage bankers to firm up underwriting standards would be to provide more details about the types of deals that we are finding that cause us such concern about slippage in underwriting standards. This is a fair comment, since the underwriting survey simply aggregates our examiners' qualitative assessments of underwriting trends. Clearly, if we want to send the most effective message to the industry, it is important that we be as specific as possible in signaling our concerns—without, of course, compromising the confidentiality of the banks under review.

So, this summer, I assembled a team of the OCC's most experienced credit analysts to undertake what we sometimes call a "horizontal review" of a sample of loans at the larger banks around the country to specifically identify loans of the sort that make us worry. Although some of these loans are currently performing, they are structurally flawed, and very likely to produce losses in the event that the optimistic expectations they rely upon regarding the borrower's prospects, future market conditions, or the economy in general do not materialize. We call loans with fundamental structural weaknesses "ugly loans." And that is why, around the OCC, this exercise has come to be known as the Ugly Loan Project.

In the interests of specificity, let me describe a few examples of what we found. The first involves the owner of a chain of franchise stores in the southwestern United States. For years it had enjoyed a mutually profitable relationship with its bank, from which it obtained working capital and long-term financing for the acquisition of new properties. The loans were secured by the acquired real estate at acceptable margins, amortized over reasonable periods, and leverage and capital expenditures of the borrower were controlled by covenants.

Eighteen months ago, the borrower received an offer that looked almost too good to be true. A competing bank proposed to extend a multimillion dollar increase in the firm's credit line, to be secured not by additional hard assets but by intangible "enterprise" values—management expertise, trademark and franchise value, market position, and so forth. The would-be lender proposed not only to turn a largely *secured* loan into a largely *unsecured* loan, but also to do it for *less* than the original lender was charging in interest and fees. Further, the borrower was required to pay only interest for the first five years. When these terms were brought to its attention, the original lender felt compelled to match them lest it lose the customer. The new deal was consummated just a year ago, with pricing 45 basis points *less,* and the annual fee *reduced* one quarter of a percentage point below the terms of the original loan. And the loan covenants were much less restrictive, with no limits on the borrower's capital expenditures and far less control on leverage.

The bank also chose to grant the loan despite the following financial facts about the borrower's business. Competition in the borrower's principal market had increased dramatically, causing deterioration in the borrower's sales and profits. In the face of this change, not only had the bank increased its exposure—and, incidentally, given the borrower the wherewithal to engage in further expansion of its business—but also reduced the return on its investment.

Let's turn to another case. This one involves a company with zero working capital, negative net worth, and over 50 million dollars in operating losses during 1997. What it also has is a brand-new revolving line of credit and multimillion-dollar term loan totaling almost $500 million. One would think that this kind of borrower would be paying a stiff premium for this credit, if it could find a loan at all. But the contracted price was LIBOR + 150 basis points, currently 7.2 percent. Moreover, the loan terms require interest payments only for the first four years, and then graduated repayment of the principal starting in year five. Consider also that two years ago this same borrower sold hundreds of millions of dollars in subordinated debentures with similar maturities and had to pay as much as 14 percent—junk bond rates.

Given this borrower's weak financial condition and risk profile, one might ask the basis upon which the lender expects to be repaid. In this case, repayment is based on projections that the borrower's cash flow will increase 300 percent over a 10-year period, when both the revolver and the term loan come due. These projections are speculative at best, and presume not only retention of the company's current market advantage, but an increase in market penetration and a significant increase in profit margins. These very same projections form the basis of the bank's collateral evaluation, which is calculated at an optimistic *nine times* future cash flow multiple.

Finally, consider this. Many banks have policies that forbid loans to new companies where repayment is dependent on the future issuance of public debt or equity. It is a prudent policy, because, as the events of recent weeks have shown, the capital markets and prospects for initial public offerings can be highly volatile and nearly impossible to predict.

That certainly raises questions about the national bank that recently extended a 20 million dollar loan to a start-up company engaged in manufacturing a single product for a specific industry. According to the bank's own analysis, the product that the firm markets has *not* received accreditation from the industry it aims to serve and faces stiff competition in a limited market. Moreover,

in 1997, the company lost more than 100 million dollars. Current liabilities exceed current assets by almost 2 to 1, and the company has a negative net worth in the millions.

All of these ugly loans—and others that came to the attention of our review team as it criss-crossed the country—are reflective of the trends identified in our underwriting survey. Our retail franchise operator capitalized on the lender's willingness to accept intangible enterprise values in lieu of tangible assets to collateralize the increase in its credit line. The start-up, one-product firm—at best a highly speculative enterprise—obtained financing on terms once reserved for the highest-rated, blue chip borrowers. In the final example, the borrower, although technically insolvent, received a loan package based on the most generous possible assumptions about its financial future.

All of these borrowers benefitted from the fact that competitive pressures to maintain loan volume are driving the marketplace. Thanks to the extraordinary levels of liquidity recently in the financial system and the aggressive entrance of nonbank financial firms into the commercial lending arena, borrowers can demand—and receive—concessions on prices and terms. And, as our examples show, that's exactly what they did.

When we bring these ugly loans to the attention of the bankers responsible for them, they often protest that they're simply following the market. And we turn around and ask: following the market where and to what end? It is time—indeed, past time—to reject the herd mentality in lending. It's time to follow your own good judgment—not "the other guy"—when it comes to sound underwriting and risk management.

In the meantime, bankers with ugly loans on their books should be taking steps to deal with them—as well as preventing other loans from joining them on the ugly list. They should be increasing the scope and frequency of loan reviews as a critical part of a bank's credit risk control process. They should be augmenting workout staff, and involving workout experts in loan monitoring efforts. They should be periodically reassessing their own strategic portfolio objectives and risk tolerance limits, resetting them to more protective levels at a time when the economic climate is becoming less favorable. And they should be carefully examining the adequacy of capital and loan loss reserves in light of credit risk ratings. If a bank has eased its underwriting standards, the assumptions upon which allowance adequacy is based should be reevaluated to reflect the likelihood of increased loan losses.

For our part, we at the OCC will be maintaining supervisory vigilance. Within the next two weeks, our examiners will begin implementing the changes to our examination procedures that I announced in my speech in July. In particular, as examiners identify loans with structural weaknesses—like those I have discussed this morning—we will capture key information about those loans through a new on-line system into which our examiners will enter key data on loan characteristics. This system will enable us to track lending trends with much greater specificity and timeliness than ever before, both as to the types of structural weaknesses that we are finding and the types of loans in which those weaknesses appear to be most prevalent. But, ultimately, it is *your* responsibility to identify and confront the problems that can affect your future—before they reach the stage where the regulators must react more forcefully.

There is a fairly widespread view these days that the good times of the past eight years cannot endure. Perhaps so. But the gains that banks have registered during most of this decade were not the result of good luck alone. Bankers have prospered very largely because they did what it took to get the fundamentals right. We look to you now for the leadership to keep those fundamentals sound.

It is not too late to deal with the slippage in standards that I have described. As we see other nations' economies bobbing in turbulent waters, it is doubly important that, here in the United States, bankers address and correct any weaknesses in their loan underwriting, mindful of the possibility that our own economic seas could also turn stormy. Taking care now is important to the future of each of your banks—and to the health of our nation's economy.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before the American Bankers Association, on credit underwriting standards, Orlando, Florida, September 27, 1998

When it was founded back in the winter of 1875, the American Bankers Association had one overriding objective: to uphold the highest standards of professionalism. That ambitious undertaking has been a key to the success of our banking system for over a century and remains uniquely relevant today as bankers face unprecedented market, technological, and social changes affecting their business.

Indeed, some would have you believe that the very idea of the professional banker is an anachronism. Thanks to technology and competition, they argue, financial products and services have been transformed into mere commodities available through far-flung electronic networks in an impersonal marketplace driven simply by price. Products once the bread and butter of a bank's business are now available from other providers. Customers, it is said, are not interested in relationships; loyalty has no meaning; expertise and good judgment—two of the hallmarks of the banking profession—are no longer necessary or relevant.

I couldn't disagree more. Year after year bankers like yourselves come to the ABA convention to enjoy the camaraderie and myriad attractions of places like Orlando, but mostly to participate in a program featuring industry experts and all the various and sundry government officials who regulate this great industry in recognition of the fact that it is—and must remain—something more than another business whose inventory simply happens to be financial products. While the financial markets—and market discipline—may exercise some quasi-supervisory functions in the coming years, the need for a government presence will never go away. And that is because of the unique place in the economy that you occupy, with your role in the economic well-being of America's households and businesses.

Therefore, it worries me when we see slipping loan underwriting standards in the banking business, as we do of late. Many words have been issued on this subject, and I shall be adding a few more in the course of my remarks today. But I would like to say to you, the financial leaders of your communities and, collectively, of our country, that my concerns about deterioration in loan underwriting are not purely a matter of dollars and cents or profit and loss, important though those things are. Over the decades, the judgment, discipline, and leadership provided by bankers has been almost as important as your banks' financial contributions to the prosperity of your customers and our nation. We looked to you for that important counsel then and we still do today, when the need for it is perhaps greater than ever. Our economy draws strength from the high standards you set and the sound judgment you employ as you conduct your business. Thus, when any standards in this profession slip, we forfeit something fully as valuable as any hard asset.

Most of our recent discussions about credit quality have centered on the commercial side of the bank portfolio. Partly, this is force of habit. As recently as 1992, commercial banks' commercial and industrial loans exceeded consumer loans as a percentage of total assets. The further back in time one goes before that, the wider the gap becomes. Moreover, the banking crises of our age have usually been attributed to bad energy loans, bad commercial real estate loans, and bad international credits—not to individual consumers falling behind or defaulting on their credit obligations. Indeed, historically, consumer loans tended to outperform business loans in times of economic stress. And so, naturally, we have tended to focus our concerns about credit risk on that part of bank portfolios where the risk seems—and has always seemed—greatest.

Since the early nineties, however, a sea change has taken place in bank loan portfolios. Beginning in 1993, consumer loans overtook commercial loans as a percentage of all commercial bank assets. Although the balance of these bank assets has again recently converged, analysis shows that this is the result not of any slowdown in the pace of consumer originations. Instead, more and more banks—of all sizes—are finding it easy and advantageous to securitize consumer assets and thus take them off their books, freeing them to make more loans. Another mitigating factor is that the consumer loan market is undergoing a period of consolidation and shake-out, as lenders discover that in some lines of consumer banking—credit cards, for example—an increased customer base and more capital-intensive technology may be required.

A number of familiar factors help to explain this sea change in banks' traditional lending orientation, including the historic safety of consumer debt that I mentioned earlier and the loss of many good corporate customers to the commercial paper market. Consumer lending remains one of the few places on the banking landscape where profit margins have held up in the face of growing competition. Add to that the low barriers to entry in many

consumer lines—thanks to securitization, outsourcing, and credit scoring technology—and it's no wonder that so many banks have gravitated to the consumer loan market.

On balance, this has been a positive development for banks and their retail customers. The rise of consumer banking is synonymous with the democratization of credit—a historical trend that has opened the door to economic opportunity for millions of Americans who would otherwise have remained on the outside looking in. It has enabled millions of our fellow citizens to buy and furnish new homes and start small businesses and join the economic mainstream. And, for their part, banks have made new customers, diversified their lending, and generated reliable fee income that enhances their safety and soundness. That's what we call a "win-win."

But no one wins when individuals receive too much credit or credit they cannot afford. No one wins when a consumer falls behind or declares personal bankruptcy or loses a home to foreclosure. And, ultimately, no one wins when, in the name of competition, a bank makes a loan that is not priced fairly—for both parties to the transaction.

In fact, the latest data shows that, in certain consumer product areas, banks are taking prudent steps to assure credit quality and protect their reputations, their balance sheets, and their customers. The OCC's "1998 Survey of Credit Underwriting Practices," which was released to the public just over a week ago, shows more rigorous underwriting standards, especially in credit cards, direct and indirect consumer loans, and consumer leasing. Banks accomplished this in various ways: by raising scorecard minimums; increasing fees and spreads; requiring additional collateral; and reducing credit lines.

I applaud these trends, but I would caution you not to read too much into them. Our underwriting survey also observed that, despite the changes in underwriting criteria I just mentioned, aggregate consumer credit risk continues to rise. This is a reflection of consumer debt levels that keep climbing to new record highs. Between 1993 and 1998, consumer credit outstanding—excluding mortgage debt—rose more than 50 percent, reaching more than one and a quarter trillion dollars. And this does not include another $2 trillion in unused credit lines—credit that consumers can tap at their convenience. Together, these numbers nearly equal the total deposits of all U.S. commercial banks.

These are staggering sums. But their true significance becomes clearer in the context of the overall recent performance of our economy. For while consumer credit outstanding was going up roughly 50 percent between 1993 and mid 1998, personal income was rising only half as fast during the same period. And debt service payments as a percent of disposable personal income are very nearly the highest they have ever been.

We should hardly be surprised, then, to see deterioration in the performance of some categories of consumer loans and the increase in personal bankruptcies of recent years. Despite the tightening of underwriting standards in the credit card industry, preliminary 1998 national bank data shows that credit card charge-offs continue to rise. And so does personal bankruptcy: last year, 1.4 million Americans filed to have their personal debts discharged, an increase of more than 100 percent over 10 years.

What makes this trend particularly worrisome is the fact that more families are struggling to keep up with their debt obligations in the midst of one of greatest economic expansions in American history, with unemployment at a 30-year low. Given the mixed performance of consumer loans during this expansion, it seems likely that consumer loans in the next downturn may prove to be something other than the safe haven that they have been in the past. And that's a possibility that should concern all bankers.

Many American households are overextended, and there is plenty of blame for it to go around. Some borrowers have run up huge bills and then tried to walk away. That may become more difficult to do if Congress passes the bankruptcy reform legislation currently before it. But if and when bankruptcy reform does pass, it may also have the effect of shifting the spotlight onto the behavior of lenders, which cannot be said to be beyond reproach. While some continue to exercise restraint and common sense, other lenders have aggressively targeted those consumers groups most likely to be seduced by easy credit: college and even high school students; recent bankrupts; and people who are already overextended. Some issuers have exploited loopholes in the law to get unsolicited credit cards into customers' hands; others resort to heavy-handed and sly marketing practices, such as "teaser" interest rates.

A particular trouble spot is the fast-growing home equity market. In the three years between 1994 and 1997, the dollar value of commercial banks' home equity loans increased more than 35 percent.

Home equity loans are usually marketed to, and used by, consumers as a means to consolidate credit card debt. According to a recent study, over the past 24 months, 4.2 million American households have converted $26 billion of credit card debt into home equity mortgage debt. For many consumers, this makes sense. The advantages of home equity-financed debt consolidation, with its lower interest rates and potential tax deductibility, can be

substantial—provided that borrowers are serious about bringing their spending under control. But the same study also shows that only a third of the 4.2 million households that had consolidated their unsecured debt were still credit card debt-free at the end of the study period. To varying degrees, the others had "reloaded" their credit cards with new purchases, leaving them worse off than before in terms of their total debt burden. Worse still, they placed their homes in jeopardy.

For bankers, too, the benefits of home equity lending can be substantial—but only if sound underwriting principles are heeded. Unfortunately, according to our underwriting survey, standards have continued to erode in the home equity market—the one area of the consumer loan market where standards have slipped. While competition is steadily driving prices down, the risks of home equity lending are increasing, as bankers drill deeper and deeper into the customer pool and base lending decisions on the value of the collateral rather than the potential borrower's ability to service the debt. Indeed, the fastest growing part of this market has been in precisely that part where the risk is greatest, in high loan-to-value (LTV) and subprime home equity loans—categories which have more than doubled in volume in just two years.

There is nothing inherently objectionable about subprime mortgage and home equity loans. Properly underwritten and administered, they can work well for borrowers and lenders. Consumers with a history of financial reverses can use these loans to rebuild their credit and then qualify for better rates on subsequent loans. And they give lenders an opportunity to reach out to previously underserved segments of their communities and build new lifelong customers.

Today, these credits may appear to be adequately collateralized. But there may come a time when real estate markets no longer support even existing levels of debt, when borrowers will not or cannot pay, and bankers find it problematical to convert that collateral into cash. Given the high costs of foreclosure and remarketing, that portion of any mortgage loan—first or second—that exceeds 85 to 90 percent of the home's appraised value is tantamount to unsecured credit at secured prices—a bargain no sensible banker should accept. Lenders must also take into account the social and political risks associated with any surge of foreclosures on home equity loans.

As with all consumer loans, the crucial caveat in the subprime and high LTV market is sound underwriting and administration. One hundred twenty-five percent LTV loans to subprime borrowers make no sense. Neither does pricing that fails to cover the additional risks these loans entail. Bankers must recognize that subprime products require specialized marketing, account management, and collection procedures in order to properly control credit risk. Banks that make and service subprime and high LTV loans as though they were no different from conventional mortgages—and no different from each other—are putting their reputations, as well as their consumer loan portfolios, at risk. In this regard, the significance of consumer lending practices as a safety and soundness issue was recently illustrated when BestBank of Boulder, Colorado, which accumulated $134 million in mostly subprime bad loans, was shut down by Colorado state regulators earlier this summer.

Recent years have seen no shortage of lessons about the importance of high standards in the banking profession. We constantly study and restudy the events of the recent and more remote past, searching for the guidance they offer us in our efforts to keep our banking system safe, sound, and competitive. History is a powerful tool. But we must be prepared to take what study and experience teach us and apply those lessons to the challenges we face today. The difficulties of the recent past can be avoided—and we can avoid creating new problem areas—if each one of you makes a personal commitment to the high standards of banking professionalism—sound judgment, informed restraint, and enlightened leadership—that have long distinguished this industry.

Given the unrest in the global economy and the disturbances we are seeing even in our own markets, the strength of this industry's fundamentals is particularly important today. By maintaining the high standards of the banking profession—standards that uniquely distinguish bankers from other purveyors of financial services—you not only help your institutions, your industry, and your customers. You also provide a great service to this country's economic stability and an essential solid foundation for our future economic growth and prosperity.

Statement of Michael L. Brosnan, Deputy Comptroller for Risk Evaluation, Office of the Comptroller of the Currency, before the U.S. House Committee on Banking and Financial Services, on derivatives markets, Washington, D.C., July 24, 1998

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

Mr. Chairman and members of the committee, I appreciate this opportunity to testify on issues related to over-the-counter (OTC) derivatives. As the primary supervisor of national banks, the Office of the Comptroller of the Currency (OCC) considers these issues to be very important. As you are aware, the OTC markets in derivatives instruments have grown steadily over the years. Properly used, derivatives provide national banks with flexible and effective risk management tools. They contribute to the viability of banks by allowing them to provide risk management products to their clients, thereby diversifying their revenue base. In general, the OCC believes that the U.S. commercial bank interaction with the derivatives markets is relatively healthy, and we do not see a need for significant changes to the regulation of derivatives markets.

In my testimony today, I will first discuss the growth in the derivatives markets and highlight the implications of such growth for the national banking system. Next, I will summarize our supervisory efforts, and how they have and continue to evolve to remain current with marketplace developments. Finally, as you requested in your letter of invitation, I will comment on the proposals that have been advanced recently to alter the laws and regulations governing derivatives, including provisions concerning the bankruptcy laws and the banking laws governing the resolution of insolvent depository institutions. The OCC's primary concern is that legal certainty, regarding the standing of existing contracts, as well as that of contracts that could be negotiated in the future, be restored to the financial markets, the U.S. banking system, and bank customers.

Derivatives Markets

Derivatives are financial contracts whose value is derived from the performance of assets, interest rates, currency exchange rates, or indexes. Derivative transactions include a wide assortment of financial contracts, including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof. As illustrated in Figure 1, the derivatives markets of commercial banks have grown rapidly over the past few years.[1] The notional amount of derivative activities at all commercial banks increased for the ninth consecutive quarter to a record $26 trillion as of March 31, 1998, up $985 billion from year-end 1997 and $4.2 trillion since the beginning of 1997.[2] This $26 trillion figure includes swaps (38.6 percent), forwards (27.4 percent), credit derivatives (0.35 percent), OTC options (18.7 percent), exchange-traded options (6.3 percent), and exchange-traded futures (8.6 percent) (see Figure 2).

Figure 1—Derivatives, Notional Amount

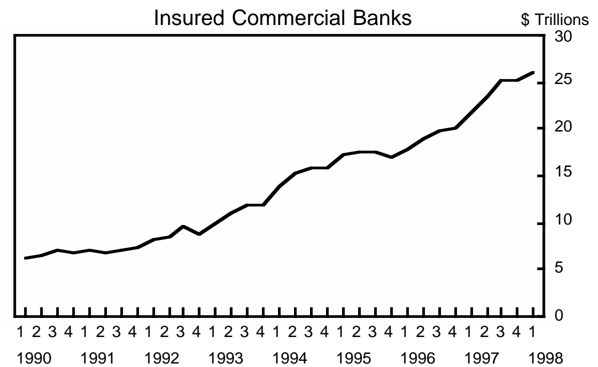
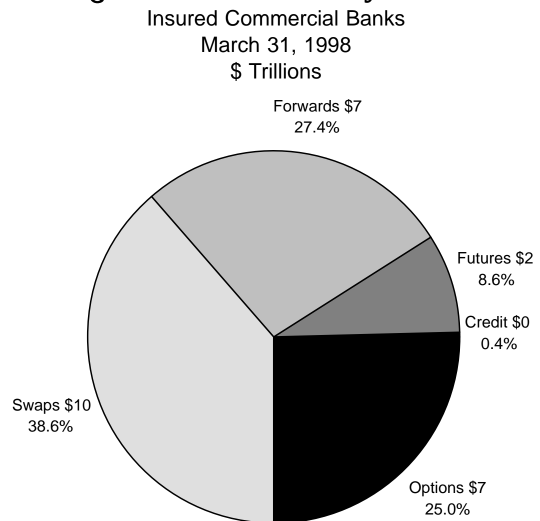


Figure 2—Derivatives by Product



[1] The call report has included extensive data on derivatives since 1995.

[2] The data are from the most recent quarterly call report.

Eighty-five percent of commercial bank derivative activity is OTC and 15 percent is exchange-traded. Swap products became the largest component of the total for the first time during the third quarter of 1997, and maintained their lead position among product types during the first quarter of 1998. As illustrated in Figure 3, 98 percent of commercial bank derivative activity involves interest rate (71 percent) and foreign exchange (27 percent) products. Interest rate and foreign exchange products also constitute 98 percent of the bank OTC market (66 percent and 32 percent, respectively—see Figure 4). Bank activity is concentrated in OTC contracts because they can be tailored to meet the firm-specific risk management needs of both banks and bank customers.

