Comptroller of the Currency
Administrator of National Banks

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Office of the Comptroller of the Currency
September 1999

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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

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

The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and congressional testimony, material released in the interpretive letters series, statistical data, and other information of interest to the administration of national banks. Send suggestions or questions to Rebecca Miller, Senior Writer-Editor, Communications Division, Comptroller of the Currency, Washington, DC 20219. Subscriptions are available for $100 a year by writing to Publications—QJ, Comptroller of the Currency, P.O. Box 70004, Chicago, IL 60673–0004. The *Quarterly Journal* is on the 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

Volume 18, Number 3
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Condition and Performance of Commercial Banks

Summary

While profitability of the banking industry remains high, maintaining that profitability has been challenging during a period of narrow net interest margins. Small banks generally have fewer geographic markets and product opportunities and, thus, less flexibility than larger banks in replacing lost net interest income. As a result, although small banks remain strong, they are reporting reduced profitability and may show greater potential financial stress if the economy slows.

Profitability of Large and Small Banks

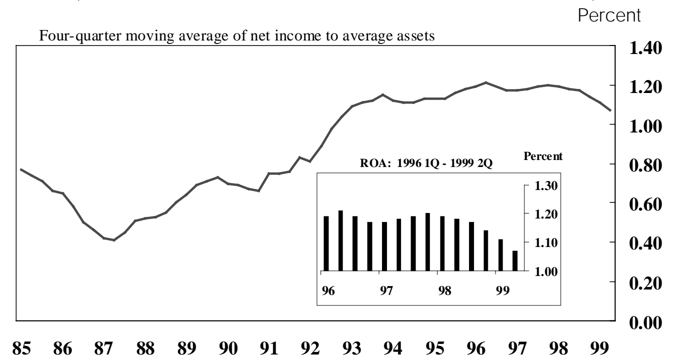
Earnings of the commercial banking industry remained at a historically high level in the second quarter, retreating moderately from the record earnings in the first quarter. Commercial banks reported net income of $17.0 billion with a return on assets (ROA) of 1.25 percent in the second quarter, compared to earnings of $18.0 billion and an ROA of 1.32 percent in the first quarter.

Industry profitability has been roughly at a plateau for four years near an ROA of 1.25 percent. Second quarter ROA in 1998 and 1999 was 1.25 percent, compared to 1.27 percent and 1.24 percent in the second quarters of 1996 and 1997, respectively. The decline in profitability from the first quarter to the second quarter 1999 occurred in large part because of a decline in trading revenue. Trading revenue declined from an abnormally high level in the first quarter to a level more consistent with the historical trend.

While the industry in the aggregate maintained a high and steady level of profitability, small banks continued to experience decreasing profitability. Return on assets for small banks (defined as banks with under $100 million in assets) declined 15 basis points from the second quarter 1998 to 1.08 percent in the second quarter 1999, the largest decline and the lowest ROA of any of the four asset categories shown in the attached tables. Nearly one-half of all small banks had a decline in earnings in the second quarter 1999, compared to less than one-quarter of banks over $10 billion.

Small banks benefited significantly from the earlier phase of the economic boom in the 1990s, as shown in Figure 1. Their decline in profitability is a relatively recent although apparently protracted development. The second quarter 1999 represents the fifth consecutive quarter in which a four-quarter moving average of small bank ROA has declined, the first time this measure has declined for five consecutive quarters since 1986–1987.

Figure 1—Return on assets for small banks (commercial banks under $100 million)

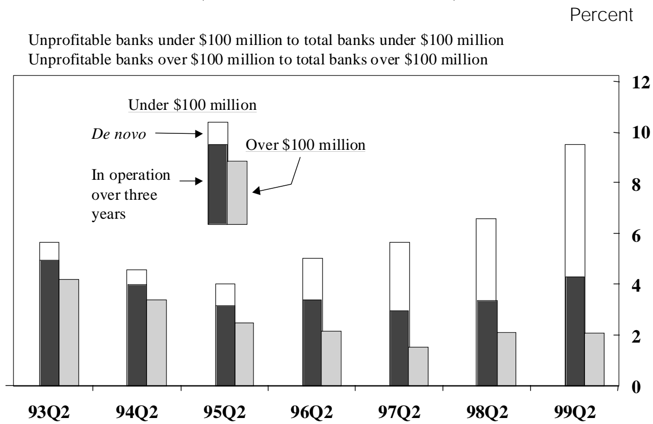


Source: Integrated Banking Information System

The gap between the percentage of small banks that are unprofitable and the percentage of larger banks that are unprofitable has risen since the mid-1990s, as shown in Figure 2. In the second quarter of 1999, the percentage of small banks that were unprofitable was approximately four times the percentage of all other banks that were unprofitable, increasing to 9.6 percent in the second quarter 1999 from 6.6 percent in the second quarter 1998.

Much of the increase in the percentage of small banks that are unprofitable is attributable to *de novo* banks as shown in Figure 2. *De novo* banks are a larger percentage of small banks because of the resurgence in *de novo* banks since 1995 and a decrease in the number of established small banks as a result of mergers. The average *de novo* bank is unprofitable until its third year of operation.

Figure 2—Unprofitable banks (commercial banks)



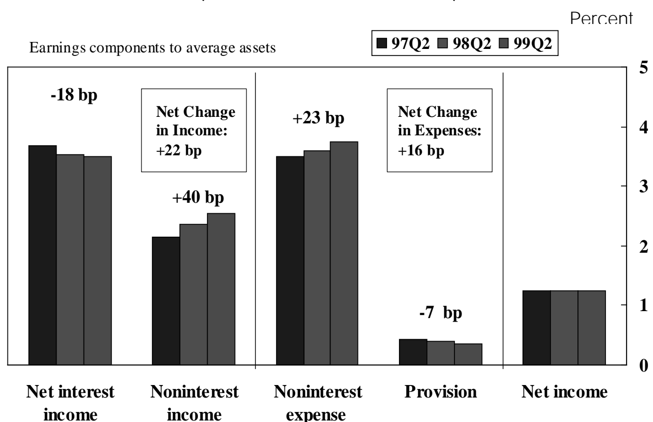
Source: Integrated Banking Information System

Figure 2 also demonstrates, however, that even established small banks are experiencing losses at twice the rate of larger banks. In the second quarter 1999, 4.3 percent of small banks in operation over three years were unprofitable, compared to 2.1 percent for all banks over $100 million.

Differences in Small and Larger Bank Earnings

Industry earnings have been remarkably stable over the past several years. Higher noninterest income has offset a shrinking net interest margin and higher noninterest expenses. As shown in Figure 3, the decline in net interest income over the past two years of 18 basis points has been offset by an increase in noninterest income of 40 basis points less a net increase in expenses of 16 basis points. The result has been steady second quarter ROA of 1.24 percent, 1.25 percent, and 1.25 percent in 1997, 1998, and 1999, respectively.

Figure 3—Primary sources of earnings (commercial banks)



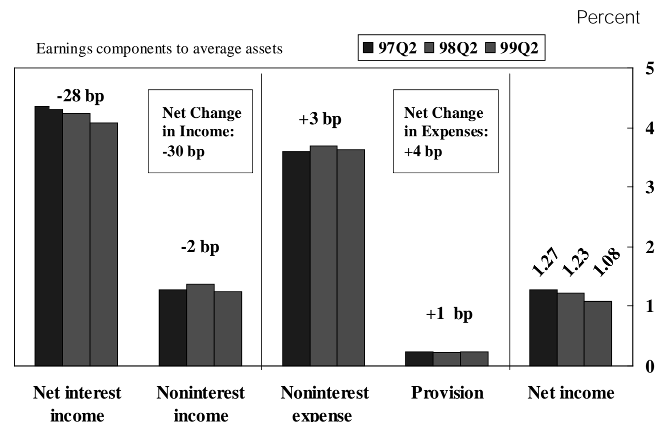
Source: Integrated Banking Information System

Small banks have had even greater compression of net interest margin than have larger banks. Net interest margin for small banks did improve between the first and second quarters of 1999 by 11 basis points, but over the longer term small banks have had a steeper decline in net interest margin than larger banks. As seen by comparing Figures 3 and 4, net interest margin in small banks fell by 28 basis points in the two years between the second quarter 1997 and second quarter 1999 compared to an 18-basis-point decline for the total industry.

While facing a steeper decline in net interest margin than larger banks, small banks have not had the advantage for diversification and gains in noninterest income as have larger banks. As shown in Figure 4, in contrast to a 40 basis point increase in noninterest income achieved by the industry in the aggregate over the past two years, small banks had a two basis point decline in noninterest income.

As one response to offset declining income, small banks have controlled their expenses. Noninterest expense as a percentage of average assets has been relatively unchanged in small banks over the past three years, in contrast to an increase of 23 basis points in noninterest expense for the industry as a whole.

Figure 4—Primary sources of earnings (commercial banks under $100 million)



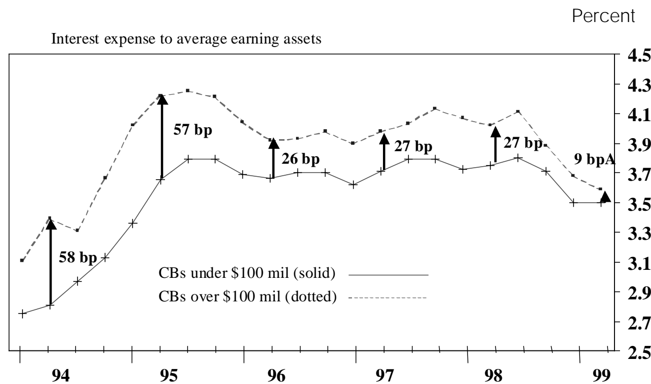
Source: Integrated Banking Information System

Changes in Net Interest Margin

Interest expense has been a source of earnings pressure on small banks. Although remaining generally stable over the past several years, interest expense for small banks has been increasing relative to interest expense for larger banks. As shown in Figure 5, the gap between interest expense at small banks and interest expense at larger banks shrank to 9 basis points as of the second quarter 1999 from a gap of 58 basis points as of the second quarter 1994.

The smaller gap between interest expenses at small banks and larger banks reflects growth of more expensive non-core deposit liabilities on the balance sheets of small banks. A recent FDIC study[1] reports that increased competition for deposits is prompting small banks to rely increasingly on non-traditional sources of funding. These include Federal Home Loan Bank advances, repurchase agreements, and subordinated notes, which typically involve higher interest costs than core deposits.

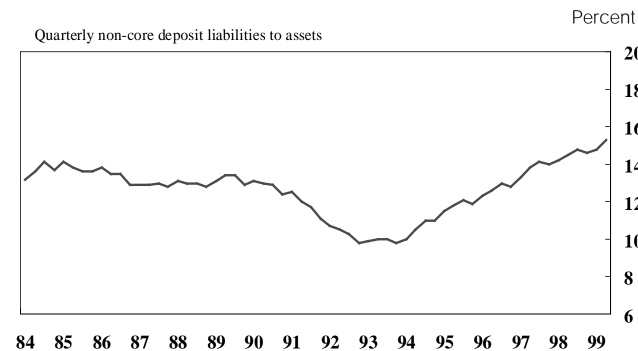
Figure 5—Interest expense (commercial banks)



Source: Integrated Banking Information System

Small banks held liabilities other than core deposit liabilities equal to 15.3 percent of assets in the second quarter 1999, following a gradual but steady increase since 1993, as indicated in Figure 6.

Figure 6—Non-core deposit liability ratio (commercial banks under $100 million)

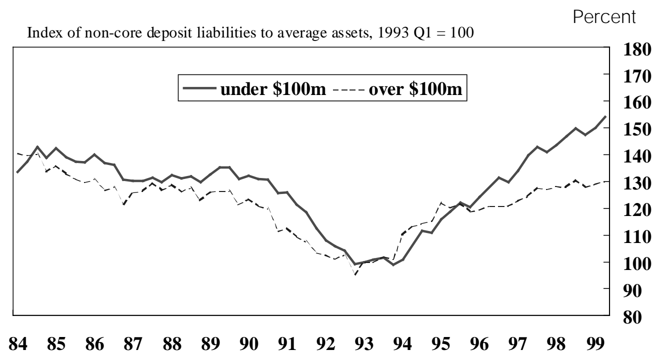


Source: Integrated Banking Information System

Although non-core deposits represents a much smaller percentage of liabilities in small banks than larger banks, Figure 7 shows that non-core deposit liabilities have grown at a relatively faster rate in small banks since 1993 as compared to larger banks.

[1] "Shifting Funding Trends Pose Challenges for Community Banks," *Regional Outlook*, Third Quarter (1999), Federal Deposit Insurance Corporation.

Figure 7—Non-core deposit liabilities (commercial banks)



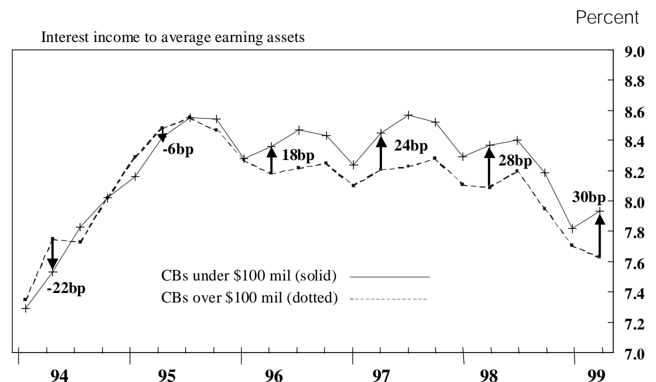
Source: Integrated Banking Information System

Interest income for small banks has been increasing relative to interest income of larger banks. As shown in Figure 8, the difference between interest income for banks under and over $100 million has been widening steadily. Interest income as a percentage of earning assets for banks under $100 million was 22 basis points less than banks over $100 million in the second quarter 1994. The ratio of interest income to average earning assets has steadily improved in comparison to the same ratio for larger banks. By the second quarter 1999, yields at small banks exceeded comparable yields for larger banks by 30 basis points.

Asset Quality and Loss Reserves

Some small banks may have accepted increased credit risk in order to earn more interest income. This is a concern raised by OCC and other regulators for the last several years. Small banks currently have a higher percentage of nonperforming assets and noncurrent loans to assets than do larger banks. Noncurrent loans of banks with over $100 million in assets have typically exceeded those in small banks. As shown in Figure 9, this typical pattern reversed in 1996.

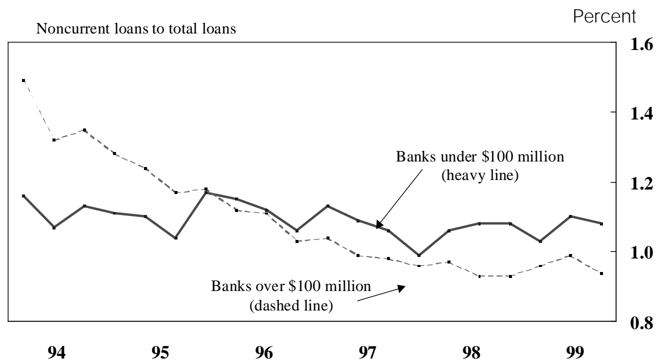
Figure 8—Interest income (commercial banks)



Source: Integrated Banking Information System

This occurred at approximately the same time that the ratio of interest income to average earnings assets in small banks began to exceed the same ratio in larger banks as shown in Figure 8. The higher level of noncurrent loans in small banks compared to larger banks may indicate that small banks are paying a risk premium for poorer quality assets.

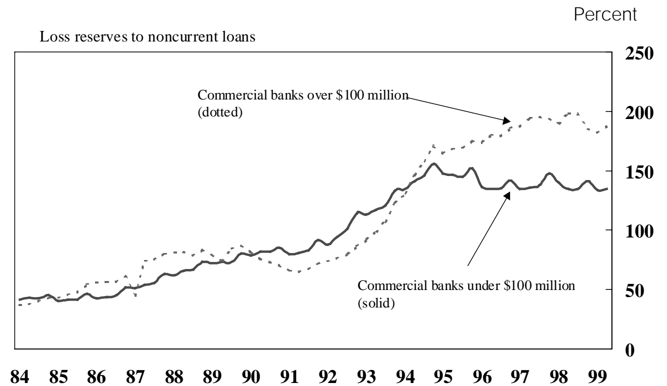
Figure 9—Noncurrent loans (commercial banks)



Source: Integrated Banking Information System

Also of note, the ratio of loss reserves to noncurrent loans has been declining for small banks. Although the ratio is near historic highs, Figure 10 indicates that this ratio has declined since 1994 for small banks. Also during this period, the ratio of loss reserves to noncurrent loans has diverged between small and larger banks. In the second quarter 1999, small banks had a loss reserves to noncurrent loans ratio of 134 percent, in comparison to a loss reserves to noncurrent loans ratio of 188 percent for banks with over $100 million in assets. During this time period, small banks had a higher percentage of noncurrent loans to assets than larger banks.

Figure 10—Coverage ratio (commercial banks)



Source: Integrated Banking Information System

Conclusion

The commercial banking industry continued to be highly profitable in the first two quarters of 1999. The economic expansion and large increases in trading revenue have contributed to the industry's financial success.

In contrast to larger institutions, small banks have had declining profitability as measured by ROA, although profitability of small banks is still high. Although both small and larger banks have encountered declining net interest margins, small banks have had more pressure to find more expensive non-traditional liabilities. Additionally, small banks have not had as much capacity as larger banks to find alternative sources of noninterest income to offset lost net interest income.

Small banks have added to interest income, but with a corresponding increase in indicators of increased credit risk. Beginning in 1996, interest income as a percentage of assets in small banks began to exceed by an increasing amount the same ratio for larger banks. At about the same time, small banks also began to have higher percentages of nonperforming assets and noncurrent loans to assets than larger banks have.

Key indicators, FDIC-insured national banks
Annual 1995–1998, year-to-date through June 30, 1999, second quarter 1998, and second quarter 1999
(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1997Q2	Preliminary 1998Q2
Number of institutions reporting	2,858	2,726	2,597	2,456	2,409	2,546	2,409
Total employees (FTEs)	840,699	850,737	912,463	974,868	960,086	952,360	960,086
Selected income data ($)							
Net income	$28,583	$30,497	$35,782	$37,621	$21,589	$9,575	$11,025
Net interest income	87,080	94,564	106,639	110,986	57,468	27,620	28,741
Provision for loan losses	6,335	9,598	13,065	15,242	7,734	3,555	3,657
Noninterest income	51,080	56,100	65,429	81,347	45,166	19,083	22,634
Noninterest expense	87,591	93,690	104,682	122,586	61,845	28,457	30,671
Net operating income	28,540	30,095	34,993	35,562	21,234	9,288	10,891
Cash dividends declared	20,516	25,279	28,587	25,411	14,082	3,855	8,889
Net charge-offs to loan and lease reserve	6,459	9,968	12,661	14,491	6,926	3,359	3,240
Selected condition data ($)							
Total assets	2,401,017	2,528,057	2,893,910	3,183,327	3,193,021	2,978,610	3,193,021
Total loans and leases	1,522,677	1,641,464	1,840,510	2,015,615	2,044,316	1,923,481	2,044,316
Reserve for losses	31,142	31,992	34,865	36,810	37,263	36,343	37,263
Securities	390,549	380,615	452,118	516,084	546,637	473,600	546,637
Other real estate owned	3,396	2,761	2,112	1,833	1,674	1,982	1,674
Noncurrent loans and leases	17,595	17,223	17,878	19,516	19,707	17,770	19,707
Total deposits	1,695,817	1,801,043	2,004,867	2,137,948	2,121,977	2,035,432	2,121,977
Domestic deposits	1,406,312	1,525,565	1,685,316	1,785,859	1,755,783	1,708,310	1,755,783
Equity capital	189,714	207,166	244,795	274,209	276,926	263,552	276,926
Off-balance-sheet derivatives	7,914,818	7,488,663	8,704,481	10,953,514	10,982,091	9,814,832	10,982,091
Performance ratios (annualized %)							
Return on equity	15.76	15.28	15.00	14.30	15.58	14.80	15.84
Return on assets	1.24	1.25	1.29	1.24	1.36	1.29	1.39
Net interest income to assets	3.78	3.88	3.83	3.67	3.62	3.71	3.63
Loss provision to assets	0.27	0.39	0.47	0.50	0.49	0.48	0.46
Net operating income to assets	1.24	1.24	1.26	1.18	1.34	1.25	1.37
Noninterest income to assets	2.22	2.30	2.35	2.69	2.84	2.56	2.85
Noninterest expense to assets	3.80	3.85	3.76	4.05	3.89	3.82	3.87
Loss provision to loans and leases	0.44	0.61	0.73	0.79	0.76	0.75	0.72
Net charge-offs to loans and leases	0.45	0.63	0.71	0.75	0.68	0.71	0.64
Loss provision to net charge-offs	98.09	96.29	103.19	105.12	111.69	105.85	112.88
Performance ratios (%)							
Percent of institutions unprofitable	3.32	4.77	4.89	5.90	5.85	5.42	5.98
Percent of institutions with earnings gains	66.83	67.83	67.96	61.89	55.87	59.78	56.87
Nonint. income to net operating revenue	36.97	37.24	38.02	42.29	44.01	40.86	44.06
Nonint. expense to net operating revenue	63.40	62.18	60.84	63.74	60.26	60.93	59.70
Condition ratios (%)							
Nonperforming assets to assets	0.88	0.80	0.70	0.68	0.68	0.67	0.68
Noncurrent loans to loans	1.16	1.05	0.97	0.97	0.96	0.92	0.96
Loss reserve to noncurrent loans	176.99	185.75	195.01	188.61	189.09	204.51	189.09
Loss reserve to loans	2.05	1.95	1.89	1.83	1.82	1.89	1.82
Equity capital to assets	7.90	8.19	8.46	8.61	8.67	8.85	8.67
Leverage ratio	7.31	7.40	7.42	7.43	7.56	7.49	7.56
Risk-based capital ratio	12.09	11.97	11.86	11.80	12.02	11.91	12.02
Net loans and leases to assets	62.12	63.66	62.39	62.16	62.86	63.36	62.86
Securities to assets	16.27	15.06	15.62	16.21	17.12	15.90	17.12
Appreciation in securities (% of par)	0.86	0.50	1.11	0.82	–1.42	0.99	–1.42
Residential mortgage assets to assets	20.13	19.81	20.10	20.41	19.88	20.44	19.88
Total deposits to assets	70.63	71.24	69.28	67.16	66.46	68.33	66.46
Core deposits to assets	53.28	54.08	51.59	49.72	48.50	50.81	48.50
Volatile liabilities to assets	30.29	29.83	31.42	31.77	33.27	31.54	33.27

Loan performance, FDIC-insured national banks
Annual 1995–1998, year-to-date through June 30, 1999, second quarter 1998, and second quarter 1999
(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1998Q2	Preliminary 1999Q2
Percent of loans past due 30–89 days							
Total loans and leases	1.26	1.39	1.32	1.27	1.12	1.12	1.12
Loans secured by real estate (RE)	1.38	1.45	1.39	1.33	1.05	1.14	1.05
1–4 family residential mortgages	1.44	1.63	1.65	1.50	1.13	1.36	1.13
Home equity loans	1.19	1.04	0.93	0.97	0.76	0.78	0.76
Multifamily residential mortgages	1.15	1.28	1.33	0.94	0.51	0.80	0.51
Commercial RE loans	1.26	1.25	0.95	1.02	0.96	0.80	0.96
Construction RE loans	1.42	1.63	1.63	1.82	1.17	1.32	1.17
Commercial and industrial loans*	0.77	0.89	0.76	0.81	0.87	0.72	0.87
Loans to individuals	2.16	2.46	2.52	2.44	2.23	2.20	2.23
Credit cards	2.35	2.70	2.75	2.52	2.42	2.42	2.42
Installment loans	2.04	2.26	2.34	2.37	2.10	2.02	2.10
All other loans and leases	0.40	0.41	0.46	0.46	0.52	0.40	0.52
Percent of loans noncurrent							
Total loans and leases	1.16	1.05	0.97	0.97	0.96	0.92	0.96
Loans secured by real estate (RE)	1.46	1.27	1.07	0.98	0.93	1.00	0.93
1–4 family residential mortgages	0.90	1.10	1.01	0.95	0.82	0.92	0.82
Home equity loans	0.52	0.47	0.43	0.41	0.34	0.41	0.34
Multifamily residential mortgages	2.21	1.47	1.01	0.88	0.83	0.87	0.83
Commercial RE loans	2.18	1.71	1.27	1.01	1.05	1.16	1.05
Construction RE loans	3.17	1.31	1.00	0.80	0.83	1.00	0.83
Commercial and industrial loans*	1.06	0.87	0.78	0.86	1.01	0.84	1.01
Loans to individuals	1.18	1.34	1.49	1.59	1.40	1.36	1.40
Credit cards	1.34	1.70	2.03	2.06	1.75	1.77	1.75
Installment loans	1.06	1.04	1.04	1.19	1.16	1.04	1.16
All other loans and leases	0.32	0.25	0.27	0.31	0.47	0.28	0.47
Percent of loans charged-off, net							
Total loans and leases	0.45	0.63	0.71	0.75	0.68	0.71	0.64
Loans secured by real estate (RE)	0.13	0.09	0.06	0.05	0.07	0.03	0.08
1–4 family residential mortgages	0.10	0.08	0.08	0.07	0.10	0.06	0.11
Home equity loans	0.23	0.24	0.18	0.16	0.19	0.15	0.18
Multifamily residential mortgages	0.20	0.09	0.01	0.07	0.01	0.09	0.02
Commercial RE loans	0.18	0.02	–0.01	–0.02	0.01	–0.08	0.01
Construction RE loans	–0.01	0.16	–0.10	–0.01	0.04	–0.02	0.05
Commercial and industrial loans*	0.10	0.22	0.27	0.38	0.50	0.32	0.55
Loans to individuals	1.80	2.45	2.86	2.92	2.62	3.01	2.35
Credit cards	3.40	4.25	4.95	5.02	4.57	5.50	4.21
Installment loans	0.76	1.04	1.20	1.23	1.15	1.12	1.01
All other loans and leases	–0.14	0.17	0.15	0.79	0.23	0.21	0.20
Loans outstanding ($)							
Total loans and leases	$1,522,677	$1,641,464	$1,840,510	$2,015,615	$2,044,316	$1,923,481	$2,044,316
Loans secured by real estate (RE)	610,405	646,570	725,305	764,868	770,457	742,105	770,457
1–4 family residential mortgages	317,521	329,031	363,329	381,522	378,174	373,968	378,174
Home equity loans	48,836	55,022	67,669	66,091	60,298	66,921	60,298
Multifamily residential mortgages	18,161	20,480	23,346	23,201	25,554	23,543	25,554
Commercial RE loans	157,638	170,350	190,067	200,469	205,312	190,758	205,312
Construction RE loans	34,736	38,848	47,410	56,260	62,609	51,950	62,609
Farmland loans	8,734	9,046	10,178	10,930	11,324	10,573	11,324
RE loans from foreign offices	24,779	23,794	23,306	26,396	27,186	24,392	27,186
Commercial and industrial loans	405,630	425,148	508,589	583,930	609,979	552,164	609,979
Loans to individuals	320,009	356,067	371,499	386,461	351,252	365,256	351,252
Credit cards	131,228	161,104	168,258	176,458	143,216	159,451	143,216
Installment loans	188,781	194,963	203,241	210,003	208,037	205,805	208,037
All other loans and leases	189,490	216,194	237,329	282,395	314,458	266,097	314,458
Less: Unearned income	2,857	2,515	2,212	2,039	1,831	2,141	1,831

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

Key indicators, FDIC-insured national banks by asset size
Second quarter 1998 and second quarter 1999
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2
Number of institutions reporting	1,329	1,237	1,030	987	147	138	40	47
Total employees (FTEs)	33,485	31,599	113,243	108,034	160,337	134,435	645,295	686,018
Selected income data ($)								
Net income	$210	$173	$898	$902	$1,722	$1,926	$6,745	$8,025
Net interest income	698	625	2,825	2,666	5,250	4,334	18,847	21,116
Provision for loan losses	37	34	193	194	1,112	756	2,213	2,673
Noninterest income	397	395	1,193	1,357	3,773	4,218	13,721	16,663
Noninterest expense	768	748	2,500	2,521	5,209	4,823	19,980	22,580
Net operating income	209	172	889	899	1,694	1,911	6,496	7,908
Cash dividends declared	143	101	452	735	1,128	1,053	2,133	7,001
Net charge-offs to loan and lease reserve	27	22	175	140	1,170	670	1,986	2,408
Selected condition data ($)								
Total assets	65,899	61,469	270,334	259,935	482,331	405,504	2,160,046	2,466,113
Total loans and leases	38,157	35,386	164,081	159,305	313,151	255,958	1,408,091	1,593,666
Reserve for losses	514	478	2,412	2,312	7,988	6,076	25,429	28,396
Securities	17,860	17,214	71,351	70,782	89,249	90,379	295,140	368,262
Other real estate owned	85	64	236	222	205	170	1,456	1,218
Noncurrent loans and leases	413	382	1,376	1,332	3,124	2,268	12,858	15,725
Total deposits	56,402	52,377	220,181	211,211	315,617	259,064	1,443,233	1,599,325
Domestic deposits	56,402	52,377	219,660	210,729	309,905	255,898	1,122,343	1,236,779
Equity capital	7,123	6,640	26,273	24,224	49,106	42,069	181,050	203,992
Off-balance-sheet derivatives	535	73	3,795	2,988	68,162	41,915	10,022,927	11,192,395
Performance ratios (annualized %)								
Return on equity	11.86	10.33	13.82	14.75	14.51	18.33	15.13	15.65
Return on assets	1.29	1.13	1.34	1.40	1.45	1.92	1.24	1.31
Net interest income to assets	4.27	4.10	4.20	4.14	4.42	4.31	3.48	3.45
Loss provision to assets	0.23	0.22	0.29	0.30	0.94	0.75	0.41	0.44
Net operating income to assets	1.28	1.13	1.32	1.40	1.43	1.90	1.20	1.29
Noninterest income to assets	2.43	2.59	1.77	2.11	3.17	4.20	2.53	2.72
Noninterest expense to assets	4.70	4.91	3.72	3.92	4.38	4.80	3.69	3.69
Loss provision to loans and leases	0.40	0.39	0.47	0.50	1.44	1.19	0.64	0.67
Net charge-offs to loans and leases	0.29	0.25	0.43	0.36	1.51	1.05	0.57	0.61
Loss provision to net charge-offs	136.18	153.59	110.33	138.93	95.05	112.83	111.40	111.01
Performance ratios (%)								
Percent of institutions unprofitable	7.60	9.86	2.72	2.03	6.12	1.45	0.00	0.00
Percent of institutions with earnings gains	53.88	49.39	65.53	63.12	67.35	73.91	80.00	72.34
Noninterest income to net operating revenue	36.29	38.74	29.69	33.73	41.81	49.32	42.13	44.11
Noninterest expense to net operating revenue	70.08	73.34	62.23	62.66	57.73	56.39	61.35	59.77
Condition ratios (%)								
Nonperforming assets to assets	0.76	0.72	0.60	0.60	0.69	0.61	0.67	0.70
Noncurrent loans to loans	1.08	1.08	0.84	0.84	1.00	0.89	0.91	0.99
Loss reserve to noncurrent loans	124.59	125.34	175.36	173.52	255.70	267.88	197.76	180.59
Loss reserve to loans	1.35	1.35	1.47	1.45	2.55	2.37	1.81	1.78
Equity capital to assets	10.81	10.80	9.72	9.32	10.18	10.37	8.38	8.27
Leverage ratio	10.58	10.75	9.21	9.11	8.67	9.04	6.91	7.07
Risk-based capital ratio	17.98	18.05	15.22	14.70	13.46	13.87	11.17	11.42
Net loans and leases to assets	57.12	56.79	59.80	60.40	63.27	61.62	64.01	63.47
Securities to assets	27.10	28.00	26.39	27.23	18.50	22.29	13.66	14.93
Appreciation in securities (% of par)	0.65	–0.99	0.85	–1.13	1.04	–1.22	1.03	–1.54
Residential mortgage assets to assets	21.97	21.70	25.83	25.70	22.34	26.14	19.30	18.19
Total deposits to assets	85.59	85.21	81.45	81.26	65.44	63.89	66.81	64.85
Core deposits to assets	74.31	73.62	70.39	69.80	56.55	55.34	46.36	44.51
Volatile liabilities to assets	12.77	13.33	16.65	17.23	26.77	26.66	35.04	36.54

Loan performance, FDIC-insured national banks by asset size
Second quarter 1998 and second quarter 1999

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2
Percent of loans past due 30–89 days								
Total loans and leases	1.42	1.32	1.23	1.18	1.61	1.33	0.99	1.07
Loans secured by real estate (RE)	1.21	1.11	0.99	0.91	1.09	0.91	1.17	1.10
1–4 family residential mortgages	1.49	1.41	1.16	1.09	1.08	0.99	1.46	1.16
Home equity loans	0.86	0.82	0.89	0.65	0.91	0.85	0.74	0.76
Multifamily residential mortgages	0.70	0.51	0.74	0.48	0.99	0.48	0.75	0.52
Commercial RE loans	0.94	0.75	0.76	0.76	1.02	0.85	0.74	1.05
Construction RE loans	1.28	1.18	1.14	0.83	1.64	0.97	1.27	1.28
Commercial and industrial loans*	2.44	2.38	1.71	1.58	1.52	1.22	0.52	0.78
Loans to individuals	2.13	1.97	1.86	2.00	2.34	2.13	2.18	2.29
Credit cards	3.90	2.19	2.75	3.63	2.41	2.46	2.41	2.33
Installment loans	2.03	1.96	1.66	1.60	2.22	1.72	2.03	2.25
All other loans and leases					1.32	1.14	0.33	0.5
Percent of loans noncurrent								
Total loans and leases	1.08	1.08	0.84	0.84	1.00	0.89	0.91	0.99
Loans secured by real estate (RE)	0.92	0.85	0.70	0.65	0.82	0.71	1.11	1.03
1–4 family residential mortgages	0.80	0.74	0.65	0.64	0.67	0.70	1.04	0.88
Home equity loans	0.61	0.52	0.35	0.40	0.53	0.44	0.39	0.32
Multifamily residential mortgages	0.29	0.38	0.52	0.47	0.75	0.44	1.00	1.02
Commercial RE loans	0.96	0.84	0.78	0.68	1.11	0.86	1.29	1.20
Construction RE loans	0.89	0.47	0.72	0.47	0.85	0.52	1.12	0.99
Commercial and industrial loans*	2.61	2.82	1.48	1.50	0.82	0.75	0.78	0.99
Loans to individuals	0.77	0.72	0.77	0.91	1.41	1.32	1.42	1.48
Credit cards	1.93	1.37	2.02	2.63	1.83	1.93	1.71	1.63
Installment loans	0.70	0.69	0.49	0.49	0.70	0.55	1.24	1.39
All other loans and leases					0.52	0.64	0.25	0.4
Percent of loans charged-off, net								
Total loans and leases	0.29	0.25	0.43	0.36	1.51	1.05	0.57	0.61
Loans secured by real estate (RE)	0.03	0.03	0.05	0.05	0.07	0.10	0.02	0.08
1–4 family residential mortgages	0.04	0.03	0.05	0.06	0.08	0.13	0.06	0.11
Home equity loans	0.02	0.06	0.08	0.07	0.12	0.21	0.17	0.19
Multifamily residential mortgages	0.09	0.02	0.32	0.07	–0.06	0.06	0.09	–0.01
Commercial RE loans	0.03	0.04	0.01	0.04	0.06	–0.01	–0.14	0.00
Construction RE loans	0.11	0.03	0.03	0.01	0.04	0.14	–0.06	0.03
Commercial and industrial loans*	0.87	0.80	0.59	0.46	0.27	0.42	0.30	0.57
Loans to individuals	0.81	0.67	1.70	1.46	4.20	3.17	2.68	2.24
Credit cards	6.68	2.17	5.67	5.41	6.17	4.96	4.98	3.86
Installment loans	0.46	0.59	0.57	0.52	0.99	0.80	1.26	1.13
All other loans and leases					0.27	0.26	0.22	0.1
Loans outstanding ($)								
Total loans and leases	$38,157	$35,386	$164,081	$159,305	$313,151	$255,958	$1,408,091	$1,593,666
Loans secured by real estate (RE)	21,206	19,957	97,818	95,632	125,426	118,352	497,655	536,516
1–4 family residential mortgages	10,565	9,510	47,172	43,955	62,463	59,126	253,767	265,581
Home equity loans	486	427	4,523	3,922	10,271	8,056	51,641	47,893
Multifamily residential mortgages	488	425	3,244	3,180	4,606	4,825	15,204	17,124
Commercial RE loans	5,908	5,748	31,705	32,752	35,886	33,989	117,259	132,822
Construction RE loans	1,418	1,510	7,432	7,854	10,349	10,858	32,752	42,388
Farmland loans	2,341	2,337	3,720	3,946	1,711	1,311	2,802	3,731
RE loans from foreign offices	0	0	22	24	140	186	24,230	26,977
Commercial and industrial loans	6,537	6,138	29,161	28,606	62,201	49,379	454,265	525,855
Loans to individuals	5,767	5,041	26,881	25,174	105,699	72,417	226,910	248,621
Credit cards	321	239	4,951	4,939	66,215	40,399	87,965	97,638
Installment loans	5,446	4,802	21,930	20,234	39,484	32,018	138,945	150,982
All other loans and leases	4,804	4,362	10,600	10,209	19,994	15,883	230,700	284,00
Less: Unearned income	156	111	378	316	168	73	1,440	1,330

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

Key indicators, FDIC-insured national banks by region
Second quarter 1999
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	267	324	496	477	599	246	2,409
Total employees (FTEs)	264,630	243,761	162,776	75,038	73,070	140,811	960,086
Selected income data ($)							
Net income	$2,955	$2,581	$1,597	$1,074	$685	$2,133	$11,025
Net interest income	7,551	7,154	4,453	2,534	1,943	5,107	28,741
Provision for loan losses	1,489	877	386	401	103	401	3,657
Noninterest income	8,318	4,803	2,846	1,922	889	3,856	22,634
Noninterest expense	9,754	7,033	4,549	2,411	1,734	5,190	30,671
Net operating income	2,910	2,544	1,583	1,068	676	2,111	10,891
Cash dividends declared	2,107	3,388	849	839	275	1,431	8,889
Net charge-offs to loan and lease reserve	1,195	644	304	404	132	561	3,240
Selected condition data ($)							
Total assets	854,905	843,081	525,755	243,731	205,852	519,697	3,193,021
Total loans and leases	531,364	520,444	353,290	165,655	117,649	355,915	2,044,316
Reserve for losses	11,524	7,816	5,263	2,962	1,566	8,132	37,263
Securities	144,758	169,247	88,834	39,667	55,055	49,076	546,637
Other real estate owned	551	443	186	77	127	291	1,674
Noncurrent loans and leases	7,282	4,393	3,047	1,354	1,191	2,440	19,707
Total deposits	575,228	512,232	341,745	162,926	161,973	367,874	2,121,977
Domestic deposits	343,972	483,241	306,556	153,765	159,741	308,509	1,755,783
Equity capital	71,064	75,164	43,779	19,854	17,217	49,849	276,926
Off-balance-sheet derivatives	4,070,038	3,538,820	1,346,929	41,321	30,482	1,954,501	10,982,091
Performance ratios (annualized %)							
Return on equity	16.58	13.51	14.64	21.49	15.89	17.14	15.84
Return on assets	1.39	1.23	1.23	1.78	1.34	1.64	1.39
Net interest income to assets	3.56	3.42	3.43	4.20	3.80	3.92	3.63
Loss provision to assets	0.70	0.42	0.30	0.66	0.20	0.31	0.46
Net operating income to assets	1.37	1.21	1.22	1.77	1.32	1.62	1.37
Noninterest income to assets	3.93	2.29	2.19	3.18	1.74	2.96	2.85
Noninterest expense to assets	4.60	3.36	3.51	3.99	3.39	3.98	3.87
Loss provision to loans and leases	1.12	0.68	0.44	0.97	0.35	0.45	0.72
Net charge-offs to loans and leases	0.90	0.50	0.35	0.98	0.45	0.63	0.64
Loss provision to net charge-offs	124.64	136.22	126.81	99.26	77.94	71.49	112.88
Performance ratios (%)							
Percent of institutions unprofitable	3.00	13.89	3.63	2.73	6.51	8.54	5.98
Percent of institutions with earnings gains	70.04	58.33	56.45	50.52	53.59	61.79	56.87
Nonint. income to net operating revenue	52.42	40.17	38.99	43.13	31.39	43.02	44.06
Nonint. expense to net operating revenue	61.47	58.82	62.32	54.12	61.25	57.91	59.70
Condition ratios (%)							
Nonperforming assets to assets	0.95	0.57	0.62	0.59	0.64	0.54	0.68
Noncurrent loans to loans	1.37	0.84	0.86	0.82	1.01	0.69	0.96
Loss reserve to noncurrent loans	158.25	177.92	172.72	218.81	131.53	333.24	189.09
Loss reserve to loans	2.17	1.50	1.49	1.79	1.33	2.28	1.82
Equity capital to assets	8.31	8.92	8.33	8.15	8.36	9.59	8.67
Leverage ratio	7.50	7.40	7.64	7.62	7.74	7.74	7.56
Risk-based capital ratio	12.48	11.34	11.78	12.15	13.10	12.18	12.02
Net loans and leases to assets	60.81	60.80	66.20	66.75	56.39	66.92	62.86
Securities to assets	16.93	20.07	16.90	16.27	26.75	9.44	17.12
Appreciation in securities (% of par)	–0.87	–1.93	–1.11	–1.27	–1.56	–1.77	–1.42
Residential mortgage assets to assets	15.54	27.10	19.63	20.35	23.05	14.09	19.88
Total deposits to assets	67.29	60.76	65.00	66.85	78.68	70.79	66.46
Core deposits to assets	34.11	50.85	51.52	57.31	67.94	53.49	48.50
Volatile liabilities to assets	45.35	31.47	30.28	25.29	20.36	28.19	33.27

Loan performance, FDIC-insured national banks by region
Second quarter 1999
(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	0.98	1.28	1.45	1.27	0.82	1.12
Loans secured by real estate (RE)	1.22	0.88	1.21	1.19	1.04	0.90	1.05
1–4 family residential mortgages	1.46	0.74	1.32	1.27	1.18	1.31	1.13
Home equity loans	0.77	0.70	0.90	0.72	0.47	0.70	0.76
Multifamily residential mortgages	0.21	0.49	0.65	1.03	0.86	0.36	0.51
Commercial RE loans	0.71	1.25	1.13	0.76	0.88	0.60	0.96
Construction RE loans	0.79	0.93	1.53	2.23	1.14	0.80	1.17
Commercial and industrial loans*	0.74	0.69	1.24	1.43	1.43	0.58	0.87
Loans to individuals	2.56	2.53	1.98	2.16	1.43	1.84	2.23
Credit cards	2.78	2.23	1.92	2.40	0.89	1.95	2.42
Installment loans	2.25	2.63	1.99	1.89	1.45	1.69	2.10
All other loans and leases	0.43	0.33	0.82	0.97	1.44	0.33	0.52
Percent of loans noncurrent							
Total loans and leases	1.37	0.84	0.86	0.82	1.01	0.69	0.96
Loans secured by real estate (RE)	1.35	0.87	0.92	0.62	1.06	0.59	0.93
1–4 family residential mortgages	1.03	0.68	1.04	0.57	0.77	0.71	0.82
Home equity loans	0.46	0.32	0.39	0.29	0.21	0.24	0.34
Multifamily residential mortgages	1.16	1.08	0.77	0.22	0.63	0.50	0.83
Commercial RE loans	1.28	1.28	0.96	0.56	1.54	0.56	1.05
Construction RE loans	0.79	0.99	0.81	0.77	0.71	0.68	0.83
Commercial and industrial loans*	1.14	0.87	1.02	0.88	1.44	0.91	1.01
Loans to individuals	2.49	0.98	0.73	1.14	0.37	0.99	1.40
Credit cards	2.16	1.22	1.21	1.60	0.54	1.49	1.75
Installment loans	2.93	0.89	0.63	0.60	0.36	0.37	1.16
All other loans and leases	0.43	0.53	0.53	0.73	0.81	0.32	0.47
Percent of loans charged-off, net							
Total loans and leases	0.90	0.50	0.35	0.98	0.45	0.63	0.64
Loans secured by real estate (RE)	0.05	0.11	0.05	0.12	0.12	0.03	0.08
1–4 family residential mortgages	0.09	0.11	0.05	0.21	0.04	0.16	0.11
Home equity loans	0.13	0.32	0.23	0.17	0.64	–0.02	0.18
Multifamily residential mortgages	0.10	–0.02	0.01	0.09	–0.15	0.01	0.02
Commercial RE loans	–0.07	0.09	–0.03	0.00	0.21	–0.13	0.01
Construction RE loans	0.02	0.00	0.07	0.03	0.06	0.13	0.05
Commercial and industrial loans*	0.60	0.54	0.39	0.39	0.70	0.66	0.55
Loans to individuals	3.22	1.86	1.06	3.22	0.90	2.45	2.35
Credit cards	4.04	4.56	2.36	5.21	2.14	4.42	4.21
Installment loans	2.01	0.95	0.76	0.92	0.85	–0.11	1.01
All other loans and leases	–0.07	0.38	0.34	0.68	0.25	0.14	0.20
Loans outstanding ($)							
Total loans and leases	$531,364	$520,444	$353,290	$165,655	$117,649	$355,915	$2,044,316
Loans secured by real estate (RE)	157,322	240,208	142,943	65,594	49,472	114,918	770,457
1–4 family residential mortgages	81,041	133,727	63,531	33,245	20,722	45,907	378,174
Home equity loans	11,827	14,232	15,290	3,919	991	14,038	60,298
Multifamily residential mortgages	5,273	6,682	5,208	1,958	1,810	4,624	25,554
Commercial RE loans	29,405	62,364	43,602	17,235	17,984	34,721	205,312
Construction RE loans	5,653	20,672	12,657	6,269	6,357	11,001	62,609
Farmland loans	461	2,328	2,628	2,967	1,609	1,332	11,324
RE loans from foreign offices	23,662	203	27	0	0	3,294	27,186
Commercial and industrial loans	173,934	152,407	102,894	42,187	34,019	104,538	609,979
Loans to individuals	112,046	67,272	54,593	38,254	23,072	56,015	351,252
Credit cards	64,485	17,040	9,119	20,525	861	31,186	143,216
Installment loans	47,561	50,232	45,474	17,729	22,211	24,829	208,037
All other loans and leases	89,047	60,868	52,996	19,643	11,266	80,638	314,458
Less: Unearned income	984	311	136	23	181	195	1,831