Figure 3—Derivatives by Type
Insured Commercial Banks
March 31, 1998
$ Trillions

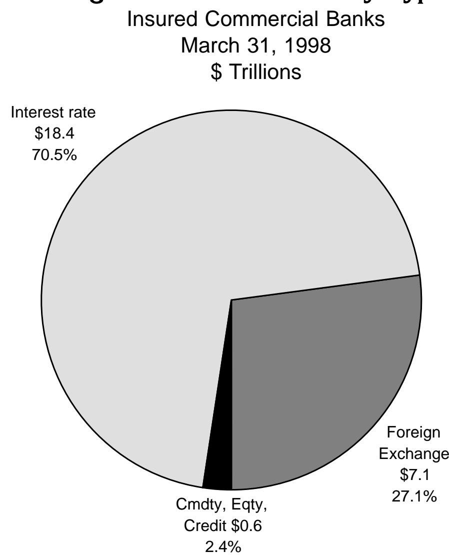
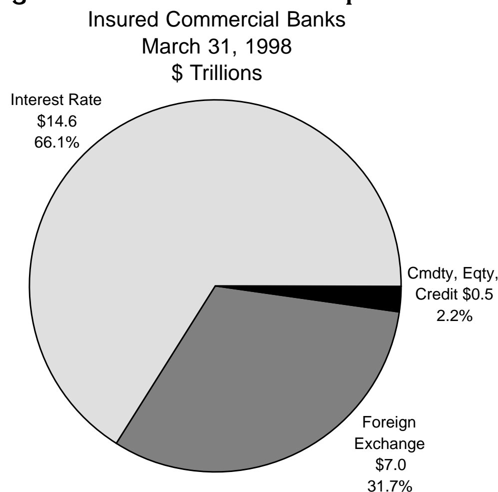


Figure 4—OTC Market Composition
Insured Commercial Banks
March 31, 1998
$ Trillions



The vast majority of commercial bank derivatives activity occurs in eight large banks, which account for 94 percent of the total notional volume of derivatives in the banking system.[3] Ninety-nine percent of the total notional volume is held by the top 25 banks. To put bank derivative activity in perspective, we used the most recent data available on global derivative activity from an International Swaps and Derivative Association (ISDA) survey from the first half of 1997. The survey data is from all of the top dealers, or roughly 70 market participants, who collectively represent about 90 percent of the global interest rate, foreign exchange swaps, and OTC options markets. Looking at interest rate swaps, currency swaps, and interest-rate options, and using comparable data from the United States over the same period, insured commercial banks in the United States handle 37 percent of the interest rate swap market, and 35 percent of the currency swap market.

Uses of Derivatives

The notional value of derivatives has grown rapidly because derivatives, when used properly, can permit more effective and flexible risk management. For example, interest rate derivatives permit users to hedge their financing costs; currency derivatives enable the management of foreign exchange risk arising from international business activities; and credit derivatives allow users to diversify credit concentrations that can arise in the normal course of business. In general, OTC-customized derivatives can permit an end-user to hedge virtually any business risk, or to tailor a portfolio to a desired risk/return profile.

In addition to being an effective risk management tool, derivatives have had an impact on the risk management of business activities in general. While the nature of the risks posed by derivatives is not new, derivatives can create more complex risk profiles. As a result, banks now use quantitative tools in the management of business risks, allowing the more precise identification, measurement, and management of those risks. Indirectly, the complex risks of derivative activities have led to a greater recognition of the importance of internal controls and corporate governance for all business activities.

As evidenced by the significant volume of bank dealer activity, derivatives offer an important and growing product line to bank clients. Banks serve as dealers of derivative products in addition to using these products for their own risk management purposes, and they derive certain benefits from engaging in such activity. Derivatives contribute to the viability of dealer banks by allowing them to diversify their revenues. For example, derivatives can improve a bank's ability to withstand downturns

[3] These eight banks include four that are state-chartered (Bank of New York, Bankers Trust, Chase, and Morgan), and four with national charters (Bank of America, Citibank, First Chicago, and NationsBank).

in the business cycle. This is true because revenue from derivatives contracts is tied to the volatility of financial markets. In an economic downturn, as markets become more volatile and the traditional banking credit business is reduced, bank customers may seek to manage their financial risks by purchasing derivatives. In turn, this provides banks with an alternative source of revenue.

Banks also can gain new business and use their expertise as risk management experts via the design and implementation of effective risk management solutions through the use of derivatives. In addition, banks can improve their ability to serve as a primary source for their clients' financial services needs—a clear benefit for bank customers. Finally, derivatives can deepen a bank's relationship with a client, because as is true with credit products, the marketing of derivative products often requires an in-depth understanding of a client's risk management objectives. In turn, bank customers benefit from having these customized products made available to them.

OCC Supervision of Derivatives

While we note that the derivatives market, and, in particular, the swaps market, is growing rapidly, we believe that the current regulatory structure for these markets is effective and appropriate. From our perspective as bank regulators, we know that banks' derivative activities include not only their role as dealers to satisfy customer demand, but also the integration of the activity into their asset/liability risk management processes. Because derivatives activities are similar to other financial and risk intermediation activities and often integral to their risk management strategies, we believe it is efficient and effective for a bank's primary regulator to have responsibility for oversight of bank derivatives activities.

As the supervisor of national banks, the OCC seeks to ensure that banks participate in the derivatives market in a safe and sound manner. Over the past six years, the OCC has embedded into its supervision of national banks the examination of derivatives and their relevant risks by issuing extensive guidance to bankers and by amending examination procedures. OCC examiners on site at large banks facilitate the information flow between such banks and the OCC, allowing us to keep current on the extent of bank derivatives activities and the level and trends of risks assumed. This on-site presence also allows us to collect information quickly and efficiently, and to augment our supervisory efforts as appropriate as risk levels increase. Overall, based on our on-site examinations, we believe that the various risks associated with derivatives at national banks are generally well managed.[4]

Guidance issued. In October 1993, the OCC issued Banking Circular 277 (BC 277), "Risk Management of Financial Derivatives," to define best practices and safe and sound procedures for managing derivatives risks. BC 277 states that banks should adopt systems and controls to measure and monitor properly the individual and aggregate risks associated with their derivatives portfolios, and advises banks to set up and follow appropriate risk limits. BC 277 includes separate standards for dealer banks and end-users. In response to questions raised by bankers concerning BC 277, on May 10, 1994, the OCC issued OCC Bulletin 94-32, "Questions and Answers About BC 277." In October 1994, we issued a supplement to the *Comptroller's Handbook* that provided detailed examiner guidance on the risk management of financial derivatives. We issued a revised version of the original handbook section in January 1997 that contains more extensive explanations of risk management issues and provides more detailed examination procedures.

Guidance on sales practices. In addition to focusing on safety and soundness concerns, BC 277 also emphasized the need for banks to establish controls that assess the appropriateness of specific transactions for customers, in order to manage the credit and reputation risk to the bank. To ensure customer appropriateness, we require that dealer banks understand the nature of each counterparty's business and the purpose of its derivative activities.

To evaluate how national banks were collectively developing processes to comply with our supervisory policy requirements, OCC staff performed a review of the sales practices at the most active national bank derivative dealers in June 1995. During this review, we found that national banks were in compliance with the customer appropriateness requirements of BC 277, and often their practices went beyond our supervisory requirements. As part of the review of sales practices, we also developed a list for public distribution of the best practices employed by banks.

On-site examinations. Our on-site supervisory efforts include both regularly scheduled and focused examinations, as well as ongoing, on-site supervision at the largest national banks. During focused examinations, emphasis is directed at those bank activities or departments exhibiting higher-than-average risk or growth, potential instability (such as that arising from management changes), or unique or new characteristics. A bank also may be selected in order to test generally the adequacy of its control systems. Focused examinations may cover certain products, such as interest rate swaps, or a given risk category, such as interest rate risk. Staff from the OCC's Risk Analysis Division—who hold Ph.D.s in economics or finance—participate in these

[4] Under supervision by risk, the OCC defined nine categories of risk: strategic, reputation, price, foreign currency translation, liquidity, interest rate, credit, transaction, and compliance. Derivatives expose banks to all nine of these risks.

examinations to assess theoretical and quantitative issues in the models used for pricing and risk management.

Off-site surveillance. The OCC supplements its on-site examination activities with off-site surveillance. Each quarter, the OCC publishes a comprehensive report, based on call report filings, summarizing trends and risk levels of derivatives activity in the U.S. commercial banking system. Also on a quarterly basis, we identify national banks that are outliers with respect to their derivative activities using call report data. Through review of examination information and contact with the examiners, we then assess whether the risks at these identified banks are well managed and if we need to take a closer look at the bank. On a semiannual basis, the director of our Treasury and Market Risk Division meets with the OCC's senior capital markets examiners, who examine banks throughout the country. This group meets to discuss current risk and control issues at banks, identify any emerging supervisory concerns, and discuss potential solutions and problems confronting the OCC and national banks.

Training. OCC examiners receive extensive, on-the-job training, under the supervision of senior examiners, and formal classroom instruction. In July 1992, the OCC created a Capital Markets Training Program (CMTP), an ongoing education program designed to provide advanced technical training for examiners specializing in capital markets, including derivative activities. Currently, 150 examiners are enrolled in the program. The program sponsors an annual week-long capital markets seminar that covers topical issues related to capital markets activities. Throughout the year, select examiners attend specialized courses on subjects ranging from mortgage banking to asset-liability management. Since 1996, the OCC has offered intensive two-week workshops on intermediate and advanced financial products for our senior capital markets examiners. To date, we have enrolled 48 examiners in these workshops, and an additional 24 are enrolled for this training in October.

Recent Proposals to Alter the Regulations Governing Derivatives

In your letter of invitation, you asked us to comment on certain proposals advanced recently to alter the regulatory structure governing derivatives activities. We have heard from some national banks that such proposals invite uncertainty regarding the legal status of certain derivatives transactions. As the administrator of national banks, the OCC is concerned about the possible impact of such uncertainty on national banks and bank customers. I will summarize the issues under discussion and explain the OCC's concerns.

Commodity Futures Trading Commission (CFTC) Concept Release

In May 1998, the CFTC published for comment a concept release to solicit industry views on the adequacy of regulation in the over-the-counter (OTC) market for derivatives. The issuance has caused concern for derivatives market participants, who have operated under the legal certainty provided by the CFTC's use of its exemptive authority in 1993, exempting swaps and hybrids from most of the requirements of the Commodity Exchange Act (CEA). That result represented a consensus, at the time, that "swap" transactions should not be regulated as contracts subject to the CEA. The CFTC's request for industry comment challenges this consensus. It appears to be predicated on the implication that swaps could be subject to their jurisdiction as futures contracts. The potential consequences of such a conclusion include the possibility that existing OTC swap transactions could be rendered illegal. These points were raised by witnesses in last week's hearing (July 17, 1998) on this subject.

In issuing the concept release, the CFTC seeks views on the continued exemptions for swaps and hybrids[5] under the CEA. When it adopted these exemptions, the CFTC conditioned the swaps exemption on the satisfaction of five criteria:

1) the instrument must meet the CFTC's definition of a swap;[6]
2) the counterparties to the swap must be limited to appropriate persons;
3) the swap must not be part of a fungible, standardized class of agreements;
4) the creditworthiness of any counterparty must be a material consideration; and
5) the swap must not involve a "multilateral transaction execution facility," e.g., an exchange.

The CFTC adopted these exemptions to provide a "safe harbor" from its regulation in response to the Futures

[5] This includes debt, preferred equity, or deposit instruments with a cash-flow component related to the value of a commodity or group of commodities, e.g., deposits with interest rates based on changes in the price of gold.

[6] As defined in Regulation 35.1(b)(1), swaps include interest rate swaps (rate swap, rate caps, rate floors and rate collars; basis swap, forward rate swaps), commodity swaps, interest rate option, currency forwards, currency options, cross-currency swaps, currency options. Part 35 additionally sets forth criteria that an instrument must meet in order to qualify for the swap exemption (restrictions on the design and execution of transactions that distinguish the exempted swap transactions from exchange-traded products).

Trading Practices Act of 1992 (FTPA). The FTPA amended the CEA by giving the CFTC exemptive authority[7] "in order to promote responsible economic or financial innovation and fair competition" and to bring legal certainty to swaps and hybrids that they would *not* be regulated as futures. As former CFTC Chairman Wendy Gramm testified last week, "[t]he purpose of the jurisdictional section of the FTPA was to provide some regulatory certainty to market participants."[8] Dr. Gramm also recounted in her testimony that such legislation was in reaction to legal uncertainties introduced into the commodity swaps markets by actions taken by the CFTC prior to the issuance of the Swaps Policy Statement in 1989, resulting in the offshore movement of "much of the commodity swap business."[9]

Unfortunately, issuance of the concept release may be re-creating the very uncertainty that Congress enacted the FTPA to cure. Because of the legal uncertainty introduced by the concept release, the United States may be perceived as having a less attractive legal environment for derivatives activity. This could result in undesirable outcomes. For example, because the OTC derivatives markets operate globally, dealers may simply move their businesses offshore. If OTC derivative dealers were to do so, the activity could continue, but U.S. regulators would have diminished ability to monitor such activities. Further, U.S. customers may experience reduced access to flexible risk management products as dealers limit their business to clients domiciled in locations with greater legal certainty.

Today, the OTC derivatives markets are functioning well. The potential negative impact on these markets of increased legal uncertainty leads us to believe that any changes in the regulatory characterization for these transactions raise important public policy issues that would be better dealt with by the relevant broader financial regulatory community. The President's Working Group on Financial Markets (PWG) is an appropriate forum for a necessarily multi-agency study of major financial markets, and related public policy issues. Because OTC derivatives have the potential to have an impact on multiple markets and multiple jurisdictions, the PWG is well positioned to evaluate the characteristics of these instruments and the need for actions to improve the safety and efficiency of the financial services industry. Furthermore, while we are not aware of any current problems in the normal functioning of these markets, the PWG is a useful forum to surface any problems of which others are aware. Accordingly, absent such a comprehensive assessment, we believe that any implication that the current regulatory characterization of swaps has changed, or should change, is unfounded.

Revisions to Bankruptcy Laws and the Banking Laws Governing the Resolution of Insolvent Depository Institutions

In your letter of invitation, you also asked that we address H.R. 4239, the Financial Contract Netting Improvement Act of 1998 (FCNIA) that the chairman and other members of the committee introduced last week to revise the provisions concerning the bankruptcy laws and the banking laws governing the resolution of insolvent depository institutions. As you know, FCNIA was drafted by staff members of the agencies represented on the PWG—Treasury, the OCC, the Federal Deposit Insurance Corporation, the Federal Reserve, the Securities and Exchange Commission, and the CFTC.

The proposed legislation would amend provisions of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation Improvement Act of 1991, and the Bankruptcy Code that address the treatment of qualified financial contracts (QFCs)[10] and other similar financial contracts in the event that a party to such a contract becomes insolvent. The purpose of the proposal is to clarify and ensure consistent treatment and enhanced enforceability of QFCs and other similar financial contracts in instances of counterparty insolvency. FCNIA would provide significant benefits to the markets by reducing systemic risk in the financial markets, increasing market liquidity, and providing legal certainty to market participants of all types.

The legislation also includes an OCC proposal to clarify that generally a counterparty to a QFC with an *uninsured* national bank or *uninsured* federal branch or agency that becomes insolvent will have the same rights and will be treated no differently than if it were a counterparty to the same contract with an insured institution that became insolvent. This issue arose in connection with recent requests for guidance about whether the rights of members of international clearing houses to execute collateral agreements, for example, will be enforced by an OCC-appointed receiver in the event that an uninsured federal

[7] "[T]o exempt any agreement, contract, or transaction (or class thereof) . . . either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a), or from any other provision of this act (except section 2(a)(1)(B)), if the Commission determines that the exemption would be consistent with the public interest." From the Conference Report 102-978 to accompany the Futures Trading Practices Act of 1992.

[8] Statement of Dr. Wendy Gramm on the Financial Derivatives Supervisory Improvement Act of 1998 before the U.S. House Committee on Banking and Financial Services, July 17, 1998.

[9] *Ibid.*

[10] Qualified financial contracts (QFCs) include securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements.

branch or agency member of the clearing house is placed in receivership.

The OCC has actively participated in the process to draft these revisions and encourages their statutory enactment. We fully support these efforts to increase market certainty.

Conclusions

The over-the-counter (OTC) markets in derivatives instruments has grown rapidly over the years. Today, derivatives provide national banks with flexible and effective risk management tools, as well as allow them to diversify their revenue base and compete effectively with other financial services providers. In general, we do not see a need for significant changes to the regulation of derivatives markets.

The OCC's primary concern is that legal certainty, regarding the standing of existing contracts, as well as that of contracts that could be negotiated in the future, be restored to the financial markets, the U.S. banking system, and bank customers, and we sincerely hope that the CFTC and other affected regulatory agencies can devise a coordinated approach to accomplish this.

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Interpretive Letters

831—June 8, 1998

12 USC 24(7)

Gentlemen:

This responds to your letter of April 2, 1998, requesting confirmation that [ ], *[city, state] [bank 1]* may lawfully acquire a minority, noncontrolling interest in [ ], *[bank 2], [city, state]*. For the reasons set forth below, it is our opinion that this transaction is legally permissible in the manner and as described herein.

I. Background

The OCC has received an application to charter *[bank 2],* a limited purpose national bank[1] in *[city]*. *[Bank 2]* is being organized on behalf of [ ] *[LLC 1],* an *[state]* limited liability company, and its sole owner, [ ] *[LLC 2],* also an *[state]* limited liability company. Shortly after the approval of the charter and the organization and capitalization of *[bank 2],* it is proposed that *[LLC 1]* will sell 24.9 percent of the outstanding stock of *[bank 2]* to *[bank 1]*.[2]

[Bank 2] is being organized in order to provide trust services primarily in the *[city]* area. *[Bank 2]* will limit its activities to the provision of fiduciary services, focusing exclusively on the personal trust business. Such services will include financial and estate planning, management of investments, real estate, and oil and gas properties, and agency and custody services. Corporate and pension services may be offered in the future. Under the proposed organization plan, *[bank 1]* will have two directors on *[bank 2]'s* five-person board.

II. Analysis

[Bank 1]'s purchase of a 24.9 percent interest in *[bank 2]* raises the issue of the authority of a national bank to hold a minority, noncontrolling interest in an enterprise. In a variety of circumstances the OCC has permitted national banks to own, either directly, or indirectly through an operating subsidiary, a minority interest in an entity. The entity may take different forms, including a limited partnership, a corporation, or a limited liability company.[3]

These letters have concluded that such minority, noncontrolling investments are legally permitted provided that four criteria or standards are met. These standards, which have been distilled from our previous decisions in the area of permissible minority investments for national banks and their subsidiaries, are: (1) the activities of the enterprise in which the bank invests must be limited to activities that are part of, or incidental to, the business of banking; (2) the bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment; (3) the bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and (4) the investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business. Each of these standards is discussed below and applied to the proposed investment by *[bank 1].*

1. The activities of the enterprise in which the bank invests must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on minority stock ownership have recognized that the enterprise in which the bank takes an equity interest must confine its activities to those that are part of, or incidental to, the business of banking.[4] In the present case, the application represents that *[bank 2]* is being organized for the limited purpose of providing trust and fiduciary services, including the normal and customary services associated with administering trusts and

[1] For purposes of this opinion, the terms "limited purpose national bank" and "limited purpose national trust company" are used interchangeably.

[2] The acquisition will not require *[bank 1]* to file a notice under the Change in Bank Control Act, since it will be less than 25 percent. *See* 12 USC 1817(j)(8).

[3] *See* OCC Interpretive Letters No. 737, [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–101 (August 19, 1996); No. 732, [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–049 (May 10, 1996); No. 694, [1995–1996 Transfer binder] Fed Banking L. Rep. (CCH) ¶ 81–009 (December 13, 1995); and No. 692, [1995–1996 Transfer Binder] Fed. Banking L. Rep (CCH) ¶ 81–007 (November 1, 1995). *See also* OCC Interpretive Letter No. 697, [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–012 (November 15, 1995) (national bank may indirectly own a 25 percent interest in a state-chartered trust company); and OCC Interpretive Letter No. 815, [Current] Fed. Banking L. Rep. (CCH) ¶ 81–263 (December 2, 1997) (national bank may retain a 15 percent interest in a state-chartered trust company).

[4] *See, e.g.*, Letter from Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in such a network is permissible); OCC Interpretive Letter No. 380, [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n. 8 (December 29, 1986) (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services).

estates, providing agency and custody services, and serving in various fiduciary capacities. Pension and employee benefit services may be provided in the future. It is well established that national banks may engage in trust activities to the same extent as state-chartered institutions in the same state. 12 USC 92a. Banks in *[state]* are permitted to exercise fiduciary powers. *[State Stat. Ann.]*. Moreover, as previously mentioned, the OCC has specifically approved minority investments in trust banks. OCC Interpretive Letter No. 815, *supra*; OCC Interpretive Letter No. 697, *supra*. Thus, the activities to be performed by *[bank 2]* are activities that are part of, or incidental to, the business of banking, and the first standard is satisfied.

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

This is an obvious corollary to the first standard. The activities of an enterprise in which a national bank invests must be part of, or incidental to, the business of banking not only at the time the bank initially acquires its ownership, but they must remain so for as long as the bank has an ownership interest. This standard may be met if the bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest. *See, e.g.*, OCC Interpretive Letter No. 711, [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–026 (February 23, 1996); OCC Interpretive Letter No. 692, *supra*. This ensures that the bank will not become involved in activities that are not part of, or incidental to, the business of banking.

The application documents in this case reflect that *[bank 2]* will be engaged in the provision of fiduciary services, which is a permissible activity for national banks. The proposed Articles of Association for *[bank 2]* provide that its business will be limited to the operations of a trust department and related support activities, and that *[bank 2]* will not expand or alter its business beyond the stated activities without the prior approval of the Comptroller of the Currency. Upon its formation, *[bank 2]* will also be prohibited from engaging in activities that are not incidental to the business of banking, under the provisions of 12 USC 24(7). Thus, *[bank 2]* will be prevented as a matter of law from engaging in activities that are not a part of, or incidental to, the business of banking.

In addition to these restrictions, the proposed bylaws of *[bank 2]* provide that the directors will have veto power over any activities which they deem unsuitable for the trust company. Also, the purchase of shares by *[bank 1]* is subject to a shareholder's agreement which provides that *[bank 1]* sell its shares in *[bank 2],* with *[LLC 1]* having a right of first refusal. Thus, *[bank 1]* may exercise a veto power over *[bank 2]'s* activities, or dispose of its interest. Accordingly, the second standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

A primary concern of the OCC is that national banks should not be subjected to undue risk. When an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a bank's investment not expose it to unlimited liability. Such is the case here. As a legal matter, the stockholders of national banks are not, as a general rule, personally liable for the debts and acts of the bank. *See* 9 C.J.S. *Banks and Banking,* section 506 (1996); *Williamson* v. *American Bank*, 115 F. 793 (1902); 12 USC 64a. Thus, *[bank 1]'s* loss exposure for the liabilities of *[bank 2]* is limited as a matter of law.

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a minority investment is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has extended a loan to the entity, guaranteed any of its liabilities, or has other financial obligations to the entity, losses are generally limited to the amount of the investment shown on the investor's books. *See generally*, Accounting Principles Board, Op. 18 § 19 (1971) (equity method of accounting for investments in common stock); OCC Interpretive Letter No. 692, *supra*.

[Bank 1] will have a 24.9 percent ownership interest in *[bank 2],* and will account for its investment under the equity method. *[Bank 1]'s* loss exposure is limited to the amount of its investment, and is also subject to *[bank 1]'s* right to dispose of its shares by selling its interest to the majority shareholder. You have represented that *[bank 1]* will not make any loans to *[bank 2],* and will not guarantee any of *[bank 2]'s* obligations or be otherwise obligated on any liabilities of *[bank 2]*.

Accordingly, for both legal and accounting purposes, *[bank 1]'s* potential loss exposure relative to *[bank 2]* should be limited to the amount of its investment. That exposure is quantifiable and controllable, and *[bank 1]* will not have open-ended liability for the liabilities of *[bank 2]*. The third standard is therefore satisfied.

4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

Under 12 USC 24(Seventh), a national bank is given all incidental powers that are necessary to carry on the

business of banking. "Necessary" has been judicially construed to mean "convenient or useful." *Arnold Tours, Inc.* v. *Camp*, 472 F.2d 427, 432 (1st Cir. 1972). A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank must also satisfy the requirement that the investment have a beneficial connection to the bank's business, *i.e.*, be convenient or useful to the investing bank's business activities, and not be a mere passive investment unrelated to its business activities. OCC precedents concerning stock ownership have consistently indicated that such ownership must be convenient or useful to the bank in conducting *that bank's* business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.

In the present case, you have represented that *[bank 1]* has valid business reasons for its investment in *[bank 2]*. You state that *[bank 1]* currently possesses fiduciary powers, but has not actively exercised those powers. The proposed minority investment in *[bank 2]* will afford *[bank 1]* the opportunity to provide a wider scope of trust services to its customers, and also to expand into new trust markets. Thus, the investment is convenient or useful to *[bank 1],* and is not merely passive or speculative. Accordingly, the fourth standard is satisfied.

III. Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, it is our opinion that *[bank 1]* is legally permitted to acquire and hold a noncontrolling interest in *[bank 2]* in the manner and as described herein, subject to the following conditions:

1. *[Bank 2]* will engage only in activities that are a part of, or incidental to, the business of banking;
2. *[Bank 1]* will have veto power over any activities and major decisions of *[bank 2]* that are inconsistent with condition number one, or will withdraw from *[bank 2]* in the event that it engages in an activity that is inconsistent with condition number one;
3. *[Bank 1]* will account for the investment in *[bank 2]* under the equity method of accounting; and
4. *[Bank 2]* will be subject to OCC supervision, regulation, and examination.

These conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that *[bank 1]'s* investment is permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

If you have any questions, please contact me or Stephen Brown, Senior Attorney, at (214) 720–7012.

Randall M. Ryskamp
District Counsel
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832—June 18, 1998

12 USC 24(7)

Dear [ ]:

This is in response to your request that the OCC reconsider the statement in OCC Interpretive Letter No. 617, *reprinted in* [1992–1993 Transfer Binder], Fed. Banking L. Rep. (CCH) ¶ 83,457 (March 4, 1993) (Letter 617) that a national bank may not invest in a small business investment company (SBIC) that is in the process of organizing and has not yet obtained its license from the Small Business Administration (SBA).

You seek confirmation of your opinion that, particularly in light of the 1997 amendments to 15 USC 682(b), it is more reasonable to take the position that a national bank may invest in an SBIC that is in the process of organization as well as one that has already been organized, approved and licensed by the SBA. For the reasons given below, I agree with your conclusion.

In 1993, when Letter 617 was issued, 15 USC 682(b) provided that "shares of stock in small business investment companies shall be eligible for purchase by national banks." The only limitation was that the bank's investment in one or more SBICs could not in aggregate exceed 5 percent of the bank's capital and surplus.

Because the investment authorization in section 682(b) referred specifically to the purchase of shares of stock in an SBIC, the question arose whether a national bank could invest in an SBIC organized as a limited partnership, as well as in an SBIC organized as a corporation. Letter 617 concluded that such a limited partnership investment would be permissible because the statute did not prohibit it, and because other OCC precedents had generally taken the position that a national bank can become a partner in an enterprise where its liability is limited and the enterprise engages solely in activities permitted for investment by a national bank. Since an

SBIC is an eligible investment for national banks, the investment could take the form of a limited partnership interest.

The letter went on to observe that the bank could make its investment in the limited partnership SBIC only after the company obtained its license from the SBA:

> Section 682(b) enables national banks to invest in SBICs, which are defined to mean "a company *approved* by the Administration [SBA] to operate under the provisions of this chapter *and issued a license* as provided in section 681 of this title." 15 USC 662(3) [emphasis added]. The statutory scheme implies that national banks are limited to investments in existing SBICs. Therefore, any potential national bank investor will have to await approval and licensing of the Partnership as a SBIC by the SBA before it disburses any funds.

Letter 617 at 2.

While this additional conclusion was not unreasonable per se, it was not compelled by the statutory language either. Upon reconsideration, both of the statutory scheme as it has existed since 1958, and particularly as Congress has revised 15 USC 682(b) in 1997, we believe that the better view is that national banks have flexibility in the timing of their investments in SBICs. There is no good reason based upon the language of the statute as amended, or its underlying policy, that national banks should be limited to investing in SBICs that have already been organized, approved, and granted a license by the SBA.

Fifteen USC 662, Definitions, subparagraph (3), states in pertinent part that "the terms 'small business investment company,' 'company,' and 'licensee' mean a company approved by the Administration to operate under the provisions of this Act and issued a license as provided in" 15 USC 681. Section 662(3) is merely identifying what is being talked about in the entire Small Business Investment Act of 1958, as amended, 15 USC 661 et seq. In order to operate, an SBIC must be approved and licensed by the SBA. But this language about SBA approval and licensure was not carried over into the more specific authorization for national banks to purchase shares of stock in SBICs. Thus, as of 1993, when Letter 617 was issued, section 682(b) did not state or imply that the bank could not purchase shares until the SBIC had become licensed by the SBA. The law was silent on this timing-of-investment issue.

We note that the Federal Reserve Board has taken a different position than Letter 617 on the investment timing issue. The Board's regulation at 12 CFR 225.107, which addresses the investment by member banks in SBICs organized as subsidiaries, authorizes a bank to "organize and subscribe for stock in" a proposed SBIC. This interpretation thus appears to contemplate and approve investment by a member bank prior to the applicant subsidiary's receipt of its license as an SBIC from the SBA.

It will be difficult if not impossible for a national bank to establish an SBIC, either alone or in conjunction with one or more other bank investors, if it cannot fund the enterprise prior to SBA licensure. An SBIC cannot obtain a license unless it is adequately capitalized, 15 USC 682(a). Current SBA regulations require that an applicant for an SBIC license must have at least $2,500,000 in contributed capital in order to be licensed as an SBIC, 13 CFR 107.210(a). This minimum capital requirement specifically excludes unfunded capital commitments.

It is our understanding that as a practical matter many SBICs are closed-end ventures. The owners tend to be few, and to fund the enterprise in the initial stages of organization. Frequently, after the SBIC obtains its license, no additional investors are sought or brought in. The ability of a bank to make an investment in an applicant, so that the applicant can meet the minimum capital requirements necessary to obtain its SBIC license, is critical to the formation of a new SBIC. As mentioned, even in the case where a bank organizes a wholly owned subsidiary that applies for an SBIC license, SBA regulations require that the bank must capitalize its applicant subsidiary before it can receive an SBIC license.

These regulatory and marketplace realities mean that limiting national bank investments to only those SBICs that have already been organized, approved, and licensed by the SBA will diminish the possibilities for national banks to participate in a meaningful way in the program. This in turn leads us to note that Congress has consistently evidenced its intention that banks be encouraged to provide loan and equity funding to small businesses through the use of SBICs.

Most recently, in 1997 Congress revised 15 USC 682(b) to authorize national banks to "invest in any 1 or more small business investment companies, or in any entity established to invest solely" in SBICs. These amendments changed section 682(b) in two ways. First, the statute now expressly authorizes national banks to "invest in" SBICs, however they may be organized. This is an expansion of the prior permission to purchase shares of stock in SBICs.

Second, the statute now authorizes national banks to invest in an entity that in turn will invest in SBICs. Clearly, the investment in such an entity will precede the entity's investment in SBICs. It is an additional option being

made available to national banks that desire to invest in SBICs. And there is no requirement that the entity be registered as an investment company or be licensed by the SBA.

The Senate Report that accompanied the Small Business Reauthorization Act of 1997 indicates that the amendments were intended to make the SBIC Program "more responsive to the small business and investor communities." In order to bring the law up to date with "current investment practices," the 1997 amendments included the changes in 15 USC 682(b) that have been quoted above. The Senate Report explains :

> Currently, the Small Business Investment Act only provides that banks may purchase stock from SBICs. Many SBICs now are organized as limited liability companies and partnerships, which do not have stock, and some banks may want to structure their SBIC investments though a separately managed "fund of funds" to diversify among several different SBICs. These language changes [to section 682(b)] are being made to allow banks to continue to invest in SBICs, whether organized as corporations, partnerships, or limited liability companies, and expressly permits banks to invest in entities established to invest solely in SBICs, with no requirement that such entities be registered investment companies.

Senate Report No. 105–62, August 9, 1997 [to accompany S. 1139], 105th Cong., 1st Sess. at 2, 8, *reprinted in* 4 U.S.C.C.A.N. at 3077, 3082 (1997).

Nothing in the literal language of the statutory permission limits a national bank's investment to a point in time after the SBIC has obtained its license from the SBA. The authority granted is to invest in SBICs, not "licensed SBICs" or some comparable limiting provision. In other words, 15 USC 682(b) as amended allows national banks to invest in SBICs, and neither this section nor any other provision in the SBIC law imposes a time period limitation, either before or after the company obtains its license.

As a result of the 1997 changes banks are now specifically authorized to invest in SBICs, rather than merely purchase their shares. Whereas the "purchase of shares" permission could reasonably be construed as limiting the investment to an existing SBIC, the broader investment authority in the 1997 amendments makes it clearer that investments are contemplated to come at any time in the process of organizing an SBIC as well as after it obtains a license. So too does the other change, permitting a national bank to invest in an entity that will in turn invest in SBICs. This confirms that there is sufficient flexibility for the bank to expend funds prior to the receipt of a license by a planned SBIC. The investment in the entity will be made prior to any particular investment in an SBIC, which obviously will follow.

Finally, concluding that banks have flexibility to time their funding of SBICs based upon individual circumstances is both consistent with and helps to promote the overall purposes of the statutory scheme. *See, e.g., ANA Small Business Invest., Inc.* v. *SBA,* 391 F.2d 739 (9th Cir. 1968) (statutory provisions relating to SBICs were enacted to increase the availability of loans to those engaged in comparatively small enterprises who could not obtain adequate borrowed funds through customary financial institution channels); *SBA* v. *Barron,* 240 F.Supp. 434 (D.S.C. 1965) (Congress enacted statute relating to SBICs for the purpose of providing additional source of long-term equity capital and long-term loans for small business concerns).

For all of these reasons, it is my opinion that a national bank may invest in an SBIC that is in the process of being organized, as well as in one that has already obtained a license from the SBA. Letter 617 is overturned on this narrow point.

I trust this reply is responsive to your inquiry.

Raymond Natter
Acting Chief Counsel

833—July 8, 1998

12 USC 24(7)

Re: [ ] Variable Rate Subordinated Notes

Dear [ ]:

This is in response to your request for confirmation that national banks may purchase Variable Rate Subordinated Notes (notes) issued by *[company 1],* the parent company and sole shareholder of *[company 2].*[1] For the reasons described below, based on the facts and representations provided, we conclude that national banks have the authority to purchase the notes as loans under 12 USC 24(Seventh).[2] However, national banks have a

[1] Borrower's common stock is listed on the New York Stock Exchange.

[2] The OCC does not endorse particular lending or investment products, and this letter is neither an endorsement nor a criticism of the notes as investments for national banks.

responsibility to ensure that the purchase of notes complies with the Real Estate Settlement Procedures Act (RESPA) and the standards and conditions set forth in a February 17, 1998, letter from Nicholas P. Retsinas, Assistant Secretary, Department of Housing and Urban Development (HUD) to W. Roger Naughton, President/Chief Executive Officer, PMI Mortgage Insurance Company (PMI).

Background

[Company 1] (borrower) proposes to issue and to sell notes to lender banks (including national banks) that obtain mortgage insurance policies (policies) from *[Company 2]* (insurer) covering individual mortgage loans made by the bank. The notes are structured to provide market-based incentives to those banks that obtain policies from insurer in order to encourage those banks to provide better performing mortgage loans to insurer. Under the terms of the notes, on a periodic basis, a bank will have an opportunity to purchase a note in a principal amount based upon either: (1) an estimate of the dollar volume of insured mortgages originated by the lender bank and insured by insurer during an agreed upon initial measuring period, such as 12 consecutive months following the date of issuance of the note; or (2) the actual dollar amount of mortgages insured by insurer originated by the lender during the preceding calendar quarter. The term of the notes is 10 years. However, in order to preserve the percentage relationship between the outstanding principal balance of the notes and the aggregate face amount of the policies, borrower anticipates making partial prepayments on the notes at periodic intervals. Borrower also has an annual opportunity to prepay the notes in full at par plus accrued interest to the date of the prepayment.

The notes would be unsecured subordinated loans that would have fixed maturities and would bear interest linked to two factors: (1) an agreed-upon fixed percentage rate that would constitute a floor interest rate; and (2) a variable interest component that would be linked to the performance of the mortgage loans originated by the lender and insured by insurer.[3] The variable rate paid on the notes would be calculated under a formula that measures the fluctuating rate of return to insurer produced by the policies that is inversely proportional to the amount of claims paid by insurer on those policies. The borrower does not intend to register the notes under the Securities Act of 1933 or obtain ratings for the notes from any rating organization.

Discussion

A national bank may purchase and hold a debt security that is not marketable if the bank treats the instrument as a loan.[4] The term "loan" includes "any direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person." 12 USC 84(b)(1); *see also* 12 CFR 32.2(j). The OCC by regulation defines the term broadly to include contractual commitments to advance funds, obligations arising from a bank's discount of commercial paper, and overdrafts. 12 CFR 32.2(j)(1)(i), (ii), and (v).

A bank may purchase non-marketable instruments under its general lending powers, subject to safety and soundness restrictions. *See* OCC Interpretive Letter No. 579, *supra*. The OCC expects a bank to make an informed credit judgment in a manner consistent with its credit policy. Such purchases should be based on a complete review of relevant credit information and be subject to appropriate loan administration practices.[5] In addition, purchases should meet bank loan underwriting standards.

Lenders may purchase and hold the notes as loans.[6] *See* OCC Interpretive Letters No. 600, 579, and 182, *supra*. The notes satisfy the definition of a "loan." The lenders would advance funds to the borrower, and the borrower would be obligated to repay the funds. 12 USC 84(b)(1) and 12 CFR 32.2(j). The note, rather than a loan agreement, would evidence the contractual commitments made by the lender and the borrower. National bank lenders that purchase the notes as loans must conduct appropriate credit reviews and determine that the notes meet the bank's underwriting standards, and must obtain from the borrower, prior to purchasing the notes, assurances of continuing access over the life of

[3] Under the terms of the notes, borrower would have the option to make interest payments on the notes to lenders in the form of shares of the parent's common stock or in cash. However, the notes expressly provide that if a lender, such as a national bank, notified borrower that its receipt of interest payments in the form of stock would be incompatible with any regulatory restrictions, the borrower's interest payments to that lender would instead be made exclusively in cash.

[4] *See* OCC Interpretive Letter No. 600, *reprinted in* [1992–1993 Transfer Binder] Fed. Banking L. Rep. ¶ 83,427 (July 31, 1992); OCC Interpretive Letter No. 579, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. ¶ 83,349 (March 24, 1992); OCC Interpretive Letter No. 182, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. ¶ 85,263 (March 10, 1981).

[5] *See* Banking Circular No. 181 (August 2, 1984); *see also* Banking Bulletin No. 97–21 (April 10, 1997) (purchase of loans and loan participations).

[6] Even though the notes will be unrated, they potentially could qualify as investment securities if they were the credit equivalent of investment grade securities. *See* 12 CFR 1.2(e). The borrower, however, does not represent that the notes will be marketable and it does not appear that national banks could purchase the notes as investment securities.

the instruments to appropriate credit data. National bank purchasers should maintain analyses conducted at the time of purchase as part of fully documented loan files. *See* OCC Interpretive Letter No. 600, *supra*.

The borrower may also pay a variable rate of interest on notes issued to national banks. National banks may make loans with variable rates, such as adjustable rate mortgages. *See* 12 CFR 34.21(a). Banks have authority to purchase a note with an interest rate linked inversely to the amount of claims that the insurer pays.

> When taking deposits and making loans, national banks are permitted to enter into contracts which provide for interest payments which have fixed or variable rates. As the OCC explained in the Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A., to offer the Chase Market Index Investment Deposit Account, national banks have the authority to establish the amount of the payments to be made and received under their deposit and loan contracts based on market conditions and the needs of their customers. Accordingly, a bank may determine the amount of those payments by reference to any index or standard as long as the bank complies with safe and sound banking principles and, in the case of loans, with state usury laws.[7]

A national bank may take as consideration for a loan a share in the profit, income, or earnings from a business enterprise, so long as the borrower remains obligated to repay the principal of the loan. 12 CFR 7.1006.

National banks should not allow their investments in the notes to affect other lending decisions in an inappropriate manner. National banks must comply with all applicable federal and state laws, including consumer protection statutes such as the Fair Debt Collection Practices Act and the Equal Credit Opportunity Act, and operate in a safe and sound manner.

The OCC has not reviewed the notes for compliance with RESPA. OCC examination staff may review purchases of the notes by national banks for compliance with RESPA and the conditions and standards described by HUD. National banks must ensure that purchases of the notes comply with section 8 of RESPA and the standards and conditions established by HUD, which has primary authority for interpreting RESPA.[8] The HUD letter outlines the standards under which the offer of interest bearing notes by a private mortgage insurance company (similar to the instant notes) for purchase by mortgage lenders which refer mortgage insurance business to that private mortgage insurance company comply with sections of RESPA.

If you have any questions regarding this matter, please contact me at (202) 874–5210.

Joel Miller
Senior Attorney
Securities and Corporate Practices Division

[7] No-Objection Letter No. 90–1, *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep.¶ 83,095 (February 16, 1990).

[8] *See* 12 USC 2607(d) and 2617(a), and Letter from Nicolas P. Retsinas, Assistant Secretary, HUD to W. Roger Naughton, PMI (February 17, 1998).

834—July 8, 1998

12 USC 24(7)

12 USC 2601

Re: [ ] (Insurer)—Performance Note Loans

Dear [ ]:

This is in response to your request for confirmation that national banks may purchase performance note loans (PNLs) issued by the parent company (borrower) of [ ] (insurer). For the reasons described below, based on the facts and representations provided, we conclude that national banks have the authority to purchase PNLs as loans under 12 USC 24(Seventh).[1] However, national banks have a responsibility to ensure the purchase of PNLs complies with the Real Estate Settlement Procedures Act (RESPA) and the standards and conditions set forth in a February 17, 1998, letter from Nicolas P. Retsinas, Assistant Secretary, Department of Housing and Urban Development (HUD), to W. Roger Naughton, President/CEO, PMI Mortgage Insurance Company.

Background

The borrower proposes to issue and sell PNLs to lenders (including national banks) that refer mortgage customers to the insurer, a private mortgage insurer, for mortgage insurance. PNLs are structured to provide market-based incentives to those banks that refer mortgages to insurer in order to encourage those banks to provide better performing mortgage loans to insurer. Each quarter, a

[1] The OCC does not endorse particular lending or investment products, and this letter is neither an endorsement nor a criticism of PNLs as investments for national banks.

lender would have an opportunity to purchase a PNL in a principal amount based on the principal amount of mortgage loans resulting from the lender's referrals to the insurer. The lender may choose to purchase a PNL up to a maximum amount established by the borrower. The lender would transmit the funds to the borrower, and in return, would receive a PNL. If a lender chooses not to purchase a PNL in a quarter, the lender may not purchase any PNL for the remainder of the year.

PNLs would be unsecured subordinated loans that would have fixed maturities and initially bear interest at fixed rates. PNLs subsequently would bear interest at variable rates linked to the performance of the mortgage loans that the lenders originated, and the insurer insured. The variable rates would be inversely proportional to the amount of claims the insurer paid on the underlying loans.

PNLs would be transferrable only with the borrower's written consent, which it would not unreasonably withhold if the transfer complies with applicable federal and state securities laws. The borrower will not register PNLs under the Securities Act of 1933 nor obtain ratings for the PNLs from any rating organization.