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

Key indicators, FDIC-insured commercial banks
Annual 1995–1998, year-to-date through June 30, 1999, second quarter 1998, and second quarter 1999

(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1998Q2	Preliminary 1999Q2
Number of institutions reporting	9,940	9,528	9,143	8,775	8,675	8,984	8,675
Total employees (FTEs)	1,484,421	1,489,203	1,538,428	1,627,069	1,623,175	1,593,918	1,623,175
Selected income data ($)							
Net income	$48,745	$52,352	$59,160	$61,811	$34,936	$16,108	$16,962
Net interest income	154,210	162,758	174,510	182,763	95,154	45,513	47,780
Provision for loan losses	12,603	16,285	19,850	22,205	10,336	5,098	4,926
Noninterest income	82,426	93,569	104,498	123,701	69,198	30,425	34,513
Noninterest expense	149,729	160,700	169,985	194,120	100,396	46,374	50,811
Net operating income	48,396	51,511	57,933	59,257	34,533	15,739	16,910
Cash dividends declared	31,053	38,792	42,540	41,002	22,705	7,522	13,653
Net charge-offs to loan and lease reserve	12,202	15,500	18,316	20,723	9,574	4,774	4,577
Selected condition data ($)							
Total assets	4,312,676	4,578,412	5,015,057	5,441,224	5,467,745	5,181,540	5,467,745
Total loans and leases	2,602,963	2,811,363	2,970,860	3,238,498	3,308,430	3,091,849	3,308,430
Reserve for losses	52,838	53,458	54,685	57,250	57,591	56,384	57,591
Securities	810,872	800,658	871,876	979,718	1,007,111	893,984	1,007,111
Other real estate owned	6,063	4,780	3,795	3,148	2,915	3,531	2,915
Noncurrent loans and leases	30,351	29,131	28,543	31,253	31,157	29,063	31,157
Total deposits	3,027,574	3,197,207	3,421,799	3,681,552	3,680,818	3,506,625	3,680,818
Domestic deposits	2,573,480	2,723,627	2,895,604	3,109,518	3,086,707	2,957,589	3,086,707
Equity capital	349,571	375,295	417,802	462,198	466,187	445,839	466,187
Off-balance-sheet derivatives	16,860,614	20,035,444	25,063,799	33,005,084	33,003,585	28,175,580	33,003,585
Performance ratios (annualized %)							
Return on equity	14.66	14.45	14.68	13.93	14.97	14.70	14.49
Return on assets	1.17	1.19	1.23	1.19	1.28	1.25	1.25
Net interest income to assets	3.71	3.70	3.64	3.51	3.49	3.54	3.51
Loss provision to assets	0.30	0.37	0.41	0.43	0.38	0.40	0.36
Net operating income to assets	1.16	1.17	1.21	1.14	1.27	1.22	1.24
Noninterest income to assets	1.98	2.13	2.18	2.37	2.54	2.36	2.54
Noninterest expense to assets	3.60	3.65	3.54	3.73	3.69	3.60	3.74
Loss provision to loans and leases	0.51	0.61	0.69	0.72	0.63	0.67	0.60
Net charge-offs to loans and leases	0.49	0.58	0.64	0.67	0.59	0.62	0.56
Loss provision to net charge-offs	103.28	105.07	108.37	104.85	107.97	104.61	107.63
Performance ratios (%)							
Percent of institutions unprofitable	3.55	4.27	4.85	6.05	6.33	4.94	6.65
Percent of institutions with earnings gains	67.53	70.78	68.39	61.47	55.48	59.35	56.77
Nonint. income to net operating revenue	34.83	36.50	37.45	40.36	42.10	40.07	41.94
Nonint. expense to net operating revenue	63.27	62.69	60.92	63.34	61.09	61.07	61.74
Condition ratios (%)							
Nonperforming assets to assets	0.85	0.75	0.66	0.65	0.64	0.65	0.64
Noncurrent loans to loans	1.17	1.04	0.96	0.97	0.94	0.94	0.94
Loss reserve to noncurrent loans	174.09	183.51	191.59	183.18	184.84	194.00	184.84
Loss reserve to loans	2.03	1.90	1.84	1.77	1.74	1.82	1.74
Equity capital to assets	8.11	8.20	8.33	8.49	8.53	8.60	8.53
Leverage ratio	7.61	7.64	7.56	7.54	7.74	7.64	7.74
Risk-based capital ratio	12.68	12.54	12.25	12.23	12.37	12.36	12.37
Net loans and leases to assets	59.13	60.24	58.15	58.47	59.45	58.58	59.45
Securities to assets	18.80	17.49	17.39	18.01	18.42	17.25	18.42
Appreciation in securities (% of par)	1.01	0.51	1.10	1.07	–1.20	1.10	–1.20
Residential mortgage assets to assets	20.31	19.79	20.04	20.93	20.28	20.01	20.28
Total deposits to assets	70.20	69.83	68.23	67.66	67.32	67.68	67.32
Core deposits to assets	53.47	52.46	50.06	49.40	48.63	49.39	48.63
Volatile liabilities to assets	29.68	30.71	31.92	31.68	33.01	32.21	33.01

Loan performance, FDIC-insured commercial banks
Annual 1995–1998, year-to-date through June 30, 1999, second quarter 1998, and second quarter 1999
(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1998Q2	Preliminary 1999Q2
Percent of loans past due 30–89 days							
Total loans and leases	1.29	1.37	1.31	1.26	1.12	1.15	1.12
Loans secured by real estate (RE)	1.38	1.41	1.33	1.26	1.02	1.11	1.02
1–4 family residential mortgages	1.53	1.57	1.59	1.44	1.14	1.30	1.14
Home equity loans	1.09	1.06	0.96	0.98	0.75	0.81	0.75
Multifamily residential mortgages	0.99	1.19	1.11	0.87	0.58	0.80	0.58
Commercial RE loans	1.21	1.24	0.97	0.99	0.86	0.84	0.86
Construction RE loans	1.41	1.58	1.42	1.50	1.13	1.31	1.13
Commercial and industrial loans*	0.86	0.95	0.83	0.88	0.92	0.82	0.92
Loans to individuals	2.21	2.50	2.50	2.43	2.18	2.24	2.18
Credit cards	2.40	2.76	2.73	2.58	2.44	2.51	2.44
Installment loans	2.08	2.31	2.33	2.33	2.03	2.07	2.03
All other loans and leases	0.37	0.37	0.51	0.51	0.60	0.52	0.60
Percent of loans noncurrent							
Total loans and leases	1.17	1.04	0.96	0.97	0.94	0.94	0.94
Loans secured by real estate (RE)	1.39	1.20	1.01	0.91	0.85	0.95	0.85
1–4 family residential mortgages	0.88	0.99	0.94	0.88	0.79	0.88	0.79
Home equity loans	0.52	0.48	0.44	0.42	0.36	0.42	0.36
Multifamily residential mortgages	1.99	1.35	0.95	0.84	0.70	0.84	0.7
Commercial RE loans	2.02	1.61	1.21	0.95	0.91	1.10	0.91
Construction RE loans	2.75	1.38	0.97	0.81	0.83	1.00	0.83
Commercial and industrial loans*	1.19	0.98	0.86	0.99	1.11	0.95	1.11
Loans to individuals	1.22	1.36	1.47	1.52	1.33	1.39	1.33
Credit cards	1.58	1.91	2.18	2.22	1.87	2.01	1.87
Installment loans	0.97	0.97	0.98	1.06	1.03	0.99	1.03
All other loans and leases	0.30	0.22	0.25	0.34	0.43	0.28	0.43
Percent of loans charged-off, net							
Total loans and leases	0.49	0.58	0.64	0.67	0.59	0.62	0.56
Loans secured by real estate (RE)	0.18	0.10	0.06	0.05	0.06	0.03	0.06
1–4 family residential mortgages	0.11	0.08	0.08	0.07	0.08	0.06	0.09
Home equity loans	0.20	0.20	0.16	0.14	0.16	0.14	0.16
Multifamily residential mortgages	0.32	0.15	0.04	0.05	0.00	0.05	0.01
Commercial RE loans	0.32	0.09	0.01	0.00	0.01	–0.04	0.02
Construction RE loans	0.22	0.19	–0.02	0.01	0.04	–0.01	0.05
Commercial and industrial loans*	0.25	0.26	0.28	0.42	0.50	0.35	0.55
Loans to individuals	1.73	2.28	2.70	2.69	2.33	2.71	2.12
Credit cards	3.40	4.35	5.11	5.19	4.60	5.41	4.25
Installment loans	0.66	0.89	1.04	1.04	0.94	0.95	0.86
All other loans and leases	–0.04	0.13	0.16	0.78	0.21	0.25	0.18
Loans outstanding ($)							
Total loans and leases	$2,602,963	$2,811,363	$2,970,860	$3,238,498	$3,308,430	$3,091,849	$3,308,430
Loans secured by real estate (RE)	1,080,116	1,139,099	1,245,073	1,345,596	1,373,189	1,285,768	1,373,189
1–4 family residential mortgages	546,808	570,190	620,676	668,741	663,159	643,974	663,159
Home equity loans	79,182	85,302	98,166	96,649	91,756	97,244	91,756
Multifamily residential mortgages	35,788	38,163	41,233	42,727	47,307	42,085	47,307
Commercial RE loans	298,533	315,989	341,523	371,022	391,134	349,237	391,134
Construction RE loans	68,696	76,407	88,246	106,727	118,124	95,721	118,124
Farmland loans	23,907	24,964	27,072	29,095	30,603	28,418	30,603
RE loans from foreign offices	27,202	28,083	28,157	30,635	31,105	29,090	31,105
Commercial and industrial loans	661,417	709,604	795,005	898,730	936,064	849,451	936,064
Loans to individuals	535,348	562,291	561,352	570,948	534,399	547,705	534,399
Credit cards	216,016	231,664	231,118	228,834	192,872	216,864	192,872
Installment loans	319,332	330,627	330,233	342,115	341,527	330,841	341,527
All other loans and leases	331,934	405,678	373,901	427,258	468,329	413,167	468,329
Less: Unearned income	5,853	5,309	4,470	4,034	3,552	4,243	3,552

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

Key indicators, FDIC-insured commercial banks by asset size
Second quarter 1998 and second quarter 1999

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2
Number of institutions reporting	5,646	5,303	2,964	2,978	310	317	64	77
Total employees (FTEs)	123,004	113,567	313,518	305,769	306,632	286,894	850,764	916,945
Selected income data ($)								
Net income	$789	$661	$2,497	$2,409	$3,239	$3,625	$9,583	$10,267
Net interest income	2,726	2,498	7,731	7,669	9,655	8,909	25,401	28,703
Provision for loan losses	140	146	480	564	1,550	1,185	2,927	3,031
Noninterest income	877	767	2,844	2,994	6,309	6,987	20,395	23,766
Noninterest expense	2,376	2,220	6,455	6,650	9,417	9,153	28,126	32,788
Net operating income	784	660	2,473	2,398	3,194	3,610	9,289	10,242
Cash dividends declared	416	346	1,155	1,503	2,255	1,907	3,697	9,897
Net charge-offs to loan and lease reserve	91	87	387	378	1,550	1,013	2,747	3,098
Selected condition data ($)								
Total assets	259,068	247,002	734,109	736,505	927,706	872,539	3,260,657	3,611,699
Total loans and leases	153,817	146,521	449,158	459,188	605,524	552,989	1,883,351	2,149,731
Reserve for losses	2,228	2,117	6,756	6,796	12,929	11,012	34,470	37,666
Securities	69,396	68,207	193,107	196,139	186,063	203,297	445,417	539,468
Other real estate owned	321	261	789	720	588	458	1,832	1,476
Noncurrent loans and leases	1,658	1,577	3,948	3,768	6,191	4,932	17,266	20,881
Total deposits	221,681	210,833	606,007	602,366	627,253	596,709	2,051,684	2,270,910
Domestic deposits	221,611	210,824	603,988	600,344	610,816	584,578	1,521,173	1,690,962
Equity capital	28,468	26,744	71,292	69,379	90,567	83,250	255,511	286,813
Off-balance-sheet derivatives	873	241	9,957	8,721	133,689	93,432	28,692,855	33,397,720
Performance ratios (annualized %)								
Return on equity	11.19	9.86	14.18	13.87	14.66	17.47	15.26	14.22
Return on assets	1.23	1.08	1.37	1.32	1.41	1.68	1.18	1.14
Net interest income to assets	4.24	4.08	4.25	4.21	4.22	4.14	3.13	3.18
Loss provision to assets	0.22	0.24	0.26	0.31	0.68	0.55	0.36	0.34
Net operating income to assets	1.22	1.08	1.36	1.32	1.39	1.68	1.14	1.14
Noninterest income to assets	1.37	1.25	1.56	1.64	2.75	3.25	2.51	2.64
Noninterest expense to assets	3.70	3.63	3.55	3.65	4.11	4.25	3.46	3.64
Loss provision to loans and leases	0.37	0.41	0.43	0.50	1.04	0.86	0.63	0.57
Net charge-offs to loans and leases	0.24	0.24	0.35	0.34	1.04	0.74	0.59	0.58
Loss provision to net charge-offs	155.12	167.88	124.18	148.39	99.79	116.92	102.97	97.89
Performance ratios (%)								
Percent of institutions unprofitable	6.62	9.56	1.89	2.18	4.52	1.26	0.00	1.30
Percent of institutions with earnings gains	54.39	50.63	67.31	65.41	69.03	73.19	81.25	77.92
Noninterest income to net operating revenue	24.35	23.48	26.89	28.08	39.52	43.95	44.53	45.29
Noninterest expense to net operating revenue	65.94	67.99	61.04	62.36	58.99	57.58	61.42	62.49
Condition ratios (%)								
Nonperforming assets to assets	0.77	0.74	0.65	0.61	0.73	0.62	0.62	0.65
Noncurrent loans to loans	1.08	1.08	0.88	0.82	1.02	0.89	0.92	0.97
Loss reserve to noncurrent loans	134.38	134.26	171.11	180.38	208.85	223.29	199.64	180.39
Loss reserve to loans	1.45	1.44	1.50	1.48	2.14	1.99	1.83	1.75
Equity capital to assets	10.99	10.83	9.71	9.42	9.76	9.54	7.84	7.94
Leverage ratio	10.78	10.84	9.28	9.24	8.63	8.73	6.73	6.99
Risk-based capital ratio	17.98	17.86	15.09	14.68	13.33	13.38	11.28	11.47
Net loans and leases to assets	58.51	58.46	60.26	61.42	63.88	62.11	56.70	58.48
Securities to assets	26.79	27.61	26.31	26.63	20.06	23.30	13.66	14.94
Appreciation in securities (% of par)	0.69	–1.03	0.93	–0.99	0.88	–1.24	1.34	–1.29
Residential mortgage assets to assets	21.29	21.08	24.38	24.32	24.25	26.81	17.72	17.83
Total deposits to assets	85.57	85.36	82.55	81.79	67.61	68.39	62.92	62.88
Core deposits to assets	74.48	73.92	71.27	70.15	56.62	57.14	40.41	40.45
Volatile liabilities to assets	12.50	13.04	15.92	16.74	26.34	25.93	39.11	39.40

Loan performance, FDIC-insured commercial banks by asset size
Second quarter 1998 and second quarter 1999
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2	1998Q2	1999Q2
Percent of loans past due 30–89 days								
Total loans and leases	1.57	1.44	1.27	1.18	1.47	1.26	0.99	1.05
Loans secured by real estate (RE)	1.34	1.23	1.05	0.93	1.07	0.92	1.13	1.06
1–4 family residential mortgages	1.67	1.58	1.26	1.15	1.12	1.07	1.35	1.12
Home equity loans	1.05	0.84	0.91	0.69	0.87	0.83	0.77	0.74
Multifamily residential mortgages	0.69	0.76	0.65	0.60	0.85	0.58	0.84	0.57
Commercial RE loans	1.04	0.86	0.81	0.72	0.98	0.77	0.74	0.99
Construction RE loans	1.21	1.08	1.20	0.98	1.44	0.92	1.32	1.32
Commercial and industrial loans*	1.60	1.46	1.43	1.36	1.30	1.21	0.51	0.72
Loans to individuals	2.32	2.21	1.95	1.99	2.32	2.15	2.26	2.23
Credit cards	3.24	2.73	2.90	3.34	2.47	2.61	2.49	2.29
Installment loans	2.27	2.19	1.79	1.71	2.15	1.77	2.10	2.19
All other loans and leases					1.15	1.08	0.48	0.59
Percent of loans noncurrent								
Total loans and leases	1.08	1.08	0.88	0.82	1.02	0.89	0.92	0.97
Loans secured by real estate (RE)	0.91	0.87	0.75	0.66	0.89	0.77	1.07	0.95
1–4 family residential mortgages	0.80	0.78	0.70	0.66	0.77	0.80	0.99	0.83
Home equity loans	0.57	0.46	0.36	0.38	0.48	0.41	0.41	0.33
Multifamily residential mortgages	0.62	0.72	0.73	0.55	0.82	0.54	0.93	0.82
Commercial RE loans	0.96	0.83	0.83	0.67	1.16	0.81	1.26	1.12
Construction RE loans	0.79	0.61	0.79	0.61	0.91	0.75	1.20	1.01
Commercial and industrial loans*	1.46	1.58	1.27	1.24	0.91	1.03	0.81	1.02
Loans to individuals	0.89	0.82	0.76	0.81	1.45	1.12	1.54	1.54
Credit cards	1.92	1.76	1.85	2.18	1.90	1.82	2.10	1.87
Installment loans	0.84	0.78	0.57	0.53	0.93	0.54	1.16	1.34
All other loans and leases					0.48	0.59	0.25	0.43
Percent of loans charged-off, net								
Total loans and leases	0.24	0.24	0.35	0.34	1.04	0.74	0.59	0.58
Loans secured by real estate (RE)	0.04	0.04	0.05	0.04	0.05	0.08	0.02	0.07
1–4 family residential mortgages	0.05	0.02	0.06	0.06	0.06	0.11	0.06	0.10
Home equity loans	0.02	0.04	0.07	0.05	0.16	0.19	0.15	0.17
Multifamily residential mortgages	0.04	–0.01	0.13	0.01	–0.05	0.06	0.07	–0.02
Commercial RE loans	0.04	0.03	0.02	0.03	0.03	0.01	–0.14	0.01
Construction RE loans	0.05	0.25	0.04	0.03	0.01	0.08	–0.06	0.02
Commercial and industrial loans*	0.38	0.42	0.48	0.47	0.29	0.46	0.32	0.56
Loans to individuals	0.72	0.68	1.38	1.41	3.39	2.68	2.78	2.14
Credit cards	3.81	2.80	5.42	5.41	5.63	4.75	5.27	3.96
Installment loans	0.56	0.59	0.62	0.58	0.90	0.86	1.13	0.96
All other loans and leases					0.30	0.28	0.27	0.19
Loans outstanding ($)								
Total loans and leases	$153,817	$146,521	$449,158	$459,188	$605,524	$552,989	$1,883,351	$2,149,731
Loans secured by real estate (RE)	85,486	82,390	277,642	286,905	272,873	280,428	649,767	723,466
1–4 family residential mortgages	41,837	38,691	124,043	122,428	133,143	130,845	344,950	371,195
Home equity loans	1,973	1,830	12,906	12,040	19,774	17,561	62,590	60,324
Multifamily residential mortgages	1,835	1,743	9,196	9,517	11,454	11,032	19,600	25,013
Commercial RE loans	23,056	22,982	95,571	102,900	81,141	89,460	149,469	175,793
Construction RE loans	5,992	6,339	25,074	27,982	23,594	27,998	41,061	55,806
Farmland loans	10,784	10,805	10,816	11,978	3,450	3,172	3,368	4,647
RE loans from foreign offices	10	0	37	59	315	360	28,728	30,687
Commercial and industrial loans	25,722	25,085	81,432	83,373	125,993	118,073	616,304	709,533
Loans to individuals	22,486	20,677	65,531	63,941	166,825	119,731	292,863	330,050
Credit cards	1,057	823	9,365	10,721	88,742	54,880	117,700	126,448
Installment loans	21,429	19,854	56,167	53,221	78,083	64,851	175,163	203,602
All other loans and leases	20,690	18,759	25,702	25,888	40,597	35,257	326,179	388,425
Less: Unearned income	567	390	1,149	920	764	500	1,762	1,743

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

Key indicators, FDIC-insured commercial banks by region
Second quarter 1999
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	685	1,439	1,880	2,243	1,485	943	8,675
Total employees (FTEs)	478,100	397,377	287,399	127,229	117,618	215,452	1,623,175
Selected income data ($)							
Net income	$4,683	$3,955	$2,853	$1,519	$986	$2,966	$16,962
Net interest income	14,330	11,040	7,744	3,875	2,955	7,837	47,780
Provision for loan losses	1,830	1,147	584	486	167	712	4,926
Noninterest income	14,969	6,851	4,370	2,317	1,151	4,855	34,513
Noninterest expense	19,551	10,629	7,347	3,450	2,530	7,304	50,811
Net operating income	4,736	3,916	2,829	1,512	977	2,941	16,910
Cash dividends declared	4,703	4,241	1,515	1,058	420	1,717	13,653
Net charge-offs to loan and lease reserve	1,782	869	460	451	174	842	4,577
Selected condition data ($)							
Total assets	1,909,654	1,233,130	901,706	374,643	304,264	744,349	5,467,745
Total loans and leases	1,005,781	777,778	598,011	250,934	171,891	504,035	3,308,430
Reserve for losses	19,891	11,438	8,611	4,319	2,324	11,008	57,591
Securities	317,463	259,121	174,167	73,416	87,017	95,927	1,007,111
Other real estate owned	840	737	362	195	251	530	2,915
Noncurrent loans and leases	12,166	6,288	4,810	2,104	1,748	4,041	31,157
Total deposits	1,205,759	801,217	617,461	271,780	244,830	539,771	3,680,818
Domestic deposits	771,767	764,496	569,998	262,619	242,598	475,230	3,086,707
Equity capital	149,500	109,680	75,379	32,688	26,532	72,408	466,187
Off-balance-sheet derivatives	25,946,572	3,602,233	1,405,748	42,073	31,097	1,975,862	33,003,585
Performance ratios (annualized %)							
Return on equity	12.43	14.26	15.19	18.51	14.85	16.48	14.49
Return on assets	0.98	1.29	1.28	1.63	1.31	1.60	1.25
Net interest income to assets	3.00	3.61	3.49	4.17	3.91	4.22	3.51
Loss provision to assets	0.38	0.37	0.26	0.52	0.22	0.38	0.36
Net operating income to assets	0.99	1.28	1.27	1.63	1.29	1.58	1.24
Noninterest income to assets	3.13	2.24	1.97	2.49	1.52	2.62	2.54
Noninterest expense to assets	4.09	3.47	3.31	3.71	3.35	3.93	3.74
Loss provision to loans and leases	0.73	0.59	0.40	0.78	0.39	0.57	0.60
Net charge-offs to loans and leases	0.71	0.45	0.31	0.73	0.41	0.67	0.56
Loss provision to net charge-offs	102.76	131.89	126.99	107.69	96.13	84.63	107.63
Performance ratios (%)							
Percent of institutions unprofitable	9.20	10.22	4.79	3.88	5.99	10.71	6.65
Percent of institutions with earnings gains	65.26	60.95	58.56	51.23	53.40	59.17	56.77
Noninterest income to net operating revenue	51.09	38.29	36.07	37.42	28.03	38.25	41.94
Noninterest expense to net operating revenue	66.73	59.41	60.65	55.72	61.63	57.55	61.74
Condition ratios (%)							
Nonperforming assets to assets	0.73	0.57	0.58	0.61	0.66	0.62	0.64
Noncurrent loans to loans	1.21	0.81	0.80	0.84	1.02	0.80	0.94
Loss reserve to noncurrent loans	163.50	181.90	179.03	205.25	132.97	272.40	184.84
Loss reserve to loans	1.98	1.47	1.44	1.72	1.35	2.18	1.74
Equity capital to assets	7.83	8.89	8.36	8.73	8.72	9.73	8.53
Leverage ratio	7.29	7.73	7.91	8.34	8.20	8.27	7.74
Risk-based capital ratio	12.42	11.86	12.07	13.04	13.89	12.58	12.37
Net loans and leases to assets	51.63	62.15	65.37	65.83	55.73	66.24	59.45
Securities to assets	16.62	21.01	19.32	19.60	28.60	12.89	18.42
Appreciation in securities (% of par)	–1.29	–1.16	–1.06	–1.07	–1.38	–1.24	–1.20
Residential mortgage assets to assets	16.71	27.34	21.56	20.12	23.21	15.10	20.28
Total deposits to assets	63.14	64.97	68.48	72.54	80.47	72.52	67.32
Core deposits to assets	32.80	54.45	55.34	63.32	68.58	55.91	48.63
Volatile liabilities to assets	44.92	28.43	28.40	20.85	19.70	27.16	33.01

Loan performance, FDIC-insured commercial banks by region
Second quarter 1999
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30–89 days							
Total loans and leases	1.09	1.04	1.29	1.38	1.31	0.88	1.12
Loans secured by real estate (RE)	1.11	0.91	1.13	1.13	1.08	0.81	1.02
1–4 family residential mortgages	1.27	0.90	1.23	1.30	1.30	1.17	1.14
Home equity loans	0.73	0.72	0.86	0.79	0.55	0.70	0.75
Multifamily residential mortgages	0.46	0.48	0.85	0.77	0.81	0.48	0.58
Commercial RE loans	0.81	1.00	1.01	0.75	0.86	0.56	0.86
Construction RE loans	1.05	0.94	1.49	1.78	1.12	0.84	1.13
Commercial and industrial loans*	0.62	0.79	1.32	1.61	1.57	0.79	0.92
Loans to individuals	2.44	2.37	1.98	2.16	1.57	1.80	2.18
Credit cards	2.80	2.52	1.96	2.59	1.37	1.80	2.44
Installment loans	2.12	2.32	1.98	1.79	1.58	1.80	2.03
All other loans and leases	0.54	0.36	1.07	0.65	1.17	0.36	0.60
Percent of loans noncurrent							
Total loans and leases	1.21	0.81	0.80	0.84	1.02	0.80	0.94
Loans secured by real estate (RE)	1.10	0.78	0.80	0.65	0.96	0.69	0.85
1–4 family residential mortgages	0.92	0.67	0.86	0.57	0.81	0.82	0.79
Home equity loans	0.47	0.31	0.38	0.28	0.29	0.28	0.36
Multifamily residential mortgages	0.76	0.86	0.70	0.30	0.63	0.57	0.70
Commercial RE loans	1.14	1.00	0.82	0.59	1.23	0.66	0.91
Construction RE loans	1.03	0.90	0.78	0.74	0.60	0.78	0.83
Commercial and industrial loans*	1.19	0.90	1.02	1.21	1.60	1.13	1.11
Loans to individuals	2.23	0.95	0.70	1.07	0.47	0.98	1.33
Credit cards	2.40	1.41	1.31	1.66	0.71	1.44	1.87
Installment loans	2.08	0.81	0.59	0.56	0.46	0.40	1.03
All other loans and leases	0.40	0.49	0.45	0.49	0.69	0.35	0.43
Percent of loans charged-off, net							
Total loans and leases	0.71	0.45	0.31	0.73	0.41	0.67	0.56
Loans secured by real estate (RE)	0.06	0.09	0.05	0.08	0.09	0.03	0.06
1–4 family residential mortgages	0.09	0.09	0.05	0.15	0.04	0.14	0.09
Home equity loans	0.12	0.23	0.22	0.13	0.58	–0.01	0.16
Multifamily residential mortgages	0.08	–0.04	0.02	0.05	–0.09	–0.04	0.01
Commercial RE loans	–0.01	0.08	–0.01	0.01	0.16	–0.08	0.02
Construction RE loans	0.01	0.01	0.10	0.03	0.08	0.08	0.05
Commercial and industrial loans*	0.59	0.52	0.35	0.40	0.71	0.77	0.55
Loans to individuals	2.70	1.64	1.12	2.76	0.85	2.55	2.12
Credit cards	4.21	4.13	3.18	5.13	2.53	4.35	4.25
Installment loans	1.31	0.84	0.70	0.76	0.78	0.19	0.86
All other loans and leases	0.04	0.36	0.28	0.43	0.19	0.15	0.18
Loans outstanding ($)							
Total loans and leases	$1,005,781	$777,778	$598,011	$250,934	$171,891	$504,035	$3,308,430
Loans secured by real estate (RE)	327,188	394,437	268,398	110,960	79,076	193,131	1,373,189
1–4 family residential mortgages	180,907	205,684	123,525	52,063	32,784	68,196	663,159
Home equity loans	21,377	23,987	23,135	5,068	1,152	17,036	91,756
Multifamily residential mortgages	12,517	10,547	9,455	3,276	2,544	8,968	47,307
Commercial RE loans	71,339	107,588	81,861	30,257	29,202	70,888	391,134
Construction RE loans	13,070	40,772	22,813	10,390	10,059	21,021	118,124
Farmland loans	1,136	5,656	7,575	9,906	3,335	2,995	30,603
RE loans from foreign offices	26,842	203	33	0	0	4,027	31,105
Commercial and industrial loans	320,543	198,845	172,084	57,916	45,460	141,216	936,064
Loans to individuals	180,862	111,462	79,845	48,761	32,381	81,088	534,399
Credit cards	85,018	27,120	11,918	22,327	1,299	45,190	192,872
Installment loans	95,844	84,342	67,927	26,434	31,082	35,898	341,527
All other loans and leases	178,731	73,730	78,033	33,360	15,359	89,116	468,329
Less: Unearned income	1,544	696	347	62	385	517	3,552

*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.

Recent Corporate Decisions

The OCC publishes monthly, in its publication *Interpretations and Actions*, corporate decisions that represent a new or changed policy, or present issues of general interest to the public or the banking industry. In addition, summaries of selected corporate decisions appear in each issue of the *Quarterly Journal*. In the second quarter of 1999, the following corporate decisions were of particular importance because they were precedent-setting or otherwise represented issues of importance. If the summary includes a decision or approval number, the OCC's decision document may be found in *Interpretations and Actions*. For decisions that have not been published yet, the summary includes the application control number, which should be referenced in inquiries to the OCC regarding the decision.

Charter

On May 8, 1999, the OCC granted preliminary conditional approval to NextCard, Inc., San Francisco, California, to charter a credit card national bank titled NextBank, National Association, San Francisco, California. The bank's activities will be limited to those specified in the Competitive Equality Bank Act of 1987, as amended. This is the second charter proposal approved by the OCC for a national bank that will deliver products and services to customers primarily through the Internet and other electronic means. Approval was granted subject to certain pre-opening requirements and ongoing conditions addressing capital, funding, technology, and Internet security matters. [Conditional Approval No. 312]

Conversion

On April 29, 1999, the OCC granted approval to Local Financial Corporation to charter Local Oklahoma Bank, National Association, Oklahoma City, Oklahoma, and to merge Local Oklahoma Bank, Federal Savings Bank, Oklahoma City, Oklahoma, into the newly chartered bank. The resulting national bank will retain and operate as branches the branches of the federal savings bank. [Corporate Decision No. 99–11]

Change in Bank Control

On June 28, 1999, the OCC granted no objection to the change in control notification filed by Thomas H. Lee Equity Fund IV, L.P., et al., to make a 29 percent investment in Metris Companies, Inc., St. Louis Park, Minnesota. Metris is the parent of Direct Merchants Credit Card Bank, National Association, Phoenix, Arizona. The notificants will acquire control by converting nonvoting preferred stock, senior notes, and warrants into voting preferred stock. [Corporate Decision No. 99–15]

Operating Subsidiary

On April 12, 1999, the OCC granted conditional approval for First Tennessee, National Association, Memphis, Tennessee, to establish an operating subsidiary to underwrite and deal in municipal revenue bonds, under authority of 12 CFR 5.34(f). The decision was similar to the OCC's three prior decisions involving municipal revenue bonds. (Conditional Approval No. 262, December 11, 1997; Corporate Decision No. 98–48, October 20, 1998; and, Conditional Approval No. 297, December 9, 1998). [Conditional Approval No. 309]

Community Reinvestment Act Decisions

On May 5, 1999, the OCC granted approval for a series of transactions that resulted in the merger of National City Trust Company, West Palm Beach, Florida, with National City Bank, Cleveland, Ohio, an affiliated bank. In approving the transactions, the OCC did not opine on the appropriateness of the bank's proposed delineations of the CRA assessment areas for West Palm Beach and Naples, Florida. The OCC noted that it will review those delineations at the next CRA examination. The OCC also noted that it will evaluate the performance of National City's Florida operations as part of the lending, investment, and service tests. While National City as a whole is a full-service bank that includes extensive retail operations, its business strategy in Florida will be one of several factors the OCC will take into account in determining the performance context when evaluating National City's CRA performance, consistent with applicable regulatory provisions. The OCC did not receive any public comments on these transactions. [CRA Decision No. 93]

On May 20, 1999, the OCC granted approval for Bank of American National Trust and Savings Association, San Francisco, California, to merge with NationsBank, National Association, Charlotte, North Carolina. While the OCC did not receive any direct protests on the application, the OCC investigated the concerns received by the Federal Reserve Board in connection with the

holding company merger application. The OCC's investigation and analysis of the issues raised indicated no basis for denying or conditionally approving the application. The OCC's decision document addresses the issues. The OCC's decision document also notes that the bank has represented that it will provide public reports on its progress in meeting the goals of its 10-year, $350 billion commitment to community development lending and investment. The progress reports will be prepared on national, state, and local bases. [CRA Decision No. 94]

On May 24, 1999, the OCC granted approval for NBD Bank, National Association, Indianapolis, Indiana, and NBD Bank, Elkhart, Indiana, to merge with Bank One, Indiana, National Association, Indianapolis, Indiana, an affiliated bank. A community-based organization expressed concerns regarding branching hours and acceptance of utility payments. The OCC investigated the concerns and found no basis for denying or conditionally approving the application. The OCC's decision document addresses the concerns. [CRA Decision No. 95]

On June 30, 1999, the OCC granted approval for US Bank, National Association, Minneapolis, Minnesota, to merge with Bank of Commerce, San Diego, California, an affiliated bank. The OCC received several protests regarding US Bank's CRA record of performance in California. The OCC's investigation and analysis of the issues raised indicated no basis for denying or conditionally approving the application. The OCC's decision document addresses the issues. [CRA Decision No. 96]

Special Supervision/Fraud and Enforcement Activities

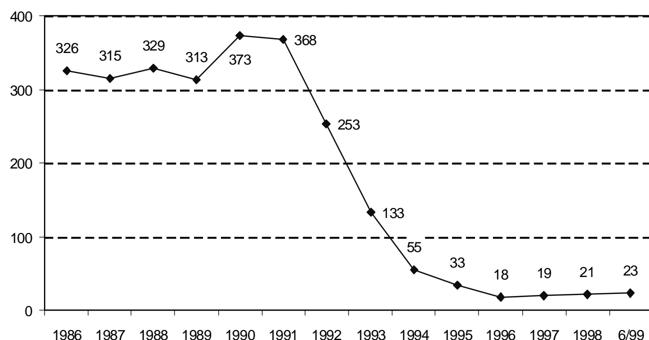
The Special Supervision/Fraud Division of the Bank Supervision Operations Department supervises the resolution of critical problem banks through rehabilitation or orderly failure management, monitors the supervision of delegated problem banks, coordinates fraud/white collar crime examinations, provides training, disseminates information, and supports OCC supervisory objectives as an advisor and liaison to OCC management and field staff on emerging problem bank and fraud/white collar crime related issues. Fraud experts are located in each district office, in the large bank division, and in OCC's Washington office.

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

Problem National Banks and National Bank Failures

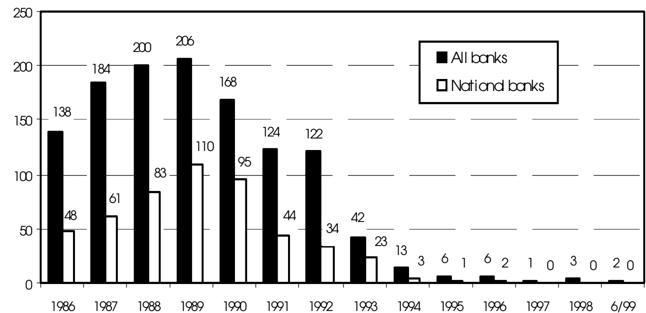
Although the number of problem banks is relatively stable, a slight increase in problem banks is now evident. Even so, problem banks represented less than 1 percent of the national bank population at June 30, 1999. The number of problem banks or those rated CAMELS 4 or 5 totals 23 at June 30, 1999. (The CAMELS rating is the composite rating based on capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.) This low volume of problem banks reflects the stable economy and generally favorable economic conditions. There were no national bank failures during the first six months of 1999, although two commercial banks failed.

Figure 1—Problem national bank historical trend line



Source: Special Supervision.

Figure 2—Bank failures



Source: OCC Supervisory Monitoring System (SMS) data. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.

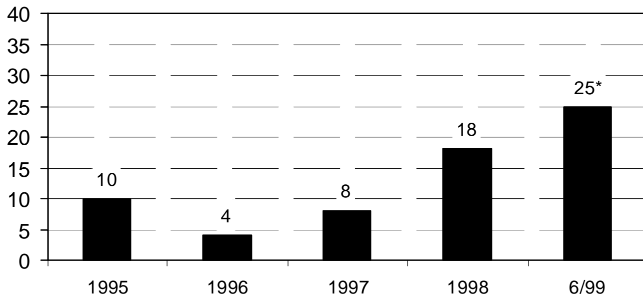
Enforcement Actions

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

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

In the first half of 1999, the OCC continued to take a substantial number of enforcement actions against institutions under its supervision. Many of these actions were designed to ensure that national banks and service providers properly prepare their computer systems for the year-2000 conversion. The charts indicate how many of the enforcement actions for the first half of 1999 were for year-2000 problems.

Figure 3—Commitment letters

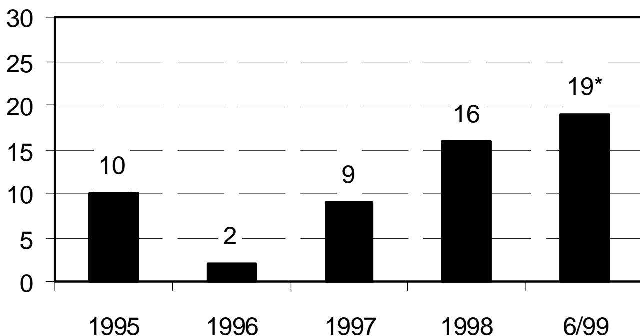


Source: OCC Supervisory Monitoring System (SMS) data. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.

* 10 of which are for year-2000 problems

In addition to traditional informal actions, the OCC also issued supervisory directives to national banks with material deficiencies in their preparation for the year-2000 conversion of their deficiencies. Supervisory directives summarize the deficiencies and the OCC's expectations of how the banks need to address them. The OCC issued 43 supervisory directives for year-2000 problems in the first half of 1999, down from a total of 330 for 1998.

Figure 4—Memorandums of understanding

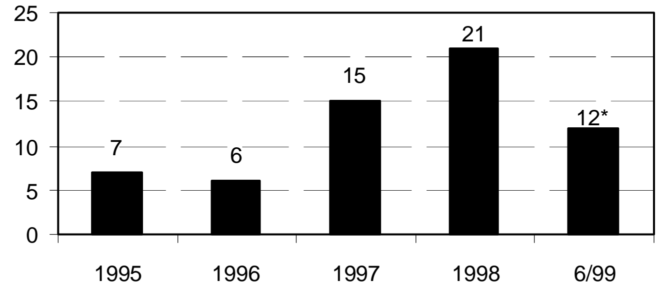


Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.

* 13 of which are for year-2000 problems

The most common types of formal enforcement actions issued by the OCC against banks over the past several years have been formal agreements and cease-and-desist orders. Formal agreements are documents signed by a national bank's board of directors and the OCC in which specific corrective and remedial measures are enumerated as necessary to return the bank to a safe and sound condition. Cease-and-desist orders (C&Ds), sometimes issued as consent orders, are similar in content to formal agreements but are public documents which may be enforced either through assessment of civil money penalties (CMPs) or by an action for injunctive relief in federal district court. The OCC issued one CMP against a national bank in the first half of 1999.

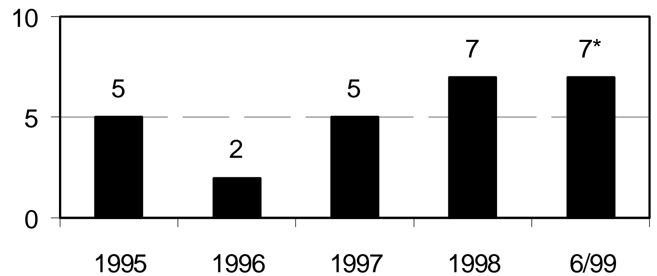
Figure 5—Formal agreements



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

* 8 of which are for year-2000 problems

Figure 6—Cease-and-desist orders against banks

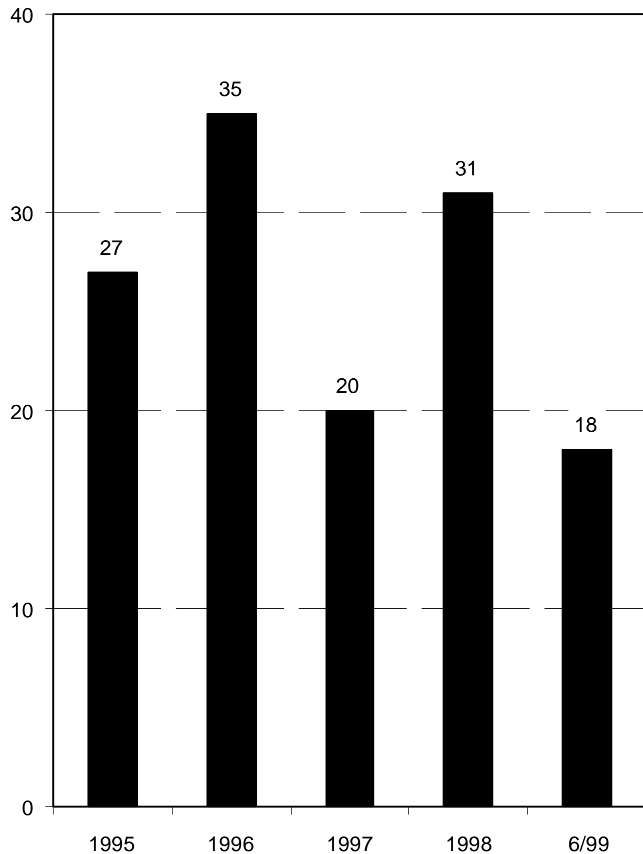


Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.

* None of which is for year-2000 problems

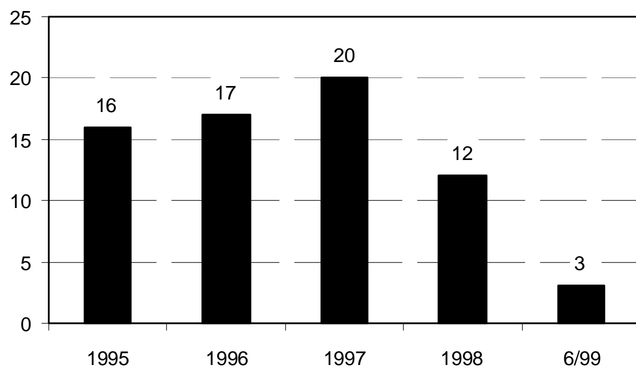
The OCC also continued to rely on the safety and soundness order process in its year-2000 enforcement efforts. In the first half of 1998, the OCC issued 59 notices of deficiency, which notified the affected banks that they needed to submit a plan for bringing their computer systems into compliance or possibly face a safety and soundness order requiring them to do so. During the first half of 1999, 60 national banks submitted acceptable safety and soundness plans (some of these banks received notices of deficiency in 1998). The OCC issued one safety and soundness order in the first half of 1999 for year-2000 problems.