Discussion

A national bank may purchase and hold a debt security that is not marketable if the bank treats the instrument as a loan.[2] The term "loan" includes "any direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person." 12 USC 84(b)(1); *see also* 12 CFR 32.2(j). The OCC by regulation defines the term broadly to include contractual commitments to advance funds, obligations arising from a bank's discount of commercial paper, and overdrafts. 12 CFR 32.2(j)(1)(i), (ii), and (v).

A bank may purchase non-marketable instruments under its general lending powers, subject to safety and soundness restrictions. *See* OCC Interpretive Letter No. 579, *supra*. The OCC expects a bank to make an informed credit judgment in a manner consistent with its credit policy. Such purchases should be based on a complete review of relevant credit information and be subject to appropriate loan administration practices.[3] In addition, purchases should meet bank loan underwriting standards. Lenders may purchase and hold PNLs as loans.[4] *See* OCC Interpretive Letters No. 600, 579, and 184, *all supra*. PNLs satisfy the definition of a "loan." The lenders would advance funds to the borrower, and the borrower would be obligated to repay the funds. 12 USC 84(b)(1); 12 CFR 32.2(j). The PNL, rather than a loan agreement, would evidence the contractual commitments made by the lender and the borrower. National bank lenders that purchase PNLs as loans must conduct appropriate credit reviews and determine that the PNLs meet the bank's underwriting standards, and must obtain from the borrower prior to purchasing PNLs assurances of continuing access over the life of the instruments to appropriate credit data. National bank purchasers should maintain analyses conducted at the time of purchase as part of fully documented loan files. *See* OCC Interpretive Letter No. 600, *supra*.

The borrower may also pay a variable rate of interest on PNLs issued to national banks. National banks may make loans with variable rates, such as adjustable rate mortgages. *See* 12 CFR 34.21(a). Banks have authority to purchase a PNL with an interest rate linked inversely to the amount of claims that the insurer pays.

> When taking deposits and making loans, national banks are permitted to enter into contracts which provide for interest payments which have fixed or variable rates. As the OCC explained in the Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A., to Offer the Chase Market Index Investment Deposit Account, national banks have the authority to establish the amount of the payments to be made and received under their deposit and loan contracts based on market conditions and the needs of their customers. Accordingly, a bank may determine the amount of those payments by reference to any index or standard as long as the bank complies with safe and sound banking principles and, in the case of loans, with state usury laws.[5]

A national bank may take as consideration for a loan a share in the profit, income, or earnings from a business enterprise, so long as the borrower remains obligated to repay the principal of the loan. 12 CFR 7.1006.

National banks should not allow their investments in PNLs to affect other lending decisions in an inappropri-

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[2] *See* OCC Interpretive Letter No. 600, *reprinted in* [1992–1993 Transfer Binder] Fed. Banking L. Rep. ¶ 83,427 (July 31, 1992); OCC Interpretive Letter No. 579, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. ¶ 83,349 (March 24, 1992); OCC Interpretive Letter No. 182, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. ¶ 85,263 (March 10, 1981).

[3] *See* Banking Circular No. 181 (August 2, 1984); *see also* Banking Bulletin No. 97–21 (April 10, 1997) (purchase of loans and loan participations).

[4] Even though PNLs will be unrated, unrated debt obligations may qualify as investment securities if they are the credit equivalent of investment grade securities. *See* 12 CFR 1.2(e). The borrower expects, however, that PNLs may not be marketable and, thus, national banks could not purchase PNLs as investment securities.

[5] No-Objection Letter No. 90–1, *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. ¶ 83,095 (February 16, 1990).

ate manner. National banks must comply with all applicable federal and state laws, including consumer protection statutes such as the Fair Debt Collection Practices Act and the Equal Credit Opportunity Act, and operate in a safe and sound manner.

The OCC has not reviewed the PNL program for compliance with RESPA. OCC examination staff may review purchases of PNLs by national banks for compliance with RESPA and the conditions and standards described by HUD. National banks must ensure that purchases of PNLs comply with section 8 of RESPA and the standards and conditions established by HUD, which has primary authority for interpreting RESPA.[6] The HUD letter to the insurer outlines the standards under which the offer of PNLs for purchase by mortgage lenders that refer mortgage insurance business to the insurer comply with sections of RESPA.

If you have any questions, please feel free to contact me at (202) 874–5210.

Frederick G. Petrick Jr.
Senior Attorney
Securities and Corporate Practices Division

[6] *See* 12 USC 2607(d) and 2617(a), and Letter from Nicolas P. Retsinas, Assistant Secretary, HUD, to W. Roger Naughton (February 17, 1998).

835—July 31, 1998

12 USC 24(7)

Joseph T. Green, Esquire
General Counsel
TCF Financial Corporation
801 Marquette Avenue
Minneapolis, Minnesota 55402–3475
Re: Proposed Mortgage Life Reinsurance Activities

Dear Mr. Green:

On February 24, 1997, the OCC approved the application of TCF Financial Corporation, Minneapolis, Minnesota (TCF), to convert its federal savings bank to a national bank, Great Lakes National Bank (bank). Pursuant to the OCC's approval, the OCC permitted Lakeland Group Insurance Agency, Inc. (Lakeland), a subsidiary of the bank, to retain its noncontrolling minority interest in MIMLIC Life Insurance Company (MIMLIC) for up to two years pending the OCC's determination of the permissibility of MIMLIC's credit-related reinsurance activities under the National Bank Act. *See* OCC Corporate Decision No. 97–13 (February 24, 1997) at 32. MIMLIC is an Arizona insurance company that reinsures mortgage life, mortgage accidental death, and mortgage disability insurance[1] (collectively, "credit life insurance")[2] on loans originated by lenders with an ownership interest in MIMLIC. For the reasons set forth below, we conclude that Lakeland is legally permitted to retain its noncontrolling minority interest in MIMLIC, subject to certain conditions.

I. Background

A. Credit-Related Insurance Generally

National banks may sell, underwrite and reinsure credit-related insurance products, including credit life insurance, that assist bank customers in meeting loan obligations when unfortunate circumstances, such as death, disability, or unemployment, occur. These credit-related products may be purchased by customers to mitigate risks arising from credit obligations, and thus constitute an important component of outstanding credit relationships.

B. Parties

MIMLIC is an Arizona insurance company that reinsures mortgage life, mortgage accidental death, and mortgage disability insurance issued by Minnesota Mutual Life Insurance Company (Minnesota Mutual) on loans originated by lenders with an ownership interest in MIMLIC. The lenders with an ownership interest in MIMLIC include the bank (which holds its ownership through its subsidiary, Lakeland) and service corporations of federal savings associations (collectively, "other depository institutions").

C. Each Lender's Interest in MIMLIC

The bank's subsidiary, Lakeland, holds approximately a 2.9 percent interest in MIMLIC. Minnesota Mutual holds approximately a 79 percent interest in MIMLIC, and the remaining shares are owned by other depository institutions.

There are three classes of MIMLIC stock outstanding: Class A stock, which is entirely owned by Minnesota Mutual; Class B stock, which is held by Lakeland and other depository institutions that participate in Minnesota Mutual's mortgage life insurance plan; and Class C stock, which is held by Lakeland and other depository institutions that participate in Minnesota Mutual's mortgage

[1] Although MIMLIC is authorized under its Articles of Incorporation to reinsure mortgage disability insurance, MIMLIC does not presently engage in this activity.

[2] *See generally* 12 CFR 2.2(b). (Credit life insurance includes credit health, accident, disability and mortgage life insurance.)

accidental death insurance plan. The number of shares of Class B and Class C stock and the value of shares held by Lakeland and the other investors reflect the relative amounts of mortgage life and mortgage accidental death insurance, respectively, in force with Minnesota Mutual on the mortgage borrowers of each lending institution. In order to maintain this relative distribution, MIMLIC may adjust the amount of stock each investor holds in MIMLIC, and has made such adjustments in April or May of each year based on the insurance in force with Minnesota Mutual on the mortgage borrowers of each lending institution as of December 31 of the prior year. The annual reallocation of shares produces share ownership among investors in each class of MIMLIC's stock in direct proportion to the total insurance written on the borrowers of the lending institution for each type of insurance during the prior calendar year.

D. MIMLIC's Reinsurance Activities

MIMLIC is authorized under Arizona law to reinsure life, accidental death, health, and disability insurance. Pursuant to MIMLIC's Articles of Incorporation, as amended, MIMLIC's reinsurance activities are limited to the reinsurance of risks ceded to it from Minnesota Mutual, which assumes such risks under group life, accidental death, and disability insurance policies related to borrowers of mortgage loans from the bank and the other depository institutions that have an interest in MIMLIC.[3]

Under MIMLIC's Articles of Incorporation, Lakeland and each of the other depository institutions with an interest in MIMLIC assume their pro-rata share of MIMLIC's total reinsurance risk. Net income received by MIMLIC from its credit life reinsurance operations is distributed pro-rata, and losses are assessed on a pro-rata basis.

E. Reserve Requirements and Capitalization

MIMLIC will comply with all capital and reserve requirements under Arizona law applicable to reinsurers of mortgage life, mortgage accidental death, and mortgage disability insurance.

F. Limitations on the Liability of Each Lender

Neither Lakeland, the other depository institutions, nor the bank, will be liable for any of the activities of MIMLIC. MIMLIC is a corporation incorporated under the laws of the state of Arizona. Arizona law provides that a shareholder of a corporation is not personally liable for the acts or debts of the corporation. A.R.S. § 10–622 (1996). Therefore, Lakeland and the other depository institutions are not liable for MIMLIC's obligations. Lakeland's potential loss exposure would be limited to the amount of Lakeland's investment, *i.e.,* its 2.9 percent ownership interest in MIMLIC.[4] The potential collective loss exposure of the other depository institutions would also be limited to the amount of their collective investment in MIMLIC. Additionally, the bank and the other depository institutions hold their interest in MIMLIC through their subsidiaries, which provides the lending institutions further insulation from MIMLIC's obligations. Provided that each lending institution's respective subsidiary is operated with appropriate corporate separateness, the bank and the other depository institutions should have no direct loss exposures for MIMLIC's obligations. With respect to the bank, its indirect exposure will be limited to losses suffered by Lakeland, which are limited to its 2.9 percent ownership interest in MIMLIC. Thus, the bank's loss exposure for the liabilities of MIMLIC will be limited from a legal standpoint.

G. Consumer Provisions

The bank does not require borrowers to obtain credit life insurance in order to obtain a mortgage.[5] If, however, a borrower chooses to obtain credit life insurance sold by the bank, the bank complies with, and makes the disclosures required under, 12 CFR 226.4(d) and 226.18(n). Specifically, the bank (i) discloses in writing to the borrower that the credit life insurance coverage is not required by the bank; (ii) discloses the premium for the term of the insurance coverage; (iii) discloses that the credit life insurance may be obtained from a person of the borrower's choice; and (iv) requires the borrower to sign or initial an affirmative written request for the insurance.

H. Safety and Soundness Considerations

As noted above, neither Lakeland, the other depository institutions, nor the bank, will be liable for any of the activities of MIMLIC. The authorized activities of MIMLIC consist solely of reinsuring mortgage life, mortgage accidental death insurance, and mortgage disability insurance on the mortgage loans of borrowers from the bank and the other depository institutions that have an interest in MIMLIC.[6] MIMLIC does not reinsure the life, accident, or disability insurance for other mortgage loans. All reinsured mortgages have to meet Minnesota Mutual's insurance criteria, which will provide minimal, uniform requirements.

[3] As noted under footnote 1, *supra.,* MIMLIC does not presently reinsure mortgage disability insurance.

[4] As of June 30, 1998, Lakeland's 2.9 percent ownership interest in MIMLIC represented approximately 0.05 percent of the bank's total equity capital.

[5] The bank generally does require that borrowers obtain mortgage insurance from third-party mortgage insurers on a loan with a down payment of less than 20 percent of the property's value, or a loan with a loan-to-value ratio in excess of 80 percent. Mortgage insurance protects an investor holding a mortgage loan against default by the mortgagor.

[6] *See* footnote 1, *supra.*

Moreover, as a licensed reinsurer in the state of Arizona, MIMLIC is subject to ongoing supervision and regulation by the Arizona Commissioner. In return for accepting the risk associated with its reinsurance activities, MIMLIC receives insurance premiums, as well as investment income from its cash flow, providing a potentially important source of revenue for lenders that have an ownership interest in MIMLIC.

II. Analysis

The bank's 2.9 percent interest (which is held by the bank's subsidiary Lakeland) in MIMLIC raises the issue of the authority of a national bank to make a noncontrolling investment in an enterprise.[7] A number of recent OCC Interpretive Letters have analyzed the authority of national banks, either directly or through their subsidiaries, to own a noncontrolling interest in an enterprise.[8] These letters each concluded that the ownership of such an interest is permissible provided four standards, drawn from OCC precedents, are satisfied.[9] They are:

1. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;
2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment;
3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and
4. The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Based upon the facts presented, the bank's proposal satisfies these four standards.

A. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

1. The "Business of Banking" Analysis

The OCC previously has determined that selling, underwriting, and reinsuring credit life insurance is generally permissible under the National Bank Act.[10] The OCC concluded that, in general, these insurance activities are part of the business of banking because credit-related insurance products are an integral part of credit transactions. Credit-related insurance products assist bank customers in meeting loan obligations when unfortunate circumstances, such as death, disability or unemployment, occur. These credit-related products may be purchased by customers to mitigate risks arising from credit obligations, and thus constitute an important component of outstanding credit relationships. Such credit-related insurance products involve the assumption by banks of risks that are inherent in the lending business. Bank lenders necessarily must assume the risk that loan borrowers will experience adverse circumstances that may interfere with their ability to repay loan obligations. Reinsurance of credit-related insurance products similarly involves the assumption of the risk that customers may experience such adverse circumstances.

In the Fleet letter,[11] the OCC concluded that credit life insurance benefits bank customers because it enables those customers to ensure repayment of their loans in the event of adverse circumstances such as death. The OCC also concluded that credit life underwriting and reinsurance activities benefitted national banks because they enable a national bank to obtain new sources of income in connection with credit risks that the bank already assumes in connection with its lending relationship with a customer. Banks' involvement in underwriting and reinsuring credit life insurance may promote competition between underwriters of credit-related insurance products, and expand

[7] The OCC recently amended its operating subsidiary rule, 12 CFR 5.34, as part of a general revision of Part 5 under the OCC's Regulation Review Program. Operating subsidiaries in which a national bank may invest include corporations, limited liability companies, or similar entities if the parent owns (1) more than 50 percent of the voting (or similar type of controlling) interest, or (2) 50 percent or less so long as the bank "controls" the subsidiary and no other party controls more than 50 percent. 12 CFR 5.34(d)(2). Here, MIMLIC will not be considered an operating subsidiary since the bank will not "control" MIMLIC.

[8] *See, e.g.,* OCC Interpretive Letter No. 697, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–012 (November 15, 1995); OCC Interpretive Letter No. 732, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–049 (May 10, 1996).

[9] *See also* 12 CFR 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 USC 24(Seventh) and other statutes.

[10] *See, e.g.,* OCC letter dated May 11, 1998, responding to an operating subsidiary application filed by Fleet National Bank (the Fleet letter) (authorizing underwriting and reinsurance of credit-related life, disability and unemployment insurance); Corporate Decision No. 97–92 (November 1997) (authorizing underwriting and reinsurance of credit-related disability and involuntary unemployment insurance); OCC Interpretive Letter No. 277, *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,441 (December 13, 1983) (authorizing underwriting and reinsurance of credit-related life insurance); 12 CFR Part 2 (Sales of Credit Life Insurance); and *IBAA* v. *Heimann,* 613 F.2d 1164 (D.C. Cir. 1979), *cert. denied,* 449 U.S. 823 (1980) (confirming the OCC's authority to adopt its credit life insurance regulation at 12 CFR Part 2).

[11] OCC letter dated May 11, 1998.

consumer choices. Finally, the OCC concluded that the risks assumed by banks when they underwrite and reinsure credit-related insurance products are not new to national banks. These risks are similar for all borrowers with the same risk characteristics, regardless of the identity of the lender. The OCC thus concluded that the underwriting and reinsurance activities are part of the business of banking. Alternatively, the OCC concluded that underwriting and reinsuring credit life insurance would be permissible as an activity incidental to banking, particularly to a national bank's express power to make loans, because it enhances a lender's ability to receive repayment for its loans; and promotes the lending business by making available a credit-related product useful to borrowers. To determine the permissibility of MIMLIC's credit life reinsurance activities, we will discuss each of the "business of banking" factors analyzed in the Fleet letter, and apply them to the specific facts of MIMLIC's case.

a. Functionally Equivalent to or a Logical Outgrowth of Recognized Banking Functions

MIMLIC reinsures credit-related insurance risks that arise from insurance policies written in connection with mortgage loans made by the bank and other depository institutions that have an interest in MIMLIC. As noted above, each lender will assume (indirectly through a subsidiary) its pro-rata share of the reinsurance risk and receive its pro-rata share of the insurance premium based on the amount of mortgage insurance issued by Minnesota Mutual to mortgage customers of the bank. Thus lenders, including the bank, are using this arrangement as a means to reinsure credit-related life insurance, an activity the OCC has found permissible for national banks.

The proposed arrangement is similar to reinsurance activities previously approved by the OCC where a bank assumes risks arising from a pool of mortgages that includes loans originated or held by the bank and other lenders. *See* OCC Interpretive Letter No. 828 (April 6, 1998) (authorizing reinsurance of private mortgage insurance on mortgage loans originated or purchased by lenders participating in a reciprocal mortgage reinsurance exchange). Similar to the arrangement described in OCC Interpretive Letter No. 828, all the loans reinsured by MIMLIC must meet Minnesota Mutual's underwriting criteria to be accepted for coverage. Thus, Minnesota Mutual's underwriting criteria will assure a level of consistency and uniformity. Those underwriting criteria will assure that each lender's subsidiary with an ownership interest in MIMLIC assumes a pro-rata share of reinsurance liability on an essentially homogenous mortgage pool issued under the same general insurance underwriting guidelines. Accordingly, MIMLIC's reinsurance of credit life insurance on loans originated by lenders with an ownership interest in MIMLIC, is functionally equivalent to, or a logical outgrowth of, previously approved credit life insurance reinsurance activities.

In addition, through its reinsurance activities, MIMLIC assumes credit-related risks that are inherent in the lending business. Lenders necessarily must assume the risk that loan borrowers will experience adverse circumstances that may interfere with their ability to repay loan obligations. Credit-related insurance products involve the assumption of the risk of losses when customers experience such unfortunate, adverse circumstances. *See* Fleet letter. The activity of reinsuring credit life insurance thus is directly related to or a logical outgrowth of a bank's lending authority and is a permissible banking activity under 12 USC 24(Seventh).

The proposal is also consistent with our precedents that hold that national banks may pool their resources to engage in banking activities collectively.[12] As with other collective ventures permitted by the OCC, MIMLIC offers the opportunity to engage in banking services more efficiently and effectively. Participating lenders can realize an overall cost savings through economies of scale offered by MIMLIC that will reduce transaction costs. Participating lenders also can achieve greater diversification through reinsuring in a larger, more diverse, portfolio of loans. This will be particularly helpful to community and mid-size banks, which, individually, may lack the resources and loan volume to achieve the level of diversification or economies of scale offered by MIMLIC.

b. Respond to Customer Needs or Otherwise Benefit the Bank or Its Customers

MIMLIC offers benefits for the bank and its customers. Credit life insurance benefits the bank's customers because these products enable those customers to ensure repayment of their loans in the event of death, disability, or involuntary unemployment. The bank's involvement in this activity will do nothing to diminish customers' ability to obtain optional credit life insurance. MIMLIC also benefits the bank by providing flexibility in structuring its activities to obtain new sources of credit-related income. MIMLIC offers the bank a potentially more cost-effective and attractive vehicle for reinsuring credit life insurance.

[12] *See* Letter from James M. Kane, District Counsel, dated June 8, 1988 (unpublished) (national banks permitted to purchase preferred stock in captive insurance company where stock purchase was a prerequisite to obtaining directors' and officers' (D&O) liability insurance); OCC Interpretive Letter No. 554, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,301 (May 7, 1990) (captive insurer similar to Kane situation); OCC Interpretive Letter No. 427, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988) (bank purchases of stock in the Federal Agricultural Mortgage Corporation (Farmer Mac)) where stock purchases were necessary for participation in the agricultural mortgage secondary market promoted by Farmer Mac; Letter of James J. Saxon, Comptroller of the Currency (October 12, 1966) (banks may purchase minority interests in a corporation that operated a credit card clearinghouse for the benefit of the owner banks); and Letter of Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (equity investment to join an ATM network).

By joining forces with other financial institutions through MIMLIC, the bank benefits from the economies of scale and diversification offered by MIMLIC.

c. Risks Similar in Nature to Those Already Assumed by National Banks

The risks assumed by MIMLIC when it reinsures credit life insurance are similar to risks national banks may assume through the reinsurance of credit life insurance on their own loans. MIMLIC merely assumes the risk that the loan borrowers may experience adverse circumstances that interfere with their ability to repay loans.

The risks assumed by the bank, by using MIMLIC to reinsure credit life insurance, also are similar to the risks the bank would assume if it conducted the reinsurance activities directly. The bank, by owning an interest in MIMLIC, assumes risks commensurate with the risks arising from reinsuring credit life insurance on the bank's loans and receives a return based on the premiums attributed to credit life insurance coverage on those loans. Thus, the bank is subject to similar risks when it reinsures credit life insurance directly, or indirectly through its ownership of MIMLIC.

2. Incidental to the Business of Banking Analysis

The OCC also determined in the Fleet letter that even if selling, underwriting, and reinsuring credit-related insurance were not viewed as a part of the business of banking, those activities would be generally permissible as incidental to a national bank's express power to make loans. Similarly, a national bank's reinsurance of credit life insurance through MIMLIC is incidental to the business of banking.

In *NationsBank of North Carolina, N.A.* v. *Variable Annuity Life Insurance Co.,* 513 U.S. 251 (1995) (VALIC), the Supreme Court expressly held that the "business of banking" is not limited to the enumerated powers in 12 USC 24(Seventh), but encompasses more broadly activities that are part of the business of banking. VALIC at 258, n.2. The VALIC decision further established that banks may engage in activities that are incidental to the enumerated powers as well as the broader "business of banking."

Prior to VALIC, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours, Inc.* v. *Camp,* 472 F.2d 427 (1st Cir. 1972) (Arnold Tours). The Arnold Tours standard defined an incidental power as one that is "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its *express* powers under the National Bank Act." Arnold Tours at 432 (emphasis added). Even prior to VALIC, the Arnold Tours formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act. OCC Interpretive Letter 494 (December 20, 1989), *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 (December 20, 1989). The VALIC decision, however, has established that the Arnold Tours formula provides that an incidental power includes one that is convenient and useful to the "business of banking," as well as a power incidental to the express powers specifically enumerated in 12 USC 24(Seventh).

Reinsuring credit life insurance through MIMLIC is incidental to the business of banking under the Arnold Tours standard. Reinsuring credit life insurance in the manner proposed through the bank's noncontrolling interest in MIMLIC is incidental to a national bank's express power to make loans. This activity is "convenient" and "useful" to the bank because it will provide the bank an alternative structure for reinsuring credit life insurance on the bank's loans. This flexibility is convenient and useful to the bank in determining how to structure its credit life reinsurance activities in the most efficient and profitable manner.

B. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment

The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking, not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest. This standard may be met if the bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest. *See, e.g.,* OCC Interpretive Letter No. 711, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–026 (February 3, 1996); OCC Interpretive Letter No. 625, *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993). This ensures that the bank will not become involved in impermissible activities.

Lakeland holds only a 2.9 percent voting stock interest in MIMLIC and thus, does not possess the power to control the activities of MIMLIC. However, the bank is able to withdraw from its investment, and TCF has represented that Lakeland would agree to dispose of its stock in MIMLIC promptly if MIMLIC were to begin to engage in impermissible activities. Therefore, the second standard is satisfied.

C. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise

1. Loss Exposure from a Legal Standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in

which the bank holds an interest, it is important that the national bank's investment not expose it to unlimited liability. Normally, this is not a concern when investing in a corporation, for it is generally accepted that a corporation is an entity distinct from its shareholders or members, with its own separate rights and liabilities. 1 William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Private Corporations,* § 25 (perm. ed. rev. vol. 1990).

Here, MIMLIC is a corporation incorporated under the laws of the state of Arizona. Arizona law provides that a shareholder of a corporation is not personally liable for the acts or debts of the corporation. A.R.S. § 10–622 (1996). Therefore, Lakeland is not liable for MIMLIC's obligations. Lakeland's potential loss exposure would be limited to the amount of Lakeland's investment, *i.e.,* its 2.9 percent ownership interest in MIMLIC. Additionally, the bank holds its minority interest in MIMLIC through Lakeland, its subsidiary, which provides further insulation from MIMLIC's obligations. Provided that Lakeland is operated with appropriate corporate separateness, the bank should have no direct loss exposure for MIMLIC's obligations. The bank's indirect exposure will be limited to losses suffered by Lakeland, which are limited to its 2.9 percent ownership interest in MIMLIC. Thus, the bank's loss exposure for the liabilities of MIMLIC will be limited from a legal standpoint.

2. Loss Exposure from an Accounting Standpoint

From an accounting standpoint, the loss exposure of the bank will also be limited. The bank has advised that the accounting treatment for its investment in MIMLIC is under the cost method of accounting. This treatment is used for equity interests of less than 20 percent in corporations. Under this method, losses recognized by the investor will not exceed the amount of the investment (including extensions of credit or guarantees, if any) shown on the investor's books. *See generally,* Accounting Principles Board, Op. 18 § 19 (1971) (cost method of accounting for investments in common stock). Under these circumstances, the loss exposure of the bank should be limited, since Lakeland owns only 2.9 percent of MIMLIC. Therefore, for both legal and accounting purposes, the bank's potential loss exposure relative to MIMLIC should be limited to the amount of its investment. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

D. The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business

Twelve USC 24 (Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful." *See Arnold Tours, Inc.* v. *Camp,* 472 F.2d 427, 432 (1st Cir. 1972). Our precedents on bank noncontrolling investments have indicated that the investment must be convenient or useful to the bank in conducting that bank's business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment. *See, e.g.,* OCC Interpretive Letter No. 697, *supra;* OCC Interpretive Letter No. 543, *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); OCC Interpretive Letter No. 427, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); OCC Interpretive Letter No. 421, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988); OCC Interpretive Letter No. 380, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 (December 29, 1986).

The bank's investment is neither passive nor speculative. The bank's investment in MIMLIC provides the bank a more cost-effective and attractive vehicle for reinsuring credit life insurance on the bank's loans. The investment in MIMLIC also benefits the bank because it provides the bank flexibility in obtaining new sources of credit-related income. For these reasons, the bank's investment in MIMLIC is convenient and useful to the bank in carrying out its business and is not a mere passive investment. Thus, the fourth standard is satisfied.

III. Conclusion

Based upon the information and representations provided by the bank, and for the reasons discussed above, it is our opinion that Lakeland is legally permitted to retain its 2.9 percent noncontrolling minority interest in MIMLIC in the manner and as described herein, subject to the following conditions:

1. MIMLIC will engage only in activities that are part of, or incidental to, the business of banking;
2. Lakeland will withdraw from MIMLIC by disposing of its stock in MIMLIC promptly if MIMLIC engages in an activity that is inconsistent with condition number one;
3. The bank will account for its investment in MIMLIC under the cost method of accounting; and
4. MIMLIC will be subject to OCC examination.

These conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that Lakeland's investment is permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

Raymond Natter
Acting Chief Counsel

836—March 12, 1996
12 USC 24(7)

Dear [ ]:

This is in response to your letters of January 10, 1996 and February 9, 1996, requesting confirmation that [ ], *[city, state]* (bank), may lawfully acquire and hold a minority interest in [ ] (company), which is engaged in medical claims processing. The company currently is owned by [ ] (holding company) and [ ] (individual). For the reasons set forth below, I agree with your conclusion.

Background

The bank intends to acquire a 49 percent interest in the company, which will use automated data processing and electronic data interchange facilities to assist hospitals and physicians (providers) in communicating billing and payment-related information, including abbreviated diagnosis and treatment information, to entities responsible for providing medical benefits (government agencies, health maintenance organizations, and insurance carriers) (payers), determining how much of the patient's bill is owed by the patient and how much is owed by the payer, billing the payer and the patient as appropriate, and facilitating payment by the patient and the patient's provider, through funds transfer and credit card processing services, including the use of bank-issued special-purpose medical credit cards, when requested by patients.[1]

The company will store, process, and retrieve documents and information needed to substantiate the medical claims being submitted and collect on past-due accounts owed to hospitals and physicians. It also will continue to maintain and operate the electronic data processing (EDP) facilities of a hospital owned by an affiliate of the company (hospital). This activity will not generate more than 5 percent of the company's gross revenues and will be done in conformity with the OCC's Interpretive Ruling 7.3500, 12 CFR 7.3500, as revised at 61 Fed. Reg. 4849, 4865 (1996) (to be codified at 12 CFR 7.1019) (effective April 1, 1996).

The company's two shareholders, the holding company and the individual, currently own 98.25 percent and 1.75 percent of the company's stock, respectively. The individual owns all the issued and outstanding stock of the holding company. The bank,[2] the holding company, and the individual have entered into a Shareholders' Agreement (agreement) that includes the following provisions:

- The initial board of directors of the company will consist of five directors. Two directors will be elected by the holding company, and two will be elected by the bank. The fifth director position will be filled by the company's chief executive officer, who will be mutually agreed upon by the company and the bank. Thereafter, the board of directors will be increased in multiples of two. The bank and the company shall have equal representation on the board so long as each owns directly or indirectly 80 percent of the shares they will hold on the effective date of the agreement.
- Major decisions of the company must be agreed to by the directors representing the holding company and the bank. The term "major decision" includes amendments to the articles of incorporation or bylaws of the company; a merger or other business combination with another corporation whose assets or net worth is more than 33 percent of the assets or net worth of the company; the acquisition of the company by any other person; the acquisition by the company of any other corporation or business whose assets or net worth are more than 33 percent of the assets or net worth of the company; the sale of substantially all of the assets of the company; the liquidation or voluntary dissolution of the company; the selection of a chief executive officer; and the registration of shares of the company with the Securities and Exchange Commission for sale of such shares to the public.
- Directors representing the holding company and the bank must adopt an annual business plan which, among other things, will assure that the company will not do anything to jeopardize the bank's compliance with regulatory requirements and that the company will not engage in any line of business which would necessitate the bank's divestiture of its ownership in the company, or the company's divestiture of any significant activity or line of business of the company. The bank and the holding company also agree that the annual business plan will restrict the company's business to the extent necessary to assure that the company will qualify for pooling-of-interests accounting treatment under then current accounting provisions.

[1] Currently, the company's medical claims processing, handled through its own self-developed software system, would be considered an information exchange network, since the company is not a financial institution and cannot provide actual funds transfer services from payers to providers.

[2] The bank was not an initial signatory to the agreement but was assigned all the rights under the agreement by a wholly owned subsidiary of the bank's parent company, which did sign the agreement.

- Two primary provisions by which control of the company may change subsequent to the closing are a put-and-call provision (put-and-call) and a buy-sell provision (buy-sell). The put-and-call permits the bank to exercise a call option on an additional 18 percent of the holding company's stock in the company under certain conditions. It also permits the holding company to cause the bank to purchase 18 percent of those shares under certain conditions. You advise that the put-and-call would not necessarily increase the bank's ownership because the bank has the right to cause additional stock purchases to be made by its nominee or designee and because one of the primary purposes of the put-and-call is to prevent or minimize dilution, for example, upon the subsequent merger of the company with another entity. The buy-sell is applicable only so long as the company and the bank own at least 80 percent of what they own at closing and only if the parties cannot reach agreement on a major decision, as described above. Again, nominees are available to make the purchases.

Analysis

The bank's plan to purchase a 49 percent interest in the company initially raises the issue of the authority of a national bank to hold a minority interest in a corporation. A recent OCC interpretive letter extensively analyzed the authority of national banks under 12 USC 24(Seventh) to own stock, and reviewed OCC precedents on the ownership of stock in amounts less than that required for an operating subsidiary, *i.e.,* noncontrolling stock investments. OCC Interpretive Letter No. 697, [Current] Fed. Banking L. Rep. (CCH) ¶ 81–013 (November 15, 1995). That letter concluded that ownership of a noncontrolling interest in a corporation is permissible provided that four standards, drawn from OCC precedents, are satisfied. They are:

1) The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;
2) The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment;
3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and
4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Each of these factors is discussed below and applied to your proposal.

1. The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on minority stock ownership have recognized that the enterprise in which the bank takes an equity interest must confine its activities to those that are part of or incidental to the conduct of the banking business. *See, e.g.,* OCC Interpretive Letter No. 380, [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n. 8 (December 29, 1986) (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services); Letter from Robert B. Serino, deputy chief counsel (November 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

The company's activities will involve automated data processing services to facilitate accounts receivable collections, billing, and related funds transfers for providers. The OCC previously has approved the activities the company will perform. The following summarizes our precedents.

National banks may use automated data processing to provide billing services and accounts receivable services for itself and others, OCC Interpretive Letter No. 419, [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,643 (February 16, 1988) (Letter 419), and engage in data processing related to funds transfer, cash management, and credit extensions, *id.*, (funds transfer); Letter from Peter Liebesman, assistant director, Legal Advisory Services Division (December 13, 1985) (cash management); OCC Interpretive Letter No. 611, [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449 (November 23, 1992) (cash management, funds transfer); Letter from Peter Liebesman, assistant director, Legal Advisory Services Division (August 15, 1983) (credit extensions). The OCC also has approved electronic data interchange services for financial information, OCC Interpretive Letter No. 653, [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (December 22, 1994) (informational and payments interface) and credit card processing; and OCC Interpretive Letter No. 689, [Current] Fed. Banking L. Rep. (CCH) ¶ 81–004 (August 9, 1995).

The OCC, on several occasions, has found health insurance claims processing and related activities to be permissible. *See* Letter from Gail W. Pohn, director, Bank Organization and Structure Division (November 19, 1975) (providing doctors with an accounts receivable and

billing system with inquiry and input capabilities); Letter 419 (settlement and payment of health insurance claims through the use of shared electronic funds transfer technology by linking health care providers, insurers, recipients, and their respective depository institutions, transmitting claim eligibility information, receiving and transmitting information for claims entry and payment, operating a data base, accomplishing payment, and developing and licensing appropriate software programs to health care providers to permit their participation);[3] Letter from Jeanne N. Devine, senior attorney (May 26, 1994) (collection services are permissible).

The company's continued maintenance, operation, and management of the EDP facilities of the hospital will include patient accounting, medical records, payroll, general ledger, accounts payable, employee time and attendance, scheduling the provision of services, and fixed assets. The contract between the company and the hospital will produce less than 5 percent of the total projected gross revenues of the company. Many of the services involve data processing, which is permissible under the above analysis. To the extent some activities may fall outside that analysis, they properly may be considered "excess capacity." The bank's acquisition of its interest in the company is being done in good faith, not to engage in such activities. *See generally* 12 CFR 7.3500 *supra.;* Preamble discussion of 12 CFR 7.1019, 61 Fed. Reg. 4853–4854 (1996); OCC Interpretive Letter No. 677, [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,625 (June 28, 1995) (national banks permitted to acquire interests in a software company where 7 percent of its revenues are derived from nonfinancial software production and distribution); OCC Interpretive Letter No. 345, [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,516 (July 31, 1985) (sale of computer hardware usable for nonfinancial purposes as well as financial purposes approved where hardware does not exceed 30 percent of cost of entire package of banking and financial data processing services).

Thus, the activities to be performed by the company are activities that are part of or incidental to the business of banking, and the first standard is satisfied.

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

The activities of an enterprise in which a national bank invests must be part of or incidental to the business of banking not only at the time the bank initially purchases stock, but they must remain so for as long as the bank has an ownership interest. However, minority shareholders in a corporation do not possess a veto power as a matter of corporate law. One way to address this problem is for the corporation's articles of incorporation or bylaws to limit its activities to those that are permissible for national banks. *See, e.g.,* Letters from Peter Liebesman, assistant director, Legal Advisory Services Division (January 26, 1981 and January 4, 1983).

Contractual solutions also are feasible. In the present case, the bank, the holding company, and the individual have entered into a Shareholders' Agreement to address this concern. According to your letter, among other things, the agreement provides that all major decisions must be approved by the affirmative vote of two-thirds of the directors, in absolute number. You have explained that this means the bank and the holding company would have to approve all major decisions. Also, the agreement requires that the board adopt an annual business plan (among the items considered major decisions) which, among other things, includes actions to assure that the company does not do anything to jeopardize the bank's compliance with regulatory requirements and to assure that the company will not engage in any line of business which would necessitate the bank's divestiture of its ownership in the company or the company's divestiture of any significant activity or line of business.

These provisions assure that the company will not engage in any activity that is not permissible for a corporation having a national bank shareholder. The bank effectively will have a veto power over any impermissible activity as long as it continues to own shares in the company. Thus, the second standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a national bank's investment not expose it to unlimited liability. Normally, this is not a concern when investing in a corporation, for shareholders are protected by the "corporate veil" from liability for the debts of the corporation. 1 William M. Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations,* § 25 (perm. ed. rev. vol. 1990). In the present case, both the company and the bank will be separate corporations, with their own capital, directors, and officers.

[3] Letter 419 found that the transfer of funds from one account to another or from one institution to another is a fundamental part of the business of banking. The transmission of treatment information was found to be an integral part of and a proper incident to performing the funds transfer service.

Further, the bank has been advised by its accountants, who have discussed the issue of limited loss exposure with the OCC's Office of the Chief Accountant, that the appropriate accounting treatment for its investment in the company will be the equity method of accounting. Under this method, which is used for equity interests of 20 to 50 percent in corporations, losses recognized by the investor will not exceed the amount of the investment (including extensions of credit or guarantees, if any) shown on the investor's books. *See generally,* Accounting Principles Board, Op. 18, § 19 (1971) (equity method of accounting for investments in common stock).

Therefore, for both legal and accounting purposes, the bank's potential loss exposure should be limited to the amount of its investment (plus, potentially, the amount of any extensions of credit that remain outstanding). Since that exposure will be quantifiable and controllable, the third standard is satisfied.[4]

4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful." *Arnold Tours, Inc.* v. *Camp,* 472 F.2d 427, 432 (1st Cir. 1972). The provision in section 24(Seventh) relating to the purchase of stock, derived from section 16 of the Glass–Steagall Act, was intended only to make it clear that section 16 did not authorize speculative investments in stock. OCC Interpretive Letter No. 697, *supra.* Therefore, a consistent thread running through our precedents concerning stock ownership is that such ownership must be convenient or useful to the investing bank in conducting its banking business. The investment must benefit or facilitate that business, and cannot be a mere passive or speculative investment. *See, e.g.,* OCC Interpretive Letter No. 543, [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); OCC Interpretive Letter No. 427, [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); OCC Interpretive Letter No. 421, [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988).

The bank seeks the relationship with the company in order to develop new financial data processing customers in the health care industry, which has proven difficult for the bank to do on its own. The health care industry is an important sector of business within the bank's market area, and it is doubtful the bank would be able to develop a separate system in a timely and reasonably priced way. With its investment in the company, the bank will have access to the company's successful payment processing business which can be integrated with other banking services provided by the bank. The bank also hopes, through its participation in the company, to build relationships with providers and insurance companies, and thereby obtain opportunities for cross-selling of banking products. The availability to the company's customers of the bank's funds transfer and credit card processing facilities will be convenient to them and should result in the development of a strong customer base for the bank in the health care industry. Thus, this activity will be useful to the bank in carrying out its banking business, and the fourth standard is satisfied.

Conclusion

For the reasons outlined above, the bank's investment in the company would satisfy the four standards the OCC has applied to noncontrolling minority investments. Our conclusion is conditioned upon the conditions listed below and compliance by the bank with commitments made in connection with its request for a legal opinion:

1) the company may engage only in activities that are part of, or incidental to, the business of banking;
2) the bank will have veto power over any activities and major decisions of the company that are inconsistent with condition 1, or the bank will withdraw its investment in the company if it proposes to engage in an activity that is inconsistent with condition 1;
3) the company will be subject to OCC supervision and examination; and
4) the bank will account for its investment in the company under the equity method of accounting.

These commitments and conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed investment is permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

I hope that this has been responsive to your inquiry.

Julie L. Williams
Chief Counsel

[4] Whether exercising the put-and-call or the buy-sell provisions of the agreement would have an impact on the bank's loss exposure as a legal or accounting matter cannot be determined unless such provisions are exercised. We do note your representation that the bank's ability to designate nominees to purchase additional shares in the event these provisions are acted upon should enable it to avoid being placed in control of the company against its wishes.

837—September 4, 1998
12 USC 24(11)

Ms. Kathryn S. Bader
Senior Vice President
Mercantile Bank
Mercantile Tower
P.O. Box 524
St. Louis, MO 63166–0524

Dear Ms. Bader:

This letter conveys the OCC's approval of the proposed investment by Mercantile Bank National Association (bank) in Mercantile Bank Community Development Corporation (MCDC) pursuant to 12 USC 24 (Eleventh) and 12 CFR part 24 (part 24). As discussed more fully below, MCDC will be a wholly owned community development corporation (CDC) subsidiary of the bank that will primarily conduct activities that promote the public welfare.

I. Description of the Proposed Investment

MCDC is currently a wholly owned subsidiary of Ameribanc, Inc., the parent holding company of the bank. MCDC was formerly known as Mark Twain Bank Community Development Corporation, Inc. By virtue of the merger of Mark Twain Bank with the bank, MCDC became a direct subsidiary of the bank. In March 1998, all of the stock of MCDC was distributed from the bank to Ameribanc, Inc. In connection with this proposal, the stock of MCDC will be contributed back to the bank, and MCDC will again be a wholly owned, for-profit subsidiary of the bank.

MCDC historically has invested directly (as a limited partner) in low-income housing real estate development project limited partnerships. MCDC's past investments have generated both federal and state low-income housing tax credits (LIHTCs), which were used to reduce the bank's tax liability. In some cases, these projects also generated state historic rehabilitation tax credits. Through its successful involvement in these projects, MCDC personnel have gained expertise in federal and state tax credit projects and investments.

MCDC intends to continue to engage in its current LIHTC project investment activities. In addition, in order to capitalize on the investment experience and expertise of MCDC personnel, the bank proposes to create a new operating division within MCDC, to be called the Missouri Tax Credit Clearinghouse (clearinghouse). The clearinghouse will:

- *Act as a "finder," by bringing together investors and tax credit developers.* The clearinghouse intends to introduce potential buyers of tax credits to sellers, find appropriate tax credits or tax credit investments for such potential buyers, and help selected nonprofit corporations, which have been allocated contribution tax credits, find donors.
- *Act as a financial intermediary, buying and reselling certain types of transferable state tax credits.*[1] In certain circumstances, the clearinghouse, in fulfilling its objective of facilitating community development tax credit assisted investments, may purchase transferable tax credits (separate from the investments or contributions that generated them) and later resell them to appropriate purchasers.
- *Act as advisor, providing financial, transactional, and tax planning advice to customers (i.e., investors and purchasers of tax credits) and potential customers to assist them in structuring, arranging, executing, and managing tax credit related transactions.* Some advisor activities, such as advising potential customers about the types of tax credit programs available and assisting them in assessing their own tax management needs, would be related to the clearinghouse's finder and intermediary roles. The clearinghouse, upon request and for a fee, also proposes to advise customers on compliance concerns related to the tax credits they have either purchased or received as a result of an investment, and assist customers in completing and filing all paperwork necessary to obtain ownership of the credit or investment or to maintain the viability of the credit.

MCDC proposes initially to provide the above services in connection with projects awarded credits under certain Missouri State Tax Credit Programs.[2] The programs fall within the following three categories:

- *Investment Credit Programs.* Investment tax credits are awarded to individuals or entities that make investments in qualifying projects. Although the investment may be made prior to construction startup or during construction, the tax credit is not awarded until construction is complete and all statutory requirements have been met.

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[1] As indicated in the bank's written submission, some state tax credits can be transferred from one taxpayer to another once they have been awarded ("transferable" credits), while others, such as LIHTCs, can only be used by a taxpayer who retains an equity or ownership interest in the qualified project. In addition, some of the credits are fully earned at the time they are granted, while others, such as LIHTCs, are subject to "recapture" (partial or total cancellation) if certain ongoing compliance requirements, generally related to the underlying project, are not met.