Figure 7—Civil money penalties against individuals



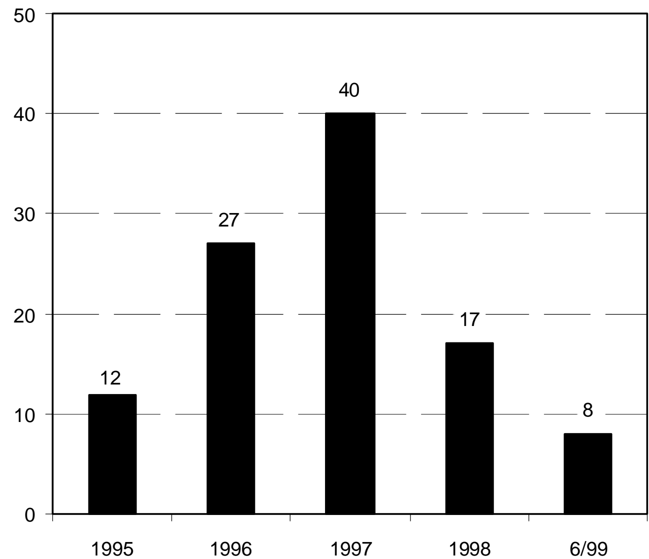
Source: SMS. Note that SMS totals for previous years' completed enforcement actions may be adjusted to reflect revised aggregates.

Figure 8—Cease-and-desist orders against individuals



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

Figure 9—Removal and prohibition orders



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

The most common enforcement actions against individuals are CMPs, personal C&Ds, and removal and prohibition orders. CMPs are authorized for violations of laws, rules, regulations, formal written agreements, final orders, conditions imposed in writing, and under certain circumstances, unsafe or unsound banking practices and breaches of fiduciary duty. Personal C&Ds may be used to restrict individuals' activities and to order payment of restitution. Removal and prohibition actions, which are used in the most serious cases, result in lifetime bans from the banking industry.

In the first half of 1999, the OCC joined with other banking regulators in taking enforcement actions against service providers. These actions are described in the next section.

Recent Enforcement Cases

Appellate Decision Regarding OCC Enforcement Actions

The U.S. Court of Appeals for the Ninth Circuit affirmed the OCC's enforcement actions against Edward Towe and Thomas Towe, president and chairman of the Board, respectively, of the First National Bank & Trust in Wibaux, Montana. The Towes were involved in numerous transactions over several years that resulted in losses to the bank and profits to the Towes. The OCC sought prohibitions from the banking industry and civil money penalties of $10,000 and $25,000. After an administrative hearing, the administrative law judge recommended the prohibitions and civil money penalties. The OCC subsequently

imposed the civil money penalties and the Federal Reserve Board ordered the Towes prohibited from the banking industry. The Towes raised several arguments on appeal, contesting the fairness of various aspects of the OCC's examination and administrative hearing. The Ninth Circuit rejected the Towes' every argument and upheld the OCC actions. Subsequently, a state in which Thomas Towe was licensed as an attorney began disciplinary proceedings based on the misconduct identified by the OCC at the national bank. The disciplinary proceedings have not been concluded.

Consent Orders

In March 1999, the former president and the former executive vice president of a community bank in California each consented to prohibitions from the banking industry and to restitution orders totaling $225,000 and $70,000, respectively. While at the bank, the two former officers originated several loans to a network of start-up companies in order to facilitate the attempted acquisition of the bank by the network's principals. The loans violated the bank's legal lending limits and resulted in approximately $1 million in losses to the bank, bringing the bank to the verge of insolvency. After recognizing these losses, the president approved additional overdrafts to some of these same start-up companies, resulting in further loss to the bank of approximately $184,000.

A former institution-affiliated party (IAP) consented to a prohibition from banking in a joint action of the OCC and the Federal Reserve Board, in January 1999. The agencies alleged that the IAP had omitted material facts in regulatory filings connected with his acquisition of control of more than 25 percent of the outstanding voting shares of a national bank.

A former officer of a national bank stipulated to a prohibition order, a civil money penalty of $75,000, and restitution of $170,000 (in accordance with a plea agreement). The OCC alleged that he (1) improperly caused the bank to fund expenses for the benefit of himself and other individuals from the bank's general ledger accounts, (2) received payments improperly funded by the bank's general ledger accounts, (3) caused the bank to significantly exceed its legal lending limit to two borrowers, and (4) caused the bank to lease a branch building from him at inflated amounts.

A former president of a national bank and his wife, a former officer of the bank, stipulated to restitution (in accordance with a plea agreement) estimated to be around $4 million and a civil money penalty that was waived due to their financial condition. The OCC alleged that they (1) engaged in several different schemes to cause the bank to fund expenses for the benefit of themselves and other individuals from the bank's general ledger accounts for expenses and income, (2) caused the bank to extend credit to them in the names of other individuals (i.e., as nominee loans), and (3) caused the bank to extend credit to lease a branch building from a former officer of the bank at inflated amounts.

Formal Agreements with Service Providers

In March 1999, the OCC joined the Federal Reserve, the FDIC, the OTS, and the NCUA and entered into a formal agreement with First Data Corporation. The agreement required First Data to correct year-2000 deficiencies at the Nashville Data Center of its subsidiary, First Data Merchant Services. The agreement required submission of a plan to correct the deficiencies by a date certain, or First Data would have to release its financial institution customers from their contracts with First Data in order to allow the customers to contract with other service providers.

In May 1999, the OCC joined the other federal banking agencies and the State of Washington's Department of Financial Institutions, and entered into a formal agreement with TransAlliance, L.P. TransAlliance is a service provider that offers automated teller machine (ATM) and point of sale (POS) services, card productions, and switching services, among other services. Similar to the First Data agreement, TransAlliance committed to correct its year-2000 deficiencies by a date certain or face the requirement of releasing its financial institution customers from their contracts with TransAlliance.

In June 1999, the OCC joined the FDIC and entered into a formal agreement with Management Information Resources, Inc. (MIR). In the agreement, MIR committed to submit and comply with a profitability and capital plan to correct its financial weakness and resulting instability. In the event MIR cannot meet its financial projections and improve its financial strength to reasonable levels, the agreement will require it to release its financial institution customers from their contracts with MIR.

Fast Track Enforcement Cases

The OCC continued its Fast Track Enforcement Program, initiated in 1996, which ensures that bank insiders who have engaged in criminal acts in banks, but who are not being criminally prosecuted, are prohibited from working in the banking industry. As part of the Fast Track Enforcement Program, in the first half of 1999, Enforcement and Compliance secured six consent prohibition orders against institution-affiliated parties. Some of these orders also incorporated restitution payments to the appropriate banks for losses incurred. In addition, Enforcement and Compliance sent out 37 notifications to former bank employees who were convicted of crimes, informing them that federal law prohibits them from working again in a federally insured depository institution.

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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, thank you for the opportunity to appear before you today to report on the progress national banks are making to address the problems associated with the century date change and to discuss pending year-2000 legislation.

For the past two years, the Office of the Comptroller of the Currency (OCC), together with its Federal Financial Institutions Examination Council (FFIEC) counterparts, has been aggressively engaged in a comprehensive program to address the challenges presented by the coming year-2000 date change. Let me say at the outset of my statement that the vast majority of national banks and their service providers have made excellent progress toward completing their testing and implementing year-2000-compliant systems.

However, in our previous reports to Congress, we also noted that year-2000 preparedness is a dynamic process and that the ratings assigned to individual banks at one stage of the process could change, particularly as that process moves into the testing phase. Indeed, since our most recent quarterly report to Congress, a number of national banks have experienced some delay in meeting some of the milestone dates set out in the FFIEC's guidance, and we anticipate that a small number of national banks may not be able to meet the June 30, 1999, target. The testing process has proven to be more complex, time-consuming, and costly than many banks anticipated. I want to make it clear that most problems encountered during the testing phase have not proven to be serious, and for the most part they have been quickly solved. It is also important to remember that while the June 30, 1999, target is an important one, the FFIEC chose this date to ensure that there would still be sufficient time remaining in the year to deal with problems coming out of the testing phase. For any banks or service providers that are unable to meet FFIEC year-2000 milestone dates, we stand well prepared to take any and all necessary steps to deal with their deficiencies.

In my responses to the questions raised in your invitation letter, I have attempted to give you an accurate picture of the OCC's comprehensive approach to the challenges presented by year 2000. Together with our FFIEC counterparts, we have:

- Developed and disseminated detailed policy guidance to our supervised institutions;
- Trained and deployed our examiners to conduct three or more on-site examinations of each institution;
- Set up systems to track and monitor progress;
- Established and implemented vigorous enforcement programs to deal with deficiencies;
- Coordinated with other government agencies as well as private enterprises, domestically and internationally, to share valuable year-2000-related information;
- Conducted numerous outreach programs to educate banks and the public; and
- Helped to organize and participated in a series of interagency contingency planning groups to plan for the orderly resolution of problems or issues that may arise either systemically or with individual banks.

This approach to the year-2000 problem has positioned us well to anticipate and deal with problems. Our examination and supervisory processes provide us with extensive information on the preparedness of each national bank. We assign and update ratings quarterly based on the results of our on-site examinations and off-site reviews. In assigning ratings, a bank's compliance with the FFIEC interim milestone dates is a key, but not the sole, factor that examiners consider. Last year we also implemented a quality assurance process to evaluate the overall quality of our year-2000 supervisory efforts. This program, staffed by experienced OCC personnel not otherwise responsible for year-2000 supervisory issues, has provided valuable input to overall management of our year-2000 effort and identified areas where we can further strengthen our year-2000 supervisory program.

We have organized the information we collect into a comprehensive database that serves as a valuable management tool for the OCC. Through application of various queries, we use this database to provide information on the preparedness levels of individual banks as well as the system at large and to check the accuracy of

our ratings. Because our examinations and reviews seldom coincide with quarter-ends, there is a timing difference between when ratings are assigned and the quarter-end-based FFIEC performance targets. To deal with this timing difference, we also compile and maintain a datasheet on each national bank that tracks the bank's progress in meeting various milestones. We use these datasheets to aggressively follow up on those banks that appear to be slipping from the established FFIEC target dates and to decide whether enhanced supervisory or enforcement action is warranted. In cases where a datasheet indicates that a bank has not met a milestone, yet is rated "satisfactory," an exception report is prepared for immediate follow-up by the supervisory office.

Our experience to date has been that a vast majority of those banks have achieved full compliance with FFIEC interim guidelines by the time we review them again. If the bank has not subsequently met the deadline, typically we downgrade the bank's rating. Exceptions to this policy are rare and require senior-level approval. With respect to the final June 30, 1999, FFIEC target, we have instructed examiners that if a national bank has not successfully met this target, the bank should be rated less than satisfactory. Exceptions to this policy will be limited.

In sum, given the large number and complexity of systems involved, as well as a host of external considerations, many of them beyond the control of individual institutions, it would be unrealistic to expect or demand a zero-defect year-2000 outcome. But it is reasonable to expect that we do everything practical to minimize disruption and to anticipate and deal effectively with problems that occur. That is what our program is designed to achieve.

Against this backdrop, Mr. Chairman, I will now address specifically the questions raised in your invitation letter. For ease of reference, I have repeated each of your questions, followed by our response.

Industry Year-2000 Readiness

Q1. In addition to the percentage of "satisfactory" ratings, please provide a report on the number of institutions which met FFIEC standards for remediation and testing, including, to the maximum extent possible, preliminary findings on the number of institutions which met the December 31, 1998, and March 31, 1999, dates for "substantial" completion of testing internally and with outside service providers (note: please clarify what "substantial" means).

Ratings Summary

The FFIEC agencies are now conducting Phase II of their year-2000 work program, which focuses primarily on year-2000 validation (testing) and implementation phases and contingency plans. At the OCC, we are well under way in conducting the second round of Phase II examinations and expect to complete them by July 1999. In cases where we uncovered testing problems, most have been corrected within a short period of time. In general, though, testing is taking longer and costing more than institutions expected last year.

Table 1 shows aggregate ratings information for national bank and federal branch examinations completed through March 31, 1999, compared with the results from the fourth quarter of 1998. The year-2000 ratings of all size classes of national banks and federal branches have slipped some from the fourth quarter, with the largest banks showing the most difference. This decline in the ratings of large banks was not unanticipated, given the complexity of large bank operations and the immense scope of their remediation and testing activities. However, the OCC is closely

Table 1—Preliminary year-2000 summary evaluations, national bank and federal branches, by asset size, 4Q98 vs. 1Q99

Evaluation	Less than $100MM 4Q98/1Q99	$100MM to $500MM 4Q98/1Q99	$500MM to $1B 4Q98/1Q99	Over $1B 4Q98/1Q99	Overall percent 4Q98/1Q99
Satisfactory	98%/97%	98%/97%	98%/98%	92%/98%	97%/96%
Needs Improvement	2%/2%	2%/3%	1%/2%	8%/12%	3%/4%
Unsatisfactory	Less than 1%/1%	Less than 1%/ less than 1%	1%/0%	0%/0%	Less than 1%/ less than 1%

and continuously monitoring their progress through resident examination teams, whose job it is to see that these banks are taking aggressive corrective action. For smaller banks, we are assessing their progress at least quarterly and more frequently when banks fall behind schedule.

The OCC and the other FFIEC agencies also examine hundreds of service providers and software vendors that play an important role in processing data and developing software for banks. The ratings for service providers and software vendors have not changed significantly since the fourth quarter of 1998. Table 2 provides a summary of preliminary first quarter year-2000 evaluations of OCC-supervised service providers and software companies compared with results from the fourth quarter of 1998. We will continue to gather information during examinations to assess the exposure of banks to service providers and software vendors with less than "satisfactory" ratings. We also are assessing the capacity of service providers and software vendors rated "satisfactory" to provide services to an institution that is using a noncompliant provider.

Institutions Meeting Interim FFIEC Dates

Your letter asked that we report on the number of institutions that met the FFIEC dates for "substantial" completion (December 31, 1998, for internal testing, and March 31, 1999, for external testing) You also requested that we clarify what "substantially complete" means. Up to now, neither the OCC nor the FFIEC has defined that term. However, with the approach of the final June 30, 1999, deadline, we have instructed our examiners that "substantially complete" means that a bank has completed all FFIEC-required testing and implementation within two weeks of that deadline.

Our database reflects when internal or external testing of *all* mission-critical systems is complete, rather than just substantially complete. Approximately 75 percent of national banks had fully completed their testing of internally developed mission-critical systems by December 31, 1998. By the end of the first quarter, the number of institutions that had completed testing of *all* internal mission-critical systems had risen to 95 percent. Again, those that have not are being subjected to more intense supervision.

Regarding testing with outside service providers, our preliminary information indicates that approximately 75 percent of national banks were complete as of the March 31, 1999, target date. We will verify the actual completion dates during our second quarter supervisory activities.

Q2. Report on the number of institutions which are currently in noncompliance with at least one FFIEC date and what actions have been taken to ensure those institutions improve compliance with FFIEC standards.

Table 2—Preliminary year-2000 summary evaluations, service providers and software vendors, 4Q98 vs. 1Q99[1]

Summary Evaluation	OCC-supervised MDPS 4Q98/1Q99	OCC-supervised SASRs 4Q98/1Q99	OCC-supervised IDCs 4Q98/1Q99	OCC-supervised institutions serving nonaffiliated institutions 4Q98/1Q99	Total 4Q98/1Q99
Satisfactory	5/5	4/4	33/30	75/71	117/110
Needs Improvement	0/0	0/0	1/1	1/2	2/3
Unsatisfactory	0/0	0/0	0/0	0/0	0/0
Total	5/5	4/4	34/31	76/73	119/113

[1] Under the Multi-regional Data Processing Services (MDPS) and Shared Application and Software Review (SASR) programs, the federal banking agencies jointly examine 12 large nonbank data processing service companies and 16 turnkey software vendors. Lead examination responsibilities are rotated among the FFEIC member agencies. The OCC is the agency in charge for supervising five MDPS and four SASR companies. Examiners from at least two of the member agencies typically participate on examinations. Additionally, the examination responsibilities of approximately 250 smaller regional data processing companies (designated as Independent Data Centers—IDCs) are assigned to specific member agencies. The OCC is responsible for examining 31 IDCs.

Noncompliance with Interim FFIEC Dates

As of March 31, 1999, only 58 banks that missed the year-end 1998 interim target for *internal* mission-critical testing were still in noncompliance. However, we believe that approximately 25 percent of the national banks missed the March 31, 1999, target for completing testing with *outside* service providers. Of those, we expect that the vast majority will come into compliance within the next few weeks, and we are monitoring those banks closely.

Based upon current examination results, we project that relatively few banks will miss the June 30, 1999, target for completing testing and substantially completing the implementation of mission-critical systems. Given the extended time needed to finish testing at some banks and the possibility of unanticipated problems during implementation, that number may grow. It is important to keep in mind that the aggressive testing targets established by the FFIEC contemplated that some institutions would encounter some difficulties and delays and provided a six-month cushion to enable full implementation before the century date change.

Institutions have missed interim target dates for a variety of reasons. These reasons range from scheduling conflicts with their software or service providers to unanticipated staffing problems and unplanned extra testing requirements. Although we are concerned about these exceptions and we are closely monitoring them, most testing problems have not required lengthy repair periods. Most banks remediated deficiencies uncovered during testing quickly because the problems they encountered were not substantive or complex.

Enforcement

National banks that miss interim FFIEC targets are subject to rigorous OCC oversight. The OCC uses a variety of enforcement tools to ensure that year-2000 laggards promptly resolve their problems. The form and severity of the OCC's action are determined by the following:

- An institution's year-2000 rating;
- An institution's 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 prior to the year 2000.

To address year-2000 deficiencies, the OCC has issued or entered into 353 supervisory directives, nine commitment letters, nine memorandums of understanding, eight formal agreements, two consent orders, and one safety and soundness order. We have also initiated the safety and soundness order process against 53 banks.[2] Overall, our enforcement actions have been successful in prompting banks to comply with FFIEC and OCC year-2000 policy, as evidenced by the large number of banks that have subsequently corrected their problems, been upgraded, and had their enforcement action terminated.

Resolution Alternatives

The OCC also is working with the other FFIEC agencies in a number of contingency planning efforts including the development of methods of resolving banks whose viability might be threatened by year-2000 problems. These efforts include analyzing legal and supervisory options that would be appropriate for such banks. The OCC and the other federal banking agencies view a resolution involving a receivership as an option that should be considered only as a last resort, and we expect to see few if any failures caused by year-2000 problems. To ensure that the agencies are prepared to resolve any such banks in an orderly manner, however, we are working to identify issues and options for handling those situations.

Q3. Report on the OCC's methodology for ensuring that "satisfactory" ratings and the exam data on which they are based are accurate and consistent with FFIEC standards.

The effectiveness of the OCC's year-2000 supervisory efforts depends on the accuracy of our ratings system. Earlier last year, the OCC incorporated several management control processes into our year-2000 supervisory approach to ensure that ratings are assigned uniformly and consistently with FFIEC and OCC policy. This oversight includes field-level review of all ratings prior to issuance of examination reports, as well as computer-based analyses that flag banks for which we need to verify their assigned rating.

Our field examiners remain our primary control mechanism in the ratings process. Field examiners have the best understanding of the issues each bank faces. They

[2] The following year-2000 enforcement actions are currently outstanding: 18 supervisory directives, four commitment letters, four memorandums of understanding, four formal agreements, one consent order, and one safety and soundness order. In addition, 31 institutions are operating under approved safety and soundness plans.

are in the best position to evaluate bank management's ability to effect corrective action. Before an assigned rating for an institution is finalized, the examiner-in-charge reviews the findings with the assistant deputy comptroller for accuracy and consistency with policy. If the institution is rated less than "satisfactory," the district or Washington Supervision Review Committee conducts additional review of the rating and prescribes enforcement follow-up.

The OCC has two mechanisms to improve the accuracy of our year-2000 ratings and the integrity of our database. The first mechanism is an OCC database that tracks bank ratings and identifies potential ratings inconsistencies. The second is our formal quality assurance function, which we use to assess the quality and consistency of examinations of banks and service providers.

Our year-2000 database contains the answers our examiners provide each quarter to specific questions on each national bank's year-2000 project plan and compliance with FFIEC guidance. This database serves as a year-2000 management reporting and monitoring tool for the OCC. We have been constantly revising and expanding this database since its inception to address emerging issues and needs. The database enables us to make *ad hoc* inquiries and filter information to best focus our supervisory activities. For example, we use a number of key questions targeted by the Gartner Group and supplemented by OCC experience to create filters that help us to determine if there are any apparent inconsistencies between the database responses and the institution's year-2000 rating.

Our quality assurance process evaluates the overall quality of our year-2000 supervision for all sizes and types of institutions. Since the quality assurance process began in October 1998, the OCC has conducted five reviews: two community bank reviews, two large bank reviews, and one mid-size/credit card bank review. Specifically, the quality assurance reviews focus on the accuracy of our year-2000 ratings, consistency of work papers, appropriateness of follow-up, and the overall quality of our communications. This program, conducted by experienced personnel who are independent of the year-2000 examination process, helps us make our year-2000 supervisory process more effective.

Q4. Please provide any rebuttal the OCC wishes to make to recent reports on a Weiss Ratings, Inc., survey suggesting that about a third of banks and thrifts responding had missed a year 2000 deadline.

In recent months, private ratings firms' reports have reflected a broad range of conclusions about the banking industry's year-2000 preparedness. One rating agency, using an extensive survey methodology, found that the banking industry is well ahead of all other industries in the United States with regard to addressing the year-2000 issue. Another, using a short and limited survey, assigned lower year-2000 performance ratings than the FFIEC to institutions that had not *fully completed* renovation and testing of *all* internal mission-critical systems by December 31, 1998.

We believe that this spectrum of conclusions is inevitable, given the dynamic and evolving nature of banks' year-2000 remediation efforts and the rather limited information that some private rating firms must rely on to make their conclusions. While we recognize that in some instances private rating firms can provide a useful source of information to customers, in other cases, their conclusions may be misleading and unfair to the banks involved. That is why we believe that banks themselves are in the best position to inform customers about their year-2000 progress. As I note in my response to question six, we stress the importance of banks having customer-awareness programs.

Q5. Report on the OCC's policy on whether financial institutions which do not meet the upcoming June 30, 1999, FFIEC regulatory deadline for completing all mission-critical testing will be rated by examiners as "satisfactory," and whether all institutions should be prepared, as a part of their public communications plan, to assure bank customers in writing that they are in compliance with the FFIEC June 30, 1999, deadline.

Generally, national banks that do not comply within the June 30, 1999, target date will be rated less than satisfactory. Exceptions may be granted when completion and implementation are expected within two weeks of that date. Exceptions may also be granted where a bank with many "mission-critical" systems has achieved implementation on all but an insignificant number of those systems, core bank functions will be sustained, and full implementation of year-2000 remedies is anticipated soon thereafter. A satisfactory rating can also be assigned to a bank that plans extra testing, provided the required testing outlined in FFIEC guidance was complete by June 30, 1999.

You also asked whether institutions should be prepared, as part of their public communications plans, to assure bank customers in writing that they are in compliance with the FFIEC June 30, 1999, deadline. I am aware that views vary on this point and that there are strong arguments on both sides of the issue. Those favoring this approach feel strongly that bank customers can only benefit from such disclosures. Those on the other side of the issue are concerned about the potential for

overreaction to the very same disclosures. I believe this issue would benefit from additional discussion before arriving at a final policy and that the FFIEC agencies should ultimately reach and follow a clear and consistent policy in this regard. I will work closely with my FFIEC counterparts to resolve this important issue.

Q6. Provide an update on year 2000 contingency planning at financial institutions, including examples of "best practices" being used by financial institutions to meet—or effectively mitigate—increased customer demand for cash in December 1999 and January 2000, and to communicate year 2000 contingency plans to bank customers.

Our supervision has identified a number of best practices used by national banks to meet or mitigate increasing customer demand for cash. These best practices generally fall into two categories: customer awareness programs and contingency funding plans.

Customer Awareness Programs

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. Both the FFIEC agencies and the banks have a role to play in assuring the public that the banking industry is aggressively addressing year-2000-related issues.

Our research indicates that customers want to hear more from their own banks about the banks' year-2000 efforts. We are encouraging bankers to take a more active role in communicating with their customers. We believe that banks can most effectively mitigate customer concerns and excessive demands for cash by adopting an aggressive communications program that includes the following five elements:

- *Effective disclosure*. A bank should keep its customers up-to-date on its efforts to meet the century date change. Customers want to be informed as to the bank's progress, whether the news is good or bad.
- *Employee training*. Bank staff at all levels is a valuable communication asset. A bank that does not provide sufficient year-2000 training risks delivering an inconsistent or misleading message to customers.
- *Consistent messages in multiple media.* Effective customer awareness programs have a core set of messages that are repeated in a variety of ways. Reliance on one delivery mechanism—like brochures or call centers—may not be sufficient.
- *Cooperation with other banks, community leaders, and leading commercial firms.* Banks have effectively addressed public concerns through joint cooperative efforts with other public and community business leaders. Cooperative efforts leverage resources and provide an opportunity to present a unified message to the public. Some banks are joining with community leaders to host a series of town meetings on year-2000 issues.
- *Work with local media.* The media have significant influence on public attitudes, including the ability to mitigate or sensationalize year-2000 issues. Bankers working with local media outlets can provide balanced information on the century date change.

Planning for Contingency Funding

The FFIEC issued specific guidance regarding liquidity issues to help banks address the potential increased demand for cash or other funding associated with the century date change.[3] A key feature of that guidance is the development of contingency funding plans that include scenarios that respond to short- or long-term liquidity problems. When establishing its year-2000 contingency funding plan, a bank should consider the following elements:

- *Borrowing from reliable sources.* One of the primary roles of the Federal Reserve is to act as the lender of last resort through the discount window and to lend to depository institutions in appropriate circumstances when market funding sources are not reasonably available. Depository institutions that plan to use the discount window as a contingent liquidity source should complete the appropriate documents and make arrangements to pledge collateral as early as possible in 1999 in order to facilitate processing.
- *Access to supplies of cash.* As part of the contingency funding planning process for the century date change, financial institutions should estimate the cash demands of their customers and determine whether they need to arrange for additional cash reserves. A financial institution also should determine how quickly it can obtain additional amounts of cash should its reserves be reduced unexpectedly. It may be necessary, for example, for institutions to increase cash reserves before the century date change.
- *Banks' cash distribution network.* A financial institution may wish to evaluate the potential for

[3] See the FFIEC's December 11, 1998, "Questions and Answers Concerning Year 2000 Contingency Planning."

disruptions in its cash distribution systems and develop plans to meet customer needs throughout its geographical service area. When a financial institution uses a third party to service its cash disbursement requirements (e.g., ATMs, armored car services), it should review the third-party provider's plan to ensure that providers of these services and facilities can provide sufficient cash to meet customer needs in late 1999 and early 2000.

- *Security risks.* A financial institution may need to review its insurance coverage and security processes if it plans to hold additional cash reserves. Further, the bank may need to consider the security risks of its customers leaving the premises with large amounts of cash.

Q7. State the OCC's recommendations to federal agencies (e.g., Social Security Administration) and private sector entities (e.g., pension funds) as to whether they should, on a one-time basis, move up to December 1999 any monthly payment ordinarily due in January 2000, whether such payments should be made by paper check rather than electronic funds transfer (EFT), what the income tax implications are for such a contingency plan, and how the OCC or others can effectively publicize such recommendations to all those involved in such contingency planning.

This matter is under review by the President's Council on Year 2000, and I understand that the council will issue a recommendation shortly.

Q8. Provide an assessment of the effectiveness of financial institution procedures for evaluating year-2000-related risk from material borrowers and the OCC's exam procedures for assessing the level of that risk for individual institutions.

In March 1998 the FFIEC issued guidance that outlines the agencies' expectations regarding how insured financial institutions manage their year-2000 customer credit risk.[4] This guidance required financial institutions to establish by June 30, 1998, and to implement by September 30, 1998, a risk control process that:

- Identifies material customers;
- Assesses the preparedness of material customers;
- Evaluates the resulting year-2000 risk to the institution; and
- Develops appropriate risk controls.

[4] See the FFIEC's March 11, 1998, "Guidance Concerning the Year 2000 Impact on Customers."

Specific procedures to evaluate banks' compliance with this guidance were included in the Phase II procedures. Examinations conducted under these procedures indicate that as of the end of last year, 97 percent of affected national banks had met this target. We are pursuing the other 3 percent through our supervisory and enforcement processes.

The OCC also assesses year-2000-related credit risk during the course of its asset quality examinations, which assess both the quantity of risk and the quality of risk management. Beginning in the second quarter of 1999, the OCC's quarterly year-2000 monitoring program will include specific questions about the level of year-2000 customer risk and how banks have modified their underwriting practices to manage that risk. We are aware that some banks have attempted to alter loan covenants to require a showing of year-2000 preparedness, but have met with mixed success due to their lack of leverage with borrowers in the currently competitive lending environment.

Q9. Report any material change in year 2000 readiness and contingency planning in the international banking and financial sector since the OCC last testified before the committee on September 17, 1998.

Before I comment on year-2000 readiness and contingency planning in the international banking and financial services sector, I would like to first make the point that direct international exposure of national banks overall is limited. Only a small number of the largest national banks engage in international transactions directly with foreign banks, private sector enterprises or foreign governments, and only a small number of those banks have significant exposure in countries that are less well prepared to address year-2000 problems.

I can report that the global financial services sector, including most central banks, large global banks, financial services firms, and clearing and settlement organizations, has made progress in testing and implementing year-2000-compliant systems. Most countries are now engaged in testing programs that involve both internal and external testing with domestic and global business partners and payment agencies. While progress has been most rapid among the world's major industrialized countries, some smaller countries are also making good progress. Also, more countries have begun active disclosure programs to inform world markets of the readiness of their financial sector for year 2000.

The greatest concern internationally is whether there are adequate plans and resources to handle the year-2000 challenge in certain countries of Latin America, Asia, and Eastern Europe. U.S. and global banking supervisors, international organizations such as the Bank

for International Settlements (BIS), and private industry groups are providing smaller countries technical assistance to advance their systems testing and remediation efforts.

The following issues will require ongoing attention from the international community over the next few months:

- *Improved information sharing and disclosure.* Financial institutions and regulators should continue to develop clear and proactive communication strategies to ensure that global confidence in their readiness is maintained through this difficult period.
- *Contingency planning.* Bank regulators, such as the members of the FFIEC and BIS, are discussing the need to coordinate contingency planning activities and develop bilateral and multilateral communications programs, particularly around the period leading up to the changeover day and immediately after.
- *Coordination of bank holidays.* Discussion continues regarding the need to add new holidays to allow additional time for year-2000 preparations. We are not in favor of additional bank holidays either before or after the century date change, as this would make the global calendar more complex and further complicate global testing plans.
- *Testing.* Testing schedules in those countries that had a late start on addressing the year-2000 problem are becoming congested. Additional coordination and tailoring of test schedules may be necessary to handle the backlog.
- *Liquidity.* Banks and regulators are closely monitoring the behavior of bank customers and investors to gauge their reactions to the century date change. Changes in perception of global risk could lead to changes in investor behavior, including a sudden flight to quality and changes in liquidity holdings, which could have an impact on world markets.
- *Infrastructure.* Although the overall quality of information on the year-2000 readiness of power companies, telecommunications providers, and maritime transportation companies, especially in certain emerging market economies, varies significantly, the quality of the information continues to improve.

Pending Year-2000-Related Legislation

Q1. Comment on legislation pending in Congress (H.J. Res. 14) which would move the federal holiday observance of New Year's Day 2000 (which falls on a Saturday), from Friday, December 31, 1999, to Monday, January 3, 2000.

H. J. Res. 14 would move the federal holiday observance of New Year's Day 2000 (which falls on a Saturday) from Friday, December 31, 1999, to Monday, January 3, 2000. We do not believe such a change would be desirable for three reasons. First, if states followed the federal lead and moved the business holiday from Friday to Monday, this would create processing backlogs and increased volumes at the start of the New Year when computer systems may be most vulnerable to year-2000 errors and malfunctions. Second, the change in the federal holiday date could be perceived as indicating a lack of congressional confidence in the banking industry and this may unnecessarily increase public concern. Third, conforming state action (moving the business holiday) could also create a testing problem for some banks because they would need to add the December 31, 1999, date to test scripts even though most have already completed their internal testing.

Q2. Comment on the potential impact of pending year 2000 liability legislation (e.g., H.R. 775) on financial institutions, federal year 2000 supervision of such institutions, or the ability of financial institutions to determine the year 2000 compliance of borrowers or other critical external parties, such as providers of telecommunications and power services; please submit, if appropriate, any recommended amendment language to H.R. 775.

Liability reform legislation, even in the limited context of year 2000, is complicated and presents both significant uncertainties and significant governmental issues. For example, the substantive limits involving contractual obligations and tort liability in the proposed legislation may raise potential constitutional issues and basic questions of federalism. However, there are in H.R. 775 several provisions that do not present these types of concerns and may diminish the risk of needless litigation and encourage parties to resolve disputes in an expeditious way. The proposed legislation establishes a required pre-filing notification period of 90 days to encourage resolution of potential year-2000 disputes without litigation. Specifically, a potential plaintiff would be required to give written notice to the defendant identifying year-2000 concerns and providing the potential defendant with an opportunity to "cure" the year-2000 problem. The proposed legislation also has provisions encouraging alternative dispute resolution, such as mediation. These are worthy of serious consideration. Finally, the proposed requirement of proportionality of damages merits further study. While the issue of damages is complex and has historically been addressed by state law, further exploration of some limited foreclosure of pure "joint and several" liability in year-2000 actions might be warranted.

You invited the OCC to suggest amendments on H.R. 775. The OCC is concerned that H.R. 775 may hinder the OCC's ability to take effective supervisory and enforcement actions regarding year-2000 problem banks. Accordingly, we suggest two amendments. First, we strongly request a clarification that agency enforcement actions are not affected or covered by the general provisions in Titles I through V of the legislation. "Government entities" are expressly included within the scope of "persons" subject to H.R. 775 and the definition of "year-2000 action" is sufficiently broad that it might arguably apply to government enforcement actions. This potential ambiguity should be eliminated by amending "year-2000 action" to expressly exclude actions brought by a federal, state, or other public entity, agency, or authority acting in a regulatory, supervisory, or enforcement capacity. A similar express exclusion is found in the definition of "covered action" in section 3 of the Year 2000 Information and Readiness Disclosure Act (P.L. 105-271) and in S. 461, the Year 2000 Fairness and Responsibility Act.

Second, we strongly recommend that section 605 of H.R. 775 be revised to make clear that banking enforcement actions are not affected by that section. Section 605 would suspend penalties for year-2000 failures by "small business concerns." It is arguable that small financial institutions might come within the definition of "small business concerns." *See 13 CFR Part 121.* We are opposed to legislation that would limit the ability of the federal bank regulators to take enforcement actions involving year-2000 concerns. Such legislation might hinder necessary and timely supervisory actions to achieve year-2000 readiness.

Q3. Comment on whether references to bona fide error in current banking consumer law would be clarified to include, in the definition of computer error, explicit reference to year 2000-related errors and, if so, please provide suggested legislative language.

In our view, computer malfunctions and programming errors due to year-2000 problems appear to be covered by the statutory provisions dealing with "bona fide errors." However, a legislative clarification could be helpful to avoid unnecessary and protracted litigation. Any clarification on this point should not affect the existing standard that institutions maintain procedures reasonably adapted to avoid bona fide errors.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Summit on Contingency Planning and Customer Awareness, President's Council on Year 2000 Conversion, on contingency planning and customer awareness, Washington, D.C., April 15, 1999

On behalf of the Office of the Comptroller of the Currency and the Financial Sector Group of the President's Council on the Year 2000 Conversion, it's a pleasure to welcome you to our Y2K summit. Holding these meetings is one way that we as financial regulators recognize the responsibility we share with you in the financial services industry to meet the challenge of the century date change with minimum disruption to our financial system and our economy.

Today's summit centers on two closely related topics: contingency planning and customer awareness. They are related in this critical sense: the industry's success in meeting its customer awareness goals will largely determine whether contingency plans will have to be activated or whether they can stay on the shelves, as all of us would prefer. Given this sequence and the limits of time this morning, I thought that I would focus my remarks on the work already done—and the work yet to be done—in educating public opinion on the dimensions of the Y2K problem and what it might mean for bank customers.

Two days ago, in testimony before the House Banking Committee along with representatives of the other FFIEC agencies, I discussed the Y2K readiness of the banks and service providers under the OCC's jurisdiction. The message that I delivered to the Committee was a positive one. I expressed the view that the banking industry would come through the Y2K experience with flying colors. Already, the vast majority of financial institutions have met or will soon meet FFIEC deadlines for Y2K testing and remediation. As of April 1, 97 percent had completed testing of mission-critical systems. In the most recent on-site Y2K examinations conducted by the OCC—"Phase II" examinations, focusing on bank testing results, business resumption contingency plans, customer risk assessments, and customer awareness programs—96 percent of our institutions were rated "satisfactory," 4 percent were rated "needs improvement," and less than 1 percent of national banks and service providers were rated "unsatisfactory"—a statistically insignificant decline from the 1998 fourth quarter results. And, when this latest round of examinations is completed by the end of July, we and the other FFIEC agencies will be in a position to provide the intensive, high-level attention that may be needed to bring any remaining "unsatisfactory" institutions into full compliance with Y2K requirements before year's end.

Obviously, a great deal of work remains to be done before we can declare the banking system fully Y2K-compliant. Our examiners have found that testing efforts are taking longer and costing more than many bankers had originally budgeted for. Some institutions have encountered scheduling conflicts with their service providers or software vendors. Others are expanding their definition of "mission-critical" systems—generating additional testing requirements now, but reducing the possibility of unpleasant surprises later, when time to correct them will be in short supply.

So we have good cause to be sanguine. The renovation process is going well—better, in fact, than we had any right to expect at this time last year. Testing has uncovered few problems that can't be fixed and fixed on time. We're confident that we have the supervisory and enforcement tools to deal with any problems that may require regulatory intervention. For good reason, in my judgment, most objective parties have concluded that no single sector of the economy—not even the computer software industry itself—is better prepared than the financial services industry for the century date change.

But that's not what the public seems to think. According to a recent survey, more than 20 percent of respondents believe that the entire banking system will crash as the result of Y2K glitches. Nearly a quarter of those surveyed said that they would probably withdraw all their money from banks, and two out of three said that they were planning to withdraw at least some extra cash. Forty percent agreed with the proposition that ATMs would not work come January 1, 2000. Large minorities expressed the conviction that checks won't properly clear, that banks will lose track of customers' funds, and that people will at least temporarily lose access to their cash. Perhaps most disturbing, nearly half of the survey respondents agreed with the statement that "people will panic and withdraw all their money" from banks.

Why the public is apparently so unimpressed by—or so unaware of—the progress in getting bank information systems in readiness for Y2K is a question that demands consideration. There are several possibilities, including a tabloid that recently appeared in the supermarket racks. I'm told that it sells almost a million copies each week. But for every copy that's sold, probably dozens of people thumb through its hyperbolic pages while waiting in the checkout line. This is how fear gets started.

People whose anxieties are aroused by this stuff may then turn to what has become the first source of information—and misinformation—in the computer age. When I did an Internet search using the key words "Year 2000 Survival," it generated 479 hits to Web pages such as one that offers the kind of advice one would expect if preparing for a nuclear holocaust. It and others like it take for granted that the financial system will collapse and bring down the rest of the economy with it. That these perceptions are taking hold with noticeable numbers of Americans is confirmed by reports in the mainstream media of long waiting lists for wood-burning stoves and gas-powered generators, and a surge in orders to processors of freeze-dried food and other emergency items.

There'll always be an element of the population that trades in conspiracies and doomsday theories. Nothing we can do or say is likely to make these folks see the light. And from certain segments of the media we cannot expect much more than negativism and sensationalism. They, too, have their rights.

Our concern—your concern—must be with the tens of millions of reasonable Americans who are legitimately concerned—but still open-minded—about Y2K. They're hungry for reassurance if we can honestly provide it, but hungry for the truth in any event. The quality of the information they obtain will shape their behavior, for better or worse, and will very largely determine whether sanity and calm—or something short of that—prevails in the days leading up to January 1, 2000.

The need is clear. It's not enough to fix your data systems if your customers don't know about it. They have to be informed—and disabused of whatever misinformation they may have picked up along the way. Unfortunately, the evidence suggests that we have a great deal of catching up to do in this vital task.

In a recent survey, 70 percent of the respondents said they hadn't received any Y2K information from their financial institution. Now, we know from our own surveys that this cannot be true. But it suggests that the materials that banks *are* sending out have done little to capture customers' attention. Either way, we must do a better job of publicizing Y2K remediation efforts if we expect to be doing any real celebrating next New Year's Eve.

That's why it's so incumbent on all of us—regulators, trade associations, bankers, and other members of the financial community—to turn our attention NOW to public opinion, to make sure that bank customers receive Y2K information that is complete, accurate, and sober about the accomplishments to date—and the challenges that remain—in preparing the financial system for the century date change. We must all work to ensure that customers are kept informed about the steps that financial institutions are preparing to take in the event that everything does not go according to plan. Helping financial institutions to develop the right messages for public consumption—to build public confidence—is a key goal of our summit today.

You'll be hearing much more in the course of our discussions—and in our future communications to the industry—about specific customer awareness initiatives and "best practices" being undertaken by various financial providers. Let me launch today's dialogue by drawing on the FFIEC's guidance on customer communications to suggest five essential elements of any effective Y2K communications plan.

The first is effective disclosure. A bank should fully and completely disclose its efforts to meet the Y2K challenge. Our research shows that customers want to be informed as to the bank's progress, whether the news is good or bad. Do not succumb to the temptation to sugarcoat the truth or cover up unpleasantness. The public knows there's a problem out there, and to suggest otherwise will only make the good news less credible when it arrives.

The second important element is employee training. Bank staffs at all levels are valuable communications assets. A bank that does not provide sufficient Y2K training risks delivering an inconsistent or misleading message to consumers. Tellers and customer service personnel should be prepared to answer customer questions about Y2K as crisply and accurately as the CEO, for they have wide networks of friends and family who will be intensely curious about bank preparations for Y2K.

The third element is the need to deliver consistent messages across all media. Effective customer awareness programs, we have found, have a core set of messages that are repeated in a variety of ways. Repetition is the key. Studies show that most people don't really absorb a message until they've heard it three times. And the more varied the sources from which they hear it, the more likely it is to register. Reliance on a single delivery mechanism—brochures or call centers, for example—may not be sufficient. It's certainly not enough simply to slip a sheet on Y2K into the customer's monthly statement and call that a customer communication program.

Fourth, we cannot overemphasize the need for cooperation with other banks, community leaders, and leading commercial firms. Banks have effectively addressed public concerns through joint cooperative efforts with other public and community business leaders. Cooperative efforts leverage resources and provide an opportunity to

present a unified message to the public. For example, some banks are joining with community leaders to host series of town meetings on year-2000 issues. That's an excellent way of making the most of your resources and getting the message out in an accessible way.

Last but not least, banks should work closely with local media on Y2K issues. The media obviously have tremendous influence on public attitudes. But, with the airwaves and the print media already crowded with inaccurate and sensational stories on Y2K, we cannot assume that journalists will get the message right, on their own, every time. If bankers make themselves available for interviews with local newspapers and television and radio outlets, the odds greatly improve that what gets reported to audiences on Y2K will be balanced and accurate.

Let me emphasize that you're not alone in promoting customer awareness. In recent months we have heard from a great many financial institutions encouraging the regulatory agencies of our government—state and national—to become more active in the Y2K public information arena.

These suggestions are well taken. And rest assured that with phase II of the Y2K examination regimen drawing to a close and with the more definitive understanding of the state of industry preparedness acquired in the process, the regulatory agencies will become much more vocal and visible in the coming weeks in communicating with bank customers and the general public on Y2K.

For example, the FFIEC member agencies have formed a communications group to coordinate messages and share ideas and techniques to better reach target audiences. Soon to enter production is a video that banks can show in their lobbies, explaining the FFIEC's Y2K supervisory efforts and all that banks must do to meet their regulatory requirements. We are developing media kits including Y2K questions and answers and other useful material for journalists, government officials, and other interested parties. I—along with my FFIEC counterparts—will be speaking out on this subject with increasingly frequency as the clock winds down to the Year 2000.

And what I'll be saying is this: thanks to the combination of their own pace-setting remediation efforts and the intensive program of agency oversight, the banking industry *will* pass the Y2K test, and pass it with flying colors.

Rumor and gossip are potentially as grave a threat to our Y2K readiness as time itself. Left unchecked, they can do great harm to public confidence in the banking system. Direct communication with bank customers is the best way I can think of to conquer fear and falsehood —and our best assurance of a bright New Year's Day 2000.