[2] Eventually, MCDC may offer services to investors and developers in other states in which the bank is located.

- *Contribution Credit Programs.* Contribution tax credits are awarded when a contribution is made to a qualifying project or entity. The effect of contribution tax credits is to reduce the overall after-tax cost of charitable contributions to the contributing donors.
- *Business Incentive Credit Programs.* Business incentive tax credits are tax credits conferred by the state in recognition of a taxpayer's operation of its business in certain statutorily favored locations or activities. For example, credits are offered to operators of businesses in economically depressed enterprise zones and businesses engaged in environmental remediation.

II. Discussion

A. Public Welfare Purpose

MCDC will be a CDC that will engage in two types of activities. First, it will make investments designed primarily to promote the public welfare in various types of tax credit projects, including those designed to provide low-income housing. Second, it will offer services intended to facilitate other investors' making investments designed primarily to promote the public welfare in such tax credit projects.

The National Bank Act authorizes national banks to make investments "designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as by providing housing, services, or jobs)."[3]

As implemented by the OCC in part 24, an investment is "designed primarily to promote the public welfare" if it "primarily [benefits] low- and moderate-income individuals, low- and moderate-income areas or other areas targeted for redevelopment . . . by providing . . . affordable housing . . . [e]quity or debt financing for small businesses . . . [a]rea revitalization or stabilization; or . . . [o]ther activities, services, or facilities that primarily promote the public welfare."[4]

Part 24 permits a national bank to invest in a CDC—which is defined as "a corporation established by one or more insured financial institutions, or by insured financial institutions and other investors, to make one or more investments that meet [part 24's criteria for public welfare investments]."[5]

Neither the statute nor part 24 specifically defines the portion of a bank's investment that must satisfy the criteria for public welfare investments; however, the statute provides that such an investment must be designed "primarily to promote the public welfare." Thus, the meaning of the term "primarily" is raised by the bank's investment proposal, particularly because the bank has represented that a significant portion, but not necessarily all, of MCDC's activities, over time, will satisfy the requirements of part 24. Neither the statute or its legislative history, nor part 24, addresses the meaning of the term, "primarily."

Under standard principles of statutory construction, if a term is not defined in the statute or its legislative history, the term should be interpreted in accordance with its "ordinary and contemporary meaning."[6] The ordinary and contemporary meaning of "primarily" is "principally" or "chiefly."[7] Clearly, if a majority of a CDC's activities qualify as activities that promote the public welfare under part 24, the investment in the CDC would qualify under the "primarily to promote the public welfare" standard.

This "majority" standard is consistent with the meaning assigned to the word "primary" in other contexts where the term is used in connection with the community development investment activities of national banks.[8] For example, under the interagency regulations implementing the Community Reinvestment Act ("CRA"), the OCC assesses the record of national banks in making "qualified investments," which are defined as those that have community development as their "primary purpose."[9] The phrase "primary purpose" is not defined in the CRA regulations, but the federal financial supervisory agencies have stated generally that the phrase would commonly be understood to mean that the "main purpose" of the investment activity is community development.[10]

As indicated in written and oral representations by the bank, a significant portion of the activities of MCDC will

[3] 12 USC 24 (Eleventh).

[4] 12 CFR 24.3(a). In effect, part 24 defines the statutory phrase "designed primarily to promote the public welfare" by reference to the persons or areas the investment benefits and the type of activity the investment supports.

[5] 12 CFR 24.2(c).

[6] *See* Norman J. Singer, *Sutherland Statutory Construction* ("Sutherland") § 47.28.

[7] *See Webster's II New College Dictionary* (1995).

[8] In other contexts, as well, courts have concluded that phrases such as "primary" and "primarily" connote at least a majority. *See, e.g., Donovan* v. *Bereuter's, Inc.*, 704 F.2d 1034, 1036 (8th Cir. 1983); *Deltide Fishing & Rental Tools, Inc.* v. *U.S.*, 279 F. Supp. 661, 670 (E.D. La. 1968).

In other cases, some courts have determined that the term "primarily" does not necessarily mean more than 50 percent. These cases have held that an activity may be considered a primary activity if it is the largest of several activities conducted by an entity. Roughly speaking, this case law adopts a "plurality" standard rather than a "majority" standard. *See Gragg* v. *Cayuga Indep. Sch. Dist.*, 539 S.W.2d 861, 869 (Tex. 1976); *Indus. Refrigeration & Equip. Co.* v. *State Tax Comm'n.,* 408 P.2d 937, 940 (Ore. 1965).

[9] 12 CFR 25.12(s).

[10] *See* OCC Interpretive Letter No. 702 (February 13, 1996). For purposes of the CRA regulation, the federal financial supervisory agencies also have proposed an interpretation of the phrase

benefit low- and moderate-income individuals or areas, or other areas targeted for redevelopment. Indeed, the bank has represented that all of MCDC's current investment portfolio consists of investments in LIHTC projects, benefitting low-income individuals. The bank anticipates that future direct equity investments at the project level, whether to be held for the account of MCDC or the bank, or to be syndicated out to interested parties, will be in projects that qualify for LIHTCs or in other tax credit programs designed to benefit low- and moderate-income individuals or areas, or other areas targeted for redevelopment. The bank and MCDC will analyze each investment for compliance with the requirements of part 24. To the extent that an investment does not qualify under part 24, such investment will be categorized as non-qualifying. The bank represents that the level of non-qualifying investments will be monitored to ensure that a majority of MCDC's investments will be public welfare investments.

In addition to making investments for its own account, the bank will also engage in providing services that will help other investors find suitable state tax credit investments. The bank represents that the clearinghouse's additional activities as "finder," financial intermediary, and advisor to investors and purchasers of tax credits (described above), will primarily benefit low- and moderate-income individuals or areas, or areas targeted for redevelopment in two ways. First, the clearinghouse activities will directly increase the initial investment in tax credit-supported activities and investments by raising awareness of the programs among potential investors or contributors and by helping to bring investors together with appropriate projects or activities in which to invest or contribute. Second, the clearinghouse will act as a market-maker, creating an efficient secondary market in tax credits, thereby promoting additional investments designed primarily to promote the public welfare. According to the bank, in the past, many of the state tax credit programs have been underutilized. The clearinghouse will increase usage of these programs and thereby increase investment in the underlying community development related projects and causes.

As with the equity investments made by MCDC, the bank represents that all clearinghouse activities will be monitored to ensure that a majority of such activities help to promote the public welfare as defined in 12 CFR 24.3(a).[11] Therefore, regardless of the relative weight of the two types of activities of MCDC (i.e., direct investments and clearinghouse services), a majority of the *total* activities of MCDC will have a public welfare purpose, as that is described in 12 USC 24 (Eleventh) and part 24. Thus, the OCC has determined that the bank's investment in MCDC is an investment designed primarily to promote the public welfare.[12]

B. Other Requirements of 12 CFR 24.3

Section 24.3 also requires that a bank be able to demonstrate that it is not reasonably practicable to obtain other private market financing for the proposed investment, the extent to which the investment benefits communities otherwise served by the bank, and that there is community support for or participation in the investment.[13]

In support of its showing that it is not reasonably practical to obtain other private market financing for the proposed investment, the bank indicates, because the investment is in an ongoing enterprise, the success of which is dependent upon the specific expertise and knowledge of the bank, MCDC, and their respective employees, the appropriate investor is the bank. Further, there is no other private entity (a clearinghouse) currently in existence in the bank's market area. In addition, as mentioned above, many of the underlying public welfare projects supported by state tax credit programs, which MCDC seeks to promote, have been consistently underutilized, evidencing the failure of the private capital market in the area.

"primary purpose" under which an investment could qualify under either a simplified threshold test or an alternative approach for finding the requisite primary community development purpose. The threshold test essentially adopts the "majority" standard: if a majority of the dollars or beneficiaries of the activity are related to one or more of the community development purposes listed in the regulation, then the activity will be considered to possess the requisite primary purpose of community development.

Under the alternative approach to the threshold test, an activity could be considered to have a primary community development purpose even if the measurable portion of any benefit bestowed or dollars applied to the community development purpose is less than a majority of the entire activity's benefits or dollar value, so long as (1) the express, bona fide intent of the activity is primarily one or more of the enumerated community development purposes; (2) the activity is specifically structured to achieve the expressed community development purpose; and (3) the activity accomplishes or is reasonably certain to accomplish the community development purpose. *See* Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestment, 62 Fed. Reg. 52,105, 52,108–09 (October 6, 1997) (Proposed Q&A 7 addressing 12 CFR ___.12(i) and 563e.12(h)).

[11] Further, the bank represents that it will monitor MCDC's purchases of tax credits to ensure that all purchased tax credits that do not arise out of projects, investments, or contributions that promote the public welfare, within the meaning of part 24, when combined with non-qualifying investments, will be less than a majority of MCDC's total investments and credits.

[12] Since a majority of the investments and activities of MCDC will meet the part 24 standard, the OCC is not making a determination at this time if other standards could be used to determine whether an investment meets the part 24 requirements. *See, e.g., supra* note 10.

[13] 12 CFR 24.3(b)–(d).

MCDC, with its clearinghouse, is intended to benefit the communities served by the bank. The bank's submission states that there is no present intention to serve communities outside of the markets served by the bank or its affiliates.

Nonbank community support of the bank's proposed investment in and startup of MCDC and clearinghouse operations has, to this point, been very encouraging. The clearinghouse concept has been discussed with local governments, community groups and civic leaders in most of the major markets to be served by the bank and its affiliates. The bank provided the OCC with a list of entities that have specifically indicated their support. Further, to the best of the bank's knowledge, nonbank community groups, local governmental authorities, and civic leaders in the affected communities have supported all the projects in which MCDC has invested to date. And, each of the projects underlying the tax credit investments of MCDC demonstrates community support from the State of Missouri in its approval as a tax credit project.

C. Investment Limitations

A bank's public welfare activities under 12 USC 24 (Eleventh) are subject to certain percentage of capital limitations. Specifically, a bank's aggregate outstanding public welfare investments may not exceed 5 percent of its capital and surplus, unless the bank is at least adequately capitalized and the OCC determines, by written approval of a proposed investment, that a higher amount (up to 10 percent) will pose no significant risk to the deposit insurance fund.

The bank's aggregate part 24 investments, after its proposed MCDC investment, will represent 1.57 percent of the bank's capital and surplus. However, the bank expects to increase the amount of its investment in MCDC in the future. The bank has requested the OCC to approve in advance the bank's investment of additional capital in MCDC, up to an amount that will not exceed, when aggregated with the bank's other part 24 investments, 10 percent of the bank's capital and surplus.

To support its request for an increased part 24 investment limit, the bank represents that, historically, MCDC has generated after-tax profits. In addition, all equity investments at the project level are made by the CDC as limited partner, limited liability member, or on a limited liability basis, thereby capping any potential liabilities at the amount of the investment.

The OCC hereby approves the bank's proposed initial investment in MCDC. Further, the OCC finds that an aggregate investment limit of up to 10 percent will pose no significant risk to the deposit insurance fund.[14] Based on this finding, the OCC approves, in advance, an increase in the amount of the bank's aggregate investments under part 24 through future investments in MCDC to an amount not to exceed 10 percent of the bank's capital and surplus.

III. Conclusion

Based on the foregoing facts and analysis, and the representations made by the bank in connection with the bank's request for approval, we conclude that the bank may invest in MCDC as an investment designed primarily to promote the public welfare, and may increase its investment in MCDC up to an amount which, when aggregated with all of the bank's part 24 investments, will at no time exceed 10 percent of the bank's capital and surplus. Accordingly, this request for approval is granted.

If requested by the OCC, the bank will provide reports concerning its investment in MCDC and MCDC's financial status, activities, and accomplishments. Copies of all reports submitted to the Community Development Division are to be forwarded to the deputy comptroller for Large Bank Supervision.

The opinions set forth in this letter are based on the information and representations provided to us by the bank. Any substantial change in the nature or purpose of the bank's investment, or in the purposes and activities of MCDC could result in a different opinion being rendered concerning the conformance of the bank's investment with 12 USC 24 (Eleventh) and 12 CFR part 24.

If you have any further questions, please feel free to contact me at (202) 874–5200.

Raymond Natter
Acting Chief Counsel

[14] The OCC bases its determination on (1) the bank's capitalization; (2) its CRA rating; (3) its CAMELS rating; and (4) the fact that the bank is not under any enforcement orders.

Mergers—July 1 to September 30, 1998

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Nonaffiliated mergers (mergers consummated involving two or more nonaffiliated operating banks) 143

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Mergers—July 1 to September 30, 1998

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

Nonaffiliated mergers (mergers consummated involving two or more nonaffiliated operating banks), from July 1 to September 30, 1998

Title and location (charter number)	Total assets
California	
The Pacific Bank, National Association, San Francisco (017917)	603,364,000
and Sterling Bank, Los Angeles	101,662,000
merged on July 3, 1998 under the title of **The Pacific Bank, National Association, San Francisco** (017917)	700,413,000
Colorado	
Vectra Bank Colorado, National Association, Denver (023684)	1,307,853,000
and Independent Bank, Kersey	144,313,000
merged on August 28, 1998 under the title of **Vectra Bank Colorado, National Association, Denver** (023684)	1,452,166,000
Vectra Bank Colorado, National Association, Denver (023684)	1,452,166,000
and Eagle Bank, Broomfield	40,785,000
merged on August 31, 1998 under the title of **Vectra Bank Colorado, National Association, Denver** (023684)	1,492,951,000
Missouri	
First National Bank of St. Louis, Clayton (012333)	514,586,000
and Colonial Bank, Des Peres	226,829,000
merged on September 11, 1998 under the title of **First National Bank of St. Louis, Clayton** (012333)	774,472,000
New Jersey	
United National Bank, Bridgewater (005621)	1,337,350,000
and State Bank of South Orange, South Orange	75,235,000
merged on September 30, 1998 under the title of **United National Bank, Bridgewater** (005621)	1,412,585,000
Ohio	
Star Bank, National Association, Cincinnati (000024)	14,812,780,000
and Trans Financial Bank, National Association, Bowling Green (022833)	1,703,699,000
and Trans Financial Bank Tennessee, National Association, Cookeville (022774)	532,447,000
merged on August 21, 1998 under the title of **Star Bank, National Association, Cincinnati** (000024)	16,914,801,000
Tennessee	
Union Planters Bank, National Association, Memphis (013349)	15,785,873,000
and Transflorida Bank, Boca Raton	317,851,000
merged on August 31, 1998 under the title of **Union Planters Bank, National Association, Memphis** (013349)	16,103,724,000
Texas	
The First National Bank of Livingston, Livingston (006169)	145,561,000
and The Bank of Livingston, Livingston	52,377,000
merged on September 11, 1998 under the title of **The First National Bank of Livingston, Livingston** (006169)	197,970,000

Nonaffiliated mergers—thrift (mergers consummated involving nonaffiliated national banks and savings and loan associations), from July 1 to September 30, 1998

Title and location (charter number)	Total assets
Pennsylvania	
The Farmers National Bank of Emlenton, Emlenton (005481)	133,948,000
and Peoples Savings Bank, Ridgway	44,515,000
merged on August 31, 1998 under the title of The Farmers National Bank of Emlenton, Emlenton (005481)	181,489,000

Affiliated mergers (mergers consummated involving affiliated operating banks), from July 1 to September 30, 1998

Title and location (charter number)	Total assets
Alabama	
SouthTrust Bank, National Association, Birmingham (014569)	30,714,713,000
and Marine Bank, St. Petersburg	58,499,000
merged on August 7, 1998 under the title of **SouthTrust Bank, National Association, Birmingham** (014569)	31,313,872,000
California	
Pacific Century Bank, National Association, Los Angeles (018152)	552,571,000
and California United Bank, Los Angeles	778,428,000
merged on August 14, 1998 under the title of **Pacific Century Bank, National Association, Los Angeles** (018152)	1,331,999,000
Colorado	
Community First National Bank, Fort Morgan (007004)	1,339,293,000
and Community First National Bank, Thornton (017379)	77,598,000
and Community First National Bank, Longmont (023619)	130,412,000
and Community First National Bank, Greeley (017478)	75,645,000
and Poudre Valley Bank, Fort Collins	41,798,000
merged on July 1, 1998 under the title of **Community First National Bank, Fort Morgan** (007004)	1,664,744,000
Norwest Bank Colorado, National Association, Denver (003269)	8,495,457,000
and Heritage Trust Company, Grand Junction	966,000
merged on August 3, 1998 under the title of **Norwest Bank Colorado, National Association, Denver** (003269)	8,495,457,000
Norwest Bank Colorado, National Association, Denver (003269)	8,744,292,000
and The Bank of the Southwest, National Association, Pagosa Springs (017645)	79,011,000
merged on August 10, 1998 under the title of **Norwest Bank Colorado, National Association, Denver** (003269)	8,823,303,000
Vectra Bank Colorado, National Association, Denver (023684)	1,125,164,000
and Pitkin County Bank and Trust Company, Aspen	182,689,000
merged on September 11, 1998 under the title of **Vectra Bank Colorado, National Association, Denver** (023684)	1,307,853,000
Illinois	
The First National Bank of Wayne City, Wayne City (010460)	49,736,000
and Bank of Illinois In Mt. Vernon, Mount Vernon	163,505,000
merged on August 21, 1998 under the title of **Bank of Illinois, National Association, Mt. Vernon** (010460)	225,595,000
Mercantile Bank National Association, Hartford (023578)	16,681,371,000
and Central Bank, Fairview Heights	598,881,000
merged on September 18, 1998 under the title of **Mercantile Bank National Association, Hartford** (023578)	17,280,252,000
Kansas	
Western National Bank, Lenexa (022906)	21,208,000
and The Peoples National Bank and Trust Company of Burlington, Burlington (003170)	53,135,000
merged on July 28, 1998 under the title of **Western National Bank, Lenexa** (022906)	74,397,000
Louisiana	
Hibernia National Bank, New Orleans (013688)	11,324,939,000
and Peoples Bank & Trust Company, Minden	227,995,000
merged on July 1, 1998 under the title of **Hibernia National Bank, New Orleans** (013688)	11,553,025,000
Minnesota	
U.S. Bank National Association, Minneapolis (013405)	67,601,627,000
and West One Trust Company, Salt Lake City	2,268,000
merged on July 6, 1998 under the title of **U.S. Bank National Association, Minneapolis** (013405)	67,603,895,000
Norwest Bank Minnesota, National Association, Minneapolis (002006)	23,005,129,000
and Norwest National Bank, Westminster (018419)	106,984,000
merged on August 1, 1998 under the title of **Norwest Bank Minnesota, National Association, Minneapolis** (002006)	23,112,113,000
Norwest Bank Minnesota South, National Association, Rochester (002088)	2,003,615,000
and Norwest Bank North Country, National Association, Brainerd (023074)	214,162,000
merged on September 12, 1998 under the title of **Norwest Bank Minnesota South, National Association, Rochester** (002088)	2,217,777,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
Norwest Bank Minnesota North, National Association, Duluth (003626)	49,788,000
and Norwest Bank Cloquet, National Association, Cloquet (015230)	12,616,000
and Norwest Bank International Falls, National Association, International Falls (007380)	13,582,000
merged on September 12, 1998 under the title of **Norwest Bank Minnesota North, National Association, Duluth** (003626)	75,986,000
Missouri	
Mercantile Trust Company National Association, St. Louis (022666)	28,702,000
and Horizon Bank, Malvern	1,000,000
merged on July 1, 1998 under the title of **Mercantile Trust Company National Association, St. Louis** (022666)	29,702,000
Mercantile Trust Company National Association, St. Louis (022666)	30,083,000
and Mercantile Bank of Northern Illinois, Freeport	5,003,000
merged on July 17, 1998 under the title of **Mercantile Trust Company National Association, St. Louis** (022666)	36,086,000
Mercantile Trust Company National Association, St. Louis (022666)	36,086,000
and Mercantile Bank of Eastern Iowa, Waterloo	11,426,000
merged on August 22, 1998 under the title of **Mercantile Trust Company National Association, St. Louis** (022666)	47,512,000
Nebraska	
American National Bank, Omaha (015435)	304,272,000
and The Fairbury State Bank, Fairbury on August 22, 1998	36,729,000
and American National Bank of Sarpy County, Papillion (018765) on August 29, 1998	91,842,000
and American National Bank, Nebraska City (022274) on September 12, 1998	111,982,000
merged on those respective dates under the title of **American National Bank, Omaha** (015435)	544,825,000
New Mexico	
First National Bank of Dona Ana County, Las Cruces (007720)	379,152,000
and First National Bank of Chaves County, Roswell (021013)	37,761,000
merged on July 1, 1998 under the title of **First Security Bank of Southern New Mexico, National Association, Las Cruces** (007720)	416,913,000
North Carolina	
Wachovia Bank, National Association, Winston-Salem (001559)	61,488,000,000
and 1st United Bank, Palm Beach	52,824,000
merged on July 1, 1998 under the title of **Wachovia Bank, National Association, Winston-Salem** (001559)	62,506,203,000
NationsBank, National Association, Charlotte (014448)	228,345,571,000
and Boatmen's National Bank of Austin, Austin (021889)	147,561,000
and Sunwest Bank of El Paso, National Association, El Paso (023647)	626,443,000
merged on July 9, 1998 under the title of **NationsBank, National Association, Charlotte** (014448)	228,781,767,000
NationsBank, National Association, Charlotte (014448)	236,630,154,000
and NationsBank, National Association, Brunswick (Glynn County) (023489)	236,778,000
merged on August 6, 1998 under the title of **NationsBank, National Association, Charlotte** (014448)	236,844,847,000
First Union National Bank, Charlotte (000001)	204,614,842,000
and Mentor Trust Company, Richmond (Virgina)	130,000
and Mentor Trust Company, Philadelphia	21,870,000
merged on August 13, 1998 under the title of **First Union National Bank, Charlotte** (000001)	204,635,842,000
First Charter National Bank, Concord (003903)	561,951,000
and Bank of Union, Monroe	205,236,000
merged on September 10, 1998 under the title of **First Charter National Bank, Concord** (003903)	767,125,000
Ohio	
KeyBank National Association, Cleveland (014761)	63,480,525,000
and Key Bank National Association, Bedford (023284)	46,652,000
merged on June 30, 1998 under the title of **KeyBank National Association, Cleveland** (014761)	63,527,177,000
KeyBank National Association, Cleveland (014761)	68,734,357,000
and Key Interim Wyoming National Association, Cheyenne (023668)	60,000
and KeyTrust Company National Association, Cheyenne (023311)	4,428,000
merged on July 31, 1998 under the title of **KeyBank National Association, Cleveland** (014761)	68,738,785,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
The Second National Bank of Warren, Warren (002479)	931,000,000
and Enterprise Bank, Solon	44,000,000
merged on August 20, 1998 under the title of **The Second National Bank of Warren, Warren** (002479)	975,000,000
Oklahoma	
F&M Bank, National Association, Yukon (023348)	240,000
and Farmers & Merchants Bank of Piedmont, Piedmont	21,141,000
merged on August 10, 1998 under the title of **F&M Bank, National Association, Yukon** (023348)	21,381,000
Tennessee	
Union Planters Bank, National Association, Memphis (013349)	15,684,563,000
and Merchants and Farmers Bank, West Helena	101,344,000
and Farmers & Merchants Bank, Des Arc	46,202,000
merged on July 6, 1998 under the title of **Union Planters Bank, National Association, Memphis** (013349)	15,785,873,000
Union Planters Bank, National Association, Memphis (013349)	5,380,592,000
and City Bank & Trust Company, McMinnville	274,045,000
merged on July 7, 1998 under the title of **Union Planters Bank, National Association, Memphis** (013349)	5,410,768,000
Union Planters Bank, National Association, Memphis (013349)	15,684,563,000
and Duck Hill Bank, Duck Hill	20,391,000
merged on August 1, 1998 under the title of **Union Planters Bank, National Association, Memphis** (013349)	15,704,954,000
Union Planters Bank, National Association, Memphis (013349)	15,684,563,000
and Union Planters Bank of Florida, Miami	2,157,591,000
merged on August 1, 1998 under the title of **Union Planters Bank, National Association, Memphis** (013349)	17,842,154,000
Union Planters Bank, National Association, Memphis (013349)	15,684,563,000
and Selmer Bank & Trust Company, Selmer	132,989,000
merged on August 6, 1998 under the title of **Union Planters Bank, National Association, Memphis** (013349)	15,817,000,000
First American National Bank, Nashville (003032)	9,738,211,000
and Deposit Guaranty National Bank, Jackson (015548)	5,316,721,000
merged on September 1, 1998 under the title of **First American National Bank, Nashville** (003032)	14,531,386,000
National Bank of Commerce, Memphis (013681)	3,377,672,000
and The Citizens Bank, Collierville	40,795,000
merged on September 18, 1998 under the title of **National Bank of Commerce, Memphis** (013681)	3,582,261,000
Texas	
Citizens National Bank, Henderson (013443)	332,389,000
and First State Bank, Waskom	25,979,000
merged on July 23, 1998 under the title of **Citizens National Bank, Henderson** (013443)	358,368,000
Norwest Bank Texas, National Association, San Antonio (014208)	8,432,349,000
and Norwest Trust Texas, Odessa, National Association, Odessa (023271)	971,000
and Founders Trust Company, Dallas	9,899,000
merged on September 28, 1998 under the title of **Norwest Bank Texas, National Association, San Antonio** (014208)	8,443,219,000
Wisconsin	
Firstar Bank Milwaukee, National Association, Milwaukee (000064)	8,249,231,000
and Firstar Trust Company, Milwaukee	620,874,000
merged on September 30, 1998 under the title of **Firstar Bank Milwaukee, National Association, Milwaukee** (000064)	8,375,096,000

Affiliated mergers—thrift (mergers consummated involving affiliated national banks and savings and loan associations), from July 1 to September 30, 1998

Title and location (charter number)	Total assets
New York	
Premier National Bank, Poughkeepsie (000035)	712,156,000
and Pawling Savings Bank, Pawling	879,152,000
merged on July 17, 1998 under the title of **Premier National Bank, Poughkeepsie** (000035)	1,587,408,000
Tennessee	
Union Planters Bank, National Association, Memphis (013349)	5,475,565,000
and Capital Savings Bank, FSB, Jefferson City	241,719,000
merged on July 9, 1998 under the title of **Union Planters Bank, National Association, Memphis** (013349)	5,717,284,000

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Tables are provided by the Economic Analysis Division and include data for nationally chartered, FDIC-insured commercial banks that file a quarter-end call report. Data for the current period are preliminary and subject to revision. Figures in the tables may not sum to totals because of rounding.

Assets, liabilities, and capital accounts of national banks
September 30, 1997 and September 30, 1998
(Dollar figures in millions)

	September 30, 1997	September 30, 1998	Change September 30, 1997–September 30, 1998 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,625	2,519	(106)	(4.04)
Total assets	$2,760,453	$3,048,935	$288,481	10.45
Cash and balances due from depositories	203,369	183,552	(19,817)	(9.74)
Noninterest-bearing balances, currency and coin	137,397	135,547	(1,849)	(1.35)
Interest bearing balances	65,972	48,005	(17,968)	(27.24)
Securities	424,932	495,814	70,882	16.68
Held-to-maturity securities, amortized cost	69,963	62,531	(7,432)	(10.62)
Available-for-sale securities, fair value	354,969	433,283	78,314	22.06
Federal funds sold and securities purchased	106,209	107,589	1,380	1.30
Net loans and leases	1,738,509	1,925,771	187,261	10.77
Total loans and leases	1,773,139	1,962,827	189,687	10.70
Loans and leases, gross	1,775,421	1,964,954	189,533	10.68
Less: Unearned income	2,282	2,128	(154)	(6.76)
Less: Reserve for losses	34,630	37,056	2,426	7.01
Assets held in trading account	89,102	98,791	9,689	10.87
Other real estate owned	2,312	1,948	(364)	(15.73)
Intangible assets	47,312	63,171	15,859	33.52
All other assets	148,708	172,299	23,591	15.86
Total liabilities and equity capital	2,760,453	3,048,935	288,481	10.45
Deposits in domestic offices	1,610,598	1,698,586	87,988	5.46
Deposits in foreign offices	297,405	335,457	38,051	12.79
Total deposits	1,908,003	2,034,043	126,039	6.61
Noninterest-bearing deposits	385,932	401,123	15,191	3.94
Interest-bearing deposits	1,522,071	1,632,920	110,849	7.28
Federal funds purchased and securities sold	221,787	243,858	22,071	9.95
Demand notes issued to U.S. Treasury	16,862	17,956	1,094	6.49
Other borrowed money	194,945	248,553	53,609	27.50
With remaining maturity of one year or less	127,378	160,930	33,552	26.34
With remaining maturity of more than one year	67,567	87,623	20,056	29.68
Trading liabilities less revaluation losses	16,757	25,664	8,906	53.15
Subordinated notes and debentures	36,588	49,082	12,494	34.15
All other liabilities	122,596	158,583	35,987	29.35
Trading liabilities revaluation losses	42,619	57,861	15,242	35.76
Other	79,977	100,722	20,745	25.94
Total equity capital	242,914	271,195	28,281	11.64
Perpetual preferred stock	434	476	41	9.54
Common stock	17,927	17,382	(545)	(3.04)
Surplus	117,794	136,570	18,777	15.94
Net undivided profits and capital reserves	107,572	117,705	10,132	9.42
Cumulative foreign currency translation adjustment	(813)	(938)	(124)	NM

NM indicates calculated percent change is not meaningful.

Quarterly income and expenses of national banks
Third quarter 1997 and third quarter 1998
(Dollar figures in millions)

	Third quarter 1997	Third quarter 1998	Change Third quarter 1997–third quarter 1998 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,625	2,519	(106)	(4.04)
Net income	$8,541	$9,174	$633	7.41
Net interest income	26,497	27,638	1,141	4.31
Total interest income	49,775	54,378	4,602	9.25
On loans	38,902	41,958	3,056	7.86
From lease financing receivables	1,253	1,570	317	25.33
On balances due from depositories	891	901	9	1.05
On securities	6,729	7,704	975	14.49
From assets held in trading account	765	837	72	9.37
On federal funds sold and securities repurchased	1,224	1,408	184	15.03
Less: Interest expense	23,278	26,740	3,462	14.87
On deposits	16,791	18,550	1,759	10.47
Of federal funds purchased and securities sold	2,623	3,179	556	21.21
On demand notes and other borrowed money*	3,206	4,164	957	29.86
On subordinated notes and debentures	656	848	192	29.31
Less: Provision for losses	3,248	4,726	1,478	45.50
Noninterest income	16,756	20,166	3,409	20.35
From fiduciary activities	2,152	2,271	119	5.53
Service charges on deposits	3,189	3,501	312	9.78
Trading revenue	1,090	359	(730)	(67.01)
From interest rate exposures	489	(88)	(577)	(117.99)
From foreign exchange exposures	516	468	(48)	(9.31)
From equity security and index exposures	78	14	(63)	NM
From commodity and other exposures	7	(35)	(42)	NM
Total other noninterest income	10,315	14,038	3,723	36.09
Gains/losses on securities	79	503	424	NM
Less: Noninterest expense	26,518	29,814	3,295	12.43
Salaries and employee benefits	10,315	11,480	1,165	11.29
Of premises and fixed assets	3,331	3,638	306	9.19
Other noninterest expense	12,872	14,696	1,824	14.17
Less: Taxes on income before extraordinary items	5,033	4,594	(440)	(8.74)
Income/loss from extraordinary items, net of income taxes	8	0	(8)	(97.76)
Memoranda:				
Net operating income	8,480	8,846	366	4.32
Income before taxes and extraordinary items	13,566	13,768	201	1.48
Income net of taxes before extraordinary items	8,533	9,174	641	7.51
Cash dividends declared	5,436	6,475	1,039	19.11
Net charge-offs to loan and lease reserve	3,195	4,096	901	28.20
Charge-offs to loan and lease reserve	4,180	5,074	895	21.40
Less: Recoveries credited to loan and lease reserve	985	979	(6)	(0.62)

* Includes mortgage indebtedness

NM indicates calculated percent change is not meaningful.

Year-to-date income and expenses of national banks
Through September 30, 1997 and through September 30, 1998

(Dollar figures in millions)

	September 30, 1997	September 30, 1998	Change September 30, 1997–September 30, 1998 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,625	2,519	(106)	(4.04)
Net income	$26,190	$28,971	$2,781	10.62
Net interest income	78,460	82,380	3,919	5.00
Total interest income	146,523	159,859	13,336	9.10
On loans	114,292	123,057	8,765	7.67
From lease financing receivables	3,432	4,501	1,069	31.16
On balances due from depositories	2,546	2,687	141	5.54
On securities	20,008	22,870	2,862	14.30
From assets held in trading account	2,195	2,498	303	13.82
On federal funds sold and securities repurchased	4,049	4,245	196	4.83
Less: Interest expense	68,062	77,479	9,416	13.83
On deposits	48,824	53,825	5,001	10.24
Of federal funds purchased and securities sold	7,994	9,330	1,336	16.71
On demand notes and other borrowed money*	9,407	11,896	2,489	26.46
On subordinated notes and debentures	1,838	2,428	590	32.12
Less: Provision for losses	9,158	11,659	2,501	27.31
Noninterest income	47,633	58,738	11,105	23.31
From fiduciary activities	5,901	6,726	825	13.98
Service charges on deposits	9,317	10,179	862	9.26
Trading revenue	2,914	2,714	(200)	(6.85)
From interest rate exposures	1,285	705	(580)	(45.14)
From foreign exchange exposures	1,502	1,832	330	21.96
From equity security and index exposures	102	154	52	50.48
From commodity and other exposures	25	24	(1)	(4.50)
Total other noninterest income	29,501	39,118	9,617	32.60
Gains/losses on securities	542	1,585	1,043	192.61
Less: Noninterest expense	76,352	87,050	10,698	14.01
Salaries and employee benefits	30,500	33,916	3,416	11.20
Of premises and fixed assets	9,750	10,649	899	9.22
Other noninterest expense	36,102	42,485	6,383	17.68
Less: Taxes on income before extraordinary items	14,972	15,546	574	3.83
Income/loss from extraordinary items, net of income taxes	37	524	486	NM
Memoranda:				
Net operating income	25,803	27,421	1,618	6.27
Income before taxes and extraordinary items	41,125	43,993	2,868	6.97
Income net of taxes before extraordinary items	26,153	28,447	2,294	8.77
Cash dividends declared	17,046	18,064	1,017	5.97
Net charge-offs to loan and lease reserve	8,947	10,880	1,933	21.61
Charge-offs to loan and lease reserve	11,979	13,835	1,856	15.50
Less: Recoveries credited to loan and lease reserve	3,031	2,954	(77)	(2.54)

* Includes mortgage indebtedness

NM indicates calculated percent change is not meaningful.

Assets of national banks by asset size
September 30, 1998
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Total assets	$3,048,935	$65,535	$264,577	$494,757	$2,224,066	$5,269,220
Cash and balances due from	183,552	3,477	11,640	27,488	140,947	307,025
Securities	495,814	17,559	71,466	92,849	313,939	923,072
Federal funds sold and securities purchased	107,589	4,197	11,074	24,635	67,682	288,418
Net loans and leases	1,925,771	37,392	158,338	312,279	1,417,761	3,088,525
Total loans and leases	1,962,827	37,912	160,692	320,265	1,443,958	3,145,788
Loans and leases, gross	1,964,954	38,065	161,057	320,428	1,445,405	3,149,981
Less: Unearned income	2,128	153	365	163	1,446	4,193
Less: Reserve for losses	37,056	520	2,353	7,986	26,197	57,263
Assets held in trading account	98,791	6	115	760	97,909	306,194
Other real estate owned	1,948	79	224	193	1,452	3,431
Intangible assets	63,171	195	1,504	11,953	49,519	77,110
All other assets	276,440	4,823	10,573	20,799	240,245	420,370
Gross loans and leases by type:						
Loans secured by real estate	742,638	21,278	95,353	127,286	498,720	1,300,378
1–4 family residential mortgages	368,257	10,506	44,933	64,268	248,551	642,390
Home equity loans	66,262	478	4,340	10,018	51,426	96,889
Multifamily residential mortgages	23,189	480	3,155	4,442	15,112	42,453
Commercial RE loans	193,429	5,943	31,600	35,892	119,994	357,524
Construction RE loans	55,257	1,499	7,546	10,826	35,385	102,467
Farmland loans	10,605	2,373	3,756	1,665	2,811	28,777
RE loans from foreign offices	25,639	0	24	175	25,440	29,878
Commercial and industrial loans	572,664	6,386	28,625	62,807	474,846	873,935
Loans to individuals	373,213	5,578	26,506	109,536	231,593	555,298
Credit cards	163,771	279	4,935	70,345	88,212	216,106
Installment loans	209,441	5,298	21,570	39,191	143,382	339,192
All other loans and leases	276,440	4,823	10,573	20,799	240,245	420,370
Securities by type:						
U.S. Treasury securities	57,044	3,398	10,894	11,259	31,492	124,893
Mortgage-backed securities	258,041	3,931	22,933	52,816	178,361	433,604
Pass-through securities	169,581	2,605	15,079	36,647	115,250	277,192
Collateralized mortgage obligations	88,461	1,326	7,854	16,169	63,112	156,412
Other securities	180,728	10,231	37,639	28,773	104,085	364,575
Other U.S. government securities	62,439	6,601	21,889	15,233	18,717	161,519
State and local government securities	38,504	2,994	11,824	7,908	15,778	83,622
Other debt securities	62,262	289	2,224	2,423	57,327	89,997
Equity securities	17,523	346	1,703	3,210	12,264	29,436
Memoranda:						
Agricultural production loans	21,275	4,257	5,478	3,181	8,359	48,214
Pledged securities	227,423	6,063	30,836	42,914	147,610	410,442
Book value of securities	489,881	17,398	70,652	91,610	310,221	910,540
Available-for-sale securities	427,349	13,090	54,196	75,743	284,320	758,382
Held-to-maturity securities	62,531	4,308	16,456	15,868	25,900	152,158
Market value of securities	496,893	17,628	71,761	93,111	314,393	925,507
Available-for-sale securities	433,283	13,251	55,011	76,981	288,039	770,914
Held-to-maturity securities	63,610	4,376	16,750	16,130	26,354	154,592

Past-due and nonaccrual loans and leases of national banks by asset size
September 30, 1998
(Dollar figures in millions)

		National banks				Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Loans and leases past due 30–89 days	$23,141	$544	$1,967	$5,230	$15,399	$37,798
Loans secured by real estate	8,783	265	905	1,488	6,125	15,180
1–4 family residential mortgages	5,294	165	515	790	3,824	8,890
Home equity loans	563	3	39	99	421	834
Multifamily residential mortgages	176	2	18	48	108	303
Commercial RE loans	1,556	56	227	349	925	3,104
Construction RE loans	688	20	78	186	405	1,296
Farmland loans	107	19	29	16	43	264
RE loans from foreign offices	400	0	0	0	400	489
Commercial and industrial loans	4,222	163	499	789	2,771	7,347
Loans to individuals	8,970	114	522	2,719	5,615	13,345
Credit cards	4,369	7	145	1,848	2,369	5,921
Installment loans	4,601	107	376	871	3,247	7,424
All other loans and leases	1,165	2	42	234	887	1,926
Loans and leases past due 90+ days	6,218	133	447	1,952	3,686	9,565
Loans secured by real estate	1,578	64	190	317	1,007	2,768
1–4 family residential mortgages	948	35	105	164	644	1,618
Home equity loans	122	1	6	35	80	179
Multifamily residential mortgages	19	0	3	2	14	35
Commercial RE loans	344	15	49	86	194	600
Construction RE loans	100	3	12	26	59	201
Farmland loans	31	10	14	5	3	117
RE loans from foreign offices	13	0	0	0	13	17
Commercial and industrial loans	606	46	109	108	343	1,266
Loans to individuals	3,861	23	135	1,497	2,206	5,239
Credit cards	2,715	4	77	1,254	1,379	3,378
Installment loans	1,146	19	57	242	828	1,861
All other loans and leases	173	0	13	29	130	292
Nonaccrual loans and leases	11,793	289	939	1,386	9,179	19,958
Loans secured by real estate	5,787	138	486	723	4,441	9,406
1–4 family residential mortgages	2,545	55	192	293	2,006	4,079
Home equity loans	154	2	8	19	125	235
Multifamily residential mortgages	182	2	12	26	142	311
Commercial RE loans	1,756	46	196	291	1,223	3,054
Construction RE loans	359	7	41	70	241	724
Farmland loans	145	26	37	23	58	283
RE loans from foreign offices	647	0	0	0	646	721
Commercial and industrial loans	4,028	131	333	430	3,134	7,081
Loans to individuals	1,399	17	81	165	1,136	2,643
Credit cards	269	0	31	89	149	1,037
Installment loans	1,130	17	49	76	987	1,607
All other loans and leases	579	3	39	69	468	827

Liabilities of national banks by asset size
September 30, 1998
(Dollar figures in millions)

		National banks				Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Total liabilities and equity capital	$3,048,935	$65,535	$264,577	$494,757	$2,224,066	$5,269,220
Deposits in domestic offices	$1,698,586	$55,846	$214,753	$307,133	$1,120,854	$2,952,178
Deposits in foreign offices	335,457	0	585	6,271	328,600	554,722
Total deposits	2,034,043	55,846	215,339	313,404	1,449,454	3,506,900
Noninterest to earnings	401,123	8,642	33,701	64,703	294,076	653,789
Interest bearing	1,632,920	47,204	181,637	248,701	1,155,378	2,853,111
Other borrowed funds	536,031	1,676	19,807	111,590	402,958	907,414
Subordinated notes and debentures	49,082	5	173	4,881	44,023	68,823
All other liabilities	158,583	734	3,286	13,155	141,408	328,653
Equity capital	271,195	7,274	25,973	51,727	186,222	457,430
Total deposits by depositor:						
Individuals and corporations	1,828,413	50,759	197,370	289,426	1,290,858	3,127,718
U.S., state, and local governments	70,242	4,271	14,342	15,098	36,532	137,068
Depositories in the U.S	49,581	450	2,099	5,757	41,274	72,288
Foreign banks and governments	73,006	4	164	1,260	71,577	144,666
Certified and official checks	9,834	362	1,364	1,820	6,288	17,184
All other foreign office deposits	2,967	0	0	42	2,925	7,977
Domestic deposits by depositor:						
Individuals and corporations	1,586,481	50,759	196,963	283,862	1,054,897	2,748,062
U.S., state, and local governments	70,242	4,271	14,342	15,098	36,532	137,068
Depositories in the U.S	28,324	450	2,034	5,708	20,132	40,527
Foreign banks and governments	4,566	4	51	644	3,867	10,285
Certified and official checks	8,973	362	1,364	1,820	5,427	16,236
Foreign deposits by depositor:						
Individuals and corporations	241,933	0	408	5,564	235,961	379,656
Depositories in the U.S	21,256	0	65	48	21,143	31,761
Foreign banks and governments	68,440	0	113	616	67,711	134,380
Certified and official checks	861	0	0	0	861	947
All other deposits	2,967	0	0	42	2,925	7,977
Deposits in domestic offices by type:						
Transaction deposits	407,414	16,682	54,721	68,746	267,265	695,262
Demand deposits	336,302	8,633	32,428	57,227	238,013	542,790
NOW accounts	69,739	7,858	21,852	11,335	28,694	149,702
Savings deposits	688,841	11,394	60,515	123,954	492,978	1,104,692
Money market deposit accounts	478,721	5,777	35,929	75,095	361,920	732,742
Other savings deposits	210,120	5,618	24,586	48,859	131,058	371,950
Time deposits	602,332	27,770	99,517	114,433	360,612	1,152,225
Small time deposits	405,997	20,321	70,114	76,041	239,520	752,189
Large time deposits	196,335	7,448	29,403	38,392	121,092	400,036