The twentieth century has been a time of challenge for all Americans. War, depression, and social unrest have tested us as a nation and brought out our best qualities as a people. It seems somehow fitting that this century should come to an end on a similar note of challenge. We in the financial services industry and the financial regulatory community have already cleared some significant hurdles to ensuring that the century change passes relatively uneventfully. What now remains is for us to prevail on the good common sense—and courage—of the American people in how they approach the year 2000. If we do that job to the best of our abilities, I'm confident that we won't be disappointed by their response.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Women in Housing and Finance, on operating subsidiaries of national and state banks, Washington, D.C., April 19, 1999

There's an old Persian fable about three noblemen who keep stumbling upon wondrous surprises. In the course of their travels together, they find themselves—unexpectedly, of course—on the paradise island of Serendip. As the author John Barth explains, "You don't reach Serendip by plotting a course for it. You have to set out in good faith for elsewhere and lose your bearings serendipitously."

History is full of happy accidents and unpredicted outcomes. Christopher Columbus discovered the New World instead of an alternate route to Asia. Alexander Graham Bell was working on a hearing aid for his wife when he hit upon the idea for the telephone. And Women in Housing and Finance, which began 20 years ago as a group of five professional women networking at lunch, is today an organization of men *and* women, more than 700 strong, who have become a major force on the local and national scene. I congratulate you on your anniversary.

Serendipity has also played an important role in the evolution of our financial system. When Congress created the national banking system in 1863, it didn't intend for state and national banks to coexist as they do today. Indeed, it was Congress' original expectation—and fervent wish—that the national charter would be so attractive that it would soon drive all others from the field. When market forces failed to do the job, Congress sought to provide the necessary push in the form of a tax on state banks. But that didn't work either, and neither did various other proposals down through the years to unify the bank charter. Like the cat with nine lives, the state banks survived and the dual banking system flourished. Not coincidentally, so has our nation's economy.

With hindsight, it's clear that attempts to suppress dual banking were both futile and ill-advised. Our system of charter and supervisory options may not conform to any predetermined model of bureaucratic organization. It may lack simplicity and well-defined, orderly lines of authority. But it does reflect fundamental values cherished by Americans: competition, federalism, and freedom of choice. It seems to me, in other words, that the dual banking system has persisted as an institution, despite its complexities and despite efforts to eradicate it, because it's an authentic reflection of what we believe—and what we practice—as a people. Balancing supervisory authority between Washington and the states has contributed to a responsive, innovative, and stable banking system capable of accommodating the full diversity of our economic life—a system that's the envy of the world.

One reason the system has thrived is that, after coming to a belated appreciation of its value, Congress intervened at critical intervals to maintain a healthy balance and to ensure that the state and national bank charters kept pace with one another. Through legislation, federal regulators and national banks obtained the authority to match innovations and incentives coming from their state counterparts. For example, in response to urgent pleas from the Comptroller of the Currency, Congress in 1927 passed the McFadden Act, granting national banks branching powers roughly equivalent to those already enjoyed by many state banks. And it relaxed other legal restrictions—such as those barring national banks from offering safe deposit boxes and making most real estate loans—that were eroding the value of the national bank franchise.

At the same time, Congress has been cautious about encroaching on the authority of the states to charter and empower banks. For example, excepting only insurance underwriting, the states have been left free to allow their banks to engage in activities not permissible for national banks so long as the FDIC determines the activity would not pose a significant risk to the insurance fund.

Let me add that this process has not been a one-way street. Many states have enacted "wild card" statutes—laws that allow state-chartered banks to exercise powers available to national banks.

Nor—despite what some critics say—has the process been a "race to the bottom." Back in the early 1960s, under Comptroller James J. Saxon, the OCC concentrated on upgrading the qualifications and skills of its examination force. This led to calls from state bankers and action by state supervisors to match these improvements. The quality of examinations improved significantly on both sides, and the whole dual banking system emerged the stronger for it.

In short, what former Federal Reserve Board chairman Arthur Burns called—in memorable if misleading terms—"a competition in laxity" between state and federal banking authorities—has actually been a textbook case of federalism in action. The competitive tension between state and national authority has produced a safe and sound banking system, an efficient

and effective supervisory regime, and regulatory structures capable of adapting to the demands of an evolving marketplace.

The point is that, while the dual banking system today *is* healthy and strong, it requires care and feeding to keep it that way. History shows that the absence of needed legislation—or the enactment of the wrong kind of legislation—can do it real harm.

We happen to be at one of those critical crossroads when Congress seems to be moving toward action on comprehensive banking legislation. I'm concerned, however, that some of the current legislative proposals would upset the balance between state and national banks in the context of the dual banking system. Last year's version of H.R. 10, for example, contained a profusion of provisions that would have discriminated—wholly unjustifiably—against national banks, and some of the most ardent proponents of financial modernization continue to urge Congress to impose discriminatory restrictions on national banks.

You have all heard the arguments about the pros and cons of operating subsidiaries ("op subs"). Some have argued that Congress should deprive national banking organizations of the ability to choose the format that suits their needs best in the name of containing some ethereal and elusive "subsidy." On the other hand, the FDIC—the agency with the greatest interest in preserving the safety and soundness of banks—has consistently made the point that the op sub advances safety and soundness, by allowing banks to diversify their income streams and to husband their resources, rather than forcing revenue and capital out of the bank to benefit Fed-regulated holding companies.

I don't want to embroil you again in the esoterica of op subs. But I do want to focus on the impact on the dual banking system of the position proposed by the anti–op-sub camp.

First of all, for some reason, this camp seems to be opposed to op subs only where they apply to newly authorized financial activities conducted by *national* banks. Despite concerns about spreading the alleged "subsidy" and their claim that op subs generally are incompatible with safety and soundness, they have not proposed to apply a similar prohibition to state-chartered banks. They seem willing to accept a structure in which the states are left free to permit new activities for state banks, subject only to the FDIC determination that no risk is presented to the insurance fund, while flatly prohibiting comparable new activities for national bank subsidiaries.

How can we explain this inconsistency? Political realism—to put the best light on it—is one possibility. The 50 state banking systems constitute a formidable political force that would surely mobilize in opposition to any overt proposal that op subs for state banks should be outlawed in the manner proposed for national banks.

But any apparent advantage for state banks may be short-lived. If those who want to put national banks in an organizational straitjacket succeed in doing so—ostensibly in the name of curtailing the spread of some "subsidy"—how long do you think it would be before someone got the idea of applying the same limits to state banks? After all, if a subsidy exists, and if the op sub presents a safety and soundness issue, it's hard to see what rationale would support legislation that arbitrarily allows *some* banks to own subsidiaries but not others, based on the source of their charter.

Please don't misunderstand me. I am not by any means suggesting that limits *should* be placed on state bank op subs. I am in favor of freedom of choice—a fundamental principle of the dual banking system—for state as well as national banks. The states have, with the concurrence of the FDIC, authorized a variety of activities for state-chartered banks, and I think they should be permitted to do so. My point is simply that the states cannot be complacent in the face of proposals to restrict the activities of national banks. To paraphrase John Donne, the bell tolls for them, too.

While the debate on this issue has focused on those proposals that would explicitly discriminate against national banks, opponents of the op sub have, to be fair to them, selectively proposed as well that Congress should do additional damage to the dual banking system by cutting back on some of the powers of state banks through a new expansion of Glass–Steagall. Despite the fact that a foundation stone of financial modernization legislation has been the *repeal* of provisions of Glass–Steagall, those opposed to op subs have actually tried to extend the reach of section 21 of Glass–Steagall. Section 21 as it now exists prohibits a deposit-taking institution from engaging in securities underwriting *in the same entity*. It does not reach relationships with affiliates—sister companies or subsidiaries—that might engage in securities activities. Those relationships have been governed by sections 20 and 32, the very sections everyone agrees ought to be repealed.

The consequence of extending section 21, as the anti–op-sub forces have proposed, would be to outlaw securities activities for *all* bank subsidiaries—state and national alike. Unlike sections 20 and 32, section 21 is not limited in its reach to member banks of the Federal Reserve System. This would effectively nullify the existing power of state banks to engage through subsidiaries in

securities underwriting—an activity the FDIC has already found *not* to pose a risk to the insurance fund.

Why, it should be asked, more than 65 years after Glass–Steagall was enacted; at a time when it is almost universally regarded as obsolete and eminently repealable; at a time when section 20 affiliates of member banks have engaged in securities underwriting under Federal Reserve jurisdiction for a number of years without apparent problems, should it be deemed necessary to prohibit the same securities activities for bank subsidiaries, state and national alike?

More to the point, why should Congress accept such a proposal to cut back on powers that a number of states have already granted to their banks? To put the kindest face on it, this proposal is not only retrogressive, but quite inconsistent with a decent respect for the dual banking system. Once again, state banks should take care that they know for whom the bell tolls.

There are other gratuitous ways in which various versions of the legislation would do violence to the dual banking system. For example, in some versions of financial modernization legislation, national banks and their subsidiaries would be barred from selling title insurance, while state banks and their subsidiaries could continue to sell title insurance. In addition, while a majority of states currently permit state banks to act as agents for the sale of insurance, with no restrictions on the size of the locality in which they operate, all the pending versions of financial modernization legislation would perpetuate the archaic "place of 5,000" limit on the ability of national banks to act as insurance agents.

I'm sure there are some state banks that might welcome and support these provisions. It's hard not to feel like a winner when you come out ahead of the other guy.

But I believe state banks and their supervisors would be terribly shortsighted if they ignored the implications of these discriminatory provisions. Once the precedent is established of accepting anticompetitive provisions—whether they involve operating subsidiaries, product restrictions, activity limits, or discrimination among types of banks—everyone is fair game.

For more than a century, the fortunes of state and national banks have been inextricably linked. That is still true today. State banking interests should keep in mind that our strength has traditionally also been their strength and vice versa. Competition can be inconvenient and even painful in the short term, but its long-term benefits are incalculable. Without the competition we provide each other, without the stimulus we generate to improve and innovate, we may all be threatened with stagnation. And that's not in the interests of the American people.

At the outset of my remarks, I suggested that the remarkable resilience of the dual banking system over the years derives from the fact that it's a true expression of our national character. Above all, we Americans are a pragmatic people; we embrace what works. The dual banking system is around today not because it was part of anyone's master plan, but because it's helped us attain our goal of a buoyant, prosperous economy. We should think twice—or three times—before enacting legislation that would cause profound injury to an institution that has been so instrumental in helping us achieve our national success.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Bank Administration Institute Security, Audit and Compliance Conference, on risk management, Orlando, Florida, May 4, 1999

Back near the end of the last century, the United States Navy, without so much as a single modern battleship to its name, ranked eleventh among the world's fighting fleets, behind Turkey and Austria. The Army was even worse off. In 1890 it fielded a total force of 28,000 officers and men, fewer than Bulgaria at the time. Coastal defense consisted of scattered batteries of mostly Civil War–vintage artillery. Other advanced nations must have had a good laugh when they compared notes about America's creaking military machine.

But they would have missed the point. Though weak, this army and navy were equal to America's security needs in the 1890s. We had no foreign enemies, and even if we had, the oceans would have kept them safely at bay. Americans were not alarmed to see their coastal guns gathering rust because there was little likelihood that those guns would be needed. In other words, there was appropriate proportionality between any risks to national security and the means available to protect against those risks.

Proportionality. That's the basis of effective risk management—whether it's national security or the safety and soundness of financial institutions that's at stake.

Four decades ago, overall risk in the banking system was low. Governmentally imposed ceilings on deposit interest rates, branching restrictions, and limitations on powers and products made banks virtually indistinguishable from one another. Competition among financial providers was muted and genteel. While the biggest corporate borrowers were already turning to the capital markets, the vast majority of credit-seekers had no place else to go except the local bank. Banks could afford to be fussy in deciding who got credit. And they were.

Meanwhile, a predictable stream of customer deposits provided bankers with cheap and abundant liquidity. While market-rate instruments such as certificates of deposit and stock market mutual funds had been around for years, they appealed only to a comparative handful of affluent Americans in 1970. The first certificates of deposit (CDs) were sold in minimum denominations of $1 million—hardly an investment vehicle for the masses. Middle-class savers had to settle for a return on bank deposits that narrowly exceeded the inflation rate—and, in many years, actually lagged behind it. And of course, demand deposits earned no interest at all.

No-cost or low-cost funds meant that bankers had to put their minds to it to lose money. It was a time when loan-to-asset ratios in the 40 percent range—compared to today's 60 percent—were not uncommon. And it was a time when some unusually risk-averse bankers saw loan production as almost not worth the effort when, as in early 1970, a one-year Treasury security returned 350 basis points above the Regulation Q passbook ceiling. The loans bankers did make could hardly go wrong on what were then standard terms. As a rule, maturities were short, loan-to-value ratios were low, pricing was stiff, and bankers slept soundly at night.

Thus safeguarded and secured, most loans essentially administered themselves. Banks managed asset quality and made loan loss provisions based on trailing measures of credit risk, such as levels and trends in past due and nonperforming loans and loan losses.

In other words, in those halcyon days of banking, there was some meaningful proportionality between the amount of risk in the banking system—low—and the simple tools bankers used to manage and control it.

Occasionally this balance went out of whack. Although competition was already increasing in the 1960s, the domestic loan market of the 1970s was relatively placid. Hungry for bigger returns, some high-rolling bankers ventured into high-risk fields of international lending and foreign currency trading, and speculated heavily in commercial real estate or on the future of interest rates. That kind of activity exposed the weaknesses of haphazard risk management, and a few national banks failed as a result.

But they were aberrations. During the 1960s, the ratio of net loan and lease charge-offs at all commercial banks averaged less than two-tenths of 1 percent. Even during the more tumultuous 1970s, it was still less than four-tenths of 1 percent—a bit more than half of what it is today, in an era of much steadier economic growth. Between 1970 and 1980, there were only 14 national bank failures.

That was then. This is now. The new era of risk management for financial providers began around 1980, with deregulation of deposit interest rates, with increased volatility in market interest rates resulting from changes made by the Federal Reserve in its monetary policy procedures, and with the gradual liberalization of constraints

on products and services. Since then, bankers, so long protected by government regulation, have had an education in the full meaning of competition.

It's been a sobering lesson indeed. More than a thousand banks failed during the 1980s and 1990s. Banks no longer hold the lion's share of America's household financial assets. In 1986, commercial bank deposits outstripped mutual fund assets by more than two to one. Today, little more than a decade later, we are well on the way to seeing that relationship reversed. Banks must look to price-sensitive, credit-sensitive—and sometimes risky—wholesale funding to meet their pressing liquidity needs.

Competition has profoundly altered the domestic credit market. In 1972, commercial banks provided nearly 75 percent of all U.S. business loans. Last year, the number was down to about 45 percent. The U.S. banking system's loss has been a windfall for investment bankers, commercial finance companies, and foreign banks. Today, it's the capital markets doing most of the cherry-picking. Bankers must scramble for the higher-risk customers that remain. These days, even marginal customers can demand and receive preferential terms and pricing that Fortune 500 corporations might have blushed to ask of their banks 20 years ago.

The challenge of today's risk environment for bankers is greater today than I have seen in almost 40 years of experience with our financial system. Part of the challenge is understanding the evolving character of risk. To aid in that understanding, I would like to suggest a new analytical distinction: between environmental risk—risk associated with the long-term, macroeconomic changes in the financial world, including the ones I've just described—and what one might call volitional risk. By definition, environmental risk involves trends and issues that bankers must understand and react to, but that are largely beyond their control. We all know that there's no rolling back the clock to the days when government offered bankers sanctuary from the competition of the free marketplace. That genie is out of the bottle for good.

By contrast, volitional risk is the risk inherent in individual decisions that individual bankers make every day—the kind of risk they often *can* control. When a banker decides to extend a loan based on patently unrealistic financial expectations, he or she is taking on a higher order of volitional credit risk. When a credit officer, bedazzled by the star quality of a fashionable hedge fund, goes ahead with a loan despite being denied access to critical financial information, that loan officer is adding to the institution's volitional risk. When a banker signs off on a deal that includes weak covenants, liberal or no amortization, aggressive advance rates, or overreliance on optimistic enterprise values, and then prices the loan as if it were a solid, investment-grade credit, he or she is—volitionally—raising the bank's credit risk profile.

While bank regulators must be concerned with the banking system's preparedness to deal with all types of risk, our job requires us to be particularly concerned about volitional risks—those business decisions that should be subject to some control. And my special concern is that we see continued evidence of credit standards being relaxed, despite the fact that the OCC and our sister agencies have been sounding off about the secular decline in credit underwriting standards for more than two years now. Our examiners are reporting an increasing incidence of structurally deficient loans: loans with elevated leverage ratios; loans based on insufficient documentation; loans whose repayment is dependent on optimistic cash flow projections or recapitalization; loans where personal guarantees of principals have been foregone.

The effects have already started showing up. Net charge-offs have been rising over the past three years, despite robust economic growth. Last year, noncurrent loans rose for the first time since the current recovery began. More banks are reporting increases in nonperforming loans—big increases in some cases.

What makes this risk trend particularly worrisome is the absence of proportionality in many banks' ability to manage and control it. In a world of rising risk, one would expect that banks would be devoting significant effort to making their risk management systems more robust.

One would expect that, especially after such a long period of economic expansion, banks would be adding to their reserves to help cover the probable losses that will invariably be realized as economic growth slows, as it is bound to do.

One would expect that banks would be strengthening their fundamental risk controls—financial statement analysis, loan review, credit administration, and the information systems that support them—in order to improve their ability to identify, measure, monitor, and control this rising risk.

One would expect that banks would be bolstering and empowering their internal control functions and audit capabilities—adding expertise, tightening procedures, and ensuring that auditors have the clout they need to get senior management to take heed and, when necessary, to act.

One would expect that banks would be augmenting their existing risk control mechanisms with technological innovations, such as risk models, that can be

of real value in the context of an effective overall risk management program.

I trust that these expectations seem as self-evident—and as reasonable—to you as they do to me. Unfortunately, in too many cases, these expectations are not being realized. In too many cases, the fundamentals of risk management are being ignored. Loan loss reserves are falling. Loan review and ongoing credit administration are not getting the attention they deserve. And internal audit functions at some banks are not as strong as they should be to protect banks against the increased risks they face, both as the result of their own business decisions and of forces beyond their control.

The effectiveness of banks' internal audit processes has been a matter of concern to the OCC for some time now. Last year we surveyed the examiners of our largest national banks to get their views on how well the banks they supervise were handling internal audit functions. What emerges from this survey is a mixed picture—itself a matter of concern in the current risk climate. For example, a large number of the national banks in our sample were viewed as understaffed in one or more audit areas. The biggest deficit in audit resources and expertise is reportedly in the information technology area—a critical component of every banking activity.

Moreover, our survey reported a high annual level of turnover in bank audit departments—more than 20 percent in some cases. This kind of mobility could actually be a source of strength to a bank if it reflected the movement of talented auditors into loan production and other front-line functions. Or it could mean that audit personnel are not being fairly compensated or recognized for the work they do, and feel compelled to seek greater recognition elsewhere.

The net effect, however, is that many banks are not as well staffed in the audit area as we would like, and that helps to explain why only one-third of the examiners we surveyed rated their bank's audit capability as "good"—that is, better than simply "adequate." Many reported that, as a result of short-handedness, internal audits had to be deferred or reduced in scope to keep up with the audit schedule—again, a worrisome trend in a time of increasing risk.

All of this may be alarming, but at least it's not mysterious. The growing imbalance between the overall risk profile of the banking system and its internal risk management capacity is the result of a curious mixture of complacency and urgency. Most bankers are quite concerned about current trends in underwriting and the fallout likely to occur if the economy softens. However, you can still find bankers who seem convinced that we have somehow tamed the business cycle, that growth will go on forever, that nothing can go seriously wrong, and that even marginal borrowers—and dubious deals—will eventually work out and pay off. In this light, internal audit capacity and credit review seem almost superfluous—needless frills.

Such complacency might have been warranted in the relatively low-risk banking world of the 1970s. It's not warranted now. As one very experienced banker said to me a few days ago, our people have to realize that trees don't grow to the sky.

Bankers are simultaneously under extreme pressure these days to maintain loan volume and earnings at their current lofty levels in the face of shrinking market share and increased competition for loans. The current economic expansion has raised expectations perhaps to unreasonable—and ultimately, I believe, unattainable—heights. A sober look at history should demonstrate that realizing a 20 percent return on equity year after year is not a goal that can be sustained—at least not for very long. Yet we are disappointed if new records do not follow one upon the other. Shareholders and equity analysts demand it. Bankers feel compelled to deliver it. And to do that, they cut corners, chip away at functions that don't contribute immediately and directly to the bottom line, and look the other way instead of walking away from some of the one-sided deals that, unfortunately, continue to be consummated.

I have heard it argued in response to our admonitions about credit quality that an abundance of liquidity in the system has forced banks to become more competitive in the terms they offer, and that if this implies greater risk, then so be it: after all, bankers are in the business of taking risk.

That's wrong. Bungee-jumpers, sky divers and Indy 500 drivers are in the business of taking risk. Bankers are in the business of *managing* risk. To manage risk effectively, they need to be able to identify, quantify, and control risk. They need to understand the implications of granting exceptions to sound credit policies. And they need to assure that exceptions are occurring in a well-modulated way. To do these things effectively, they need internal audit, loan review, and compliance resources commensurate with the amount of risk they must manage. I can think of no practice more penny-wise and pound-foolish than to reduce those resources simply because things seem to be going swimmingly right now.

Anyone involved in the independent control functions in banks—loan review, audit, or credit administration—has a difficult job under the best of circumstances. But internal controls are more urgently needed right now than

perhaps at any time in recent memory. Federal Reserve chairmen are fond of saying that the job of the central bank is to pull the punch bowl away just as the party is getting good. Internal controls over bank credit practices serve a very similar purpose. They are an essential safeguard against undue—even irrational—exuberance in the loan origination process.

As Acting Comptroller Julie Williams told this conference last year, the vigor and independence of bank control procedures, risk management, and early-warning systems are matters of primary importance to the OCC in our supervision of the national banking system. And we continue to refine and update our supervisory policies and practices to reflect this emphasis.

Since Julie spoke to you, we have issued guidance on loan portfolio management and have delivered specialized training to our examiners to better enable them to recognize weaknesses in portfolio management processes and systems. In response to reports of increasing numbers of loans with structural weaknesses of the sort that I mentioned earlier, we have provided new training and procedures that have already been of material assistance to examiners in bringing such credits to the early attention of senior bank managers and directors.

Just yesterday, the OCC released the latest installmenti in a series of issuances related to leveraged lending activities, including hedge funds. Yesterday's letter highlights the unique risks associated with today's leveraged lending activities, outlines OCC's risk management expectations for banks that engage in this business, and aims to resensitize bankers to existing OCC policies and guidance.

Following up on our internal audit survey of last year, the OCC has launched a study that aims to validate the consistency and quality of our supervision of banks' audit functions. With this information, we should be better able to allocate the right amount of supervisory resources to ensure that the audit function receives the high-quality, high-level attention it requires during our regular examinations.

And in the five months that I have been in office, I have put enormous emphasis on our need to assure that the OCC has the most effective early-warning systems we can devise—to supplement and complement the systems in use at banks.

I hope you find it of some reassurance that the OCC is at your side in helping to maintain the safety and soundness of your institutions during these challenging times. All who have an interest in the continued strength of the American economy are counting on the vitality and integrity of banks' internal control functions as the front line of defense in maintaining the health of our financial system.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Neighborhood Housing Services of New York, on equitable housing and consumer credit markets, New York, New York, May 5, 1999

It's truly a pleasure to join you this morning. Of course, I'd heard about Fran Justa well before I became Comptroller of the Currency. But only recently did I get to meet her. And only then did I come to fully appreciate the outstanding work that she and New York NHS and all the financial institutions represented here today—and many that are not—have been doing together in partnerships formed over the past 17 years.

I could spend all of my time with you today discussing those accomplishments, and still not do them justice. So, instead, I thought I would offer some observations on a subject in which I know NHS has had a long and abiding interest: the development of more equitable and efficient housing and consumer credit markets.

I'm told that Fran's involvement in community development grew out of a personal encounter with discrimination. Sad to say, her experience was all too common. Not too long ago, redlining prevented credit from flowing into many communities, and far too many would-be borrowers were denied loans on the basis of race, gender, or ethnic origin. The result was stagnation and decay in redlined neighborhoods, hardship and hopelessness among many of our citizens, and lost business opportunities and productivity in our economy.

Slowly, things changed for the better. The passage of laws such as the Equal Credit Opportunity Act, Home Mortgage Disclosure Act, and the Community Reinvestment Act (CRA) brought the resources and authority of the federal government to bear in the fight against unequal access to financial services. Regulators and public interest groups did their part to ensure that the laws were properly implemented and enforced. And organizations like NHS sprang up to provide leadership, bringing borrowers and lenders together, educating homeowners and those who aspired to join their ranks.

While CRA has known its share of controversy, its fundamental purpose is to overcome market imperfections in the flow of information to—and from—lenders. Empirical evidence suggests that information barriers have impeded the efficient operation of financial markets. CRA created incentives for banks to reduce the barriers that obstructed the flow of market information. For example, when lenders shied away from some low- and moderate-income borrowers, it was in part because they didn't know enough about them—and because they thought that the cost of obtaining additional information was not worth it.

For their part, aspiring borrowers found themselves caught in a vicious—and pernicious—cycle. Without a verifiable credit history, they were unable to obtain the loans they needed to establish a verifiable credit history. Without good information, lenders relied on what they had, including misperceptions and flawed generalizations. Someone—or something—had to break the logjam.

That's what CRA was designed to do—to overcome the market imperfection of inadequate information, and to help lenders and creditworthy borrowers connect. And they have. As Chairman Greenspan noted last year, "increased focus on [community development] lending has helped financial institutions discover new markets that may have been underserved before."

We can measure this progress in at least two ways. First, there is the growing volume of CRA-qualifying loans and investments. Since 1993, financial institutions have made CRA commitments and pledges totaling more than one *trillion* dollars.

The second measure of progress is the success of CRA asset-backed securities in the capital markets. Since late 1997, more than $2 billion worth of community reinvestment loans have been packaged and marketed into securities. As a percentage of all lending that earns CRA consideration, of course, that's a drop in the bucket. But it's an important start. Every dollar taken off the originator's books through securitization is a dollar available for new loans. And, more to the point, securitization reflects a growing confidence among secondary market investors—many of whom, after all, are under no CRA obligation of their own—in the quality of these loans. I think that it proves we're on the right track.

As we develop more complete information on low- and moderate-income borrowers and the performance of their loans over time, competitive markets are developing, just as we'd hoped. Lenders are discovering opportunities in community development and the low- and moderate-income housing market to build new and profitable business relationships. I trust that NHS of New York is finding the going somewhat easier than it was 17 years ago. Government encouragement is no longer the sole force driving the process.

Some emerging financial sub-markets are experiencing growing pains, however. For example, I know of no financial product with greater potential for good—or for

abuse—than subprime loans. Potentially, they offer first-time borrowers a chance to build a credit history, and repeat borrowers a chance to rehabilitate a blemished history. Under the right conditions, subprime loans can provide entry—or reentry—into the financial mainstream—but only if they're marketed and used responsibly. An increasing number of subprime lenders are taking the lead in developing programs that reward good payment performance with gradually lowered rates. That's the way efficient markets should work.

But sharp and shady practices unfortunately abound. Subprime borrowers often lack professional advisers to help them in shopping for a mortgage, which can make them easy targets for unscrupulous lenders. When the paycheck's gone and there are still bills left to pay at the end of the month, the offer of credit—on any terms—can be hard to resist, and lenders know it. Yet evidence suggests that at least 30 percent of subprime mortgage borrowers would actually qualify for prime rates if they only knew to ask or to shop around. And we continue to hear heartbreaking stories of people—especially the elderly—who have little cash flow, but lots of home equity, being signed up for loans they cannot possibly repay, and losing their homes as a result. Through no fault of their own, subprime borrowers can easily become trapped in a financial straitjacket from which Houdini himself would have trouble escaping.

I would like to believe that these predatory practices are less common among commercial banks with subprime departments than among other subprime providers. And I wonder whether the CEOs and directors of any offending banks are actually aware that these practices are taking place.

Just as with community development lending in the recent past, I believe that sunshine is the best antidote to predatory and discriminatory lending practices in the subprime field today. That means full, complete, and conspicuous disclosure of terms to potential borrowers, to let them see the actual cost of their loan, how rapidly it will amortize, and what the consequences of nonpayment will be—a matter of particular importance when loans are secured by the borrower's primary residence.

Consumers need full and accurate information if they are to make intelligent choices. The lack of information plays directly into the hands of the financial predators.

Another essential piece of the disclosure picture concerns credit bureau reporting. Subprime loans can't become a vehicle for upward mobility if creditors in the broader credit market lack access to consumer credit history. Yet, a growing number of subprime lenders have adopted a policy of refusing to report credit line and loan payment information to the credit bureaus—without letting borrowers know about it. Some make no bones about their motives: good customers that pay subprime rates are too valuable to lose to their competitors. So they try to keep the identity and history of these customers a closely guarded secret.

When they do, it's the borrower who loses. A credit history can't be built or repaired if lenders refuse to let anyone else know about it. The failure to report is unfair to customers, unfair to competition, and ultimately inconsistent with the values of our national economy.

I'm also concerned that a decline in credit bureau reporting could have broader safety and soundness implications for the whole banking system. Lenders that continue to rely on credit bureau information—as most still do—on the assumption that it is fair and complete, and lenders who construct their scoring systems using such data, will have less complete information. This must inevitably skew lending decisions and eventually compromise the integrity of those lenders' risk management processes.

That's why we recently brought this issue to the attention of the other banking agencies, and why our staff has raised questions about these practices with staff at the Federal Trade Commission. In the coming weeks, we will be formulating a joint supervisory response to the nonreporting of favorable consumer credit histories. In the meantime, I would urge any banks and other financial institutions with subprime interests that might be reconsidering their policy on credit bureau reporting to think about the potential consequences—for themselves and for their customers—before they jump aboard this bandwagon.

Thanks to the NHS of New York and its many corporate and community partners, thousands of New Yorkers are better housed than they've ever been. You should be very proud of that achievement. One of the things I've tried to do in my remarks this morning is to remind you that the impact of your good work goes beyond the individual neighborhoods of this great city. You've made a significant contribution to a national economy that's more open, more rational, and more humane. That's no small feat. I congratulate you—and thank you.

Statement of John D. Hawke Jr., Comptroller of the Currency, before the Financial Institutions and Consumer Credit Subcommittee, U.S. House Committee on Banking and Financial Services, on the Depository Institution Regulatory Streamlining Act of 1999, Washington, D.C., May 12, 1999

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

Madam Chairwoman and members of the subcommittee, I appreciate this opportunity to discuss continuing efforts to reduce regulatory burdens on the banking industry, and specifically to offer the views of the Office of the Comptroller of the Currency on H.R. 1585, the Depository Institution Regulatory Streamlining Act of 1999. I commend you for your leadership in crafting a bill that builds on prior successful efforts to provide prudent and effective regulatory relief for banks.

Effective bank supervision requires a regulatory infrastructure that maintains the safety and soundness of the industry, ensures that the credit needs of the public are served, and protects the interests of banking customers. The achievement of these goals necessarily results in some degree of regulatory burden on the banking industry. However, those of us in the bank regulatory community share with the Congress the responsibility to identify and eliminate the regulatory and supervisory burdens that are unnecessary and to streamline the requirements that are needed in order for banks to serve their important role in our national economy and our nation's communities. Needless burdens make banking more costly, inhibit banks' ability to serve their customers, and, in the long run, undermine safety and soundness.

The Office of the Comptroller of the Currency (OCC) has a strong continuing commitment to reduce unnecessary regulatory burdens and improve the efficiency of our supervision. A few weeks ago, I announced that the OCC would undertake a program to address the needs of community banks. As part of that program, we are conducting a community-bank-focused review of our regulations that will enable us to identify and to change rules that are particularly onerous for community banks. I am pleased to report to you that today's edition of the *Federal Register* contains an advance notice of proposed rule making (ANPR) soliciting public comment and suggestions for addressing the regulatory burdens that especially impact community national banks. This ANPR is the first step toward revising our rules to lessen community banks' burden consistent with maintaining safety and soundness. We look forward to hearing the suggestions of community banks and others interested in this effort.

Of course, the need for regulatory burden reduction is felt throughout the industry, not only among community banks. The OCC has a consistent record of working hard to ensure that regulation and supervision are efficient for all national banks. Efficient supervision means that the OCC focuses its regulations and its supervisory resources on those bank activities and products that present the greatest risks to safety and soundness or that most directly affect the other aspects of the national banking system's mission. Our recent initiatives include the OCC's regulation review program, completed in 1996, 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, facilitating equitable access to banking services for all consumers, or accomplishing the OCC's other statutory responsibilities. Second, we have implemented a supervisory approach, supervision by risk, which deploys our examiners as efficiently as possible by focusing their attention on the supervisory issues that have the greatest effect on the nature and extent of the risks in each particular institution. Finally, we have reduced the assessments and charges national banks pay the OCC to pass along savings in our actual cost of supervision.

The OCC's ability to undertake these initiatives successfully owes much to the leadership that the Congress has shown over the last five years in reducing needless burden on the banking industry without compromising either safety and soundness or the community and customer responsibilities of banks. And there is still opportunity to do more. As you know, regulatory burden on national banks can take many forms. In addition to unnecessary and antiquated statutory requirements, banks face regulatory burden through unwarranted restrictions that impede their ability to compete with other financial services providers. For example, national bank insurance sales activities are subject to a geographic constraint—the so-called "place of 5,000" restriction—that limits their ability to conduct this business in a way that is both outdated and anticompetitive. Unfortunately, none of the financial modernization bills currently under

consideration removes this burdensome restriction. Whatever the outcome of the financial modernization debate in this Congress, I believe this restriction is no longer warranted and should, consistent with the elimination of needless regulatory burden, be repealed.

I thank you, Madam Chairwoman, the members of the subcommittee, and your staffs for working with the OCC and the other federal banking regulators to craft a bill that takes into account many of our concerns and suggestions for appropriate regulatory burden relief. The OCC supports the subcommittee's efforts to provide regulatory relief and promote economic efficiency in the banking industry.

In the remainder of my statement, I will offer the OCC's comments on several provisions in the bill and recommend additional changes that I believe would provide additional burden relief.[1]

Comments on the Depository Institution Regulatory Streamlining Act of 1999

Removal of Restrictions on Interest Payments

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

Interest on business checking accounts. H.R. 1585 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,[2] 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 agree with the sponsors of this legislation, however, that it is appropriate to provide a transition period so that financial institutions can make necessary changes in their funding sources and pricing to accommodate the repeal of the prohibition, especially in light of the unique challenges financial institutions now face in readying themselves for the year 2000. The proposed effective date of October 1, 2004, provides an ample transition period for this purpose.

Interest on reserves. The question of paying interest on 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 reduce required reserves.[3] The practical result of these measures has been the shrinkage of the reserve base.[4] 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 required reserves would reduce revenue that the Federal Reserve Board currently turns over to the Treasury.

This provision thus has a budgetary impact. Accordingly, while we have no objection in principle to paying interest on required reserves, without knowing the budgetary ramifications of the changes, and given the range of programs that could be detrimentally affected, we are not able to take a position on this provision 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.

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[1] Appendix A to this statement contains the OCC's section-by-section comments on the bill. Appendix B lists the OCC's additional suggestions for regulatory burden relief.

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

[3] 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.

[4] 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).

The Bank Examination Report Privilege Act (BERPA)

Your invitation letter also specifically requested that we comment on the Bank Examination Report Privilege Act (BERPA), contained in sections 501 and 502 of the bill, which would establish a bank supervisory privilege to protect confidential supervisory information, such as depository institution examination reports and other documents relating to the examination. The OCC supports BERPA. 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 that is so critical to maintaining an institution's safety and soundness. 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. They also 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 fair process, including judicial review, by which third parties may seek access to supervisory information.

Limited Purpose Banks

You also requested our comments on sections 222 and 223, which contain amendments relating to limited purpose banks, otherwise known as "nonbank banks." Among other things, these sections would exempt well-capitalized and well-managed nonbank banks from the activities restrictions contained in the Competitive Equality Banking Act of 1987, although leaving in place the prohibition on nonbank banks accepting both demand deposits and making commercial loans. The OCC has no objections to these changes.

Corporate Governance Provisions

The bill contains important, burden-reducing provisions that would streamline and modernize aspects of the corporate governance of national banks. The OCC supports all of these provisions and, as described in Appendix A of this statement, under "Title III—Streamlining Federal Banking Agency Requirements," we have some suggestions for additional amendments that would complement those already included in the bill.

Expedited procedures for corporate reorganization. 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 the bank to accomplish this type of reorganization in a single, 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.

Authority to allow additional directors. Section 201 would permit the OCC to allow a national bank to have more than the current limit of 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.

Waiver of citizenship requirement. Section 603 reinstates the Comptroller's authority to waive the citizenship requirement for up to a minority of directors of national banks that are subsidiaries or affiliates of foreign banks. Congress inadvertently repealed this longstanding authority when it adopted the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The OCC supports the correction of this technical error. However, we prefer the provision adopted by the Senate Banking Committee in S. 576, which expands this amendment to give the OCC the flexibility to waive the citizenship requirements for up to a minority of the directors for any national bank, whether or not affiliated with a foreign bank.

Ownership of a depository institution's own stock. Section 202 permits any depository institution to own or hold its own stock. Under current law, a national bank is prohibited from 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 OCC has concluded that, in light of other provisions in national banking law, a national bank may acquire its own stock for certain legitimate corporate purposes. This amendment is important, however, because it will eliminate any confusion about the authority of a national bank to purchase its own shares for legitimate corporate purposes, *e.g.,* offering stock in connection with an officer or employee stock option or bonus plan; selling stock to a potential director in circumstances where a director is required to own qualifying shares; reorganizing as a subchapter S corporation; or reducing capital when market conditions or internal operations indicate that doing so is in the best

interest of the bank and is consistent with safety and soundness.

Provisions Affecting the Banking Agencies' Supervisory Authorities

H.R. 1585 contains a number of provisions that affect various supervisory authorities of the federal banking agencies. Here, I would like to highlight a few specific suggestions with respect to certain of these amendments for the subcommittee's consideration.

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 lending limits. The OCC believes that the subcommittee should proceed cautiously with the relaxation of insider lending limits proposed in section 310. 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.

Additional Regulatory Relief Items

The OCC also asks that the subcommittee consider additional amendments that would further reduce burden for national banks, streamline corporate governance procedures, and clarify existing laws. A few of these suggestions are described here.

Corporate Governance Provisions

Facilitating subchapter S status. Amendments to the Internal Revenue Code enacted in the 104th Congress now permit banks to organize as subchapter S corporations. With subchapter S status, corporations pay no corporate income taxes and pass profits (and losses) directly to shareholders, who are individually taxed. However, under existing banking laws, banks, especially small community institutions, often have trouble qualifying for this corporate status. Specifically, because subchapter S corporations may only have 75 shareholders or less, the requirement that a bank's directors own shares in the bank or the bank's holding company may limit the ability of some banks to obtain subchapter S status. In addition, there is no express authority in the national banking laws for banks to conduct reverse stock splits, which can be a useful mechanism for a bank to reduce its number of shareholders for subchapter S status. Therefore, in order to permit more national banks to take advantage of subchapter S status, we urge that provisions be added to H.R. 1585 to permit the Comptroller to waive the directors' stock purchase requirement, in whole or in part, in the case of national banks that elect to be subchapter S corporations, and to clarify the authority of a national bank to engage in reverse stock splits, upon the approval of the Comptroller and with protections for dissenting shareholders. These two amendments would work together with section 202, which repeals the prohibition on a national bank's purchasing or holding its own shares, to make it easier for community banks to qualify as subchapter S corporations.

Elections of national bank directors. As indicated by my earlier comments, the OCC supports the proposal included in the bill that would permit the OCC to allow a national bank to have more than 25 directors. We also believe it would be appropriate to allow national banks to elect their directors for terms of up to three years in length and to permit these directors to be elected on a staggered basis, so that only one-third of the board of directors is elected each year. 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 disruptive of regular business operations and there are, in addition, sound public policy reasons for allowing banks to choose a staggered election process. Staggered elections can help ensure that a board will always include experienced members, a factor that tends to enhance safety and soundness. This change would be consistent with the Model Business Corporation Act and with many state corporate codes, including Delaware's General Corporation Law. Moreover, it would promote stability on bank boards of directors and enhance a bank's flexibility to determine the membership of the board to reflect its lines of business and the markets in which it operates.

Further streamlining national bank corporate reorganizations. The OCC also suggests permitting national banks to merge or consolidate with nonbank subsidiaries or affiliates that are engaged in activities that are permissible for the bank to conduct directly. The National Bank Consolidation and Merger Act authorizes and establishes the procedures for the merger or consolidation of national banks with other national banks or with state banks. However, there is no express authority under federal law for national banks to merge with nonbank subsidiaries or affiliates. As a result, in order to accomplish

a corporate reorganization involving a combination of an uninsured subsidiary or affiliate with the bank, the bank must use a more burdensome form of corporate transaction—a purchase of assets and assumption of liabilities of the subsidiary or affiliate. The *substance* of the transaction is the same as a merger in that the bank acquires the other entity, but the purchase and assumption transaction can require extensive documentation of transfers of individual assets and can entail issues of corporate succession that do not arise in a merger. Permitting national banks to merge with their nonbank subsidiaries and affiliates would enhance the ability of banks to organize activities and assets within their banking organizations in the way that makes the best business sense and does not impose unnecessary burdens.

Community Involvement and Banking Access Amendments

Clarifying national bank authority to branch on Indian reservations. The national bank branching statute provides that the OCC may authorize branches "within the city, town or village" or, alternatively, "at any point within the State" in which the bank "is situated" to the same extent permitted to state banks. However, because Indian land is sovereign territory, it is unclear whether an Indian reservation is located "within" a state. In addition, the fact that state banking laws generally do not apply on Indian reservations also makes it unclear whether the federal statute, which incorporates state branching laws, permits national banks to branch on Indian reservations. Finally, it is also unclear how the federal branching statute applies in situations where an Indian reservation spans more than one state. In order to enhance the ability of national banks to serve the financial needs of Native American communities, we suggest that this section be clarified to specifically permit a national bank to establish and operate branches on Indian reservations, provided tribal law permits such branching. This approach would treat Indian reservations and other lands comprising Indian country similarly to states by permitting tribal governments to control branching laws in their local jurisdiction.

National bank participation in certain community activities. Current law generally prohibits national banks from announcing, advertising, or publicizing lotteries or any lottery winners or participants. The legislative history of this prohibition indicates that Congress clearly intended to prohibit banks from being used for state lottery activities. However, because this section broadly defines the term lottery to include any arrangement in which the participants advance money or credit to another in exchange for the possibility or expectation of winning an amount more than they advanced, this provision could be interpreted to prohibit types of community-related fund-raising activities that were not intended to be covered by the statute, such as raffles sponsored by community or non-profit organizations. We propose that the Comptroller be allowed to permit activities that include the use of national bank premises for charitable fund raising that does not involve cash awards. This change would enhance the ability of national banks to participate in and support community-based fund-raising activities.

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 you, Madam Chairwoman, and the subcommittee for your efforts to reduce unnecessary regulatory burden, consistent with these goals.

Appendix A: H.R. 1585, the Depository Institution Regulatory Streamlining Act of 1999, as introduced on April 27, 1999

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 thus has a budgetary impact. Accordingly, while we have no objection in principle to paying interest on required reserves, without

knowing the budgetary ramifications of the changes, and given the range of programs that could be detrimentally affected, we are not able to take a position on this provision 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.

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 authorizes depository institutions, as of enactment, 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. Effective October 1, 2004, section 102 permits depository institutions to offer interest-bearing NOW accounts to businesses and to pay interest on demand deposits (thereby providing a five-year transition period).

OCC comment: The OCC supports this amendment. 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 believes that the prohibition on paying interest on business checking accounts is outdated in the modern financial services environment. While banks may 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. The amendments also provide a period during which financial institutions could make necessary changes in their funding sources and pricing to accommodate the repeal of the prohibition. Providing for an adequate transition period is particularly important as institutions face unique challenges readying themselves for the year 2000. The proposed effective date of October 2004 provides an ample transition period for this purpose.

Sec. 103. Study of Reserve Ratios for Deposit Insurance Funds

Summary: This section requires the FDIC, in consultation with the Fed and Treasury, to conduct a study of the adequacy of the deposit insurance funds and to recommend to Congress, before June 30, 2000, an appropriate range of reserve ratios of the Bank Insurance Fund (BIF) and the Savings Insurance Fund (SAIF) to the aggregate amount of insured deposits, and an appropriate mechanism for rebating or providing credit from BIF or SAIF when the balance of either fund exceeds the applicable reserve ratio. This study must take into account expected operating expenses, case resolution expenditures and income, and the effect of assessments on members' earnings and capital; historical failure rates and loss experiences; recent changes in law; the investment income of each fund; the potential implications of the year-2000 computer problem and industry consolidation; and the historical experiences of the FDIC in providing rebates or credits.

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

Title II—Improving Depository 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 five 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.

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 a conforming change to section 18 of the FDI Act so that all insured depository institutions may be permitted to own or hold their own stock.

OCC comment: The OCC supports this section. While the OCC has interpreted section 83 in light of other provisions in national banking law and has concluded that a national bank may acquire its own stock for certain legitimate corporate purposes (12 CFR 7.2020), deleting the prohibition in section 83 will eliminate any confusion about the authority of a national bank to purchase its own shares for legitimate corporate purposes, *e.g.,* to reduce its capital when market conditions or internal operations indicate that doing so is in the best interest of the bank and is consistent with safety and soundness. Other examples of legitimate corporate purposes for which a bank may wish to acquire or hold its own stock include offering stock in connection with an officer or employee stock option or bonus plan, selling stock 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 10, line 17, and again on page 11, line 8.