Off-balance-sheet items of national banks by asset size
September 30, 1998
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Unused commitments	$2,658,365	$69,761	$253,173	$716,753	$1,618,678	$3,616,982
Home equity lines	85,441	370	4,175	11,625	69,271	118,129
Credit card lines	1,611,234	65,093	222,802	627,904	695,435	2,019,087
Commercial RE, construction and land	75,303	1,078	6,816	11,734	55,674	124,928
All other unused commitments	886,386	3,219	19,380	65,489	798,298	1,354,838
Letters of credit:						
Standby letters of credit	135,100	169	1,716	10,305	122,909	216,814
Financial letters of credit	105,712	110	1,067	8,474	96,062	176,156
Performance letters of credit	29,388	60	650	1,831	26,848	40,658
Commercial letters of credit	20,084	37	675	884	18,488	29,698
Securities borrowed and lent:						
Securities borrowed	10,425	21	503	4,668	5,233	22,455
Securities lent	47,576	14	1,234	5,884	40,444	343,253
Financial assets transferred with recourse:						
Mortgages—outstanding principal balance	24,947	29	219	4,911	19,788	40,413
Mortgages—amount of recourse exposure	5,816	27	182	1,381	4,225	10,658
All other—outstanding principal balance	228,376	1	532	91,200	136,644	266,241
All other—amount of recourse exposure	16,510	0	50	6,489	9,971	19,165
Spot foreign exchange contracts	357,094	0	2	105	356,987	807,966
Credit derivatives (notional value)						
Reporting bank is the guarantor	18,081	0	35	30	18,017	66,588
Reporting bank is the beneficiary	25,041	0	0	0	25,041	95,233
Derivative contracts (notional value)	11,585,255	590	4,159	69,125	11,511,380	32,640,859
Futures and forward contracts	4,525,350	82	624	11,207	4,513,438	11,643,712
Interest rate contracts	1,940,933	82	599	10,605	1,929,647	5,937,597
Foreign exchange contracts	2,555,660	0	25	601	2,555,034	5,594,435
All other futures and forwards	28,757	0	0	0	28,757	111,680
Option contracts	3,550,955	508	954	11,664	3,537,828	8,466,799
Interest rate contracts	2,654,675	508	950	11,664	2,641,553	6,221,379
Foreign exchange contracts	741,832	0	0	0	741,832	1,736,312
All other options	154,448	0	4	0	154,444	509,108
Swaps	3,465,828	0	2,547	46,224	3,417,057	12,368,527
Interest rate contracts	3,310,442	0	2,547	45,530	3,262,365	11,680,045
Foreign exchange contracts	138,015	0	0	695	137,320	624,419
All other swaps	17,372	0	0	0	17,372	64,062
Memoranda: Derivatives by purpose						
Contracts held for trading	10,658,396	481	576	11,501	10,645,838	30,961,667
Contracts not held for trading	883,737	109	3,549	57,595	822,485	1,517,371
Memoranda: Derivatives by position						
Held for trading—positive fair value	148,271	0	0	75	148,196	494,853
Held for trading—negative fair value	144,747	0	0	46	144,701	491,951
Not for trading—positive fair value	15,205	0	15	1,238	13,952	21,228
Not for trading—negative fair value	6,206	0	66	307	5,834	10,487

Quarterly income and expenses of national banks by asset size
Third quarter 1998
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Net income	$9,174	$277	$902	$2,235	$5,759	$15,047
Net interest income	27,638	696	2,698	5,504	18,739	46,303
Total interest income	54,378	1,252	4,948	9,738	38,440	92,355
On loans	41,958	916	3,668	7,815	29,559	67,495
From lease financing receivables	1,570	4	28	111	1,428	2,238
On balances due from depositories	901	12	28	75	785	1,669
On securities	7,704	260	1,061	1,381	5,002	14,159
From assets held in trading account	837	0	1	24	812	2,942
On federal funds sold and securities repurchased	1,408	60	162	331	854	3,851
Less: Interest expense	26,740	556	2,249	4,234	19,701	46,051
On deposits	18,550	533	1,990	2,627	13,399	32,013
Of federal funds purchased and securities sold	3,179	8	116	640	2,416	5,722
On demand notes and other borrowed money*	11,896	68	371	2,633	8,824	20,367
On subordinated notes and debentures	848	0	13	81	754	1,238
Less: Provision for losses	4,726	41	205	1,226	3,255	6,585
Noninterest income	20,166	510	1,285	4,779	13,592	29,717
From fiduciary activities	2,271	1	220	315	1,735	4,613
Service charges on deposits	3,501	78	277	546	2,599	5,051
Trading revenue	359	3	8	60	289	565
From interest rate exposures	(88)	3	8	44	(143)	(242)
From foreign exchange exposures	468	0	0	5	462	1,185
From equity security and index exposures	14	0	0	5	9	(67)
From commodity and other exposures	(35)	0	0	5	(39)	(222)
Total other noninterest income	14,038	431	780	3,859	8,968	19,490
Gains/losses on securities	503	3	13	79	409	681
Less: Noninterest expense	29,814	806	2,462	5,682	20,865	47,418
Salaries and employee benefits	11,480	313	1,091	1,719	8,356	19,327
Of premises and fixed assets	3,638	85	312	536	2,704	6,022
Other noninterest expense	14,696	407	1,058	3,426	9,804	22,069
Less: Taxes on income before extraordinary items	4,594	85	427	1,220	2,861	7,641
Income/loss from extraordinary items, net of taxes	524	(0)	1	531	(8)	513
Memoranda:						
Net operating income	8,846	275	894	2,186	5,491	14,658
Income before taxes and extraordinary items	13,768	363	1,329	3,455	8,621	22,699
Income net of taxes before extraordinary items	9,174	277	902	2,235	5,759	15,058
Cash dividends declared	6,475	490	417	2,115	3,453	10,107
Net loan and lease losses	4,096	25	165	1,281	2,625	5,670
Charge-offs to loan and lease reserve	5,074	37	225	1,509	3,303	7,169
Less: Recoveries credited to loan and lease reserve	979	12	61	228	678	1,499

* Includes mortgage indebtedness

Year-to-date income and expenses of national banks by asset size
Through September 30, 1998

(Dollar figures in millions)

		National banks				Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Net income	$28,971	$723	$2,605	$6,505	$19,138	$47,091
Net interest income	**82,380**	**2,143**	**7,976**	**15,941**	**56,319**	**136,234**
Total interest income	159,859	3,823	14,562	28,421	113,052	271,261
On loans	123,057	2,809	10,805	22,750	86,693	198,034
From lease financing receivables	4,501	11	79	311	4,101	6,382
On balances due from depositories	2,687	34	81	198	2,375	4,935
On securities	22,870	796	3,142	4,218	14,713	42,277
From assets held in trading account	2,498	0	3	56	2,439	8,341
On federal funds sold and securities repurchased	4,245	173	453	888	2,731	11,291
Less: Interest expense	77,479	1,680	6,587	12,480	56,732	135,027
On deposits	53,825	1,588	5,816	7,823	38,598	94,200
Of federal funds purchased and securities sold	9,330	24	360	1,791	7,155	16,889
On demand notes and other borrowed money*	11,896	68	371	2,633	8,824	20,367
On subordinated notes and debentures	2,428	0	39	233	2,156	3,571
Less: Provision for losses	**11,659**	**148**	**570**	**3,478**	**7,464**	**16,720**
Noninterest income	**58,738**	**1,352**	**3,774**	**12,872**	**40,739**	**89,448**
From fiduciary activities	6,726	4	641	939	5,142	13,603
Service charges on deposits	10,179	230	797	1,556	7,596	14,679
Trading revenue	2,714	8	24	126	2,557	5,731
From interest rate exposures	705	8	23	91	583	1,780
From foreign exchange exposures	1,832	0	1	12	1,819	3,964
From equity security and index exposures	154	0	0	14	140	195
From commodity and other exposures	24	0	0	8	15	1
Total other noninterest income	39,118	1,111	2,312	10,251	25,444	55,436
Gains/losses on securities	**1,585**	**7**	**35**	**168**	**1,374**	**2,051**
Less: Noninterest expense	**87,050**	**2,353**	**7,378**	**16,134**	**61,186**	**139,616**
Salaries and employee benefits	33,916	927	3,248	4,964	24,777	57,932
Of premises and fixed assets	10,649	244	913	1,549	7,943	17,560
Other noninterest expense	42,485	1,182	3,218	9,621	28,465	64,125
Less: Taxes on income before extraordinary items	**15,546**	**279**	**1,234**	**3,396**	**10,637**	**24,820**
Income/loss from extraordinary items, net of taxes	**524**	**(0)**	**1**	**531**	**(8)**	**513**
Memoranda:						
Net operating income	27,421	718	2,578	5,869	18,256	45,284
Income before taxes and extraordinary items	43,993	1,002	3,837	9,371	29,783	71,398
Income net of taxes before extraordinary items	28,447	723	2,603	5,974	19,146	46,578
Cash dividends declared	18,064	963	1,236	4,096	11,769	28,465
Net loan and lease losses	10,880	104	464	3,799	6,513	15,282
Charge-offs to loan and lease reserve	**13,835**	**148**	**649**	**4,507**	**8,531**	**19,739**
Less: Recoveries credited to loan and lease reserve	**2,954**	**44**	**185**	**707**	**2,018**	**4,457**

* Includes mortgage indebtedness

Quarterly net loan and lease losses of national banks by asset size
Third quarter 1998
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Net charge-offs to loan and lease reserve	$4,096	$25	$165	$1,281	$2,625	$5,670
Loans secured by real estate	105	2	11	22	70	175
1–4 family residential mortgages	68	(0)	5	12	51	110
Home equity loans	19	0	0	4	14	27
Multifamily residential mortgages	15	0	0	(0)	15	18
Commercial RE loans	(22)	2	4	10	(38)	(7)
Construction RE loans	(4)	0	1	(4)	(2)	0
Farmland loans	(1)	0	(0)	(1)	0	(0)
RE loans from foreign offices	30	0	0	0	30	26
Commercial and industrial loans	590	12	36	42	501	851
Loans to individuals	2,756	11	112	1,200	1,432	3,757
Credit cards	2,162	3	78	1,111	970	2,895
Installment loans	594	9	33	89	463	862
All other loans and leases	645	0	6	17	622	887
Charge-offs to loan and lease reserve	5,074	37	225	1,509	3,303	7,169
Loans secured by real estate	256	4	16	41	195	380
1–4 family residential mortgages	91	1	7	16	67	147
Home equity loans	27	0	0	7	20	38
Multifamily residential mortgages	21	0	0	0	20	28
Commercial RE loans	72	2	6	17	47	111
Construction RE loans	8	0	1	2	5	17
Farmland loans	4	0	0	0	3	5
RE loans from foreign offices	33	0	0	0	33	34
Commercial and industrial loans	763	17	52	68	625	1,212
Loans to individuals	3,349	16	148	1,378	1,806	4,604
Credit cards	2,481	4	98	1,240	1,139	3,356
Installment loans	869	12	50	139	667	1,248
All other loans and leases	707	0	8	21	677	973
Recoveries credited to loan and lease reserve	979	12	61	228	678	1,499
Loans secured by real estate	151	1	5	19	125	204
1–4 family residential mortgages	23	1	2	4	17	37
Home equity loans	8	0	0	2	6	10
Multifamily residential mortgages	6	0	0	1	5	10
Commercial RE loans	94	0	2	6	85	117
Construction RE loans	12	0	0	5	7	17
Farmland loans	4	0	0	1	2	6
RE loans from foreign offices	3	0	0	0	3	8
Commercial and industrial loans	173	5	16	26	125	361
Loans to individuals	593	5	37	178	374	847
Credit cards	319	1	19	128	170	461
Installment loans	274	4	17	49	204	385
All other loans and leases	62	0	2	5	55	87

Year-to-date net loan and lease losses of national banks by asset size
Through September 30, 1998
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,519	1,321	1,008	150	40	8,910
Net charge-offs to loan and lease reserve	10,880	104	464	3,799	6,513	15,282
Loans secured by real estate	263	6	26	57	174	422
1–4 family residential mortgages	189	3	11	34	140	301
Home equity loans	79	0	2	14	63	103
Multifamily residential mortgages	19	0	3	(1)	16	22
Commercial RE loans	(69)	2	7	13	(91)	(48)
Construction RE loans	(5)	1	2	(2)	(6)	0
Farmland loans	3	(0)	0	(1)	4	2
RE loans from foreign offices	47	0	0	0	47	42
Commercial and industrial loans	1,320	31	92	96	1,102	2,154
Loans to individuals	8,412	67	336	3,605	4,404	11,350
Credit cards	6,594	44	239	3,304	3,007	8,825
Installment loans	1,818	23	97	301	1,397	2,525
All other loans and leases	885	1	10	41	833	1,355
Charge-offs to loan and lease reserve	13,835	148	649	4,507	8,531	19,739
Loans secured by real estate	688	11	44	116	517	1,036
1–4 family residential mortgages	257	5	19	48	185	417
Home equity loans	109	0	3	20	86	139
Multifamily residential mortgages	37	0	4	3	30	50
Commercial RE loans	192	4	15	39	134	307
Construction RE loans	29	1	3	6	19	53
Farmland loans	10	1	1	1	7	16
RE loans from foreign offices	54	0	0	0	54	55
Commercial and industrial loans	1,864	46	139	193	1,485	3,193
Loans to individuals	10,228	90	450	4,138	5,550	13,903
Credit cards	7,545	54	300	3,678	3,513	10,210
Installment loans	2,683	36	150	460	2,037	3,693
All other loans and leases	1,055	1	15	59	979	1,607
Recoveries credited to loan and lease reserve	2,954	44	185	707	2,018	4,457
Loans secured by real estate	425	5	19	59	343	614
1–4 family residential mortgages	69	2	8	14	45	116
Home equity loans	30	0	1	6	23	36
Multifamily residential mortgages	18	0	0	4	14	28
Commercial RE loans	261	2	8	25	226	355
Construction RE loans	34	0	1	7	25	53
Farmland loans	8	1	1	2	3	14
RE loans from foreign offices	6	0	0	0	6	12
Commercial and industrial loans	544	15	47	98	383	1,039
Loans to individuals	1,816	23	114	533	1,146	2,553
Credit cards	951	10	61	374	506	1,385
Installment loans	865	13	53	159	640	1,168
All other loans and leases	170	0	5	18	147	252

Number of national banks by state and asset size
September 30, 1998

	All national banks	National banks: Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
All institutions	2,519	1,321	1,008	150	40	8,910
Alabama	34	18	15	0	1	169
Alaska	3	1	0	2	0	6
Arizona	15	6	4	4	1	44
Arkansas	60	22	36	2	0	214
California	96	42	48	3	3	337
Colorado	66	47	15	4	0	201
Connecticut	7	3	4	0	0	26
Delaware	17	3	6	6	2	34
District of Columbia	5	1	4	0	0	6
Florida	86	35	39	11	1	256
Georgia	63	29	32	2	0	349
Hawaii	1	0	1	0	0	13
Idaho	1	0	1	0	0	17
Illinois	221	108	99	12	2	757
Indiana	43	10	25	8	0	183
Iowa	52	31	19	2	0	442
Kansas	114	87	26	1	0	398
Kentucky	66	38	24	4	0	267
Louisiana	24	12	7	4	1	156
Maine	5	1	4	0	0	17
Maryland	20	4	14	1	1	83
Massachusetts	12	4	7	0	1	44
Michigan	37	17	17	1	2	162
Minnesota	139	85	47	5	2	517
Mississippi	21	9	11	1	0	100
Missouri	51	26	20	4	1	397
Montana	17	13	2	2	0	90
Nebraska	97	73	21	3	0	320
Nevada	7	2	1	4	0	26
New Hampshire	6	1	4	1	0	19
New Jersey	25	2	16	6	1	70
New Mexico	19	7	10	2	0	56
New York	64	23	33	6	2	152
North Carolina	11	2	5	1	3	62
North Dakota	19	9	8	2	0	117
Ohio	99	46	42	6	5	222
Oklahoma	120	81	37	2	0	315
Oregon	4	1	3	0	0	42
Pennsylvania	109	32	68	6	3	204
Rhode Island	2	0	0	1	1	7
South Carolina	23	12	10	1	0	81
South Dakota	22	12	8	1	1	104
Tennessee	34	9	17	5	3	208
Texas	404	274	119	9	2	808
Utah	8	2	3	2	1	49
Vermont	11	4	6	1	0	21
Virginia	30	8	20	2	0	149
Washington	18	13	5	0	0	81
West Virginia	32	14	13	5	0	92
Wisconsin	58	28	27	3	0	350
Wyoming	21	14	5	2	0	52
U.S. territories	0	0	0	0	0	18

Total assets of national banks by state and asset size
September 30, 1998
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
All institutions	$3,048,935	$65,535	$264,577	$494,757	$2,224,066	$5,269,220
Alabama	40,054	1,159	3,443	0	35,452	122,187
Alaska	4,385	51	0	4,333	0	5,091
Arizona	34,094	130	1,553	15,294	17,117	38,078
Arkansas	13,544	1,281	8,375	3,888	0	28,272
California	384,490	1,993	13,400	8,188	360,909	493,219
Colorado	21,405	2,157	3,219	16,030	0	36,672
Connecticut	934	230	705	0	0	6,312
Delaware	87,302	147	1,884	32,612	52,658	121,875
District of Columbia	1,192	32	1,161	0	0	1,278
Florida	82,695	2,009	10,667	27,587	42,432	117,433
Georgia	21,750	1,550	9,149	11,052	0	73,198
Hawaii	300	0	300	0	0	23,597
Idaho	184	0	184	0	0	1,680
Illinois	155,846	5,541	25,277	41,932	83,097	263,859
Indiana	45,987	462	8,823	36,702	0	71,819
Iowa	15,045	1,576	4,774	8,695	0	44,496
Kansas	13,044	3,917	7,253	1,874	0	32,552
Kentucky	25,062	2,347	4,308	18,407	0	50,907
Louisiana	32,759	597	2,168	17,480	12,514	47,985
Maine	1,178	62	1,116	0	0	4,771
Maryland	17,045	263	4,818	1,237	10,729	38,460
Massachusetts	72,499	212	1,910	0	70,377	139,693
Michigan	30,430	885	3,572	2,299	23,673	117,554
Minnesota	118,390	3,857	10,592	10,595	93,346	138,448
Mississippi	9,027	536	2,272	6,219	0	25,666
Missouri	45,099	1,160	5,970	20,961	17,008	82,020
Montana	3,398	439	282	2,678	0	9,571
Nebraska	15,352	3,086	4,572	7,695	0	26,665
Nevada	16,732	77	127	16,528	0	25,129
New Hampshire	6,467	41	952	5,474	0	14,851
New Jersey	48,069	109	5,267	14,372	28,321	92,095
New Mexico	7,568	295	2,807	4,466	0	11,592
New York	365,894	1,668	10,980	11,216	342,029	1,169,603
North Carolina	542,128	53	2,053	1,029	538,993	599,093
North Dakota	5,788	336	2,422	3,030	0	10,641
Ohio	206,610	2,296	15,304	19,859	169,150	254,278
Oklahoma	20,695	3,948	8,024	8,722	0	35,028
Oregon	460	4	456	0	0	6,575
Pennsylvania	154,616	1,780	20,681	8,490	123,665	199,291
Rhode Island	77,671	0	0	6,304	71,367	84,946
South Carolina	3,878	491	2,006	1,380	0	18,200
South Dakota	20,901	437	2,376	4,844	13,245	28,223
Tennessee	77,540	646	4,207	18,011	54,676	97,781
Texas	121,234	13,206	26,686	33,503	47,839	178,601
Utah	23,571	114	423	7,565	15,470	40,575
Vermont	3,569	250	1,484	1,834	0	7,351
Virginia	11,110	408	4,301	6,402	0	71,812
Washington	1,750	537	1,213	0	0	12,692
West Virginia	13,490	854	3,403	9,233	0	23,204
Wisconsin	20,255	1,608	6,808	11,839	0	76,807
Wyoming	6,449	696	853	4,900	0	9,217
U.S. territories	0	0	0	0	0	38,277

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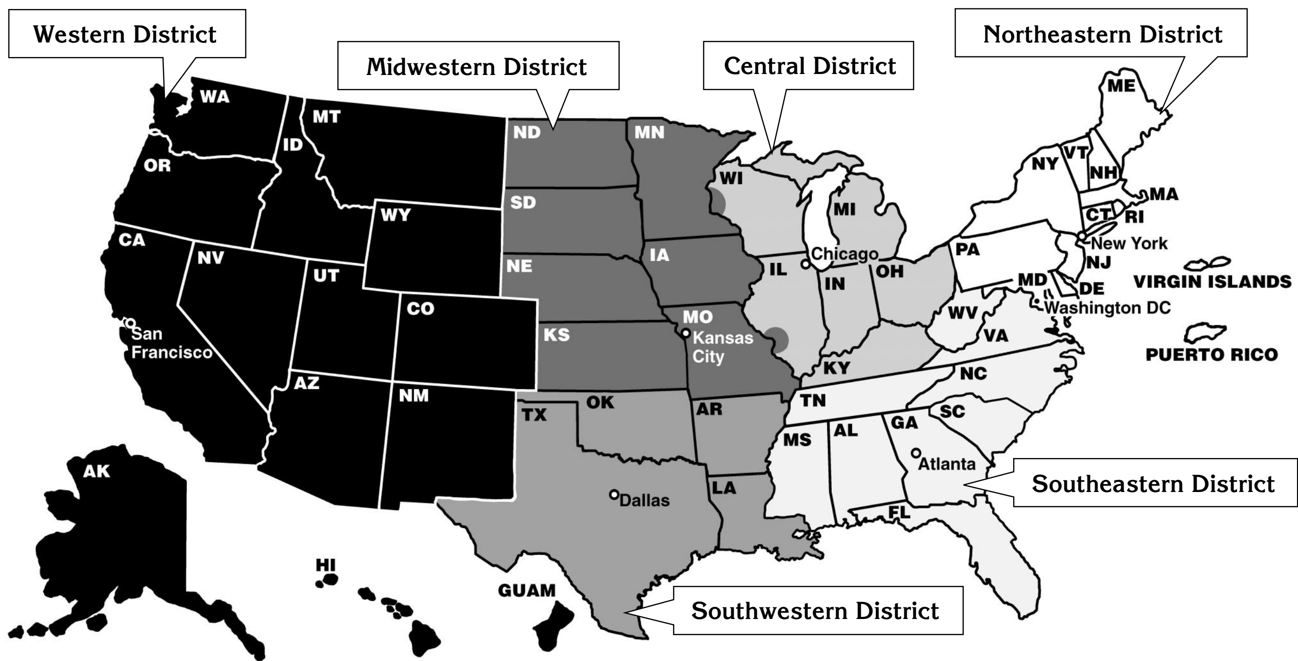

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