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 transactions would not change, and the requirements of the Bank Holding Company Act (BHC Act) would still apply. In addition, this section requires the OCC, in approving these transactions, to continue to apply the Bank Merger Act's public notice requirements, statutory convenience and needs test, and CRA review as if the transaction were still subject to the Bank Merger Act. 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 a bank to reorganize into a subsidiary of a holding company, if it chooses that corporate 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 multi-step process because there are no provisions in current law that permit a national bank reorganization 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 converted into 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 unnecessarily expensive and time-consuming, and imposes needless burdens.

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 notes that the authority for subsidiaries of federal thrifts to engage in activities not permissible for the thrift itself does not include the types of safety and soundness safeguards that pending financial modernization legislation would apply to subsidiaries of banks engaged in activities not permitted for the bank itself.

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 community development authority that is substantially the same as that which is authorized for 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. A higher amount may be permitted up to 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. The OCC and the Fed have similar authority to permit community development investments up to 10 percent of capital and surplus for national and state member banks, respectively. *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. Prohibition on Accrual to Insiders of Economic Benefits from Credit Union Conversions

Summary: This section amends section 18 of the FDI Act (12 USC 1828) to prohibit an insured credit union from converting to an insured depository institution or to a stock form of ownership unless the appropriate regulator determines that no current or former (within the past five years) director, committee member, or senior management official will receive any economic benefit as a result of the conversion with regard to shares or interests in the credit union or resulting insured depository institution.

OCC comment: The OCC takes no position on this section.

Sec. 222. Amendments Relating to Limited Purpose Banks

Summary: Section 4(f) of the BHC Act (12 USC 1843(f)) grandfathers companies that control so-called nonbank banks (*i.e.,* banks that were not defined as banks under the BHC Act until that definition was amended by the Competitive Equality Banking Act of 1987 [CEBA]). Under section 4(f)(3), certain restrictions are imposed on grandfathered nonbank banks' activities. Cross-marketing

of products or services that a bank holding company could not provide under section 4(c)(8) of the BHC Act is prohibited. Overdrafts (including intra-day overdrafts) on behalf of an affiliate are also prohibited except for those that are defined as "permissible overdrafts." CEBA also permitted bank holding companies to retain ownership of nonbank banks provided that the nonbank bank did not engage in any activity in which it was not engaged as of March 5, 1987 or that would have caused the institution to be a bank before the enactment of CEBA or increase the number of locations from which the institution transacts business. (The 7 percent asset growth restriction was repealed by the Economic Growth and Regulatory Paperwork Reduction Act of 1996.) Section 4(f)(4) of the BHC Act 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 described above. 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: (1) permits a company to control another company that engages in activities permissible for credit card banks without losing its nonbank bank exemption; (2) allows overdrafts incurred as a result of an inadvertent computer or accounting error that is beyond the control of the bank or affiliate or is fully secured by direct obligations of or guaranteed by the United States or securities and obligations eligible for settlement on the Federal Reserve book entry system; (3) exempts well-capitalized and well-managed nonbank banks from the activities restrictions of section 4(f)(3); (4) repeals the cross-marketing restrictions; and (5) provides that, if a company fails to continue to qualify for the nonbank bank exemption, the company does not have to divest the nonbank bank if it corrects the condition or ceases the activity that violated the exemptions or receives approval from the Fed of a plan 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, provided the company notifies the Fed immediately upon failing to qualify for the exemption.

OCC comment: The OCC does not object to this provision.

Sec. 223. Business Purpose Credit Extensions

Summary: This section adds a provision to section 4 of the BHC Act (12 USC 1843) to provide that CEBA credit card banks and nonbank banks that provide credit card accounts for qualified business purposes will not be treated as engaging in the business of making commercial loans by reason of such extensions of credit. The Fed is given the authority to define "qualified business purposes," with specific parameters: expenditures for capital improvements, inventory acquisitions, or other large acquisitions may not be considered a "qualified business purpose," while expenditures for employee travel, entertainment, and subsistence, and certain small acquisitions and purchases may meet this definition.

OCC comment: The OCC does not object to 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 rule makings published in the *Federal Register* after January 1, 2000. In addition, each federal banking agency must submit a report to Congress by June 1, 2001 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.)

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 no later than July 1, 2001, 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: These requirements have essentially already been enacted by Congress, and the federal banking agencies are in the process of implementing them. *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 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, within 180 days of enactment of this legislation, that such valuation would not have an adverse affect on the deposit insurance funds or on the safety and soundness of insured depository institutions. This section also requires that any regulations issued pursuant to this section be issued jointly by the banking agencies.

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 United States 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 limitations 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 permit post-insolvency interest to be paid 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 deposits 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. 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 USC 375a) to permit executive officers: (1) to obtain home equity lines of credit up to $100,000 secured by a lien on their primary residence, provided that the aggregate amount of the lien and all other extensions of credit secured by such liens do not exceed the appraised value of the residence; and (2) to obtain credit in an amount not to exceed the greater of (a) the amount that is the lessor of 2.5 percent of the aggregate amount of capital and unimpaired surplus of the bank or $100,000, or (b) $25,000, provided that in either case the extension of credit is 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 310. 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. 311. 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 under0 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 could qualify for the loan using this additional collateral. Section 11(m) thus hinders a bank's ability to make loans collateralized to the maximum extent possible and, thus, is inconsistent with safety and soundness.

Sec. 312. Repeal of Bank Holding Company Act Provision Limiting Savings Bank Life Insurance

Summary: Section 312 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 that the BHC Act does not apply to activities conducted directly or through subsidiaries by national or state bank affiliates of BHCs, and legislation subsequently enacted by Congress, notably section 24 of the FDI Act, which governs the permissible insurance activities of state banks (including savings banks) and their subsidiaries

Sec. 313. Amendment to Section 5137 of the Revised Statutes of the United States.

Summary: Currently, section 5137 of the revised statutes (12 USC 29) prohibits national banks from holding any real estate acquired in satisfaction of debts previously contracted (real estate acquired "DPC") for more than five years. However, the OCC may approve possession for an additional five years if: (1) the bank has made a good faith attempt to dispose of the real estate within the five-year period, or (2) disposal within the five-year period would be detrimental to the bank. In addition, national banks which on October 15, 1982, held real estate, including any subsurface rights or interests therein, that, as of December 31, 1979, had not been valued on the books of the bank for more than a nominal amount, may continue to hold such real estate, rights, or interests for such longer period of time as would be permitted a state-chartered bank by the law of the state in which the national bank is located, if the aggregate amount of earnings from such real estate, rights, or interests is separately disclosed in the annual financial statements of the association. (Texas law characterizes all mineral interests as real property and has a divestiture requirement similar to section 29. Thus, under current state law, Texas banks must follow the same rules for divestiture of these interests as do national banks.)

This amendment would provide an additional five-year holding period for subsurface rights of real estate, and interests in such rights, held by a national bank DPC with the approval of the OCC pursuant to section 29, notwithstanding their location and state law treatment of subsurface rights and interests as real or personal property. Specifically, this amendment provides that the OCC may approve possession of these rights and interests for an additional five years provided: (1) the national bank acquired the property in satisfaction of debts previously contracted; (2) the bank holds the subsurface rights and interests passively and is not engaged in production, extraction, exploration, or other active use of the rights or interests, (3) the bank values the rights and interests for no more than a nominal amount and separately discloses the aggregate amount of earnings from these rights and interests in its annual financial statements, and (4) the Comptroller determines that the possession of the rights and interests is not inconsistent with the bank's safety and soundness. In addition, the amendment would permit the Comptroller to require divestiture if it is later determined that continued possession of the rights and interests would be detrimental to the bank.

OCC comment: The OCC does not object to this amendment. However, we note that, as drafted, it is unclear whether this amendment would apply to mineral rights and interests acquired before October 15, 1982, and, therefore, whether national banks that acquired such rights and interests on or before this date may continue holding these rights and interests pursuant to state law, which may have a longer holding period than what is provided by this section. We also have technical comments on this amendment.

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 does not object to this section.

Title V—Bank Examination Report Privilege Act

Sec. 501. Amendment to the Federal Deposit Insurance Act

Summary: This section adds a new section 45 to the FDI Act 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 created ambiguity about the confidential status of supervisory information, which is the foundation for the supervisory process.[5]

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 bank supervisory 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 of information or documents prepared 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 U.S. 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 Representative 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, nonadversarial 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 federal banking 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 fair process, including judicial review, by which third parties may seek access to supervisory information in appropriate circumstances. The OCC recommends, however, that the subcommittee include the technical amendments that have been discussed with the staffs of the other federal banking agencies, which clarify the scope of the definition of "confidential supervisory information," insure that confidential supervisory information can be used for law enforcement purposes, and make other minor technical corrections. We look forward to working with the subcommittee to perfect this amendment.

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[5] *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); and *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).

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 from the NCUA in the case of federal credit unions. 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 defers to the comments of the NCUA on this section.

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, Senators 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.

OCC comment: The OCC supports this section. The OCC, however, prefers the provision adopted by the Senate Banking Committee in S. 576 that gives the OCC the flexibility to waive the citizenship requirements for up to a minority of the directors for any national bank.

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.

Sec. 605. Applicability of Limitation to Prior Investments

Summary: Section 18(s) of the FDI Act (12 USC 1828(s)(1)), as added by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, P.L. 104–208, prohibits a bank or savings association from being an affiliate of, being sponsored by, or accepting financial support, directly or indirectly, from any government-sponsored enterprise (GSE), except for routine business financings. For purposes of this prohibition, a GSE includes Fannie Mae, Freddie Mac, Farmer Mac, Sallie Mae, the Federal Home Loan Bank System, the Farm Credit Banks, the Banks for Cooperatives, the College Construction Loan Insurance Association, and any of their affiliated or member institutions. Section 605 provides that the prohibition on investments does not apply to investments made in any GSE prior to April 11, 1996. This change is made retroactive back to the effective date P.L. 104–208.

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

Title VII—Special Reserve Funds

Sec. 701. Abolition of Special Reserve Funds

Summary: The Economic Growth and Regulatory Paperwork Reduction Act, P.L. 104–208, 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. (FDIC staff currently predicts that the SAIF reserve ratio to be within the range of 1.37 to 1.45 percent on December 31, 1998, which would result in a Special Reserve of $883.6 million to $1.35 billion on January 1, 1999.) The FDIC has stated that, by eliminating any cushion in the SAIF above the designated reserve ratio, the Special Reserve increases the likelihood that the SAIF will fall below this ratio. This would require the FDIC to raise SAIF premiums, which would re-open the issues associated with a BIF–SAIF premium differential.

Public Law 104–208 also establishes the Deposit Insurance Fund (DIF) Special Reserve, which would have the same functions and operations as the SAIF Special Reserve once the BIF and SAIF are merged into the new Deposit Insurance Funds.

This section eliminates both the SAIF and DIF Special Reserves.

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

Appendix B: OCC Regulatory Relief Items

Subcommittee on Financial Institutions and Consumer Credit, U. S. House of Representatives, May 12, 1999

The OCC requests that the following items be considered for inclusion in H.R. 1585:

1. Facilitating subchapter S status for national banks (12 USC 72)

   Recent amendments to the Internal Revenue Code permit banks to organize as subchapter S corporations. However, because subchapter S corporations may only have 75 shareholders or less, the requirement in section 72 that directors own qualifying shares may limit the ability of some banks to obtain subchapter S status. This amendment would permit the Comptroller to waive this stock purchase requirement, in whole or in part, in the case of national banks that elect this corporate status.

2. *Clarifying recapitalization authority for national banks (12 USC [new section])*

   This section would clarify the authority of a national bank to engage in reverse stock splits with the approval of the Comptroller and pursuant to any regulations issued by the Comptroller. A reverse stock split is a useful method of enabling a bank to recapitalize. In addition, recent amendments to the federal tax law enable banks to reorganize as subchapter S corporations. Because a subchapter S corporation may have no more than 75 shareholders, a reverse stock split can be a useful mechanism for a bank to reduce its number of shareholders to achieve subchapter S status. In order to protect the rights of dissenting shareholders, this amendment requires that OCC regulations provide a means for dissenting shareholders to obtain payment of the fair value of their shares.

3. *Streamlining national bank corporate reorganizations (12 USC 215* et seq.)

   The National Bank Consolidation and Merger Act, 12 USC 215 *et seq.*, authorizes and establishes the procedures for the merger or consolidation of national banks with other national banks or with state banks. However, there is no express authority under federal law for national banks to merge with nonbank subsidiaries or affiliates that are engaged in activities that are permissible for the bank to conduct directly. As a result, in order to accomplish a corporate reorganization involving a combination of an uninsured subsidiary or affiliate with the bank, the bank must use a more burdensome form of corporate transaction—a purchase of assets and assumption of liabilities of the subsidiary or affiliate. The *substance* of the transaction is the same as a merger in that the bank acquires the other entity, but the purchase and assumption transaction can require extensive documentation of transfers of individual assets and can entail issues of corporate succession that do not arise in a merger.

   This amendment would expressly permit a national bank, upon the approval of the Comptroller and pursuant to regulations issued by the Comptroller, to merge or consolidate with its nonbank subsidiaries or affiliates, without providing for an increase in powers for the national bank. This amendment, which is included in S. 576, as reported by the Senate Banking Committee, would enhance the ability of banks to organize activities and assets within their banking organizations in the way that makes the best business sense and does not impose unnecessary burdens.

4. *Permitting choice of appraisal procedures for national banks (12 USC 214a, 215, and 215a)*

   Under current law, shareholders of the target bank who dissent from the merger or consolidation of the bank are entitled to receive the value of their shares

under certain circumstances. The laws also set out procedures for the formation of a three-member appraisal committee to ascertain the stocks' value. If the committee is not formed or cannot reach agreement as provided by the statute, the Comptroller makes the initial appraisal which is final and binding. In practice, rarely is the full committee of appraisers appointed and, therefore, the Comptroller performs the appraisal. Even if the committee is formed and does reach agreement on an appraised value, under current law, the Comptroller must make the reappraisal if a dissenting shareholder appeals the committee's decision. This amendment provides that the valuation of a dissenting shareholder's stock will be done in accordance with the corporate governance procedures designated in the bylaws of the bank in which the dissenting shareholder owns stock rather than by the Comptroller.

5. *Enhancing national banks' corporate flexibility in the election of directors (12 USC 61)*

Currently, section 61 requires that, in all elections of national bank directors, each shareholder has the right to (1) vote the number of shares owned for as many persons as there are directors to be elected, *or* (2) cumulate these shares by multiplying the number of directors by the number of his or her shares and giving all votes to one or more candidates. This amendment would permit national banks to choose which method of electing their directors best suits their business goals and needs, thereby making cumulative voting optional. It also would provide the OCC with authority to issue regulations to carry out the purposes of this section. Because the Model Business Corporation Act and most states' corporate codes provide that cumulative voting is optional, this amendment would make national banking law consistent with the majority rule under state corporate law. In so doing, it would reduce unnecessary regulatory burden by providing national banks with the same corporate flexibility available to many state corporations and state banks.

6. *Promoting management continuity for national banks (12 USC 71)*

Currently, section 71 provides that directors of a national bank may hold office for only one year and must be elected on an annual basis. This amendment would permit national banks to elect their directors for terms of up to three years in length and would permit these directors to be elected on a staggered basis in accordance with regulations issued by the OCC, so that only one-third of the board of directors is elected each year. This would provide national banks with flexibility in their corporate election process. Also, a bank that chooses a staggered election process will at all times have experienced members on its board, thereby enhancing the bank's safety and soundness. This change, which is included in S. 576, as reported by the Senate Banking Committee, is consistent with section 8.06 of the Model Business Corporation Act (1984, as amended 1994) and with many state corporate codes, including Delaware's General Corporation Law, Del. Code Ann. Tit. 8, section 141 (1991, as amended 1994).

7. *National bank participation in certain community activities (12 USC 25a)*

Section 25a broadly defines prohibited "lottery" activities to preclude banks from engaging in *any* arrangement in which the participants advance money or credit to another in exchange for the possibility or expectation of winning an amount more than they advanced. This provision could be interpreted to prohibit types of community-related fund-raising events that are not intended to be covered by the statute and for which there is no cash prize. However, the legislative history of this section indicates that Congress clearly intended to prohibit banks from being used for state lottery activities in which tickets are sold for a chance to win a cash jackpot. This amendment would enhance the ability of national banks to support their community by allowing the OCC to authorize the use of national bank premises to be used for charitable fund raising that does not involve cash awards, such as community raffles.

8. *Clarifying national bank authority to branch on Indian reservations (12 USC 36)*

Section 36 provides that the OCC may authorize intrastate branches "within the city, town or village" or, alternatively, "at any point within the State" in which the bank "is situated" to the same extent permitted to state banks. However, because Indian land is sovereign territory it is unclear whether an Indian reservation is located "within" a state. In addition, the fact that state banking laws generally do not apply on Indian reservations also makes it unclear whether the National Bank Act, which incorporates state branching laws, permits national banks to branch on Indian reservations. Finally, it is also unclear how section 36 applies in situations where an Indian reservation spans more than one state.

This amendment would enhance the ability of national banks to serve the financial needs of Native American communities by clarifying a national bank's authority to establish and operate branches on Indian reservations, notwithstanding the law of

the state or states in which the Indian reservation is located, and provided tribal law permits such branching (thereby treating the various Indian reservations and other lands comprising Indian country similarly to states by permitting tribal governments to control branching laws in their local jurisdiction).

9. *Providing parity for federal agencies of foreign banks (12 USC 3102)*

   This amendment would amend the International Banking Act ("IBA") to provide that federal agencies may accept foreign source deposits. Currently, pursuant to a decision by the D.C. Circuit Court of Appeals, federal agencies of foreign banks are prohibited from taking any deposits, including the limited foreign-source deposits (*i.e.*, deposits that are not from "citizens or residents of the United States") even though that type of deposit may be accepted by state-licensed agencies of foreign banks. *Conference of State Bank Supervisors* v. *Conover*, 604 F.2d 604, 623 (D.C. Cir. 1983). Consequently, foreign banks that operate federal agencies in the United States are competitively disadvantaged because they cannot offer the same services to foreign customers that may be offered by state agencies. The recommended change to the IBA would provide that federal agencies have the same right as state agencies to receive limited foreign source deposits. This amendment would not make any other change to current law or in any other way expand or affect the activities that are permissible for federal agencies operating in the United States.

10. *Providing examination parity for branches and agencies of foreign banks (12 USC 3102(b))*

    Section 2214 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996, P.L. 104–208, replaced the annual requirement for an on-site examination of a branch or agency of a foreign bank with a requirement that these branches and agencies be examined as frequently as would a national or state bank by the appropriate federal banking agency. As a result, branches or agencies that satisfy a comparable asset test imposed on domestic banks may be examined on an 18-month cycle rather than a 12-month basis. However, this legislation did not make a conforming change to section 3102. This amendment, which is included in S. 576, as reported by the Senate Banking Committee, would make that conforming change and clarify that the same rules easing examination requirements and costs for domestic banks apply to federal branches and agencies of foreign banks.

11. *Reducing regulatory burden for representative offices of foreign banks (12 USC 3102)*

    Although the International Banking Act (IBA) sought to provide foreign banks with a federal option for their U.S. offices, it did not provide the OCC with authority to establish federal representative offices. In this respect, the IBA does not fully implement the dual banking option nor advance the goal of national treatment. In addition, the absence of a federal representative office option has in some cases resulted in additional regulatory burden for those foreign banks that would prefer to have their entire U.S. operations under a federal license. This amendment would amend 12 USC 3102 to provide foreign banks with the option of establishing federal representative offices with OCC approval and under the OCC's supervision, provided that this establishment is not prohibited by state law. This amendment would not affect the Federal Reserve's existing authority to also approve or examine representative offices.

12. *Reducing regulatory burden of the capital equivalency deposit requirement for federal branches and agencies of foreign banks (12 USC 3102)*

    The capital equivalency deposit requirement is intended to ensure that assets will be available in the U.S. for creditors in the event of liquidation of the U.S. branch or agency of a foreign bank. This amendment would reduce regulatory burden by clarifying, streamlining, and deleting obsolete provisions of the capital equivalency deposit requirement, thereby making this requirement more consistent with comparable state law requirements for asset deposits by foreign banks.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before a conference sponsored by the Consumer Bankers Association and Robert Morris Associates, on customer credit and personal financial information, San Francisco, California, June 7, 1999

Last November, when I was awaiting the White House announcement of my appointment to serve as Comptroller of the Currency, the then-Acting Comptroller, Julie Williams, made a speech on customer service. It was a speech that I'd long thought needed to be given and had been looking forward to giving myself as Comptroller.

The thrust of her remarks seemed irrefutable—at least to me. She began by sketching the historical evolution of bank supervision from the days when it consisted of a simple measurement of a bank's internal management and core operations, to today's broader, more encompassing approach of assessing risk in all its manifestations—political, social, and economic.

And that brought her to the central point. "Bankers," she said, "need to weigh their business decisions—decisions that might be perfectly aboveboard from a legal or regulatory standpoint— against the reaction those decisions might elicit from the customers and communities they are chartered to serve." "They need to be aware," she added, "that actions perceived by a customer to be unreasonable or unfriendly may trigger a backlash whose costs can easily exceed the narrow value of that customer's business." Indeed, she argued that perceptions of deterioration in bank customer service had already hurt the industry in its efforts to achieve its legislative goals. By working to improve customer service, she concluded, banks had an opportunity to swing public opinion more to their side.

Generally, the speeches of bank regulators have a short shelf life: you read about them in the trade press for a day or two, and that's that. But Julie's speech sparked a spirited debate that lasted for weeks. Some people were startled—even offended—that a regulator would depict customer service as a safety and soundness issue. Others suggested pointedly that regulators keep their noses out of the banks' lawful relationship with their customers and let the free market do its job. After all, they said, if customers don't like the service they're getting, they're always free to take their business somewhere else.

But most commentators called the speech timely and important. Said one banker, "We as an industry would be better off paying attention" to the customer service problem than "to deny it or make excuses about it."

I applaud that kind of candor. I believe that customer service is a subject that clearly falls within the OCC's purview—for all the reasons Julie cited and for a few more. Of course, while it's important to generate discussion, it's even better if a speech leads to constructive action. The industry's progress—or lack of it—in dealing with the customer service issue since Julie delivered her speech is what I'd like to talk to you about today. And I'd like to discuss the work of the OCC's customer assistance group—one way we're trying to help bankers to do an even better job of meeting their customers' service expectations.

First, Julie was absolutely right in affirming that customer service is a safety and soundness issue —that is, unless you hold the view that a bank can afford to alienate its customers and damage its reputation without weakening itself. History is replete with cases of whole industries brought to the brink of extinction because a "customer be damned" attitude became embedded in the corporate culture. During the late 1970s and early 1980s, for example, the domestic auto industry's indifference to customer satisfaction and changing customer preferences cost it a huge piece of the U.S. market—a loss it's still struggling to recoup.

Banks could afford to turn a deaf ear to their customers if there were no place else for their customers to turn. But that's clearly not the case. Just as American households turned to foreign auto manufacturers 20 years ago, consumers of financial services have a wide choice of nonbank suppliers today. Competition has never been stronger, and, more than ever, customer service is a key competitive battleground. It concerns me—as I know it concerns you—that an increasing number of nonbank competitors are making a selling point of their nonbank status. When advertising stresses, "We're NOT a bank," and promises a higher level of responsiveness, local decision making, and customer service, it highlights a problem of major proportions for banks.

Customers all too frequently have negative predispositions about banks, and bank practices too often validate them. For example, some institutions' penchant for piling on fees and penalties reinforces the stereotype of the banker as Scrooge. Customers often don't understand why they should have to pay to gain access to their funds, or why talking to a teller might warrant a surcharge. *You* know that all bank services are delivered at a cost, and that you can't last long giving away products and services for nothing. But banks generally have not done a good job of explaining this fact of life to customers.

Industries that regularly win higher scores for customer service are likely to become your most significant future competitors. The computer software industry, for example, always ranks near the top in consumer surveys—a fact that should worry traditional bankers, given the rapid growth of on-line financial transactions. Merrill Lynch just last week announced a major move into electronic delivery of financial services. To suggest that the competitive challenges you face from those quarters are unrelated to the safety and soundness of the banking system and the value of the bank charter strikes me as woefully misinformed.

It's also the OCC's responsibility under the law to ensure that consumers are protected in their dealings with national banks. Unfortunately, there's mounting evidence of an increase in banking practices that are at least seamy, if not downright unfair and deceptive—practices that virtually cry out for government scrutiny.

Two particularly objectionable practices have recently come to our attention. The first involves financial institutions that, without letting customers know about it, have stopped reporting consumer credit lines, high credit balances, and payment records to credit bureaus. Some lenders, in particular, appear not to be reporting their payment experiences with subprime borrowers in order to protect against good customers being picked off by the competition—even though these customers may have been lured into a high-rate loan as a way of repairing a bad credit history. These high-interest borrowers may be rudely surprised when they discover that their good credit history as a subprime borrower isn't reflected in their credit files when they seek credit in the future and that they are unable to obtain better rates based on their good credit record.

Failure to report may not be explicitly illegal. But it can readily be characterized as unfair; it may well be deceptive, and—in any context—it's abusive. OCC staff has been discussing this issue with the other banking agencies and with the Federal Trade Commission staff, and is working to develop a joint supervisory response to this practice. But that may not be the end of it: Congress is already homing in on the problem.

The second item involves the sale of personal customer financial information to telemarketing firms. What's happening is basically this. A bank will enter into an agreement with an unaffiliated telemarketing firm under which the bank provides extensive confidential customer information in return for a commission on sales made by the marketing firm. And the information goes well beyond mere lists of names. It also includes addresses, telephone numbers, social security numbers, dates of birth, credit card numbers, checking account numbers, account balances, credit card purchases, last payment dates, occupations, marital status, and credit-scoring information.

With this information, a telemarketer can profile bank customers and offer so-called "trial memberships" most likely to appeal to a particular customer. If a customer indicates an interest in seeing materials about the offer or expresses an interest in the trial membership, his account at the bank is automatically charged by the telemarketer—without the customer ever divulging his account number, much less knowingly authorizing the charge or withdrawal.

In many cases, the customer may not realize that he's being charged unless he spots and questions an unfamiliar item that appears on his monthly statement. And in many cases, the "trial" membership automatically converts into a continuing series of monthly charges unless the customer affirmatively "opts out" of the program. The disclosures provided to a customer about the need to opt out in order to avoid continuing charges often leave much to be desired, and the bank's published privacy policies frequently fail to make reference to this use of confidential customer information.

In my judgment, this practice raises a number of serious legal concerns, which we and others are currently reviewing. Judging from the calls we receive from state attorney general offices around the country, the scope of the concern may be widespread.

In addition to the legal issues, however, one must be troubled about the implications of this practice for the preservation of customer confidence in the confidentiality of the bank–customer relationship. We heard loud complaints from many in the banking industry that the now-defunct "know your customer" regulation would do severe damage to customer confidence—as I believe it would have. But there doesn't seem to be the same sensitivity about damaging that relationship when there are commissions to be earned from the sale of confidential information.

Issues surrounding the transfer of customer information already have lent momentum to proposals for new federal legislation, and the emergence of practices such as I've described will only increase the likelihood of new legislation.

And that brings up the third reason why customer service is a legitimate public policy issue for bank regulators. What Julie warned about in her November speech—the risk that consumer complaints would translate into legislation that the industry may view as adverse to its interests—now seems more real than ever before.

One can review the history of consumer protection legislation over the past three decades and see one common and compelling theme: consumer abuses that are allowed to continue without being addressed by the industry are eventually addressed through regulatory legislation. And this audience knows as well as any that the cure can be more painful than the disease. Truth in Lending, Fair Credit Billing, Fair Credit Reporting, and Truth in Savings were legislative responses to clear abuses the industry proved unwilling to address on its own. These enactments not only created significant compliance burdens for the industry, but vastly expanded the enforcement responsibilities of the banking agencies, and added significant complexity to the traditional process of safety and soundness examination.

While it might be unfair to burden an entire industry with legislation aimed at curbing the poor conduct of a few institutions, the persistent failure of the industry itself to address abusive conduct creates a fertile seedbed for legislation. Perhaps it's too late for industry codes of conduct, self-policing arrangements, or even statements of best practices to relieve the burdens of regulatory legislation already on the books. But it may still be possible to avoid new legislation crafted to remedy today's excesses.

What's needed, in my judgment, is for the leaders of the industry, including the Consumer Bankers Association and RMA, to speak out on these issues. You must emphasize to Congress and the American people that the banking industry stands ready to take the steps necessary to clean up its act. If you are unable or unwilling to develop an industry self-regulatory mechanism, or to promulgate codes of conduct with incentives for voluntary compliance, you can at least assist in that effort by providing guidance on the kinds of practices that are and are not acceptable. In my view, the banking industry's response must be prompt and unambiguous in order to stem the tide of corrective legislation.

This represents a significant challenge. And while it's not our job to draft standards of fair conduct, we can help banks to respond more effectively to consumer issues and concerns. In fact, over the past year, we have—quite unexpectedly, I should add—amassed a significant amount of information about bank–customer relationships that can be of real value to bank management seeking to upgrade its service.

In April 1998, the OCC installed a state-of-the-art consumer hotline system at our customer assistance center in Houston. Although we have not widely advertised or promoted this facility, our call volume has grown dramatically. In 1997, before we installed the new system, our customer assistance group logged some 16,000 consumer complaints. In 1998, the number rose to more than 68,000. And, if the complaint volume during the first quarter of 1999 holds for the entire year, we should be well over 100,000 this year. Again, that's without any promotion on our part.

Our approach to this operation is not regulatory- or compliance-oriented. We are not seeking out violations of law. Most of the complaints we receive are the result of a breakdown in communications between a bank and a customer. We lend our good offices to the resolution of disputes. If the customer's complaint lacks merit, we're frank to say so. In my view, this operation has been a great success, for both customers *and* banks.

What's most disturbing, however, is the large number of complaints we receive about bank practices—such as those I've already mentioned—that, intentionally or not, violate the letter or the spirit of consumer protection laws or that clearly strain the boundaries of ethical conduct.

I think of our customer assistance center as performing two critical functions. First, it provides an outlet for consumers, where their complaints will receive prompt and efficient attention. Second, it adds value to the supervisory process by giving bankers insight into their customers' assessment of the service they provide. A number of national bank CEOs to whom I've spoken have expressed surprise at learning the extent of the service problem, and I suspect most CEOs or boards of directors never learn through internal processes about bad customer assessments of their service, or about questionable practices at the marketing level. The information collected by our Houston unit can inform senior management where steps are necessary to improve the quality of the service their banks deliver. It can also point toward internal processes and control weaknesses that they should be interested in fixing.

Of course, when we find that consumer protection laws have been violated, our response will be firm. But shoddy and unethical practices, marketing schemes that overreach or exploit, and offensive sales techniques may not be currently sanctionable under the law. It's very much in the interests of the banking industry *and* its customers to eliminate such conduct. Effective self-policing should be undertaken as a matter of enlightened self interest—not only to improve customer relationships, but to demonstrate to Congress that new regulatory legislation aimed at curbing abuses by banks is not needed. The industry's future could well depend on how it responds to this challenge.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the International Monetary Conference, on revising the Basel Accord of 1988, Philadelphia, Pennsylvania, June 8, 1999

Introduction

Few would disagree that the financial world has changed substantially since the Basel Committee on Banking Supervision promulgated the Capital Accord in 1988. Internationally active banks today are significantly more complex, more driven by technology, and more global in their scope. Clearly, for these more sophisticated banks, a "one-size-fits-all" approach to capital is no longer appropriate. Instead, we must find new ways to reflect credit risks in the capital framework. The Basel Committee has taken the first step in this direction by recently issuing a consultative paper looking toward a revision of the accord.

Today, I will focus my remarks on the issues raised by the 1988 accord and the options we at the OCC see for the future of the regulatory capital framework, in light of the new Basel Committee proposal.

1. Deconstructing the 1988 Accord

In retrospect, there is no question that the 1988 accord represented a significant step forward on several fronts. It has been credited with reducing international disparities in the regulation of capital adequacy, addressing the risks posed by the growth of off-balance sheet instruments, making banks' capital levels more transparent to market participants, and reversing what had been a prolonged decline in the capital levels of internationally active banks. However, as institutions have grown in complexity and have increasingly resorted to the use of sophisticated financial tools such as securitization and complex derivatives to reduce capital requirements, manage risk and allocate credit, the limitations of the accord have become manifest. Many of the limitations of the current accord are already well recognized. One fundamental problem is that the current system does not adequately or accurately assess risk. The current "risk-bucketing" approach, under which assets are sorted into different buckets based on broad categories of risk, is a crude approach to allocating capital. It has resulted in a poor differentiation of credit risks, given rise to tremendous arbitrage opportunities, and led to distortions in the way that banks allocate credit and price products.

Moreover, the current system does not take into account some of the common risk management techniques used by banks today, including diversification and hedging. Although these techniques have helped bankers to better manage risks, the regulatory capital framework has not been adjusted to reflect these improvements. Nor has it been adjusted to take account of the additional risks that stem from concentrations and other broader "portfolio effects."

Finally, the accord has not kept pace with developments in risk management and capital allocation in the banking industry. It has become increasingly difficult to fit many new product offerings into the existing risk buckets—credit derivatives being a prime example. The inability of the accord to stay abreast of market innovations has become one of the main reasons the Basel Committee is looking toward a substantial revision of the accord.

Given the problems posed by the current system, our goal *and* our challenge is to develop a system that is flexible and forward looking, and that provides for a useful and rational assessment of risk upon which to base a capital charge.

II. What a Revised Accord Offers

The first step toward meeting that goal was taken last week with the release of the Basel Committee's consultative paper describing elements for a new capital framework. This paper represents the first step in a two-step process: first, the development of the framework for the future accord; second, the articulation of the details. In each case, industry comment will be sought, and this is an opportunity that the industry should grasp. Ultimately, the views of the industry will be of critical importance to the framing of any future accord. The committee has made it clear that it wants capital rules that reflect not only the risks, but also the realities of banking today.

The new proposal will seek to update the 1988 accord in a number of different areas. First, the proposal would expand the "standardized" or risk-bucketing approach. Second, it looks to the use of new approaches to measuring credit risk, such as internal ratings. Third, it raises the issue of what other areas need to be covered by a revised accord.

Among the fundamental changes that the proposal would make is the introduction of the "three pillars" of capital. To date, the accord has looked primarily at the quantitative

aspects of capital. The new accord will add two new pillars as integral parts of the regulatory capital framework: supervisory review and market discipline.

The OCC has long believed that supervisory review and market discipline are important elements in the review of capital adequacy. However, this is not a view that is held around the world. Qualitative elements tend to be forgotten when viewed alongside the challenges posed by quantitative measures such as internal ratings and credit risk modeling. While most supervisors have ways to implement and enforce capital adequacy standards, there is now a need to enhance the role that supervision plays in assessing the qualitative aspects of capital and identifying the specific methods by which to do so. Market discipline must also play a role in any capital adequacy framework, as it rewards banks that manage risks effectively and penalizes those whose risk management is less prudent. Greater transparency will improve the market's ability to make rational judgments about an institution's risk management and overall soundness.

Another change is the proposal for the addition of a capital charge for "other" risks, such as operational risk and interest rate risk.

The main issue here is how to arrive at an appropriate capital charge. These "other" risks are not easily quantifiable. Even interest rate risk, while measurable, is not measured in a consistent way among banks or countries. The charge for "other" risks will be the source of much discussion within the Basel Committee, and, I expect, within the banking community, over the coming months. The third major change addresses the most serious shortcoming of the present accord—the need to make the credit risk measurement criteria more sensitive to actual risk.

III. The Future Methodologies

Four approaches to credit risk measurement have been suggested: expansion of risk buckets, use of external ratings, use of internal ratings, and portfolio credit risk modeling.

Expanded risk bucketing would not, in my view, be a major step forward or an option we should pursue avidly in the future. While it offers some opportunities for refinement, it would perpetuate some of the problems of the present accord—lumping assets that inevitably have differing risk characteristics into fixed categories, with attendant opportunities for arbitrage.

A second approach, the use of external ratings from widely recognized rating agencies, could be applied to both sovereign and corporate credits. However, there are still some issues that must be thought through before this approach could be used. For sovereign credits, there are currently only two risk buckets, one for sovereigns that are members of the Organization for Economic Cooperation and Development; another for those who are not. While there is wide agreement that the present framework for rating sovereigns should be dismantled, the track record of the rating agencies on sovereign credits has proved disappointing. We have seen during the Asian crisis of the past two years that ratings were often lagging indicators of emerging problems. The use of external ratings also presents some problems for corporate credits. The fact is that there are generally very few externally rated credits on the books of most U.S. banks, and outside of the United States, the use of external ratings is much less common than in the United States. While external ratings may prove useful as a part of a broader package, particularly as they become more common abroad, I do not believe that the external ratings approach alone will go very far in solving the problems of the current accord.

The other two approaches raised in the proposal—internal ratings and, over the longer term, full portfolio credit risk modeling—offer the greatest promise for the most sophisticated internationally active banks. But given the current state of the art of these methodologies, it is questionable whether they will be feasible options in the near term.

The internal ratings approach is geared toward basing a capital charge on the ratings that banks themselves assign to the credits in their portfolios. Full portfolio credit risk modeling goes a step further, using the internal risk ratings as a starting point and then applying sophisticated modeling techniques to adjust the ratings for "portfolio effects" to arrive at a capital charge for the entire portfolio. Advances are being made in both of these methodologies by many institutions. However, there are still a number of difficulties to work out before either of these approaches can be reliably used.

Two major challenges posed by the internal risk ratings approach are the lack of consistency among the internal ratings systems, and the need to "map" internal ratings to a uniform schedule of capital charges. Systems developed by individual banks can differ in a number of very important ways. For example, some institutions may define the credit risk attributable to "default" as the probability that a loan will go bad, while others may go further and derive a loss figure that would result if the credit becomes a problem, the so-called loss given default. These inconsistencies compound the problem of translating internal ratings into a generally applicable range of risk weightings. Of course, moral hazard must also be considered in connection with any methodology that attaches significant economic consequences to a bank's own classification of its risks.

Despite the issues raised by the internal ratings approach, it is still far closer to implementation than portfolio credit risk modeling, where challenges are much more difficult to overcome. A recent Basel Committee report highlighted two substantial difficulties with the current state of credit risk modeling—a lack of data and the inability to validate the models. As I noted, this approach has promise, but we are still a number of years away from being able to depend comfortably on credit risk models.

The good news is that many of you in this audience are devoting significant resources to the development of systems that can overcome the difficulties that I have just described. I see this process as a continuing collaborative effort between the public and private sector.

IV. Conclusion

The effort to amend the accord in a way that both addresses problems already recognized and takes account of emerging technologies of risk assessment has substantial momentum behind it. The process will take some time to complete, but that is desirable for a number of reasons.

As time passes, we will continue to see advances in credit risk measurement methodologies that will allow for a more precise calculation of the risks against which capital should be held. Despite the challenges that must be overcome, the internal ratings approach and, further down the road, portfolio modeling, offer the most promise for the future. At the same time that these new methodologies are being developed, the focus on qualitative approaches to capital, namely supervisory review and market discipline, will sharpen. Together, these elements will allow for a more supportable determination of capital adequacy, while retaining the flexibility to adapt to the changes—in risk management and in products and services offered by the banking community—that are inevitable in the future.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the American Bankers Association Regulatory Compliance Conference, on compliance, Washington, D.C., June 28, 1999

According to the latest report from the U.S. Bureau of Labor Statistics, the nation's fastest-growing occupations today are—again—by-products of the microprocessor. Database administrators, computer engineers, and systems analysts rank first, second, and third.

Of course, not all of our new professions have high-tech roots. For example, back in the 1970s, few financial institutions employed people with the title of "compliance officer." Since then, however, compliance has become a major focus for banks—and a major responsibility for bank supervisors. That's the result of the proliferation of laws governing banks' relationships with their customers. Truth in Lending, Truth in Savings, Fair Credit Billing, Electronic Funds Transfer, Expedited Funds Availability, and Real Estate Settlement Procedures are examples of the many and complex laws enacted since the 1970s to address consumer concerns. And, for reasons I'll discuss in a minute, I think it's safe to say that these won't be the last laws of their kind.

These laws not only have created a demand for your specialized skills. They've also fundamentally altered the nature of the bank examination process and, indeed, of bank supervision itself. At the OCC and the other federal banking agencies, compliance has become, and will remain, a significant component of our mission.

There's a paradox here. When the economic history of the United States during the last quarter of the twentieth century is written, it will undoubtedly take as one of its main themes the triumph of deregulation in key sectors of the economy. Some regulatory structures erected in earlier times, such as those applying to the airlines and the trucking industry, have been totally dismantled. Others have been appreciably modified. In banking, for example, we've seen the elimination of deposit interest rate ceilings and geographic limits on expansion.

At the same time, however, I know of no other industry where the progress toward deregulation has been so largely offset by new regulatory measures. Despite the fact that we have seen some deregulation in banking, I think most bankers would agree that the hand of government has, if anything, become progressively heavier.

Why are compliance issues so prominent today? Why has banking been subjected to such a profusion of regulatory legislation when deregulation has triumphed nearly everywhere else? And, looking to the future, what can we do—you as compliance specialists and we as bank supervisors—to turn compliance functions and controls into positive enhancements to banks in their quest for safety, soundness, customer service, and competitiveness?

Of course, there would have been no consumer protection laws if consumers of financial services hadn't been able to make a persuasive case that they were needed. Although never involving more than a small minority of financial providers, market abuses have not been uncommon. Too often over the years, bankers and their trade associations have passed up opportunities to address these abuses through their own codes of conduct or self-regulatory mechanisms. That's left Congress with very little choice but to adopt legislation to address consumers' concerns.

A related factor has been the vastly increased empowerment of consumers over the last three or four decades. "Consumerism" has become a movement of formidable proportions, as consumer advocacy groups have grown in experience and sophistication, and have become more adept at using the political process to redress consumer grievances. Consumers have learned that through concerted action they can bring about change, not only in laws and regulations, but in the marketplace, as well.

It's a simple but profound fact that, in conducting the business of banking, financial institutions touch the lives of their customers in ways that no other business does. Banks serve as a repository for savings, as a means of making payments, as a source of financing for cars, homes, education, and the myriad durable goods essential to our modern quality of life. But more than that, they are the custodians of people's money and the bearers of their trust. When that special relationship breaks down—when customers feel that their trust has been betrayed—they tend to react passionately and volubly.

Was it inevitable, one might ask, that these laws—and the burdens to which they have given rise— should have multiplied so fast?

In one sense, that question was answered when Congress chose regulation as the method for correcting abuses in the banking system. Compare, for example, the system of bank compliance regulation with the means chosen to protect competition in the marketplace. Our nation's antitrust laws empower the Department of Justice and the Federal Trade Commission to

initiate enforcement actions, and they created private rights of action for injunctive relief and damages. But they generally leave the responsibility for interpreting and applying the law to the federal courts, rather than to a regulatory agency. As a consequence, while corporate America has clearly understood the need to comply with the antitrust laws—and the consequences of noncompliance— it has not had to deal with voluminous regulations in the process.

In the area of depository institutions, however, Congress has repeatedly and unfailingly chosen a regulatory remedy. It has enacted corrective laws, and vested in one or more of the banking agencies the responsibility for writing rules to implement the mandate, with the expectation that the rules will be enforced through regular examinations.

As you know well, the banking agencies have been diligent over the years in using the examination process to carry out the intent of Congress. At regular intervals, banks are visited by compliance examiners whose job it is to assure that you are doing *your* job.

To put a somewhat different perspective on it, Congress is likely to choose a regulatory remedy in the area of banking *because* banks are already subject to formal regulation. One might argue that the existence of the bank examination process has been an invitation to add additional tasks to those already performed by examiners. And Congress has repeatedly made clear that it intends that process to be used to ensure compliance.

There are at least three important implications of this history. First, bankers are much more likely to be subject to new regulatory legislation than their nonbank, nonsupervised competitors. Insurance companies and securities firms—while subject to their own regulatory schemes, to be sure—are not subject to routine examination in the manner of banks. The government's scrutiny of finance companies and mortgage companies is even less comprehensive and exacting. It seems certain that future statutory consumer protection measures—privacy is a likely subject—will again have a much heavier impact on banks than nonbanks.

Second, Congress' choice of remedy has significantly altered the nature of bank examination. To be sure, safety and soundness is still the major focus of the examination process. But today, safety and soundness examiners are accompanied by highly skilled and well-trained compliance examiners, whose task it is to assure that banks are fulfilling their responsibilities under the various consumer protection laws.

Third, history suggests that your role as bank compliance officers is likely to become even more important as time goes on. In short, you're in no imminent danger of working yourselves out of your jobs. Banks operate today in a fishbowl, and their compliance is closely and continuously monitored—by the regulatory agencies, the banking public, the investing community, and elected officials. In this environment, there's a growing recognition that compliance slip-ups can be every bit as harmful to a bank's long- and short-term prospects as mismanaged credit risk. Time and again, we've seen what the consequences of inattention to compliance requirements can be: lawsuits, social stigma, reputational damage, and lost customers. Given what it costs to replace a customer these days, financial institutions may incur a heavy price indeed if they fail to take their compliance obligations seriously enough.

The multiplication of consumer protection laws has raised challenges for us as regulators, too. We, too, have had to learn to work smarter; to manage our compliance resources more efficiently; and to maintain the proper balance between compliance examinations and all the other activities we conduct to maintain a safe and sound banking system.

To do that, we have taken a page from our own approach to safety and soundness supervision. Since the 1980s, the OCC has been targeting its supervisory resources to those institutions and banking activities that seemed to pose the greatest systemic risk. While all national banks continued to receive supervisory attention, they no longer receive the equal attention implicit in a calendar-driven examination schedule. Today, the OCC supervises noncomplex community banks very differently than its population of megabanks—exactly as logic would dictate.

When our formal compliance program was launched in 1987, the OCC adopted what amounted to a "one-size-fits-all" approach to compliance examinations. Our original procedures were designed to test the effectiveness of banks' compliance systems irrespective of asset size. But the growing number and complexity of consumer and community protection laws forced some hard choices on us—just as they have on the banks we supervise. And so, in 1995, we modified our program to take account of the different ways that community and large banks control compliance risk. Community banks—those with total assets of $250 million or less—generally have less formal compliance mechanisms in place; so, for those banks, we take a transaction-based approach, focusing on the results of operations rather than the methods used to achieve them. The results of this transaction testing enables examiners to derive conclusions about the quality of an institution's compliance risk management, and take appropriate follow-up action.

By contrast, compliance examinations of our large banks—with $1 billion or more in total assets— are process driven. Our examiners evaluate the bank's compliance management systems, selectively drill down to make sure systems are working as intended, and make recommendations for improvements where these systems are found wanting.

For banks between $250 million and $1 billion in assets, examiners themselves make the determination as to which of the two approaches to take, based on, among other things, the complexity of the bank's structure and its history of compliance management.

This risk-focused approach to compliance continues to undergo expansion and refinement. Last year, the OCC launched a pilot program targeting high-risk national banks for more intensive Bank Secrecy Act (BSA) examinations, including extensive transaction testing by a cross-functional team of BSA specialists. The banks selected for this more intensive scrutiny included a number of institutions already under suspicion with law enforcement agencies. To that pool were added four other banks, one each from the nation's four most active drug-trafficking areas. Three of the four were found to have serious BSA deficiencies, which led to corrective action. Next year, we plan to expand this program to include banks from each of the Justice Department's 21 high-intensity drug-trafficking areas.

Expanding this targeted approach to other compliance areas requires that we first identify the relevant risk factors. That work is already under way. For example, in the future, we might target fair-lending exams to institutions displaying particular risk factors: significant management turnover, or a large number of consumer complaints; where loan officers have unusual discretion in underwriting and pricing; or where there are conspicuous gaps in geographic lending patterns on the basis of race or ethnicity.

As it's fleshed out in the coming months, this risk-based approach promises to reduce regulatory burden on banks that are meeting their compliance responsibilities and to help us better identify— and correct—deficiencies at those institutions that are falling short. I believe that this approach to compliance management is the wave of the future—for the industry as well as for regulators.

Bank compliance officers have a lot to offer their institutions beyond the scope of existing laws and regulations. They should be considered members of the bank's total risk-management team. In my experience, the most successful financial institutions are those in which a *culture* of compliance is embedded in the institution. By that I mean an atmosphere in which employees up and down the organization not only understand the specific provisions of the law as they apply to their own functions, but where they have internalized the *spirit* of the law, as well. That calls for a conservative approach to customer relations even in those areas where no specific regulatory guidelines currently exist. Most importantly, it means anticipating the kinds of problems that can lead to new compliance requirements if they're not corrected first. If all banks were to adopt this kind of cross-functional, proactive approach to compliance, the industry might finally win real regulatory relief—from both existing and future requirements.

So the next time your boss asks you to sit down and review your performance goals, I suggest that you propose to add the following line to your job description: "works to inculcate a compliance *consciousness* throughout the organization." And when you're asked how you propose to accomplish that, emphasize the importance of having a voice in the process of designing new products and marketing strategies. Do that, and you'll be making a major contribution to the safety, soundness, and competitiveness of your institution.

Our ability to adopt the risk-based approach to compliance I have just described depends on the extent of the industry's success in meeting its own compliance obligations. The better *you* do in upholding the letter and spirit of these laws—and making new laws unnecessary—the less that we in government will have to do.

Remarks by Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency, before the Financial Institutions Insurance Association Regulatory and Compliance Conference, on banks and consumer privacy, Washington, D.C., June 22, 1999

When this conference was being scheduled several months ago, my topic was listed as "Guarding Consumer Privacy: Understanding the Guidelines for Sharing Customer Data." Little did any of us know that the timing of this speech would coincide with the explosion of privacy as an issue in the debate on financial modernization legislation, litigation challenging a major financial firm's privacy practices in connection with telemarketing, and a surge of privacy-related stories in the media.

This morning I will first recap recent developments that have shaped the privacy debate for the financial services industry. Then I will cover the status of regulatory and legislative responses as well as the role of the marketplace in safeguarding privacy. I will conclude with a snapshot of where we are today and dust off some old, but still relevant, perspectives on the issue of privacy.

It would require an extraordinary set of blinders not to recognize that American consumers are increasingly privacy conscious. Survey data bear out that consumers are concerned about threats to their privacy and about whether they have lost control of information they consider personal and private. Interestingly, whereas in the past, customers seemed to be most concerned about government intrusions into their privacy, current customer concerns about privacy appear to be greatest in the areas of private sector uses of financial and health information.

When a privacy issue—identity theft—is the premise for a hit movie starring Sandra Bullock—*The Net*—I do not think it is productive to continue to debate whether privacy is a major consumer issue, or to suggest that customer concerns are merely "anecdotal." The question must be, rather, how the issue can be credibly addressed, and how fast that can be done.

Privacy abuses touch a common nerve. They may come in the form of the inconvenience of dealing with a telemarketing call at dinner time; having to empty a mailbox full of unwanted catalogues; finding a plethora of identifying information about yourself on the Internet; the sudden appearance of unexplained credit card charges; having your bank account robbed by way of a forged check; having your identity stolen; or being stalked. Each of these is a breach of personal privacy—ranging in severity from mere irritants to crimes that incite fear for personal safety. They are not academic or remote occurrences. We can identify with their victims.

It is against this backdrop—this increasingly charged atmosphere where each new reported invasion of personal privacy triggers a visceral public reaction—that I would like to reflect on the topic of privacy and the privacy challenges you are facing in your businesses.

In part, we have arrived at this point in the privacy debate because of the explosion of information technology. Technological advances have greatly facilitated the collection, dissection, and transfer of vast amounts of personal data. Information can be sliced, diced and shared at a level of personal detail that was never before possible. These new capabilities have turned personal information into a marketable commodity, and cause consumers—when they learn about it—to question whether highly personal medical and financial information should be in the hands of, and exploited by, third parties.

There are two sides to the commoditization of information. Businesses, armed with extensive data about individual preferences and circumstances, can profit by tailoring products and services to maximize their appeal to consumers. A banker recently told me about his company's goal of customizing and individualizing credit cards to appeal to a market of one. Bankers talk about the ability to anticipate and satisfy their customers' changing financial needs over the course of a lifetime. It is the availability of these opportunities that may well cement relationships between customers and their financial institutions. In short, personal information is a potent and profitable tool in a company's portfolio—when used responsibly.

The pace and magnitude of mergers and affiliations in the financial services industry fuel the privacy debate. Moreover, Congress is currently considering legislation that would enhance the ability of different types of financial services companies to affiliate, thereby increasing the potential for gathering and using personal financial and medical information about the company's customers.

One key rationale for these combinations is that resulting companies will be able to "warehouse" data on an expanded customer pool and "mine" that data to design an increasing array of targeted and profitable product and service offerings. Affiliations among diverse

sectors of the financial services industry are intended to create new synergies and opportunities for cross-marketing to customers. Again, this ability is heavily reliant on sharing and pooling data. The sheer magnitude of these data warehouses and the sensitivity of the information they hold fuels public skepticism and anxiety about the security and proper uses of such data and propels Congress to devise safeguards to protect against its misuse.

That gets us to the heart of the privacy debate—both the perception and the reality that individuals are losing control over their personal information. When the information is highly sensitive, such as medical and financial information, consumer concern about who has control over its disposition is compounded. And that leads me to the other part of the privacy equation—the industry's response.

Curiously, given the importance of information as a valuable business asset, the financial services industry has been more defensive than proactive in its reactions to date to customer privacy issues. Frankly, I find this somewhat surprising given the virulence of the industry's opposition to the proposed "know your customer rule" on grounds that it would lead to unwarranted intrusions on customer privacy. The attitude of at least some industry representatives has been, "Show me the harm, show me the complaints." The problem with this attitude is that, in many instances, individuals may not realize—and have no way of forcing disclosure of—just how their personal information is being handled. However, as daylight begins to shine on firms' practices for handling customers' personal information, the public appears ready to make a stink about the shortcomings they see. Any company that ignores, or fails to understand, the tinderbox of public sentiment waiting to ignite on privacy, acts at its peril.

An example comes to mind that the Comptroller spoke about two weeks ago—the exchange of extensive confidential customer information by a bank and its insurance affiliate to an unaffiliated telemarketer in return for commissions on sales made by the marketing firm to bank customers. Imagine how customers reacted when they learned from press accounts of a lawsuit filed by a state attorney general that alleged that their trusted financial institution had sold their name, address, phone number, social security number, account number, account balance, last payment date, occupation, marital status, and much more, to a telemarketer. A telemarketer. I'll tell you how they reacted. They phoned in complaints in droves. They lined up at the bank to demand an explanation, and in some cases, to close their accounts.

Commendably, senior management of the bank reacted swiftly. In a newspaper ad directed at its customers the bank announced, "There is nothing we value more than the trust you put in us. When that trust is called into question, it's something we take very seriously." The bank announced that it would end its participation in all such marketing relationships.

This particular bank learned a very expensive lesson about respecting customer privacy. I certainly hope that other financial service providers are learning this same lesson derivatively, and not waiting to get burned.

I'd like to take a moment to comment on the proliferation of bank privacy policies. I commend the banking trade groups for promulgating privacy principles and urging their members to adapt and adopt such principles. Many, many banks have heeded the call—more and more banks are posting privacy policies on their Web sites. It is essential, however, that these steps be more than window-dressing. Privacy policies are meaningful only if they reflect an organizational commitment, are adhered to, are stated in terms customers can readily understand, and meet legitimate customer expectations about the handling of their personal information.

As many of you know, the banking regulators have also weighed in on this debate. At the OCC, we have been gently, and perhaps sometimes not so gently, prodding the industry to get its privacy house in order. We have issued guidance to the industry in areas such as safeguarding customer data from unauthorized release to unscrupulous information brokers or "pretext callers" posing as bank customers. Where there are relevant privacy laws, we have taken steps to encourage banks to scrupulously adhere to them. Last March, the OCC issued guidance to national banks about effective practices for meeting the notice and opt-out requirements for affiliate information sharing under the Fair Credit Reporting Act. Most recently, in May, again through the issuance of effective practices guidance, we encouraged banks to establish privacy policies and post them on their Web sites. We are currently considering mechanisms to ensure that banks maintain adequate procedures and internal controls to enhance compliance with stated privacy policies.

Pressure on the privacy front is further being exerted by the states through legislation restricting the uses of customer information, and lawsuits, such as the one I noted that was filed two weeks ago, that also seek to stem the flow of customer information. Also, Congress presently has pending many bills concerning the treatment of personal information—most of which are aimed squarely at the financial services industry. The evolution of the privacy debate surrounding consideration of financial services modernization legislation reveals what a potent issue privacy has become.

In the last Congress, discussions of privacy were at the periphery of the debate over modernizing the financial services industry. Privacy legislation affecting the industry that was either enacted into law, or came close to passage in the last Congress, was aimed at data security—such as curbing identity theft, which is now law, or punishing pretext callers who obtain confidential information from banks under false pretenses. The dynamics have shifted dramatically over the course of this year, however.

In March, the House Banking Committee had an unexpectedly long and vigorous debate over an amendment offered by a freshman congressman that would have required banks to notify customers about their information-sharing practices with third parties and an opportunity to opt out of the sharing of that information. Members reacted viscerally to descriptions of current practices and the limited reach of existing privacy laws. But, by the next day, after committee members were "educated" by the industry, many had set aside their gut reactions and spoke about operational difficulties and unknown consequences of increased restrictions on the transfer of customer information. The amendment failed, and in its place, the committee adopted an amendment requiring disclosure of privacy policies.

When the Senate considered S. 900, its financial modernization bill, in the beginning of May, privacy amendments were generally fended off. A number of pro-privacy senators announced that the issue should be considered separate and apart from S. 900. That view largely prevailed.

But just weeks ago, the issue resonated when the House Commerce Committee considered H.R. 10. A Commerce subcommittee adopted a measure mandating that financial services companies disclose their information-sharing practices to their customers. However, by June, a growing clamor to address existing and potential privacy abuses resulted in the passage of an amendment that requires financial services companies to provide their customers with the opportunity to opt out of all types of information-sharing arrangements with unaffiliated and affiliated third parties.

It remains to be seen whether some type of enhanced privacy protections will be retained in financial modernization legislation as it continues to move through the Congress. But, it is evident that the marketplace has already begun to recognize the significance of distinctions in privacy protections afforded consumers. There is evidence that—when information is available—market forces will take privacy issues into account. Just last week, a large bank announced that it was taking an "industry-leading" privacy position by ceasing the sharing of customer information with third-party marketers. In doing so, the bank said that "customer privacy is one of our highest priorities."

That brings me to my last point—where do we go from here? The financial services industry is just beginning to realize the potential of the Internet and the business opportunities made available by technology. But these very developments increase the potential for intrusions on personal privacy and facilitate the transfer of personal data. And, as more information about how customer information is collected and used becomes available, market forces increasingly will take privacy consequences into account.

I would offer one suggestion today for how the financial services industry can approach this challenge. It is not a solution, but rather an attitude, drawn from Justice Louis Brandeis' eloquent description—over 70 years ago—of the concept of privacy. He called it "the right to be left alone—the most comprehensive of rights, and the right most valued by a free people." These words capture an issue central to treatment of privacy concerns in the new information age.

Privacy as an individual right implies that to some degree personal and private information about an individual is the property of *that individual*. That also implies that when a customer gives that property to another for one express purpose, he or she is not implicitly giving it for whatever other purposes the recipient may want to use it.

My suggestion is to think of personal information from your customers' perspective, as something they feel belongs to *them*. In developing and implementing privacy policies, think about how your customers would react if you gave them a full description of how much of their information you collect, what you do with it, whether you transfer it, whom you transfer it to, and what happens to it then.

Would you be embarrassed?

Would your customers feel they have been treated fairly?

Structure your privacy policies—and implement them—accordingly.

Statement of Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency, before the Oversight and Investigations Subcommittee, U.S. House Committee on Commerce, on regulating bank subsidiaries and the NationsSecurities example, Washington, D.C., June 25, 1999

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 subcommittee, I appreciate this opportunity to discuss the Office of the Comptroller of the Currency's (OCC) role and supervisory approach with respect to subsidiaries of national banks that are registered broker–dealers, and to review the NationsSecurities matter. The OCC is the primary supervisor for national banks. The National Association of Securities Dealers Regulations, Inc., (NASDR) and the Securities and Exchange Commission (SEC) are the primary supervisors for registered broker–dealers, including those that are subsidiaries of national banks. The OCC recognizes that these securities regulators have primary responsibility for overseeing the operations of brokerage subsidiaries of national banks and their compliance with comprehensive securities law requirements.

However, because we are responsible for supervising the parent bank, the OCC also has an interest in—and responsibilities that pertain to—the activities of bank subsidiaries. Our approach begins with identifying risks these activities pose and determining if those risks are being managed appropriately. Risk may be present, for example, if the bank and its subsidiary do not have in place procedures to assure that bank customers receive full and accurate disclosures about the uninsured status and risks of investment products they buy through the bank's subsidiary. Failure to do so may injure the bank's customers, damage their relationship with the bank, mar the bank's reputation, and expose the bank to liability. We thus fully share the goals of the SEC and the NASDR to assure fair treatment of customers. We do not, however, seek to duplicate or intrude into the responsibilities or activities of the securities regulatory bodies with respect to registered broker–dealers.

In that regard, we have learned a great deal about effective regulatory coordination in this area since our efforts in 1993 and 1994 to establish disclosure and operational guidance for sales of investment products on bank premises. We have learned, for example, that no regulator's supervisory interests need be compromised simply because different regulators have different direct and indirect interests with respect to the same entities. We have worked hard to coordinate on individual cases as well as larger policy and regulatory issues with the SEC and the NASDR. And we have learned that recognition of each agency's respective responsibilities, and effective interagency coordination, maximizes *both* safety and soundness of national banks and investor protection, and helps securities and bank regulators achieve their goals.

OCC's Supervisory Approach

It is in that spirit that I will explain in more detail the OCC's current supervisory approach to broker–dealer subsidiaries of national banks, and our particular experiences in the NationsSecurities matter. As noted at the outset, in determining our role with respect to broker–dealers that are subsidiaries of national banks, the OCC has been mindful of the vital primary supervisory role of the SEC and the NASDR. One recent industry survey suggests that 96 percent of the sales force involved with bank-related investment sales are registered with the NASDR and are subject fully to regulation as brokers.

Brokerage subsidiaries of national banks must register with the securities regulators and comply with a comprehensive securities law regulatory scheme that offers significant customer protection, to the same extent as brokers that are not affiliated with banks. The NASDR and SEC have primary responsibility for inspecting these subsidiaries, interpreting and applying securities law and regulatory standards, and addressing any compliance concerns. We fully understand the SEC's interest in maintaining its primacy in this area, as the SEC has clearly communicated, and fully support its supervisory efforts to assure adequate protections for investors. Accordingly, the OCC defers to the SEC and the NASDR to conduct inspections, address securities law compliance concerns and generally supervise brokers that are subsidiaries of banks.

At the same time, due to our responsibilities for the safety and soundness of national banks, the OCC also has an interest in the operations of bank subsidiaries. We seek to assure that the parent bank effectively monitors and controls risks presented by the subsidiary's operations. We focus on the adequacy of policies, procedures, and risk management systems, and we test and verify to determine whether those systems work. With respect to

brokerage subsidiaries of banks, we emphasize risk identification and risk management systems applicable to a subsidiary's operations, rather than attempting to duplicate the work of the SEC or the NASDR by examining the subsidiary's daily operations. In the case of a brokerage subsidiary that operates on bank premises or effects sales through banks, however, a review of the bank's management and control systems for that activity will inevitably touch on aspects of the operations of the brokerage subsidiary as well.

If, as a result of our oversight of a bank's compliance and risk management systems, the OCC becomes aware of conduct or activities that raise concerns about securities law compliance by a brokerage subsidiary or affiliate, we would promptly consult with the primary regulator to determine appropriate examination efforts and supervisory responses by each regulator to the situation. A recent example of how this functional approach works involved a national bank brokerage subsidiary with plans to significantly expand its securities sales program through the parent bank. OCC examination staff had concerns with the sales program based on our knowledge of compliance function issues at the bank itself, and prior SEC inspections. Accordingly, prior to the expansion of the bank's sales program, the OCC invited the SEC to participate in an examination that reviewed these sales activities.

Collaborative efforts between examiners on-site and the local SEC office contributed to the success of the examination. An SEC examiner participated directly in the examination and OCC staff met with representatives of the local SEC office before, during, and at the conclusion of the examination. Since that review, OCC and SEC examiners have continued to share information and maintain communication. Another joint examination is planned within the next twelve months. Staff from both agencies found this approach efficient and effective.

The OCC coordinates in other respects with the primary regulators for brokerage subsidiaries of national banks because of our related areas of responsibility. In January of l995, the OCC and the other federal financial institution regulators signed an agreement with the NASDR relating to sharing information and coordinating efforts. Shortly thereafter, the OCC exchanged lists of local contacts with the NASDR to facilitate exchanges of information and coordination at the local level, where coordination concerning individual institutions is most effective. The OCC also coordinates and shares information with the SEC. As noted above, we have contacted the SEC when it appears that a substantive issue, subject to SEC's jurisdiction, exists with respect to a broker subsidiary of a bank. We also make examination reports available to the SEC relating to investigations and provide access to examiner work papers, internal documents and examination staff. The OCC also has provided examination staff as witnesses in SEC enforcement actions.

The OCC's policies on functional oversight of brokerage subsidiaries are reflected in revisions to the OCC's bank examination booklet of the *Comptroller's Handbook* that have been under way for some time and will be published shortly in a new examination booklet. Under these policies, examiners defer to the primary role of the securities regulators, while reviewing risks to the bank from the subsidiaries' operations, in evaluating the composite risk profile of the parent bank. Examiners are instructed that if they have concerns with the securities activities of a subsidiary, they should contact the primary regulator and work with the regulator to obtain necessary information and determine appropriate action. Examiners also are advised to maintain communications with the local contacts for the primary regulators on an ongoing basis to keep abreast of any developments that could affect the bank. The booklet also reminds examiners of the OCC's policy to refer evidence of potential violations of law that fall within the jurisdiction of another primary regulator. All of these steps will enhance information sharing and coordination between our examination staff and securities regulators.

In addition to the guidance contained in revisions to the OCC's bank examination booklet, OCC bank supervision staff have held meetings with representatives of the SEC in Washington, D.C., to identify areas where it is productive to exchange supervisory information. We intend to continue this dialogue. The intent of these meetings is to establish avenues of communication similar to those that have traditionally existed with other federal and state bank supervisory agencies.

Development of Consumer Protection Standards For Securities Sales

As noted at the outset, the OCC and the securities regulators share a common concern that bank customers understand the risks involved in securities investments and not mistakenly believe these products are FDIC-insured or guaranteed by the bank. In July of 1993, the OCC issued Banking Circular 274, which established standards for national banks offering mutual funds, annuities and other nondeposit investment products. The circular stressed that "[b]anks should view customers' interests as critical to all aspects of their sales programs." It directed banks to disclose that securities products are not FDIC-insured, not backed by the bank and involve investment risks, including possible loss of principal. In addition, the circular further directed that banks

obtain signed statements from customers acknowledging receipt and understanding of these disclosures. The circular also addressed program management, physical separation of securities and depository activities, advertising, suitability, qualifications and training, and other consumer protection issues.

Shortly after the issuance of Banking Circular 274, the OCC worked with the other federal banking regulators to establish uniform interagency guidance for securities sales through banks. In February of 1994, the agencies issued the "Interagency Statement on Retail Sales of Nondeposit Investment Products," which embraced the standards from Banking Circular 274 and provided more detailed guidance on sales programs. The OCC also issued detailed examination procedures for examiners on evaluating compliance with the interagency statement. The banking agencies developed these standards due to the absence—at the time—of securities regulatory requirements directed at the special concerns that arise from sales by registered broker–dealers through banks.

In 1998, the NASDR adopted its final rule applicable to broker–dealers governing their securities sales through banks. The new NASDR standards incorporate many of the standards in the interagency statement. We appreciate the efforts of the NASDR to coordinate and establish consistent standards with the banking agencies, and since then, the OCC and the other federal banking agencies have undertaken a project to codify the interagency statement standards, in a manner consistent with the NASDR rules. We anticipate our proposal will focus on activities and obligations that apply directly to *banks*, and should therefore mesh with the NASDR rules, which focus on the activities of the broker–dealer.

OCC Supervisory Efforts Relating to NationsSecurities

I would now like to turn to the matter of securities sales abuses involving NationsSecurities in late 1993 and early 1994.

On April 9, 1993, the OCC approved a partnership between a NationsBank subsidiary and Dean Witter named "NationsSecurities." It was contemplated that the partnership would operate from some NationsBank offices and would offer securities to bank customers. Before approving the proposal, the OCC required representations and imposed enforceable conditions of approval designed to establish proper management oversight of and basic customer protection standards for securities sales effected by the partnership on the premises of, or otherwise through, NationsBank.

For example, one condition required that the partnership disclose that the products were not FDIC-insured, were not backed by the bank, and involved investment risks, including loss of principal. The condition also required that a signed statement be obtained from customers acknowledging receipt and understanding of these disclosures. Another condition required that the partnership's products not be marketed in a manner that would mislead or deceive consumers as to the products' uninsured nature and lack of any guarantee by the bank or the partnership. Various other disclosure and operational requirements designed to protect bank customers were established in the 12 conditions imposed on this approval. The OCC approval noted that the partnership would be registered as a broker–dealer and subject to the requirements of the federal securities laws and "Rules of Fair Practice" of the NASDR. Shortly after the partnership commenced operations on June 7, 1993, the OCC adopted Banking Circular 274, which imposed additional consumer protection standards for banks offering securities on bank premises designed to avoid customer confusion.

On November 1, 1993, the OCC commenced an examination of NationsBank to evaluate the bank's progress towards compliance with the conditions in the OCC's approval and Banking Circular 274. At that time there was great interest in the adequacy of disclosures of the uninsured nature of investment products sold on bank premises, and the SEC had just issued its "Chubb Letter" addressing the propriety of payment of referral fees to unregistered employees of financial institutions. Thus, the examination concentrated on the disclosures being provided to customers and reviewed the operational policies and procedures of the bank, particularly with respect to whether the incentives made available to bank employees for referring business to the partnership were appropriate. Our examiners issued an examination report that was critical of compliance efforts in general, stemming from a lack of coordinated effort by bank management to achieve compliance. The report found specific noncompliance with Banking Circular 274 provisions relating to advertising, compliance management, disclosures and employee compensation.

On reviewing our examination findings, the bank took corrective actions to address areas criticized by the OCC and to ensure future compliance with the interagency statement. Bank management's response commenced during the examination with the formation of a compliance committee in January of 1994 to establish a corrective action response plan. The plan was drafted by February of 1994 and the response was in place by April of 1994.

In late spring and summer of 1994, the OCC received customer and broker complaints about sales abuses

relating to sales of Term Trusts[1] that had occurred between August and September of 1993 and January and February of l994. After learning of these complaints, OCC examination staff immediately began a review, including interviewing employees of the bank and NationsSecurities and doing on-site reviews in the bank's Tampa locations. The OCC also met with the SEC and other regulators and began sharing information regarding their work and their findings. At roughly the same time, our on-site examination staff conducted additional inquiries regarding the sales practices at issue and planned and organized an intensive examination of the bank's nondeposit investment products sales practices.[2] This exam formally began in January of 1995, using resident examiners and a cadre of expert examiners brought in from other parts of the country. During that examination, OCC examination staff advised the bank of major deficiencies in the customer suitability and product selection process. Between May and September of 1995, at the direction of the OCC, the bank and NationsSecurities responded to OCC concerns and took actions to correct the customer suitability and product selection deficiencies.

On July 24, l996, the OCC commenced another examination of NationsBank's retail sales program. Following that exam, our examiners confirmed that corrective action had been taken to resolve concerns identified in the l995 examination and noted no instances of noncompliance with the interagency statement.

The OCC, SEC, and NASDR Coordinated their Efforts Along Functional Lines of Regulation

The OCC and securities regulators pursued our examination and investigation reviews and enforcement actions consistent with our functional lines of regulation. The SEC primarily investigated potential violations of securities laws by NationsSecurities and the bank, while the OCC focused on the bank's compliance with banking laws and standards applicable to the *bank* that were relevant to customer protection.

On learning of the sales practice abuses, the OCC and SEC staff consulted with one another and exchanged formal requests for access to each other's documents. The OCC provided the SEC access to our examination information and set up meetings between OCC examination staff and SEC investigators, which occurred in August of 1994.

In September of l994, the SEC opened a formal Order of Investigation. Subsequently, the SEC would be conducting an in-depth investigation, including depositions of customers, and would share information from the investigation with the OCC. The SEC shared with the OCC information gathered from its investigation. The OCC also shared with the SEC our examination reports, work papers, and other internal information relating to the securities sales programs.

During the negotiation of settlement actions, the OCC, the SEC, and the NASDR effectively coordinated their respective enforcement efforts and announced the settlements together on the same date. At a joint press conference, the agencies expressed appreciation for each other's coordination and cooperation in these enforcement endeavors. The agencies' final enforcement actions reflect a functional regulation approach. The OCC brought an action against the bank based on the bank's failure to comply with the OCC's condition requiring that the bank assure that securities products not be marketed in a manner that would mislead or deceive bank consumers as to the products' uninsured nature and lack of any guaranty by the bank. Through the bank's noncompliance with this condition, the bank failed to adhere to the OCC's standards on retail nondeposit investment sales contained in Banking Circular 274. The OCC assessed a civil money penalty of $750,000 against the bank for this violation. The OCC also suspended from engaging in bank securities activities and assessed a penalty against a bank employee who had been involved in the sales practice abuses and entered into agreements with two other individuals to prevent them from engaging in securities activities within banks during the period they had been suspended by the NASDR. In addition, the SEC assessed a $4 million penalty and the NASDR assessed a $2 million penalty against NationsSecurities for securities law violations. The SEC also entered into a consent order with the bank in which it agreed to cease and desist from causing or engaging in violations of certain securities law provisions. The NASDR also fined and suspended three individuals based on violations of the federal securities laws falling within their jurisdiction. The agencies relied upon information developed by each other in completing their respective enforcement actions.

Legislative Proposals Affecting the Bank Regulators' Role

In closing, I would like to briefly note a development that could impair much of the progress that has been

[1] The 2003 and 2004 Term Trusts were two closed-end investment companies that were sold by NationsSecurities and other broker–dealers.

[2] In November of 1994, NationsBank bought out Dean Witter's interest in NationsSecurities. We were informed by the bank that it made these structural changes to assure greater control over securities sales through the bank and compliance with regulatory standards and to facilitate corrections of the kinds of problems experienced with the sales of the Term Trusts.

made in recent years in coordination between bank regulators and securities regulators who are working toward that common goal of fair treatment of customers. The current system of functional regulation involves different regulators on the lookout—from their different perspectives—for customer concerns arising from securities sales through banks. We are concerned that H.R. 10 could diminish these safeguards. Under Section 117, the ability of a bank or thrift regulator to seek information from, or examine, a functionally regulated bank affiliate or subsidiary, would be severely limited. As a practical matter, this could preclude a bank regulator from promptly taking reasonable steps to verify the existence of information relevant to a potential problem that would warrant a contact with the appropriate functional regulator.

We would respectfully suggest that setting a framework for cooperation and coordination between, rather than segregation of, regulators would be preferable and would enhance both investor protection and the safety and soundness of all types of financial institutions that have functionally regulated affiliates and subsidiaries.

Conclusion

We appreciate this opportunity to explain to the subcommittee the OCC's role with respect to brokerage subsidiaries of banks and our coordination with their primary regulators, and hope you will find this information useful in your oversight activities. I would be pleased to answer any questions you have.

Statement of Emory W. Rushton, Senior Deputy Comptroller for Bank Supervision Policy, before the Financial Institutions and Consumer Credit Subcommittee, U.S. House Committee on Banking and Financial Services, on loan loss reserves, Washington, D.C., June 16, 1999

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

Chairwoman Roukema and members of the subcommittee, I am Wayne Rushton, the senior deputy comptroller for Bank Supervision Policy. I have been a national bank examiner for 34 years, and I appreciate this opportunity to present the testimony of the Office of the Comptroller of the Currency (OCC) on the important issues associated with the allowance for loan and lease losses (loan loss reserves).

History has shown repeatedly that loan losses are difficult to accurately measure before they become obvious. Nonetheless, the procedures banks employ to estimate loan losses are critical to their health. Loan losses that exhausted a bank's reserve, and ultimately wiped out equity capital, have been the primary cause of almost all bank failures. For that reason, it is critical that any external actions that could have the effect of causing banks to lower their reserves receive close scrutiny.

The OCC does not believe there is a widespread problem with inflated loan loss reserves. Bank examiners and public accountants who regularly review financial institutions' reserves have not reported such problems. Moreover, we are especially concerned that the current debate on the treatment of reserves occurs at a time when the risk of loss in many bank loan portfolios is increasing.

The SEC's primary mandate of investor protection and the banking agencies' primary mandate of safety and soundness are not in conflict. Indeed, conservative reserve practices that protect a bank's capital also protect investors. The best antidote for concerns about the possible misuse of loan loss reserves is clear and consistent guidance by all the agencies on process, documentation, and disclosure.

My testimony today begins with an overview of the practical application of loan loss reserves, followed by a brief discussion of how OCC examiners assess the reserving policies and practices of national banks. I will then respond to the questions posed in your letter of invitation.

The Role of Loan Loss Reserves

Loan loss reserves play a critical role in the health of the banking system. Simply stated, a bank's reserve should represent the best estimate its management can make of how much money the bank will lose on the loans it has made. A bank creates and replenishes its reserve by charging a loan loss provision expense against income and setting that amount aside in a separate account on the bank's books. The reserve does not count as part of the bank's equity capital, and the bank may use it only for the purpose of absorbing loan losses.[1]

When a bank charges off a bad loan, it makes the charge against the reserve. Periodically, but not less frequently than quarterly, each bank must reassess whether the amount remaining in its reserve is appropriate, given the amount of estimated losses inherent in its remaining loans. A wide range of factors comes into play in that analysis, including economic trends and other environmental influences. If the reserve is found to be too small, then the bank must increase its provision—the amount it takes out of earnings—to restore the reserve to an appropriate amount. If, on the other hand, the reserve exceeds the amount of estimated losses, the bank must decrease its provision.

It is fair to say that the bank and thrift failures of the 1980s and early 1990s are still fresh in the minds of most bankers. As a result, most of them have tilted toward maintaining healthy reserves to provide a margin for error in their estimates of loan losses. Indeed, the bank regulators have consistently encouraged them to do so. For example, when I began my present assignment two years ago, one of my first actions was to send a letter to every national bank's chief executive officer to remind them of the need for capital and reserves commensurate with their risks.

This does not mean, however, that banks should build their reserves to levels that are beyond the amount they can reasonably justify or that they should engage in pure speculation about losses that could possibly materialize in the future. Nor should they in any way manipulate their reserves to achieve some predetermined path for earnings or otherwise deceive investors or regulators.

[1] See 12 CFR Part 3, Appendix A, section 2(b)(1).

The OCC, through its examination processes and its written guidance, has emphasized the need for national banks to maintain *appropriate* levels of loan loss reserves.

The OCC's Assessment of National Banks' Loan Loss Reserves

Lending remains one of the riskiest businesses that banks conduct. Therefore, the evaluation of credit risk receives a very high priority in our examinations. Our general examiner staff is bolstered by a cadre of credit specialists who maintain state-of-the-art knowledge and skills in analyzing particular forms of lending. Our staff of Ph.D. economists provides macro-analyses of major borrowing industries and collaborates with our examiners in the use of a variety of computer-assisted models designed to predict the risk of default and loss in loans.

At the largest national banks, we have on-site teams of full-time credit experts who track loan quality and trends on a real-time basis so that our assessments of credit quality are predictive as well as historical. At smaller national banks, examiners typically assess the reserve on-site at least once every 12 to 18 months, depending on the bank's size and risk profile. We supplement this with interim off-site analyses of reported data and through telephone contact with bank management.

Our examinations include a review of a bank's internal loan reports and the work of outside auditors. Importantly, however, we also perform independent testing procedures to determine the adequacy of reserves. We dig into the loan files, analyze financial statements, check loan covenants, and evaluate collateral. We also evaluate the bank's loan loss reserve methodologies and the quality of the documentation of its reserves. This comprehensive approach enables us to make an independent judgment about a bank's exposure to losses and the adequacy of its reserves. If we find that a bank is significantly over- or under-reserved, or that it lacks adequate documentation, we require the bank to take corrective action.

Based on those direct assessments our opinion is that national banks, as a group, are not materially over- or under-reserved. That is why we are so concerned about any government action that might have the effect, albeit unintended, of applying general downward pressure on bank reserves.

Madam Chairwoman, I will now turn to the questions posed in your letter of June 8, 1999.

Responses to Questions

1. Federal law requires that financial statements to be filed by banks with the federal bank agencies must be in compliance with GAAP. Some have suggested that in the area of loan loss reserves the federal banking agencies apply regulatory accounting principles (RAP) to banks and thrifts, which are less stringent than GAAP. Please discuss what accounting standards the federal banking agencies apply to financial institutions, and if it is GAAP, the process by which the federal banking agencies interpret and apply GAAP.

The federal banking agencies require all institutions to follow generally accepted accounting principles (GAAP), including the provisions of GAAP applicable to loan loss reserves. Interpretations of GAAP are provided by the OCC's chief accountant's office. All of the accountants on its staff are certified public accountants (CPAs) and intimately knowledgeable with all aspects of GAAP affecting banks. For interpretations of GAAP on areas in which GAAP is not definitive, the chief accountant's staff frequently consults with the staffs of the other banking agencies, the SEC, the Financial Accounting Standards Board (FASB), and the American Institute of Certified Public Accountants (AICPA). This consultation helps to ensure consistent GAAP application among all federal government agencies that have a regulatory role over the banking industry.

GAAP is applied through both the reporting and examination processes. Banks are required to file quarterly and annual financial reports (call reports) prepared in accordance with GAAP. The call report instructions provide a summary of the more significant GAAP standards affecting banks.

During bank examinations, examiners seek to ensure the accuracy of those financial reports. Our examining staff includes a number of CPAs, and we provide accounting guidance for all examiners. For example, the "Allowance for Loan and Lease Losses" booklet (June 1996) of the *Comptroller's Handbook* specifically emphasizes the importance of understanding the guidance in the Statement of Financial Accounting Standards No. 114 (SFAS No. 114) as a prerequisite to any discussion about the allowance determination process. Furthermore, the Federal Financial Institutions Examination Council (FFIEC) call report instructions and the "Interagency Policy Statement on the Allowance for Loan and Lease Losses" also provide guidance that is consistent with GAAP.

2. Please discuss how frequently examiners review a financial institution's loan loss reserves. In reviewing loan loss reserves do the federal banking agencies compare loan loss reserves to financial institutions in the same peer group as well as local and regional economic trends?

OCC examiners review and determine the adequacy of the reserve in conjunction with every full-scope on-site examination. This occurs at least once every 18

months for the smallest, lowest-risk national banks, and annually for all others. Examiners conduct more frequent reviews of the reserve, if deemed necessary, based on the level and direction of a bank's credit risk, and the quality and effectiveness of its credit risk management.

During their on-site reviews, examiners consider the following factors:

- The quality of bank underwriting standards and risk selection criteria;
- Product risk (high loan-to-value lending, leveraged finance, etc.);
- Portfolio composition, including concentrations and correlations among portfolio exposures;
- Loan growth rates;
- The quality and effectiveness of risk management and control processes, such as policymaking, loan administration, loan review;
- Management integrity, expertise, and risk tolerance (overall lending culture);
- Historical default and loss rates, including those experienced through a business cycle; and,
- The bank's capacity and experience in collecting loans, such as through workout and/or collateral liquidation.

In addition to on-site reviews, examiners perform quarterly off-site monitoring of the condition of all national banks using call reports and other submitted financial information. Depending on the bank's risk profile, an examiner may require the bank to submit specific information about its loan portfolio and credit quality. In most cases, these reviews will include analyses of credit risk and reserve levels, and the effect of local and regional trends on the bank's credit risk. Any significant change in risk levels requires further investigation by the examiner, which may range from a telephone call to bank management up to an on-site visit. The quarterly financial information examiners use includes bank-specific and peer-bank data on both the reserve and the loan portfolio. Examiners look for deviations from the selected peer group(s) that signal the need for further inquiry or analysis.

In addition to bank financial information and peer data, examiners also use several analytical tools designed to identify risk outliers. They apply these analytical tools systematically to each national bank every quarter and use comparative financial information and analytical models to identify banks, and specific risk areas within and among banks, including the reserve, that may warrant further investigation.

It is important to point out that this quarterly monitoring only serves as an interim and analytical tool. It is not a substitute for on-site examination. The determination of the adequacy of the reserve requires on-site analysis and verification of the risks in individual credits as well as portfolios of credits.

Does the guidance require examiners to review allowances to determine if they are in accordance with GAAP?

Yes, as noted in my response to Question 1, we train our examiners to review loan loss reserves consistent with GAAP requirements. As also noted in that answer, the *Comptroller's Handbook* booklet emphasizes the importance of understanding the guidance in SFAS No. 114. In addition, call report instructions and the "Interagency Policy Statement on the Allowance for Loan and Lease Losses" provide guidance that is consistent with GAAP.

3. Some have suggested that the federal banking agencies always encourage institutions to increase their reserves, whether warranted or not, due to safety and soundness concerns. Please indicate whether this is consistent with existing examiner guidance.

The OCC does not encourage banks to increase their loan loss reserves unnecessarily; our guidance to examiners on this subject is clear. Within the context of the OCC's responsibility to ensure the safety and soundness of the national banking system and consistent with GAAP, the OCC requires that a bank's financial statements accurately reflect its risks. Given the difficulties of measuring credit risk precisely, the OCC encourages prudence and conservatism in measuring and reporting such risks.

One of the major examination objectives in the "Allowance for Loan and Lease Losses" booklet of the *Comptroller's Handbook* is "To determine if the process for determining the *appropriate* [emphasis added] level for the allowance is sound, based on reliable information, and well documented." The booklet, published in June 1996, makes it clear that "appropriate" includes "determining whether there has been a significant misstatement of the operating results and financial condition of the bank." It also points out that the allowance should be neither "inadequate" nor "excessive." The section addressing adjustment to the allowance concludes, "If, after considering all available information, the examiner concludes that the allowance has been significantly misstated, bank management should be requested to make the necessary adjustments to bring the allowance to an appropriate level." We chose the

word "appropriate," instead of the word "adequate," so that examiners and bankers would understand that both "inadequate" and "excessive" levels of the loan loss reserve are unacceptable. Examiners are also directed to ensure that banks have consistent and well-documented processes for establishing their reserves. Such processes and documentation help to prevent decisions to arbitrarily increase or decrease reserve levels.

More recently, the OCC released Advisory Letter 97–8 (AL 97–8) dated August 6, 1997. The advisory cautioned national banks about observed diverging trends in credit risk and reserve levels and advised them to carefully review their reserve methodologies in light of these trends. The advisory states, in part, that the OCC considers unallocated reserves to be a prudent way for banks to recognize the imperfect nature of most estimates of inherent loss. But it also cautions that unallocated reserves "must not be used to obfuscate the determination of overall allowance adequacy, mask significant deteriorating trends, or 'manage' earnings." The advisory further states that "bank management is expected to have a clear and consistent methodology and supporting documentation for determining an adequate allowance, including the size of both the allocated and unallocated components. Examiners will work with banks to ensure that flawed methodologies are corrected promptly."

4. Please discuss whether the SEC has consulted with and coordinated its comments on loan loss reserves with the Federal Reserve and other federal banking regulators. Please discuss whether you believe consultation between the SEC and the regulators prior to the SEC issuing loan loss reserve comments would be workable and whether prior consultation would promote a more consistent approach to GAAP.

Although SEC staff occasionally consult with the OCC's chief accountant's staff on accounting issues, the SEC has not generally done so on issues involving comments for a specific registrant, particularly regarding the registrant's loan loss reserve.

The OCC believes that such consultation would promote a more consistent approach to GAAP. However, because of examination timing and other logistical issues, such consultation, if practiced for all filings, might detract from the SEC's ability to ensure that registrants receive timely reviews of their statements. A more efficient approach would be for the SEC to consult with bank regulators on filings when it has significant questions pertaining to a registrant's loan loss reserve.

5. Please discuss whether you believe there is a widespread problem with financial institutions inflating their loan loss reserves outside of what is permitted under GAAP.

The OCC does not believe there is a widespread problem with inflated loan loss reserves. Bank examiners and public accountants who regularly review financial institutions' reserves have not reported such problems. To the contrary, the OCC has for the past several years been concerned about increasing credit risk trends within bank portfolios. This prompted the OCC to issue Advisory Letter 97–8 in August 1997, which discussed our concerns with concurrent declining trends in allowance coverage and increasing portfolio credit risk indicators.

That concern has not abated. Indicators of increasing credit risk continue to surface. They include relaxed underwriting standards and risk selection standards by banks (*e.g.,* increasing willingness by banks to lend to leveraged or subprime borrowers and to extend high loan-to-value real estate loans to consumers), significant loan growth, high and increasing consumer debt levels, and high consumer loan past due, charge-off and bankruptcy rates. We believe that this increase in credit risk may require some banks to increase reserves to account for expected inherent loss.

6. In the early 1990s several bank holding companies were sued for securities fraud with respect to arguably inadequate loan loss reserves. Did you take action against any of the banks or bank holding companies involved?

During the late 1980s and early 1990s, there were numerous actions brought by both the government and shareholders against bank holding companies concerning public statements by such companies about the adequacy of their loan loss reserves. With respect to companies with significant national bank subsidiaries, the OCC had a key role in those actions, involving both formal and informal actions.

Many of those actions had certain procedural similarities. The precipitating event in those cases was an OCC onsite examination that identified deficiencies in the bank's allowance levels and methodologies. At the conclusion of the examination, the OCC required the bank to provide a significant additional allowance provision, make fundamental changes to the reserve process, and institute independent loan review programs and/or other similar enhancements. In many cases, the OCC also brought formal enforcement action against the institution, including requiring a restatement of relevant call reports.

In many of the cases referenced above, the SEC followed up the OCC's actions with enforcement actions of its own. Leveraging off of the OCC's supervisory and enforcement actions, and relying on OCC documents and OCC examiners as experts, the SEC commenced enforcement proceedings against the bank's parent holding company under section 15 of the Securities Exchange

Act of 1934. The fundamental allegation in those proceedings was that the understatement of the loan loss reserve resulted in an overstatement of the company's net income. For an example of a typical enforcement proceeding, see *In the Matter of Texas Commerce Bancshares, Inc.*, Securities Exchange Act of 1934, Release No. 34–24803 (August 17, 1987). In the late 1980s and early 1990s, the OCC referred or otherwise provided information to the SEC on over 40 similar cases involving inadequate allowances.

7. In response to the problems of the early 1990s, did the SEC meet and work with the federal banking agencies on loan loss reserves?

In developing new accounting guidance, the OCC routinely consults not only with the other federal banking agencies, but others as well with expert accounting knowledge such as the SEC, FASB, and AICPA.

a. Did the SEC review or have input into the 1993 Interagency Statement on loan loss reserves? Please comment generally on how bank loan loss reserve practices have changed since 1993.

Yes, the consultation process on the 1993 interagency statement on loan loss reserves included seeking the SEC's review and comments. The SEC's chief accountant's office reviewed the draft interagency statement and provided a number of comments and suggestions. These comments were an important contribution to the final interagency statement.

Reserve techniques have continually improved and become more sophisticated since the late 1980s, partially as a consequence of the lessons learned from bank failures caused by under-estimated loan losses. For example, during the period since 1993, the number of institutions using analytical tools such as stress testing, concentration and correlation analysis, and other similar devices in the management of credit risk has grown. Banks often use these tools to assist in the development of a bank's loan loss reserve. While use of these tools does not eliminate the inherent imprecision in the allowance process, the tools provide valuable prospective information upon which to apply sound judgment consistent with both safety and soundness and GAAP.

b. Please describe how the SEC and federal banking agencies communicated and coordinated on the loan loss reserve accounting between 1993 and November of 1998.

As stated above, the banking agencies endeavored to ensure that the 1993 interagency statement on loan loss reserves was consistent with GAAP by seeking the SEC's views, as well as others'. During the intervening time period from 1993 until early 1998, the OCC and SEC staffs had only a few discussions on loan loss reserve issues. This was due in part to a lack of problem loan situations and few questions involving the loan loss reserve.

The OCC issued AL 97–8 in August 1997 on the allowance for loan and lease losses to address questions resulting from examination observations. Because AL 97–8 focused on supervisory issues, we did not consult with the SEC.

Within the last year, the OCC and SEC have also discussed loan loss reserves relating to the year-2000 issue.

c. In November of 1998 and March of 1999 the agencies issued interagency statements on the loan loss reserve issue. Please discuss these statements and how the coordination provided for in these statements is working.

Both the November 1998 and March 1999 issuances emphasized ongoing cooperative relationships among the federal banking agencies and the SEC (collectively, "the agencies") and a commitment to work with the accounting profession and standard setters, and with the banking industry. The March 1999 issuance also went somewhat further by establishing two joint SEC/banking agency working groups to provide additional guidance on the allowance with respect to financial statement disclosure and best practices for loan loss reserve documentation.

Both the November and March issuances were intended to provide a consistent message on the level, documentation, and disclosure of the allowance for loan losses. Recently, however, the SEC determined that institutions could use a "change in accounting principle" mechanism ("transition adjustment") to adjust their loan loss reserve in light of an April 12, 1999, FASB *Viewpoints* article. Although many bankers and accountants viewed this as reflecting an expectation that banks should make significant reductions in reserves, SEC Chairman Levitt on May 19 strongly stated that it was not the SEC's intention to promote widespread reductions in levels of reserves.

The November and March statements have established clear points of agreement among the agencies on important aspects of reserve practices. For example, all have agreed that:

- Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses;
- Prudent, conservative, but not excessive loan loss allowances that fall within an acceptable range of

estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management's best estimate is at the high end of the range;

- The process for determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses;
- An "unallocated" loan loss allowance is appropriate if it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported;
- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio; and
- The loan loss allowance should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors.

Further, interagency efforts are ongoing to provide the banking industry and accounting profession with enhanced guidance on appropriate methodologies, disclosures, and supporting documentation for loan loss allowances. The agencies, in cooperation with the AICPA Allowance for Loan Loss Task Force, will continue efforts to clarify several aspects of GAAP related to the allowance. In addition, the agencies will continue to seek input and guidance from the banking industry and accounting profession in all of these efforts.

8. The FASB issued Statement No. 114 in 1993. This statement was supposed to supplement FASB Statement No. 5. Did the SEC, federal banking agencies, and FASB work on Statement No. 114 together?

Yes. The OCC has an excellent working relationship with the FASB. OCC staff, along with representatives from the other federal banking agencies, meet quarterly with the staff of the FASB. Also, the OCC's accounting staff frequently consults with the FASB staff on banking matters, and the OCC's chief accountant has served on the FASB's Financial Instruments Task Force.

During the development of SFAS No. 114, the OCC provided its comments and concerns to the FASB separately and in joint efforts with the other federal banking agencies. Further, OCC accounting representatives informally discussed these issues with members of the SEC's chief accountant's staff.

As a result of this process and the comments of other parties, the FASB delayed the effective date of SFAS No. 114. The FASB also amended the standard with the issuance of SFAS No. 118. This allowed the banking industry sufficient time to implement the changes resulting from the new standards, which were responsive to many concerns and comments of the industry and bank regulators.

9. Please discuss your understanding of the issues which the AICPA Task Force on Loan Loss Reserves is intended to address.

The AICPA recently formed the Allowance for Loan Loss Task Force ("task force") to help clarify and provide additional accounting guidance on accounting for loan losses. Although the task force may recommend changes to existing accounting standards to the FASB, it is only permitted to interpret these standards and provide implementation guidance. Any proposed interpretations and guidance developed will be submitted for public comment and are subject to a review and no objection by the FASB. Upon completion of this comment and approval process, the interpretations and guidance formally become part of GAAP.

The OCC is very familiar with the issues that the AICPA Allowance for Loan Loss Task Force plans to address. The OCC's chief accountant is a member of the task force, serving as the federal banking agencies' representative. The task force is currently finalizing the scope of issues it expects to address and the additional loan loss allowance guidance it intends to develop.

The task force recognizes that there are numerous issues that need to be addressed because current guidance on accounting for loan losses appears to lack the degree of clarity and specificity that is needed to ensure that it is consistently applied. One of the major issues the task force intends to provide guidance on is how to differentiate a current loss from a future loss. This is an important and difficult issue because GAAP presently only allows a loan loss reserve for a current loss even though the accuracy of the loss estimate will not be known until sometime in the future. Furthermore, SFAS No. 114 requires that a bank estimate "future" cash flows in assessing whether a loan is impaired and the amount of a loan loss reserve that should be provided. Much of the confusion today revolves around this issue, and additional guidance is clearly needed to assist banks in developing loan loss reserves consistent with GAAP.

Other issues the task force may address include fundamental questions such as how a creditor should determine that it is probable it will be unable to collect the full amount of the loan and how various credit risk models may be used within the context of GAAP. Additionally, a number of measurement questions will be addressed,

including providing guidance on how current trends, future events, and economic conditions should be considered in the measurement of loan losses. The task force may also provide additional guidance on disclosure and documentation requirements in cooperation with the work being done jointly with the SEC and banking agencies.

It is obvious the task force will have a full agenda, but also a very important task in achieving both a better understanding of GAAP requirements and consistent application in the banking industry. Consequently, we believe banks generally should not make fundamental changes to their processes for determining loan loss reserve adequacy until this guidance and interpretations are available for implementation.

10. The federal banking agencies closely monitor economic trends on a regional, national, and international basis. Please discuss whether you believe that financial institutions should be permitted to establish loan loss reserves for expected future losses based on local or regional market conditions or expected trends.

The line between probable losses presently inherent in the portfolio (current GAAP standards) and expected future losses is difficult to draw since both rely on estimates about the future. As noted in my response to Question 9, this is one of the issues that the AICPA Allowance Task Force will be addressing.

The OCC strongly believes that banks must include an assessment of local and regional market conditions and trends as well as any other factors that affect credit quality in establishing and maintaining their loan loss reserves. We believe such an approach is consistent with and integral to sound contemporary credit risk measurement and management practices. It is also consistent with our interpretation and application of GAAP.

By its very nature, lending involves an assumption of risk of future losses. Loans are not repaid by historical cash flows or collateral. While the borrower's financial and repayment history are important elements of any lending or reserving decision, the expectation that the borrower will have the capacity to repay the loan, when due, must be based on careful analysis of the borrower's future business and cash generation prospects, as well as the amount, quality, and liquidity of any collateral pledged. In other words, the repayment of a loan made today can only be based on the expectation that the borrower will perform over the term of the loan going forward.

Both bankers and regulators like to think that we learn from our mistakes. And we have both made mistakes in the past. That includes establishing (or accepting) reserves overly dependent on historical performance and ignoring current information that signals the probability of higher loss levels in the future.

11. In connection with the Viewpoints *article, the SEC indicated that "transition adjustments" for loan reserves should be made prior to the end of the second quarter. Please discuss whether you expect many financial institutions to take advantage of this one-time opportunity.*

Although we do not know how many banks will take advantage of this "one-time opportunity" to make a transition adjustment, we do know that there is continuing confusion in the industry on this issue. Let me elaborate by recounting some history.

Beginning last fall, many bankers and the bank regulators became concerned when the SEC required a large banking company to restate its loan loss reserves in connection with an acquisition. To allay those fears, the banking agencies and the SEC in November 1998 issued an interagency agreement in which we pledged to work together to develop joint prospective guidance on reserving practices. Unfortunately, the apprehension continued, so in March 1999, the banking agencies and the SEC entered into another interagency agreement, which, among other things, created two working groups to address issues regarding reserving practices of banks.

After FASB staff issued a *Viewpoints* article interpreting SFAS Nos. 114 and 5, the SEC announced that banks that had previously misinterpreted GAAP, as expressed in the article, had until the end of the second quarter of this year to make an adjustment to their reserves. Comments received from banks we supervise indicated to us that this announcement reflected an expectation that significant reductions in reserves were expected. The chairman of the SEC subsequently made a strong public statement that it was not the SEC's intention to bring about widespread reductions in reserves.

That's where we are today. We continue to work with the other agencies in an effort to reach common ground and to develop clarifying guidance. We have also urged national banks to consult with us if they are considering reducing their reserves in light of the current uncertainty regarding the SEC's application of GAAP.

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Interpretive Letters

857—December 4, 1998

12 USC 3103(a)7

12 USC 3103(a)1

12 USC 1831(u)

Dear [ ]:

This letter responds to your inquiry requesting the views of the Office of the Comptroller of the Currency (OCC) on whether the interstate branching provisions of the International Banking Act (IBA) permit a foreign bank, such as [ ] ("bank"), to establish an interstate federal branch or agency in Florida. Currently, the bank operates a federal branch in *[State]*.

It is the view of the OCC that, pursuant to 12 USC 3103(a)(7), the IBA permits a foreign bank, whose home state is not Florida, to establish an interstate limited federal branch or a federal agency in Florida. Additionally, pursuant to 12 USC 3103(a)(1) and 1831u, the IBA may permit a foreign bank to establish an interstate federal branch or federal agency where such office results from a merger.

1. Pre-Riegle–Neal[1] Interstate Authority under 12 USC 3103(a)(7)

The IBA, at 12 USC 3103(a)(7), restates the limited interstate branching authority for foreign banks that existed prior to the enactment of Riegle–Neal. This provision now reads as follows:

> Notwithstanding paragraphs (1) and (2), a foreign bank may, with the approval of the Board and the Comptroller of the Currency, establish and operate a Federal branch or Federal agency or, with the approval of the Board and the appropriate State bank supervisor, a State branch or State agency in any State outside the foreign bank's home State if—
>
> (A) the establishment and operation of a branch or agency is expressly permitted by the State in which the branch or agency is to be established; and
>
> (B) in the case of a Federal or State branch, the branch receives only such deposits as would be permissible for a corporation organized under section 25A of the Federal Reserve Act [12 USC A. 611 et seq.].

12 USC 3103(a)(7)(1996).[2] In other words, the statute permits a foreign bank to establish an interstate branch or agency in Florida if: (a) Florida expressly permits such branches or agencies; and (b) the branch's deposit-taking activities were limited in the same manner as that of an Edge Act corporation. An analysis of the relevant statutes demonstrates that, in the case of Florida, these conditions are met. Therefore, we conclude that the IBA permits a foreign bank to establish an interstate federal agency or a limited federal branch in Florida pursuant to 12 USC 3103(a)(7).

Florida law provides that foreign banks may establish "international bank agencies" in Florida.[3] However, the broad powers given to Florida's international bank agencies indicate that, in practice, Florida permits its "agencies" to engage in activities that, for the purposes of the IBA, would constitute "branches" (despite their designation as "agencies" under state law). Specifically, state-licensed international bank agencies in Florida are permitted to accept a number of types of deposits, such as those from nonresident U.S. citizens: "An international bank agency may not receive deposits in this state *except:* (a) Deposits from *nonresident entities or persons whose principal places of business or domicile are outside the United States*. . . ." Fla. Stat. ch. 663.061 (1996) (emphasis added).

Thus, Florida permits its "agencies" to receive deposits from U.S. citizens not residing in the United States. The IBA, on the other hand, defines and limits a foreign bank "agency" operation to mean " . . . any office or any place of business of a foreign bank located in any State of the United States at which credit balances are maintained incidental to or arising out of the exercise of banking powers, checks are paid, or money is lent but at which *deposits may not be accepted from citizens or residents of the United States.*" 12 USC 3101(1) (emphasis added). A branch, on the other hand, is defined as "any office or place of business of a foreign bank located in any State of the United States at which deposits are received." 12 USC 3101(3).

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[1] The Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103–328, 108 Stat. 2338 (enacted September 29, 1994) ("Riegle–Neal").

[2] Under the plain language of the IBA it appears that the establishment of interstate federal branches in a state is permitted if the state permits the establishment of either a branch or an agency. However, this letter does not rely on that theory since, as discussed below, we have determined that under Florida law the establishment of an interstate limited branch is permitted.

[3] *See, e.g.,* Fla. Stat. ch. 663.06 (1996) (Licenses; permissible activities), added by 1992 Fla. Laws ch. 92–303, § 160 (effective July 3, 1992).

Consequently, because Florida allows its state-licensed "international bank agencies" to accept deposits from U.S. citizens, beyond those permitted to "agencies" in the IBA, those Florida-licensed organizations may be regarded, for the purposes of the IBA, as "branches." In other words, for the purposes of the IBA, Florida allows the establishment of both interstate branches and agencies, and the first criterion of 12 USC 3103(a)(7) is thus satisfied.[4]

To meet the second criterion of section 3103(a)(7), a federal branch may only receive such deposits that are permissible for an Edge Act corporation. 12 USC 3103(a)(7)(B). By definition, the deposit-taking activities of a "limited federal branch" are restricted in this manner. 12 CFR 28.11(t). Thus, the Comptroller may approve an application by a foreign bank to establish an interstate limited federal branch in Florida.[5]

2. Post-Riegle–Neal Interstate Authority under 12 USC 1831u

The Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 amended the IBA to provide an additional basis for interstate operations. As amended by Riegle–Neal, 12 USC 3103(a)(1) now provides:

> Subject to the provisions of this chapter and with the prior written approval by the Board and the Comptroller of the Currency of an application, a foreign bank may establish and operate a Federal branch or agency in any State outside the home State of such foreign bank to the extent that the establishment and operation of such branch would be permitted under section 36(g) of this title or section 1831u of this title if the foreign bank were a national bank whose home State is the same State as the home State of the foreign bank.

12 USC 3103(a)(1).

Thus, under the IBA, 12 USC 3103, there are three different statutory bases that authorize a foreign bank to establish interstate operations: (1) authority under 12 USC 36(g) ("the McFadden Act"); (2) authority under 12 USC 1831u (the Federal Deposit Insurance Act or "FDIA"); and as discussed above, (3) the pre-Riegle–Neal authority under 12 USC 3103(a)(7) for limited interstate operations. Florida law appears to prohibit *de novo* branching by out-of-state banks and, therefore, *de novo* interstate operations under 12 USC 36(g) are not discussed further in this letter. However, that statutory authority may be a basis for establishing *de novo* interstate operations in other states.

Section 1831u of Title 12, United States Code, provides that, unless a state has enacted legislation to "opt-out" prior to June 1, 1997, insured banks with different "home states" may merge, thereby establishing a single bank with interstate branches. Florida has not "opted-out" of the Riegle–Neal interstate branching provisions, and in fact specifically permits the merger of an out-of state insured bank with a Florida bank that has been in existence for at least three years. The resulting bank may be either an out-of-state bank with Florida branches, or a Florida bank with out-of-state branches.

Under section 3103(a)(1), the Riegle–Neal interstate provisions are to be applied to foreign banks "as if the foreign bank were a national bank whose home State is the same State as the home State of the foreign bank." However, because the specific application of these provisions is beyond the scope of your general inquiry, this letter does not address in detail the extent and circumstances to which Riegle–Neal provisions and the IBA provide for interstate operations through mergers of foreign banks. However, it appears clear that the Riegle–Neal interstate

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[4] It is well-established that the interpretation of federal statutes, such as the IBA, is a matter of federal law, even when federal law contains a reference to a state statute. *See, e.g., Chase Manhattan Bank N.A.* v. *Finance Administration of City of New York,* 440 U.S. 447, 449 (1979); *SEC* v. *Variable Annuity Life Insurance Co.,* 359 U.S. 65, 69 (1959). The case law has also established that it is within the Comptroller's discretionary authority in making licensing decisions to make his own assessment of a state statute, based upon the plain language of the statute, rather than be bound by a state's interpretation. *Cf. Decision of the Comptroller of the Currency on the Application of First National Bank of Jackson, Jackson, Tennessee (April 13, 1990); see also, e.g., Bank of North Shore* v. *FDIC,* 743 F.2d 1178, 1184 (7th Cir. 1984) (holding that the OCC has broad authority to interpret state branching laws in the context of applying the McFadden Act [and by analogy, the IBA's interstate branching provisions].) Consequently, in this case, the Comptroller has the authority to interpret the IBA and Florida law in order to determine whether Florida permits interstate branches or agencies of foreign banks, for the purposes of 12 USC 3103(a)(7). Moreover, the conclusion that the Comptroller may approve an interstate limited federal branch in Florida, while Florida labels comparable offices "international bank agencies," is fully consistent with the IBA and its purpose of creating a federal option for foreign banks in the United States. In the report to accompany H.R. 10899, the International Banking Act of 1978, Congress explained the policy objectives of the IBA:

> The bill incorporates two principal policy objectives. The first objective is to provide a system of Federal regulation of foreign banking activities. . . . The second objective is to provide to the extent possible for appropriate equal treatment for foreign and domestic banks operating in the United States. . . . While recognizing that current regulation of foreign banks is in the hands of the States and providing a framework which will allow this to continue, the bill also provides the option of Federal chartering.

H.R. Rep. No. 910, 95th Cong., 2nd Session, Discussion, at 5 (1978).

[5] Under 12 USC 3103(a)(7), approval would also be required by the Federal Reserve Board.

provisions provide an alternative method for foreign banks to engage in interstate operations, including interstate entry into Florida.

If you have any questions regarding this letter, please do not hesitate to call me or Raija Bettauer, Counselor for International Activities, or Maureen Cooney, Senior Attorney (both at 202–874–0680).

Raymond Natter
Acting Chief Counsel

858—March 17, 1999

12 CFR 1

Re: Philadelphia Authority for Industrial Development Pension Funding Bonds (City of Philadelphia Retirement System), Series 1999A–1999C

Dear [ ]:

This responds to your letter on behalf of [ ] requesting that the Office of the Comptroller of the Currency (OCC) conclude that the Philadelphia Authority for Industrial Development Pension Funding Bonds, Series 1999A - 1999C (Bonds) are Type I investment securities as defined in 12 CFR 1.2(i), and qualify for a 20 percent risk-weight under the OCC's risk-based capital regulations. Based on your representations, and for the reasons discussed below, we conclude that the Bonds are Type I investment securities that qualify for a 20 percent risk weight under those regulations.

Background

The Philadelphia Authority for Industrial Development (Authority) is issuing the Bonds pursuant to, *inter alia*, the Municipal Pension Plan Funding Standard and Recovery Act,[1] to fund a portion of the unfunded actuarial accrued liabilities (Unfunded Liability) for the retirement system of the City of Philadelphia, Pennsylvania (City). You represent that the Bonds will be issued and secured under a Trust Indenture dated January 15, 1999 (Indenture) between the Authority and [ ], as trustee (Trustee).

The City's Home Rule Charter and the Pension Plan Act impose funding and other requirements on the City's pensions plans. The Home Rule Charter requires the City to maintain an actuarially sound pension and retirement system for all its officers and employees, and to obtain an annual actuarial valuation and computation of any related Unfunded Liability.[2] The Pension Plan Act requires the City to budget for and provide minimum annual contributions to its pension plans, payable from revenues of the City, that take the Unfunded Liability into consideration.[3] The Pension Plan Act also provides alternatives for reducing or eliminating the Unfunded Liability (described as "Funding Alternatives" in the Act).[4] The Funding Alternative chosen by the City is a service agreement between the City and the Authority under which the Authority will provide financial services to the City, including the funding of all or a portion of its Unfunded Liability (Service Agreement).[5] You represent that the Funding Alternative and the Service Agreement were approved by ordinance (Bill No. 980789), and adopted by the City's City Council on December 19, 1998.

The Pension Plan Act requires all payments under the Service Agreement to be paid in full when due and to be included in the City's annual budget.[6] Moreover, the City's Home Rule Charter requires the City to appropriate monies for the amounts due under contracts, like the Service Agreement, in its annual operating budget.[7] The City's Home Rule

[1] Act No. 205 of the General Assembly of the Commonwealth of Pennsylvania, approved December 18, 1984 (P.S. 1005) as amended (Pension Plan Act or Act).

[2] 53 P.S. § 895.302(d).

[3] 53 P.S. § 102 and § 404(a).

[4] 53 P.S. § 202.

[5] You represent that the Service Agreement requires the City to pay amounts sufficient to pay when due, *inter alia*, the principal or redemption price of, and interest on, the Bonds. You also represent that the Service Agreement provides that the City's obligations are absolute and unconditional, and are not subject to any set-off or diminution.

[6] 53 P.S. §§ 895.302 and 1001. Failure to pay the full amount of the payment requirements of the Funding Alternative when due, may be remedied by the institution of legal proceedings for mandamus. 53 P.S. § 1001. Any person beneficially interested, including the Authority, has standing to institute a legal proceeding for mandamus. *Id.* The Indenture and the Service Agreement purportedly authorize the Trustee to proceed by mandamus to compel the budgeting and payment of all amounts due under the Service Agreement. The Public Employee Retirement Study Commission (Commission) may also issue an order requiring the City to comply with the Pension Plan Act. 53 P.S. § 895.307. If the City fails to comply with any lawful order of the Commission, the Commission may institute legal proceedings for injunction, mandamus or other appropriate remedy at law or in equity to enforce compliance with, or restrain violations of, the Commission's orders. *Id.*

[7] Under the City's Home Rule Charter, the City Council may by ordinance enter into a contract with a duration of more than one year without making appropriations beyond the current year. Section 2-309 of the City's Home Rule Charter. Those contracts are valid and binding on the City even though no appropriations have been made for the ensuing years for which the contract is in operation; but it is the duty of the City Council to make appropriations from year to year to pay amounts coming due under those contracts. *Id.*

Charter requires the City to balance its budget each year by raising revenue sufficient to pay all budgeted obligations.[8] As a result, the City is obligated, by reason of the mandatory inclusion of the Service Agreement obligations in its annual budget, to raise taxes, if necessary, to make its payments under the Service Agreement.

You assert that the Bonds are limited obligations of the Authority, payable from amounts received from the City pursuant to the Service Agreement. Although the Authority has no taxing power, you represent that the City is obligated by the Pension Plan Act, the City's Home Rule Charter, and the Service Agreement to appropriate monies from the revenues of the City, including taxes, to satisfy its budget obligations.[9]

You believe that the Bonds qualify as Type I securities regardless of the applicable "appropriations clause" in the City's Home Rule Charter. You state that, despite the appropriations clause, the City's obligations under the Service Agreement are required to be included in the City's budget under the Pension Plan Act and the City's Charter. Thus, you argue that Philadelphia's City Council is legally required to include those amounts in its budget and to appropriate sums to pay those amounts, with no discretion to omit the obligation.

You request that the OCC conclude that the Bonds qualify as a Type I investment securities as defined in 12 CFR 1.2(i)(4), and that they receive a 20 percent risk-weight under the OCC's risk based capital guidelines, on the basis that the Bonds constitute indirect general obligations of the City.

Applicable Law

A national bank is permitted to "purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe."[10] Section 24(Seventh) states that the limitations on bank purchases of securities do not apply to obligations of the United States or general obligations of any State or of any political subdivision of a State.[11] Part 1 of OCC regulations implement the investment securities provisions of section 24(Seventh).[12] Under Part 1, "Type I" investment securities include general obligations of a State or any political subdivision.[13] A "political subdivision" includes a city.[14]

General obligations may be supported indirectly by political subdivisions with powers of taxation.[15] Where an obligor does not have powers of taxation, an obligation may be supported indirectly by a political subdivision having those powers and still qualify as a general obligation.[16] Accordingly, a general obligation of a political subdivision includes an obligation payable by an obligor that does not possess general powers of taxation, when a party possessing general powers of taxation has unconditionally promised to provide funds to cover all required payments on the obligation.[17] In addition, a political subdivision that possesses general powers of taxation can indirectly support a general obligation by committing its full faith and credit in support of the obligation in an agreement in which the political subdivision unconditionally promises to make payments for services provided by the issuer of the obligation.[18] Finally, a political subdivision can indirectly support a general obligation where a statutory provision or agreement unconditionally commits the political subdivision to provide funds sufficient for the timely payment of interest on, and principal of, the obligation.[19]

A bond's status as an indirect general obligation is not necessarily affected by the existence of an "appropriations clause." Appropriations clauses generally include language that states that certain payments, that are statutory or contractual obligations to be made periodically by a State or political subdivision, require appropriation by a body such as a legislature or city council.[20] A security that otherwise qualifies as an indirect general obligation

[8] Section 2-302 of the City's Home Rule Charter.

[9] The Philadelphia City Council may by ordinance authorize contracts for services to be rendered over a period of more than one year without making appropriations beyond the current year. The Council must make subsequent appropriations from year to year to pay amounts coming due under its contracts. Section 2-309 of the City's Home Rule Charter. Such expenditures are to be met out of annual operating appropriations and thus out of current revenues. *Id.*

[10] 12 USC 24(Seventh)

[11] *Id.*

[12] 12 CFR Part 1.

[13] 12 CFR 1.2(i)(4).

[14] 12 CFR 1.2(h).

[15] 12 CFR 1.2(b).

[16] 12 CFR 1.100.

[17] 12 CFR 1.2(b)(2) and 1.100(a).

[18] 12 CFR 1.100(b)(2). The payments must be sufficient, together with any other available funds, for the timely payment of the interest on, and principal of, the obligation. *Id.*

[19] 12 CFR 1.100(b)(4). The payments must be sufficient, together with any other available funds, for the timely payment of the interest on, and principal of, the obligation. *Id.*]

[20] OCC Interpretive Letter No. 791 (July 10, 1997) *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-218; OCC Interpretive Letter No. 675 (March 14, 1995) *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,623.

may be considered supported by the full faith and credit of a State or political subdivision if the bank determines, on the basis of past actions by the legislative body or city council in similar situations involving similar types of projects, that it is reasonably probable that the obligor will obtain all necessary appropriations.[21]

OCC risk-based capital regulations contain four risk weights for national bank assets and off-balance sheet items, ranging from zero to 100 percent.[22] The 20 percent risk-weight category includes "claims representing general obligations of any public-sector entity in an OECD country [which includes the U.S.] and that portion of any claims guaranteed by any such public sector entity."[23] In the U.S., these obligations must meet the requirements of 12 CFR [1.2(b)].[24] In contrast, revenue obligations of a public-sector entity in an OECD country that are repayable "solely from revenues generated by the project financed through the issuance of the obligations" receive a 50 percent risk weight.[25]

Discussion

We conclude that the Bonds qualify as Type I investment securities and should be subject to a 20-percent risk weight under Part 3. The City, with general powers of taxation, indirectly supports the obligation at issue by committing to provide funds that cover all the required payments on the Bonds, as Part 1 requires.[26] The unconditional nature of the City's Home Rule Charter, the Pension Plan Act and the terms of the Service Agreement, commit the City to appropriate sufficient revenues to cover service on the Bonds. The obligation must be included in the City's annual budget and be paid from, if necessary, taxes imposed by the City pursuant to its taxing power. The Authority, an entity without taxing powers, will service the Bonds with the funds appropriated by the City.

The existence of the "appropriations clause" in the City's Home Rule Charter does not bar the conclusion that the Bonds are Type I investment securities. The City's Home Rule Charter provides that multiple year service contracts entered into by the City are valid and binding on the City even though appropriations must be made for the ensuing years for which the contract is in operation. The City's Home Rule Charter requires the City Council to make appropriations from year to year to pay amounts coming due under the Service Agreement. You represent that those Home Rule Charter provisions apply not only to the Service Agreement, but to other agreements between the City and the Authority, the City and Pennsylvania Convention Center Authority, and the City and the Philadelphia Municipal Authority. You state that historically, amounts due under those agreements are appropriated and paid when due and always included in the City's operating budgets. Indeed, if the City fails to make adequate annual appropriations under the Service Agreement and include the obligations in its annual budget, the obligation can also be enforced by the institution of legal proceedings by the Commission or by the Authority. Thus, national banks have a reasonable basis for concluding that the City will meet its obligations on the Bonds.

The Bonds meet the requirements of 12 CFR 1.2(b)(2) for a general obligation of a political subdivision, and therefore qualify for a 20 percent risk weight under the OCC's risk-based capital regulations. The Bonds are obligations of a public sector entity in the U.S. since the Authority constitutes an entity established by the City and the Bonds ultimately are supported by payment from the City's general revenues.

Conclusion

For the foregoing reasons, and based on your representations, national banks may purchase the Bonds as Type I investment securities and treat them as having a 20 percent risk-weight under Part 3. The OCC does not endorse specific investments and this letter should not be used in a manner that suggests otherwise. If you have any questions, please contact me at (202) 874-5210.

Tena M. Alexander
Senior Attorney, Securities and Corporate Practices Division

859—March 29, 1999

12 USC 24(6)
12 CFR 7.2000

Office of the District Counsel
Northeastern District
1114 Avenue of the Americas, Suite 3900
New York, New York 10036–7780

Dear [ ]:

This responds to your letter, dated February 18, 1999, requesting that the Office of the Comptroller of the Currency ("OCC") not object to the Board of Directors ("Board") of

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[21] *Id.*

[22] 12 CFR Part 3, Appendix A.

[23] *Id.*, at section 3(a)(2)(ix).

[24] *Id.*

[25] *Id.*, at 3(a)(3)(i).

[26] 12 CFR 1.2(b)(2).

the [   ] ("Bank"), conducting regular meetings of the Board by means of video teleconference. In your letter, you suggest that the routine use of video teleconferencing would be consistent with federal banking law and regulations and with safe and sound banking practices. As discussed below, the OCC will not object to the Bank's proposal.

You indicate that the Board of the Bank has received from the OCC a waiver of the residency requirements of 12 USC 72 and that the directors, in fact, are located in different states. The different locations of directors result in difficulties in coordinating the scheduling of meetings and the attendance of the full Board at all regular meetings. You suggest permitting the Board to participate at such meetings by means of video teleconference technology will enhance each director's ability to fulfill his statutory and fiduciary duties by making his attendance and participation at meetings more convenient. In addition, use of video teleconferencing will enable directors to participate fully and effectively in the meetings with less expenditure of time and expense to travel to the Bank's main office in Wilmington, Delaware, or to another designated location.

As you note, federal banking law does not specify the manner in which a national bank's Board must conduct its meetings. The National Bank Act, however, permits a national bank's Board "[t]o prescribe bylaws not inconsistent with law regulating the manner . . . its general business [is to be] conducted. . . ." 12 USC 24(Sixth). This authority to adopt by-laws is sufficiently broad to include the power to adopt procedures governing regular Board meetings, including the ability to conduct these meetings by video teleconferencing. You note that the Bank has, in fact, already adopted in its by-laws the Delaware General Corporation Law for its corporate governance procedures, and that this law allows meetings to be conducted by means of conference telephone or similar communications equipment.[1] You further note that this method of conducting Board meeting is not inconsistent with federal banking law. Accordingly, the OCC will not object if the Board holds its regular meetings by video teleconference.

Jonathan H. Rushdoony
District Counsel

[1] 8 Del. Code §141(i) (1998). OCC Interpretive Ruling 7.2000(b) accepts the Delaware General Corporation Law as a source of corporate governance procedures for national banks.

860—April 5, 1999

12 USC 24(6)

50 Fremont Street, Suite 3900
San Francisco, CA 94105

Dear [   ]:

This is in response to your letter on behalf of your client, [ ] *(ACQ)* requesting a no-objection letter from the Office of the Comptroller of the Currency (OCC) permitting the Board of Directors of [   ] (NB or "bank") to hold regular board meetings by telephone or video conference. Based on the facts presented in your letter, the OCC does not object to *[NB]* conducting board meetings by telephone or video conference, provided that the Bank amends its bylaws to provide for telephonic and video telephonic board meetings.

[ACQ] is a bank organized under the laws of the [   ] with its headquarters located in *[City, Country]*. In *[Month, Year]*, *[ACQ]* acquired *[NB]*, a national bank headquartered in *[City, State]*. The Board of Directors of *[NB]* now consists of three Directors who are residents of *[State]* and three Directors who are residents of *[Country]*. Five of the six Directors are United States citizens, and the OCC has granted appropriate waivers pursuant to 12 USC 72 for the Director who is not United States citizen and for the Directors who are not United States residents.

[NB] holds regular Board meetings on a monthly basis at least 10 times per year. Under the proposal, *[ACQ]* proposes that regular Board meetings of *[NB]* be conducted by telephone or video conference. The three *[Country]* residents would ordinarily gather in a single conference room in [*Country*], and the three *[State]* residents would gather in a single conference room in *[City]*. If a director is unable to attend in person in *[non-U.S. City]* or in *[City]*, the director would attempt to conference into the Board meeting by telephone. Telephone or video conferencing facilities would be arranged so that every participant could hear everything said by every other participant. In addition, *[ACQ]* may, from time to time, arrange for all directors to be together in person for Board meetings.

Recently, *[ACQ]* and *[NB]* have installed videoconferencing equipment in *[non-U.S. City]* and *[City]*. This equipment utilizes a six-position video camera at each facility that is operable by remote control so that directors at one location can select the camera angle at the other location. This permits the remote location to not only hear everything said by everyone at the other location, but also permits the participants at the remote location to select the camera angle to view the speaker at the other

location, or any other participant. Packages of the material for the Board will ordinarily be distributed prior to the meeting so that every Director will have a complete set of materials to reference. However, the video conferencing technology will also permit the remote viewing of additional materials discussed that are not part of the Board package. Computer support equipment is also available so that materials that are in electronic format can be distributed electronically and viewed immediately at the remote location.

By conducting regular board meetings by telephone and video conferencing, the Bank and its directors would not be subject to the substantial inconvenience and expense associated with inter-continental travel. For example, traveling from *[non-U.S. City]* to *[City]*, conducting one day's business in *[City]*, and traveling back to *[non-U.S. City]* would, in effect, consume three to five days of a director's time. Absent the travel time, and the associated fatigue, the Bank's directors could focus on the board meeting rather than the logistics of traveling to and returning from *[City]*.

In addition, as banking becomes increasingly internationalized, conducting regular board meetings by video or telephone conferencing permits *[NB]* to benefit from having skilled and experienced international bankers on the Bank's board. *[ACQ]'s* management philosophy is to focus on banking opportunities throughout the Pacific Rim. The three directors who reside in *[Country]* include the President of *[ACQ]* and two outside Managing Directors of *[ACQ]*. The presence of these individuals on the Bank's Board is essential to *[ACQ]* integrating *[NB]* in its overall banking strategy.

Although the National Bank Act does not specifically address the manner in which a national bank's board of directors shall conduct its meetings, it does authorize national banks "[t]o prescribe, by its board of directors, bylaws not inconsistent with law, regulating the manner . . . its general business [is to be] conducted." 12 USC 24 (Sixth). This authority to prescribe bylaws to conduct a national bank's general business is sufficiently broad to permit a national bank to adopt procedures governing the practice of conducting board meetings, including the ability to conduct regular board meetings by telephone or video conferencing.

Based on these facts, the OCC does not object to *[NB]* conducting board meetings by telephone or video conference, provided that the Bank amends its bylaws to provide for telephonic and video telephonic meetings. I trust this has been responsive to your inquiry. If you have any further questions, please call Senior Attorney Jimmy Singh or the undersigned at (415) 545–5980.

Lance Cantor
District Counsel

861—February 5, 1999

12 CFR 16.6

Re: [ ](“Bank”), *[City, State]* and *[Bank 2]* (collectively, the “banks”)

Dear [ ]:

This responds to your request for written confirmation that staff of the Office of the Comptroller of the Currency (OCC) would not object if the banks engage in the offer and sale of fixed and variable nonconvertible debt securities (“notes”) as part of a multibank note offering pursuant to section 16.6 of the OCC's securities offering disclosure regulations (12 CFR 16.6), subject to one exception described in your letter. Based upon the facts set forth in your letter and on additional information and representations you have provided, we will not object to the proposed offering pursuant to section 16.6.

Background

Each of the banks is a wholly owned subsidiary of [ ] (“corporation”). The corporation, in turn, is a wholly owned subsidiary of [Inc.], which is a wholly owned subsidiary of [ ] (“parent bank”). The parent bank is headquartered in [ ] with assets of approximately $412 billion and is a subsidiary of *[Co.]*, a [ ] corporation with shares that are publicly traded on the Amsterdam Stock Exchange.

The banks intend on offering and selling the notes with *[Bank A, Bank B, and Bank C]* (together and individually, the “issuing banks”), as part of a multibank $6,000,000,000 debt offering. The notes will range in maturities from 30 days to 10 years. The notes will be offered and sold to accredited investors pursuant to an offering circular that fully discloses the terms and conditions under which the notes will be offered and sold and significant regulatory matters which may affect the business and financial condition of each banking organization. The banks have further indicated that the notes will be sold to new purchasers in minimum initial denominations of $1,000,000 or more, and to existing holders in subsequent minimum denominations of $250,000. The notes will also be legended to preclude their transfer in denominations of less than $250,000. Each note issued pursuant to the offering will be an obligation solely of the issuing bank and not be an obligation of, or otherwise guaranteed by, the other issuing banks, *[Co.]* or any other affiliate, and the offering circular and related subscription and confirmation documents will make this fact clear.

In a March 28, 1995 letter (the “1995 letter”), we advised you that we would not object to the offer and sale of fixed

and variable nonconvertible debt securities by the bank in reliance on section 16.6, subject to certain conditions. As part of these conditions, the bank agreed, among other things, that it would provide: (i) prospective purchasers with its recent financial statements and the corporation's audited financial statements; and (ii) the OCC, and note purchasers on request, with the annual report of *[Co.]*, which is published in [ ]. The bank also agreed to sell its debt to new purchasers in minimum initial denominations of $1,000,000 or more, and to existing holders in subsequent minimum denominations of $250,000. At the time the letter was written, the bank could not technically rely upon section 16.6 because it was not a reporting bank under the Securities Exchange Act of 1934 (the Exchange Act), a subsidiary of an Exchange Act reporting holding company, or a federal branch or agency of a foreign bank.

Ordinary shares of *[Co.]* trade in the United States in the form of American Depository Shares (ADSs), each of which represents the right to receive one ordinary share. Since May of 1997, the ADSs have been listed on the New York Stock Exchange and the underlying ordinary shares have been registered pursuant to section 12 of the Securities Exchange Act of 1934 (Exchange Act). As a result, *[Co.]* is subject to the reporting requirements that the Securities and Exchange Commission prescribes for foreign private issuers under section 13 of the Exchange Act. To comply with these requirements, *[Co.]* files Form 20–F with the SEC, which is used by foreign issuers for the annual report under section 13(a) of the Act, and Form 6–K, which foreign private issuers must file to report current information that is made public or required to be filed in the issuer's home country.

Discussion

As a result of *[Co.]'s* compliance with the Exchange Act requirements for registration of securities and periodic reporting, the banks propose to follow the current requirements of the OCC's abbreviated disclosure procedure for debt securities in 12 CFR 16.6 in their offer and sale of the notes, with one exception[1]. Section 16.6 requires that prior to or simultaneous with the sale of debt securities, each purchaser must receive an offering document that contains a description of the terms of the debt, the use of proceeds and the method of distribution, and incorporates the issuing bank's call report, as well as its (or its holding company's) quarterly, annual, and special (if any) reports filed under the Exchange Act on Forms 10–Q, 10–K, and 8–K. The banks request that, instead of meeting the requirement to incorporate the holding company's Forms 10–Q, 10–K, and 8–K or continuing to rely on the 1995 Letter, they be permitted to substitute Form 20–F and other reports that *[Co.]* files under the Exchange Act. You have represented that the information provided on the forms filed by *[Co.]* is substantially similar or, in some cases, substantially equivalent to the information required by the forms specified in section 16.6. As a result, you believe that the use of the forms filed by *[Co.]*, in lieu of the forms specified in section 16.6, would fully satisfy the disclosure purposes underlying the section 16.6 requirements.

We agree that the purposes of the abbreviated disclosure procedure in section 16.6 would be satisfied if the banks were to incorporate by reference in the offering documents for the notes the Forms 20–F and 6–K filed by *[Co.]* under the Exchange Act in lieu of Forms 10–K, 10–Q, and 8–K. Therefore, the banks may proceed with the offering of notes as proposed in your letter, subject to the specific condition that, in addition to compliance with all other provisions of section 16.6, the notes will be sold to new purchasers in minimum initial denominations of $1,000,000, as described above. This response is based solely on the facts as represented and any changes in the facts could require a different result. The OCC may impose additional limitations to address compliance issues that may arise.

If you have any questions regarding this response, please contact me at (202) 874–5210.

Virginia S. Rutledge, Senior Attorney
Securities and Corporate Practices Division

[1] You represent that the banks would meet the remaining requirements of section 16.6. The banks will sell the notes only to accredited investors and in minimum initial denominations of $1,000,000. (Section 16.6 requires a minimum denomination of at least $250,000.) The notes will be rated investment grade. The banks or one of their holding companies will be subject to the reporting requirements of the Exchange Act. The banks will file offering documents with the OCC no later than the fifth business day after which they are first issued.

862—June 7, 1999

12 USC 24(7)

Dear [ ]:

This responds to your request that the Office of the Comptroller of the Currency (OCC) confirm that it would be permissible for a national bank's captive mortgage reinsurance subsidiary ("captive reinsurer") to enter a mortgage reinsurance agreement with a segregated portfolio company[1] domiciled in the Cayman Islands,

[1] A segregated portfolio insurance company insures or reinsures separately the risks related to the business of each portfolio company and is subject to a special insurance statute that protects the assets of each portfolio company from creditor claims against the insurer based on liabilities related to the activities of other portfolio companies. *See* Sections 229–237 of The Companies (Amendment) (Segregated Portfolios Companies) Law (1998) (Cayman Islands).

to reinsure private mortgage insurance on loans originated or purchased by the bank or one of its affiliates. Your request is on behalf of *[Co.], [State]* domestic monoline mortgage guaranty insurer that is a wholly owned subsidiary of [Inc.]. Based on the information and representations provided, and for the reasons discussed below, we agree with your conclusion that the proposed structure would be permissible under the National Bank Act.

Background

A. The Proposed Reinsurance Activities

Pursuant to a Facultative Excess Layer Primary Mortgage Guaranty Reinsurance Agreement ("reinsurance agreement")[2] which has been approved by the *[State]* Department of Insurance, *[Co.]* will write mortgage insurance coverage, for loans originated or purchased by a national bank or its affiliates, that will be reinsured by [ ] ("Cayman Segregated Portfolio Reinsurer"). The Cayman Segregated Portfolio Reinsurer is a segregated portfolio company domiciled in the Cayman Islands that is wholly owned by *[Inc.]*, and that is authorized to write mortgage reinsurance coverage for loans originated or purchased by a national bank, or an affiliate of a national bank.[3] Under the proposed arrangement, *[Co.]* will agree to cede mortgage insurance risk on an excess of loss or quota share basis, on specified books of business and risk layers and premiums to be determined and set forth in separate Certificates of Facultative Reinsurance (each a "certificate").

[Co.] will negotiate the terms of a reinsurance transaction with a particular bank's captive reinsurer. The bank must obtain approval from the OCC to establish such a subsidiary, and the bank and the subsidiary will be subject to any conditions imposed by the OCC in its decision approving the subsidiary.[4] The captive reinsurer will also be subject to regulation by state insurance authorities and state law requirements including licensing, capital, and reserve requirements.[5]

In connection with a particular bank's or its affiliate's book of business, *[Co.]* would obtain a certificate from the Cayman Segregated Portfolio Reinsurer accepting the reinsurance of that bank's or affiliate's loans. The Cayman Segregated Portfolio Reinsurer would in turn enter into a Mortgage Guaranty Insurance Retrocession Agreement ("retrocession agreement") with the bank's captive reinsurer. Under the retrocession agreement, the Cayman Segregated Portfolio Reinsurer would retrocede to the captive reinsurer all the risk ceded pursuant to the certificate and substantially all the premium ceded pursuant to the certificate (the difference to be sufficient to cover the Cayman Segregated Portfolio Reinsurer's expenses of operation).[6]

Under the proposed arrangement, therefore, the captive reinsurer would agree to accept from the Cayman Segregated Portfolio Reinsurer a portion of the risk of default associated with certain mortgage loans made or purchased by the captive reinsurer's parent bank or the bank's affiliates. In return for accepting risk of loss from default, the captive reinsurer will receive substantially all the premiums paid under the reinsurance agreement and certificate between the Cayman Segregated Portfolio Reinsurer and *[Co.]*. *[Co.]* represents that its proposal will enable *[Co.]* to remain flexible and achieve efficiencies in doing business with lenders that have captive mortgage reinsurance subsidiaries through the use of the Cayman Segregated Portfolio Reinsurer, which is, in effect, a vehicle to consolidate relationships between *[Co.]* and captive reinsurers.

B. Limitations on the Liability of the Bank and the Captive Reinsurer

Each captive reinsurer's performance under its individual retrocession agreement with the Cayman Segregated Portfolio Reinsurer will be secured by assets in a trust account to be established with a United States bank acceptable to both *[Co.]* and the captive reinsurer. The captive reinsurer would be required to deposit funds equal to a specified percent of the risk being retroceded into the trust account and all retroceded premium would initially be deposited into the trust account, subject to release to the captive reinsurer as long as a specified minimum funds requirement is maintained. Under this structure, there would be a separate trust account for

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[2] Reinsurance is a process whereby an original insurer reduces its underwriting risk by passing all or part of this risk on to another insurance company. The first underwriter may retain only a portion of the risk and reinsure the balance with a second company that then owns the cash flow and assumes that portion of the risk. *See* 13A John Alan Appleman & Jean Appleman, Insurance Law and Practice § 7681 (1976).

[3] As a licensed reinsurer in the Cayman Islands, the Cayman Segregated Portfolio Reinsurer will be subject to ongoing supervision and regulation by the Cayman Islands Inspector of Financial Services. Any material change in the Cayman Segregated Portfolio Reinsurer's plan of operation would require the prior approval of the Cayman Islands Inspector of Financial Services.

[4] *See, e.g.,* Corporate Decisions No. 99-04 (December 23, 1998) (Hibernia); No. 98-43 (September 11, 1998) (M&I); and No. 98-22 (April 22, 1998) (Fifth Third) and the decisions cited therein (collectively, the "Mortgage Reinsurance Approval Letters").

[5] *See id.*

[6] Copies of the reinsurance agreement and certificate would be appended to the retrocession agreement.

each book of business retroceded by the Cayman Segregated Portfolio Reinsurer and assumed by the captive reinsurer.

The captive reinsurer would become liable to the extent provided in the retrocession agreement to the Cayman Segregated Portfolio Reinsurer when a bank's or its affiliate's loan insured by *[Co.]* goes into default (i.e., the borrower does not make a scheduled payment of principal and/or interest by the stated due date or within the stated grace period). The potential exposure to loss of a captive reinsurer's parent bank for the captive reinsurer's reinsurance obligation will not exceed the bank's investment in the captive reinsurer.

No captive reinsurer will be liable for any of the activities of the Cayman Segregated Portfolio Reinsurer or other captive reinsurers. The Cayman Segregated Portfolio Reinsurer's reinsurance obligation will be made without recourse to the captive reinsurer.[7]

[Co.] represents that its reinsurance agreement with the Cayman Segregated Portfolio Reinsurer meets the requirements of, and has been approved by, the *[State]* Department of Insurance. The form of the retrocession agreement that the Cayman Segregated Portfolio Reinsurer will use with each captive reinsurer has been approved by the *[State]* Department of Insurance.

Discussion

The OCC has previously determined that a captive reinsurer may reinsure a portion of the mortgage insurance on loans originated or purchased by the captive reinsurer's parent bank, or by the parent bank's lending affiliates.[8] The OCC concluded that this reinsurance activity is part of the business of banking because the activity (1) is functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) responds to customer needs or otherwise benefits the bank or its customers; and (3) involves risks similar in nature to those already assumed by banks. The OCC also concluded that, even if the activity were not part of the business of banking, it was permissible as an activity incidental to a national bank's express power to make loans, because it optimized the use of the bank's credit underwriting capacities.[9]

The primary difference between the proposed arrangement and the activities that the OCC has previously approved for captive reinsurers is the introduction of the Cayman Segregated Portfolio Reinsurer as an intervening reinsurer between the primary insurer and the captive reinsurer. The existence of the Cayman Segregated Portfolio Reinsurer, however, will not alter the nature of the activities conducted by the captive reinsurer, which are the same types of mortgage reinsurance activities that have been approved by the OCC. Similar to the mortgage reinsurance activities previously approved by the OCC in the Mortgage Reinsurance Approval Letters, it is envisioned that the captive reinsurer in this arrangement will reinsure mortgages held by its parent bank or the parent bank's affiliates, and will receive compensation for the risk of default through its share of premiums paid under the reinsurance contracts. Thus, this arrangement will also involve credit judgments and the assumption of credit risks, and resemble the repurchase of bank loans or the extension of low down payment loans without mortgage insurance. The proposed arrangement also will provide exactly the same kinds of benefits to customers and to the bank as the mortgage reinsurance activities already approved by the OCC. In addition, the risks involved in the proposed arrangement will be comparable both to the risks involved in mortgage lending and the risks of the previously approved reinsurance activities. As in the other cases considered by the OCC, the proposed reinsurance arrangement additionally will enable the bank to optimize the use of its existing credit staff and credit expertise to generate additional revenues through activities that support and enhance the bank's lending business.

Conclusion

Based upon the foregoing facts and analysis, we agree with your conclusion that under the National Bank Act, a national bank's captive reinsurer may enter into a mortgage reinsurance agreement with a segregated portfolio company to reinsure private mortgage insurance on loans originated or purchased by the bank or its affiliates, in the manner described herein.[10]

Julie L. Williams
Chief Counsel

[7] The Cayman Segregated Portfolio Reinsurer will have no less than $1 million of policyholders surplus as required under *[State]* law. This surplus will be provided by The *[Inc.]*.

[8] *See* the Mortgage Reinsurance Approval Letters.

[9] *See id.*

[10] A specific proposal by a national bank's captive reinsurer to enter a mortgage reinsurance agreement with the Cayman Segregated Portfolio Reinsurer to reinsure mortgage insurance on loans originated or purchased by the bank or one of its affiliates would be subject to the OCC's review under 12 CFR 5.34. The OCC's review would include an assessment of whether any supervisory concerns or legal issues in addition to those discussed herein are presented in each case. Also, of course, activities of individual banks and their subsidiaries are subject to other applicable laws and regulations.

Mergers—April 1 to June 30, 1999

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Mergers—April 1 to June 30, 1999

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

Nonaffiliated mergers (mergers consummated involving two or more nonaffiliated operating banks), from April 1 to June 30, 1999

Title and location (charter number)	Total assets
Louisiana	
Hibernia National Bank, New Orleans (013688)	14,020,332,000
and Beaumont Trust Company, National Association, Beaumont (023794)	200,000
merged on May 21, 1999 under the title of **Hibernia National Bank, New Orleans** (013688)	14,020,532,000
New Jersey	
Valley National Bank, Passaic (015790)	5,016,163,000
and The Ramapo Bank, Wayne Township	327,169,000
merged on June 11, 1999 under the title of **Valley National Bank, Passaic** (015790)	5,343,332,000
New Mexico	
The First National Bank of New Mexico, Clayton (015259)	46,556,000
and Zia New Mexico Bank, Tucumcari	13,450,000
merged on April 23, 1999 under the title of **The First National Bank of New Mexico, Clayton** (015259)	60,006,000
Texas	
The State National Bank of Iowa Park, Iowa Park (013614)	60,761,000
and Electra State Bank and Trust Company, Electra	37,640,000
and Windthorst National Bank, Windthorst (020472)	28,421,000
merged on May 13, 1999 under the title of **State National Bank of Texas, Iowa Park** (013614)	126,822,000
Wyoming	
Norwest Bank Wyoming, National Association, Casper (010533)	4,581,695,000*
and Riverton State Bank, Riverton	61,896,000
and Dubois National Bank, Dubois (015205)	22,923,000
merged on May 15, 1999 under the title of **Norwest Bank Wyoming, National Association, Casper** (010533)	2,958,930,000

* Note: Adjustment of $1,707,584,000 done to resulting national bank prior to consummation.

Nonaffiliated mergers—thrift (mergers consummated involving nonaffiliated national banks and savings and loan associations), from April 1 to June 30, 1999

Title and location (charter number)	Total assets
New Jersey	
United National Bank, Bridgewater (005621)	1,508,573,000
and Raritan Savings Bank, Bridgewater	433,325,000
merged on March 31, 1999 under the title of **United National Bank, Bridgewater** (005621)	1,941,898,000
New York	
City National Bank and Trust Company of Gloversville, Gloversville (009305)	255,568,000
and Gloversville Federal Savings and Loan Association, Gloversville	68,732,000
merged on June 1, 1999 under the title of **City National Bank and Trust Company of Gloversville, Gloversville** (009305)	329,460,000
North Carolina	
The First National Bank of Shelby, Shelby (006776)	392,396,000
and First Carolina Federal Savings Bank, Kings Mountain	94,726,000
merged on April 2, 1999 under the title of **The First National Bank of Shelby, Shelby** (006776)	479,868,000

Affiliated mergers (mergers consummated involving affiliated operating banks), from April 1 to June 30, 1999

Title and location (charter number)	Total assets
Arizona	
Bank of America National Association, Phoenix (022106)	4,899,313,000
and NationsBank of Delaware, National Association, Dover (022279)	7,785,570,000
merged on March 31, 1999 under the title of **Bank of America, National Association (USA), Phoenix** (022106)	12,684,883,000
Arkansas	
Simmons First National Bank, Pine Bluff (006680)	733,245,000
and American State Bank, Charleston	89,619,000
merged on March 26, 1999 under the title of **Simmons First National Bank, Pine Bluff** (006680)	822,864,000
The Citizens National Bank of Hope, Hope (010579)	228,908,000
and Peoples Bank and Loan Co., Lewisville	34,912,000
merged on April 8, 1999 under the title of **The Citizens National Bank of Hope, Hope** (010579)	263,820,000
The First National Bank of Fort Smith, Fort Smith (001950)	559,160,000
and River Valley Bank and Trust, Lavaca	75,826,000
merged on June 4, 1999 under the title of **The First National Bank of Fort Smith, Fort Smith** (001950)	634,986,000
Colorado	
Norwest Bank Colorado, National Association, Denver (003269)	9,906,710,000
and Community Bank of Parker, Parker	71,663,000
merged on April 24, 1999 under the title of **Norwest Bank Colorado, National Association, Denver** (003269)	9,978,373,000
Florida	
West Coast Guaranty Bank, National Association, Sarasota (023829)	147,923,000
and West Coast Bank, Sarasota	115,020,000
merged on February 16, 1999 under the title of **West Coast Guaranty Bank, National Association, Sarasota** (023829)	262,943,000
Illinois	
LaSalle National Bank, Chicago (014362)	21,126,000
and LaSalle Bank National Association, Chicago (014450)	6,150,000
merged on April 30, 1999 under the title of **LaSalle Bank National Association, Chicago** (014362)	27,198,000
Castle Bank National Association, Sandwich (023817)	132,862,000
and The Bank of Yorkville, Yorkville	79,014,000
merged on June 25, 1999 under the title of **Castle Bank National Association, Sandwich** (023817)	211,876,000
Indiana	
The Merchants National Bank of Terre Haute, Terre Haute (023076)	657,128,000
and Dulaney National Bank, Marshall (004759)	42,235,000
merged on May 13, 1999 under the title of **The Merchants National Bank of Terre Haute, Terre Haute** (023076)	700,363,000
Kentucky	
Community First Bank, National Association, Maysville (003291)	77,898,000
and Community First Bank of Kentucky, Warsaw	85,646,000
merged on June 25, 1999 under the title of **Community First Bank, National Association, Maysville** (003291)	163,544,000
Citizens National Bank of Paintsville, Paintsville (013023)	161,126,000
and The Bank Josephine, Salyersville	109,633,000
merged on May 25, 1999 under the title of **Citizens National Bank of Paintsville, Paintsville** (013023)	270,759,000
Minnesota	
The First National Bank of Hudson, Woodbury (000095)	155,261,000
and Merchants State Bank of North Branch, North Branch	53,593,000
merged on June 30, 1999 under the title of **The First National Bank of Hudson, Woodbury** (000095)	208,855,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
Community National Bank, Northfield (013350)	73,753,000
and Roseville Community Bank, National Association, Roseville (022046)	49,047,000
merged on May 10, 1999 under the title of Community National Bank, Northfield (013350)	122,800,000
U.S. Bank National Association, Minneapolis (013405)	67,367,865,000
and Northwest National Bank, Vancouver (016523)	386,024,000
merged on May 7, 1999 under the title of U.S. Bank National Association, Minneapolis (013405)	67,753,880,000
Missouri	
Commerce Bank, National Association, Kansas City (018112)	9,196,823,000
and the Citizens National Bank in Independence, Independence (013924)	95,695,000
merged on June 4, 1999 under the title of Commerce Bank, National Association (018112)	9,292,518,000
TeamBank, National Association, Freeman (003350)	256,770,000
and TeamBank Nebraska, Bellevue	34,347,000
merged on June 26, 1999 under the title of TeamBank, National Association, Freeman (003350)	291,117,000
Nebraska	
First National Bank Northeast, Lyons (006221)	108,874,000
and The Farmers and Merchants National Bank of Oakland, Oakland (010022)	23,720,000
merged on April 30, 1999 under the title of First National Bank Northeast, Lyons (006221)	132,743,000
The First National Bank & Trust Company of Beatrice, Beatrice (002357)	109,245,000
and Farmers Bank of Clatonia, Clatonia	9,204,000
merged on June 30, 1999 under the title of The First National Bank & Trust Company of Beatrice (002357)	118,449,000
New York	
The Oneida Valley National Bank of Oneida, Oneida (001090)	233,721,000
and First National Bank of Cortland, Cortland (002272)	233,538,000
merged on April 16, 1999 under the title of Alliance Bank, National Association, Oneida (001090)	467,259,000
North Carolina	
NationsBank, National Association, Charlotte (014448)	294,483,000,000
and Bank of America Texas, National Association, Dallas (022429)	5,114,000,000
and Interim Bank of America (NM), National Association, Santa Fe (023832)	396,000,000
merged on April 8, 1999 under the title of NationsBank, National Association, Charlotte (014448)	299,993,000,000
Ohio	
FirstMerit Bank, National Association, Akron (014579)	6,146,930,000
and Signal Bank, National Association, Wooster (023344)	1,347,815,000
and NC Interim National Bank, New Castle (023780)	401,089,000
and Summit Bank, National Association, Akron (023439)	108,266,000
merged on February 12, 1999 under the title of FirstMerit Bank, National Association, Akron (014579)	8,702,173,000
Firstar Bank, National Association, Cincinnati (000024)	16,750,000
and Firstar Bank Iowa, National Association, Des Moines (016324)	2,949,000
and Firstar Bank Illinois, Chicago	2,732,000
merged on May 27, 1999 under the title of Firstar Bank, National Association, Cincinnati (000024)	22,431,000
National City Bank, Cleveland (000786)	31,049,288,000
and National City Interim Trust Company, West Palm Beach (023894)	7,818,000
merged on June 30, 1999 under the title of National City Bank, Cleveland (000786)	31,057,288,000
Oklahoma	
Home National Bank, Blackwell (013891)	227,855,000
and Home National Bank, Arkansas City (004487)	210,269,000
merged on June 25, 1999 under the title of Home National Bank, Blackwell (013891)	438,124,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
Tennessee	
Union Planters Bank, National Association, Memphis (013349)	27,406,926,000
and Ambank Indiana, National Association, Vincennes (003864)	443,901,000
and Ambank Illinois, National Association, Robinson (013605)	250,164,000
merged on May 07, 1999 under the title of **Union Planters Bank, National Association, Memphis** (013349)	30,959,419,000
Union Planters Bank, National Association, Memphis (013349)	27,406,926,000
and The First National Bank of Wetumpka, Wetumpka (007568)	190,187,000
merged on May 21, 1999 under the title of **Union Planters Bank, National Association, Memphis** (013349)	27,597,113,000
First Citizens National Bank, Dyersburg (005263)	363,447,000
and First Volunteer Bank, Union City	50,436,000
merged on June 14, 1999 under the title of **First Citizens National Bank, Dyersburg** (005263)	490,656,000
Union Planters Bank, National Association, Memphis (013349)	32,977,865,000
and First and Farmers Bank of Somerset, Inc., Somerset	309,834,000
and Bank of Cumberland, Burkesville	59,432,000
merged on June 11, 1999 under the title of **Union Planters Bank, National Association, Memphis** (013349)	33,347,131,000
First American National Bank, Nashville (003032)	20,359,042,000
and Peoples Bank, Dickson	145,666,000
merged on June 30, 1999 under the title of **First American National Bank, Nashville** (003032)	20,504,708,000
Texas	
Continental National Bank, El Paso (016381)	120,657,000
and First National Bank, Denver City (017365)	781,000
merged on March 30, 1999 under the title of **Continental National Bank, El Paso** (016381)	121,438,000
Norwest Bank Texas, National Association, San Antonio (014208)	9,907,642,000
and The First National Bank of Franklin, Franklin (007838)	72,439,000
merged on April 17, 1999 under the title of **Norwest Bank Texas, National Association, San Antonio** (014208)	9,965,203,000
Norwest Bank Texas, National Association, San Antonio (014208)	9,965,203,000
and First Bank Katy, National Association, Katy (023651)	297,561,000
and Mercantile Bank, National Association, Brownsville (012236)	828,530,000
merged on June 19, 1999 under the title of **Norwest Bank Texas, National Association, San Antonio** (014208)	11,063,154,000
Woodforest National Bank, Houston (016892)	504,416,000
and Highlands Bank, Highlands	75,438,000
merged on March 31, 1999 under the title of **Woodforest National Bank, Houston** (016892)	579,854,000
Austin Bank, Texas National Association, Jacksonville (005581)	137,000,000
and Austin Bank, National Association, Longview (018291)	172,000,000
merged on April 12, 1999 under the title of **Austin Bank, Texas National Association, Jacksonville** (005581)	309,000,000
Austin Bank, Texas National Association, Jacksonville (005581)	137,044,000
and Austin Bank, Whitehouse, Texas, National Association (015544)	84,251,000
merged on May 10, 1999 under the title of **Austin Bank, Texas National Association, Jacksonville** (005581)	221,295,000
Austin Bank, Texas National Association, Jacksonville (005581)	137,044,000
and Austin Bank, Big Sandy, Texas, Big Sandy	21,480,000
merged on April 12, 1999 under the title of **Austin Bank, Texas National Association, Jacksonville** (005581)	158,524,000
The American National Bank of Texas, Terrell (017043)	680,506,000
and The Bank of Van Zandt, Canton	71,359,000
merged on June 1, 1999 under the title of **The American National Bank of Texas, Terrell** (017043)	751,865,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
The Frost National Bank, San Antonio (005179)	6,830,500,000
and Bank of Commerce, Fort Worth	188,923,000
merged on May 20, 1999 under the title of **The Frost National Bank, San Antonio** (005179)	7,052,587,000
Extraco Banks, National Association, Temple (013778)	389,523,000
and Extraco Banks, National Association, Waco (020014)	114,271,000
merged on May 21, 1999 under the title of **Extraco Banks, National Association, Temple** (013778)	503,794,000
Virginia	
First Community Bank, National Association, Tazewell (023892)	397,960,000
and First Community Bank of Mercer County, Inc., Princeton	436,402,000
and First Community Bank of Southwest Virginia, Inc., Tazewell	106,100,000
and Blue Ridge Bank, Sparta	123,335,000
merged on April 30, 1999 under the title of **First Community Bank, National Association, Tazewell** (023892)	1,063,797,000
West Virginia	
City National Bank of West Virginia, Charleston (014807)	1,476,138,000
and Bank of Raleigh, Beckley	402,324,000
and Greenbrier Valley National Bank, Lewisburg (005903)	182,533,000
and First National Bank In Marlinton, Marlinton (013783)	75,545,000
and The National Bank of Summers of Hinton, Hinton (007998)	77,332,000
and The Twentieth Street Bank, Huntington	305,830,000
merged on April 26, 1999 under the title of **City National Bank of West Virginia, Charleston** (014807)	2,519,702,000
First Century Bank, National Association, Bluefield (004643)	257,450,371,000
and First Century Bank, Wytheville	38,361,670,000
merged on May 7, 1999 under the title of **First Century Bank, National Association, Bluefield** (004643)	294,511,533,000
Wisconsin	
Associated Bank Green Bay, National Association, Green Bay (002132)	1,362,930,000
and Citizens Bank National Association, Shawano (021289)	139,349,000
merged on June 18, 1999 under the title of **Associated Bank Green Bay, National Association, Green Bay** (002132)	1,502,279,000
Associated Interim Bank Green Bay, National Association, Green Bay (023695)	252,362,000
and Associated Bank Green Bay, National Association, Green Bay (002132)	1,357,874,000
merged on November 12, 1998 under the title of **Associated Bank Green Bay, National Association, Green Bay** (023695)	1,610,236,000
Associated Interim Bank, National Association, Neenah (023700)	179,072,000
and Associated Bank, National Association, Neenah (001602)	521,012,000
merged on November 12, 1998 under the title of **Associated Bank, National Association, Neenah** (023700)	700,084,000
Associated Interim Bank Lakeshore, National Association, Manitowoc (023701)	122,362,000
and Associated Bank Lakeshore, National Association, Manitowoc (015972)	422,698,000
merged on November 12, 1998 under the title of **Associated Bank Lakeshore, National Association, Manitowoc** (023701)	545,060,000
Amcore Bank, National Association, South Central, Monroe (000230)	26,257,000
and Amcore Bank, Argyle, Argyle	3,853,000
and Amcore Bank, Mount Horeb, Mount Horeb	8,394,000
merged on November 13, 1998 under the title of **Amcore Bank, National Association, South Central, Monroe** (000230)	38,506,000

Affiliated mergers—thrift (mergers consummated involving affiliated national banks and savings and loan associations), from April 1 to June 30, 1999

Title and location (charter number)	Total assets
Ohio	
The Second National Bank of Warren, Warren (002479)	963,960,000
and Trumbull Savings and Loan Company, Warren	508,715,000
merged on November 18, 1998 under the title of The Second National Bank of Warren, Warren (002479)	1,472,675,000
Tennessee	
Union Planters Bank, National Association, Memphis (013349)	27,406,926,000
and First Mutual Bank, S.B., Decatur	404,006,000
merged on May 21, 1999 under the title of Union Planters Bank, National Association, Memphis (013349)	27,810,932,000
Texas	
Southwest Bank of Texas National Association, Houston (017479)	1,983,330,000
and Fort Bend Federal Savings & Loan Association of Rosenberg, Rosenberg	327,495,000
merged on April 1, 1999 under the title of Southwest Bank of Texas National Association, Houston (017479)	2,310,825,000

Tables on the Corporate Structure of the National Banking System

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Changes in the corporate structure of the national banking system, by state, January 1 to June 30, 1999

	In operation January 1, 1999	Organized and opened for business	Merged	Voluntary liquidations	Payouts	12 USC 214		In operation June 30, 1999
						Converted to non-national institutions	Merged with non-national institutions	
Alabama	31	0	3	0	0	0	1	27
Alaska	4	0	0	0	0	0	0	4
Arizona	16	0	0	0	0	0	0	17
Arkansas	57	0	1	0	0	1	2	53
California	102	1	1	0	0	1	3	98
Colorado	64	1	1	0	0	0	2	61
Connecticut	9	1	0	0	0	0	0	10
Delaware	22	2	2	1	0	0	2	19
District of Columbia	8	0	0	0	0	0	1	7
Florida	93	3	2	0	0	0	1	93
Georgia	65	5	1	0	0	2	0	67
Hawaii	1	0	0	0	0	0	0	1
Idaho	1	0	0	0	0	0	0	1
Illinois	229	2	3	1	0	0	5	222
Indiana	45	1	1	0	0	0	2	43
Iowa	51	0	1	0	0	1	0	49
Kansas	112	2	2	0	0	1	1	110
Kentucky	63	0	0	0	0	0	0	63
Louisiana	20	0	0	0	0	0	0	20
Maine	7	0	0	0	0	0	0	7
Maryland	19	0	1	0	0	1	0	17
Massachusetts	20	1	0	0	0	0	0	21
Michigan	36	1	0	0	0	0	0	37
Minnesota	144	1	4	0	0	0	0	141
Mississippi	20	2	1	0	0	0	1	20
Missouri	51	0	0	0	0	0	0	51
Montana	18	1	0	0	0	0	0	19
Nebraska	96	1	1	0	0	0	2	94
Nevada	8	0	0	0	0	0	0	8
New Hampshire	7	0	0	0	0	0	0	7
New Jersey	25	3	0	0	0	0	1	27
New Mexico	21	1	2	0	0	0	0	20
New York	67	2	1	0	0	0	1	67
North Carolina	11	0	0	0	0	1	0	10
North Dakota	18	0	0	0	0	0	0	18
Ohio	105	0	3	0	0	1	2	99
Oklahoma	119	1	0	0	0	2	0	118
Oregon	5	0	0	0	0	0	0	5
Pennsylvania	108	3	6	0	0	1	4	100
Rhode Island	2	0	0	0	0	0	0	2
South Carolina	20	3	0	0	0	1	0	22
South Dakota	23	1	0	0	0	0	0	24
Tennessee	34	0	0	0	0	0	0	34
Texas	408	8	14	0	0	1	4	397
Utah	8	0	0	0	0	0	0	8
Vermont	13	0	0	0	0	0	1	12
Virginia	32	4	0	0	0	0	0	36
Washington	20	0	1	0	0	0	1	18
West Virginia	31	0	3	0	0	0	1	27
Wisconsin	61	4	4	0	0	0	1	60
Wyoming	21	1	2	0	0	0	0	20
United States:	2,571	56	61	2	0	14	39	2,511

Notes: The column "organized and opened for business" includes all state banks converted to national banks as well as newly formed national banks. The column titled "merged" is a generic term and includes all mergers, consolidations, and purchases and assumptions of branches in which the resulting institution is a nationally chartered bank. Also included in the column are immediate FDIC-assisted "merger" transactions in which the resulting institution is a nationally chartered bank. The column titled "voluntary liquidations" includes only straight liquidations of national banks. No liquidation pursuant to a purchase and assumption transaction is included in this total. Liquidations resulting from purchase and assumptions are included in the "merged" column. The column titled "payouts" includes failed national banks in which the FDIC is named receiver and no other depository institution is named as successor. The column titled "merged with non-national institutions" includes all mergers, consolidations, and purchase and assumptions of branches in which the resulting institution is a non-national institution. Also included in this column are immediate FDIC-assisted "merger" transactions in which the resulting institution is a non-national institution.

Applications for new, full-service national bank charters, approved and denied, by state, January 1 to June 30, 1999

Title and location	Approved	Denied
Arizona		
First Bank of Arizona, N.A., Scottsdale	March 23	
California		
South County Bank, National Association, Rancho Santa Margarita	February 11	
Colorado		
First National Bank of Steamboat Springs, Steamboat Springs	April 29	
Florida		
Century National Bank, Orlando	June 23	
Citizens National Bank of Southwest Forida, Naples	February 12	
First National Bank of Nassau County, Fernandina Beach	January 27	
Flagship National Bank, Bradenton	January 6	
Heartland National Bank, Sebring	January 27	
Lehigh Acres First National Bank, Lehigh Acres	March 30	
National City Interim Trust Company, West Palm Beach	May 4	
Suncoast National Bank, Sarasota	January 21	
West Coast Guaranty Bank, National Association, Sarasota	January 11	
Georgia		
Albany Bank & Trust, National Association, Albany	February 9	
Alliance National Bank, Dalton	May 27	
Cherokee Bank, National Association, Canton	April 8	
First National Bank of Johns Creek, Forsyth County	February 9	
United Americas Bank, National Association, Atlanta	February 22	
Maryland		
Harbor Capital National Bank, Rockville	April 21	
Minnesota		
Washington County Bank, National Association, Oakdale	January 22	
Missouri		
Old Missouri National Bank, Springfield	May 14	
New Mexico		
Interim Bank of America (NM), National Association, Santa Fe	February 19	
Oklahoma		
American Bank of Locust Grove, National Association, Locust Grove	April 26	
Local Oklahoma Bank, National Association, Oklahoma City	April 29	
South Carolina		
Bank of Commerce, National Association, Prosperity	January 6	
Cornerstone National Bank, Easley	May 19	
Hartsville Community Bank, National Association, Hartsville	February 12	
New Commerce Bank, National Association, Simpsonville	February 11	
Texas		
Addison National Bank, Addison	January 15	
Mission National Bank, San Antonio	January 8	
Virginia		
Access National Bank, Chantilly	June 8	
Cardinal Bank–Dulles, National Association, Reston	May 14	
Cardinal Bank–Manassas/Prince William, National Association, Manassas	April 2	
Millennium Bank, National Association, Reston	February 18	
Shenandoah Valley National Bank, Winchester	January 25	
The Bank of Richmond, National Association, Richmond	May 19	
Washington		
Hometown National Bank, Longview	June 4	
Wyoming		
Wyoming National Bank, Riverton	February 18	

Applications for new, limited-purpose national bank charters, approved and denied, by state, January 1 to June 30, 1999

Title and location	Type of bank	Approved	Denied
California			
Bessemer Trust Company of California, National Association, San Francisco	Trust (non-deposit)	March 11	
Generations Trust Bank, National Association, Long Beach	Trust (non-deposit)	June 8	
NextBank, National Association, San Francisco	Credit card	May 8	
Delaware			
The Glenmede Trust Company, National Association, Wilmington	Trust (non-deposit)	April 15	
Georgia			
Trustmark Bankcard, National Association, Columbus	Credit card	January 29	
U.S. Bank Trust National Association, Atlanta	Trust (non-deposit)	March 11	
Texas			
Beaumont Trust Company, National Association, Beaumont	Trust (non-deposit)	January 5	

New, full-service national bank charters issued, January 1 to June 30, 1999

Title and location	Charter number	Date opened
Colorado		
First Commerce Bank of Colorado, National Association, Colorado Springs	023825	May 3
Connecticut		
Westport National Bank, Westport	023664	December 28, 1998
Florida		
National City Interim Trust Company, West Palm Beach	023894	June 30
West Coast Guaranty Bank, National Association, Sarasota	023829	January 12
Flagship National Bank, Bradenton	023764	May 18
Georgia		
Albany Bank & Trust, National Association, Albany	023752	April 28
North Georgia National Bank, Calhoun	023547	February 10
Kansas		
Horizon National Bank, Leawood	023748	March 30
University National Bank, Pittsburg	023731	January 4
Minnesota		
Washington County Bank, National Association, Oakdale	023800	April 6
Mississippi		
The First National Bank of the Pine Belt, Laurel	023724	January 19
Commerce National Bank, Corinth	023710	January 19
Nebraska		
First Central Bank McCook, National Association, McCook	023734	January 4
New Jersey		
Grand Bank, National Association, Monmouth Junction	023743	February 23
New Mexico		
Interim Bank of America (NM), National Association, Santa Fe	023832	April 8
New York		
Intervest National Bank, New York	023712	April 1
Metropolitan National Bank, New York	023576	June 21
Oklahoma		
Local Oklahoma Bank, National Association, Oklahoma City	023900	May 11
South Carolina		
New Commerce Bank, National Association, Simpsonville	023818	May 17
Hartsville Community Bank, National Association, Hartsville	023798	June 15
Seneca National Bank, Seneca	023799	February 5
Texas		
Mission National Bank, San Antonio	023730	March 9
Clear Lake National Bank, San Antonio	023711	April 2
Fort Worth National Bank, Fort Worth	023708	April 12
Redstone Bank, National Association, Houston	023686	February 17
South Padre Bank, National Association, South Padre Island	023670	March 1
Addison National Bank, Addison	020065	April 8
Virginia		
Millennium Bank, National Association, Reston	023828	April 1
Shenandoah Valley National Bank, Winchester	023826	May 17

New, full-service national bank charters issued (continued)

Title and location	Charter number	Date opened
Wisconsin		
Associated Interim Bank Lakeshore, National Association, Manitowoc	023701	November 12, 1998
Associated Interim Bank, National Association, Neenah	023700	November 12, 1998
Associated Interim Bank Green Bay, National Association, Green Bay	023695	November 12, 1998
Wyoming		
Wyoming National Bank, Riverton	023802	June 14

New, limited-purpose national bank charters issued, January 1 to June 30, 1999

Title and location	Charter number	Date opened
Delaware		
The Glenmede Trust Company, National Association, Wilmington	023864	June 14
PNC Trust Company Delaware, National Association, Wilmington	023763	December 1, 1998
Georgia		
U.S. Bank Trust, National Association, Atlanta	023863	March 16
Belk National Bank, Norcross	023726	May 3
Illinois		
D.L. Moody Trust Company, National Association, Chicago	023707	February 5
Massachusetts		
Cambridge Appleton Trust, National Association, Cambridge	023689	January 19
Michigan		
King Trust Company, National Association, Spring Arbor	023706	January 4
Pennsylvania		
First National Trust Company, Hermitage	023778	January 28
PNC Trust Company Pennsylvania, National Association, Pittsburgh	023762	December 1, 1998
Texas		
Beaumont Trust Company, National Association, Beaumont	023794	March 22
Virginia		
Old Point Trust & Financial Services, National Association, Newport News	023702	April 1

State-chartered banks converted to full-service national banks, January 1 to June 30, 1999

Title and location	Effective date	Total assets
Georgia		
Georgia First Bank, National Association (023837)		
conversion of Georgia First Bank, Gainesville	February 12	84,630,000
Illinois		
Castle Bank, National Association (023817)		
conversion of The Sandwich State Bank, Sandwich	January 1	102,425,000
Montana		
Farmers Bank of Montana, National Association (023803)		
conversion of The Farmers State Bank of Montana, Conrad	January 1	93,829,000
New Jersey		
Commerce Bank/Central, National Association (023840)		
conversion of Prestige State Bank, Raritan Township	January 15	319,537,000
South Dakota		
Cortrust Bank, National Association (023771)		
conversion of Cortrust Bank, Mitchell	January 1	199,572,000
Texas		
Citizens Bank, National Association (023834)		
conversion of Citizens Bank, Abilene	January 25	36,564,000
Security State Bank, National Association (023867)		
conversion of Security State Bank, Ore City	February 18	35,942,000
Virginia		
First Community Bank, National Association (023892)		
conversion of First Community Bank, Inc., Tazewell	April 30	397,960,000
Wisconsin		
The Bank of Edgar, National Association (023787)		
conversion of The Bank of Edgar, Milwaukee	January 19	68,097,000

Nonbanking institutions converted to full-service national banks, January 1 to June 30, 1999

Title and location	Effective date	Total assets
Indiana		
ONB Bloomington, National Association (023836)		
conversion of ONB Bloomington, FSB, Bloomington	December 31, 1998	351,611,000
New Jersey		
Banco Popular, National Association (New Jersey) (023776)		
conversion of Banco Popular, FSB, Newark	December 31, 1998	1,557,098,000
Pennsylvania		
NC Interim National Bank (023780)		
conversion of First Federal Savings Bank of New Castle, New Castle	February 12	401,089,000

Voluntary liquidations of national banks, January 1 to June 30, 1999

Title and location	Charter number	Effective date
Delaware		
JCPenney National Bank, Harrington	003883	December 17, 1998
Illinois		
Household Bank (Illinois), National Association, Prospect Heights	018767	December 31, 1998

National banks merged out of the national banking system, January 1 to June 30, 1999

Title and location	Charter number	Effective date
Alabama		
The First National Bank of Opelika, Opelika	003452	December 31, 1998
Arkansas		
The First National Bank of Nashville, Nashville	011113	November 19, 1998
First National Bank, Searcy	015631	November 20, 1998
California		
First Central Bank, National Association, Cerritos	018695	May 28
Banco Popular, National Association (California), City of Commerce	017817	January 1
Pacific National Bank, Newport Beach	017166	February 26
Colorado		
Aurora National Bank, Aurora	015126	April 1
Aurora National Bank–South, Aurora	017143	April 1
Delaware		
CoreStates Bank of Delaware, National Association, Wilmington	018011	October 19, 1998
PNC Trust Company Delaware, National Association, Wilmington	023763	December 1, 1998
District of Columbia		
Franklin National Bank of Washington, D.C., Washington	017899	February 19
Florida		
Banco Popular, National Association–Florida, Sanford	021061	December 31, 1998
Illinois		
First National Bank of Evergreen Park, Evergreen Park	014618	December 12, 1998
Heartland National Bank, Herrin	023075	June 18
Central National Bank of Mattoon, Mattoon	014416	September 18, 1998
Citizens Bank of Illinois, National Association, Mt. Vernon	023252	December 31, 1998
The First National Bank of Central Illinois, Springfield	000205	September 18, 1998
Indiana		
Citizens Trust Company of Indiana, National Association, Evansville	022962	December 31, 1998
The Citizens National Bank of Evansville, Evansville	002188	December 31, 1998
Kansas		
Peoples National Bank, Overland Park	023069	January 1
Mississippi		
First National Bank of Bolivar County, Cleveland	015124	December 31, 1998
Nebraska		
Ogallala National Bank, Ogallala	023319	January 4
Wauneta Falls Bank, National Association, Wauneta	023318	January 4
New Jersey		
Banco Popular, National Association (New Jersey), Newark	023776	January 1
New York		
First National Bank of Rochester, Rochester	015556	June 1
Ohio		
American Community Bank, National Association, Lima	018342	December 4, 1998
AmeriFirst Bank, National Association, Xenia	022623	December 4, 1998

National banks merged out of the national banking system (continued)

Title and location	Charter number	Date opened
Pennsylvania		
The First National Bank of Jermyn, Jermyn	006158	February 27
NBO National Bank, Olyphant	014079	February 27
The Century National Bank and Trust Company, Rochester	004549	December 29, 1998
The First National Bank of Spring Mills, Spring Mills	011213	January 11
Texas		
Addison National Bank, Addison	020065	January 8
Caldwell National Bank, Caldwell	006607	April 7
Clear Lake National Bank, Houston	017113	April 9
Brazos Bank, National Association, Joshua	016358	December 31, 1998
Vermont		
The Woodstock National Bank, Woodstock	001133	May 21
Washington		
Pioneer National Bank, Yakima	016663	January 23
West Virginia		
One Valley Bank of Clarksburg, National Association, Clarksburg	007029	November 16, 1998
Wisconsin		
Evergreen Bank, National Association, Poy Sippi	023221	March 15

National banks converted out of the national banking system, January 1 to June 30, 1999

Title and location	Effective date	Total assets
Arkansas		
First Community Bank, National Association, Conway (023270)	April 15	160,691,000
California		
United Security Bank, National Association, Fresno (020993)	February 3	278,497,000
Georgia		
First National Bank of Union County, Blairsville (017171)	March 29	46,838,000
Security National Bank, Macon (021715)	March 1	160,241,000
Iowa		
The Lakes National Bank, Arnolds Park (015933)	January 1	41,000,000
Kansas		
First National Bank and Trust Osawatomie, Kansas, Osawatomie (012439)	January 1	73,231,000
Maryland		
The First National Bank of Maryland, Baltimore (001413)	December 31, 1998	17,000,000,000
North Carolina		
First National Bank Southeast, Reidsville (011229)	March 15	420,390,000
Ohio		
Mid American National Bank and Trust, Toledo (015416)	January 23	801,222,000
Oklahoma		
Bank of Commerce, National Association, Catoosa (023265)	December 16, 1998	24,064,000
Security National Bank of Sapulpa, Sapulpa (014751)	March 19	87,407,000
Pennsylvania		
Southwest National Bank of Pennsylvania, Greensburg (005351)	December 30, 1998	955,000,000
South Carolina		
Greenville National Bank, Greenville (018097)	March 26	140,631,000
Texas		
First National Bank in Lockney, Lockney (014604)	March 11	64,307,000

Federal branches and agencies of foreign banks in operation, January 1 to June 30, 1999

	In operation January 1, 1999	Opened January 1—June 30	Closed January 1—June 30	In operation June 30, 1999
Federal branches				
California	2	0	0	2
Connecticut	1	0	0	1
District of Columbia	1	0	0	1
New York	42	0	0	42
Washington	1	0	0	1
Limited federal branches				
California	8	0	0	8
District of Columbia	2	0	0	2
New York	3	0	0	3
Federal agency				
Illinois	1	0	0	1
Total United States	61	0	0	61

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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
June 30, 1998 and June 30, 1999
(Dollar figures in millions)

	June 30, 1998	June 30, 1999	Change June 30, 1998–June 30, 1999 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,546	2,409	(137)	(5.38)
Total assets	$2,978,610	$3,193,021	$214,411	7.20
Cash and balances due from depositories	205,009	197,351	(7,658)	(3.74)
Noninterest-bearing balances, currency and coin	146,914	139,446	(7,468)	(5.08)
Interest bearing balances	58,095	57,905	(190)	(0.33)
Securities	473,600	546,637	73,037	15.42
Held-to-maturity securities, amortized cost	65,243	55,578	(9,664)	(14.81)
Available-for-sale securities, fair value	408,357	491,059	82,701	20.25
Federal funds sold and securities purchased	95,754	106,183	10,429	10.89
Net loans and leases	1,887,138	2,007,053	119,915	6.35
Total loans and leases	1,923,481	2,044,316	120,835	6.28
Loans and leases, gross	1,925,622	2,046,147	120,525	6.26
Less: Unearned income	2,141	1,831	(310)	(14.48)
Less: Reserve for losses	36,343	37,263	920	2.53
Assets held in trading account	92,287	85,137	(7,149)	(7.75)
Other real estate owned	1,982	1,674	(308)	(15.54)
Intangible assets	61,993	70,403	8,410	13.57
All other assets	160,847	178,582	17,734	11.03
Total liabilities and equity capital	2,978,610	3,193,021	214,411	7.20
Deposits in domestic offices	1,708,310	1,755,783	47,473	2.78
Deposits in foreign offices	327,123	366,194	39,072	11.94
Total deposits	2,035,432	2,121,977	86,545	4.25
Noninterest-bearing deposits	422,028	429,414	7,385	1.75
Interest-bearing deposits	1,613,404	1,692,564	79,160	4.91
Federal funds purchased and securities sold	219,351	273,061	53,710	24.49
Demand notes issued to U.S. Treasury	28,006	26,771	(1,235)	(4.41)
Other borrowed money	232,199	279,644	47,444	20.43
With remaining maturity of one year or less	152,415	171,365	18,950	12.43
With remaining maturity of more than one year	79,784	108,279	28,494	35.71
Trading liabilities less revaluation losses	17,649	17,756	107	0.61
Subordinated notes and debentures	47,805	54,898	7,093	14.84
All other liabilities	134,615	141,988	7,373	5.48
Trading liabilities revaluation losses	47,665	48,622	957	2.01
Other	86,949	93,366	6,416	7.38
Total equity capital	263,552	276,926	13,374	5.07
Perpetual preferred stock	505	784	279	55.34
Common stock	17,403	16,613	(790)	(4.54)
Surplus	133,626	143,743	10,117	7.57
Net undivided profits and capital reserves	113,029	116,803	3,774	3.34
Cumulative foreign currency translation adjustment	(1,011)	(1,017)	(6)	NM

NM indicates calculated percent change is not meaningful.

Quarterly income and expenses of national banks
Second quarter 1998 and second quarter 1999
(Dollar figures in millions)

	Second quarter 1998	Second quarter 1999	Change Second quarter 1998–second quarter 1999 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,546	2,409	(137)	(5.38)
Net income	**$9,575**	**$11,025**	**$1,450**	**15.14**
Net interest income	**27,620**	**28,741**	**1,121**	**4.06**
Total interest income	52,743	53,312	569	1.08
On loans	40,987	39,633	(1,354)	(3.30)
From lease financing receivables	1,475	1,895	420	28.51
On balances due from depositories	623	890	267	42.83
On securities	7,623	8,883	1,259	16.52
From assets held in trading account	831	674	(157)	(18.88)
On federal funds sold and securities repurchased	1,204	1,338	133	11.07
Less: Interest expense	25,123	24,571	(552)	(2.20)
On deposits	17,482	16,505	(977)	(5.59)
Of federal funds purchased and securities sold	2,864	3,040	176	6.13
On demand notes and other borrowed money*	3,987	4,197	210	5.27
On subordinated notes and debentures	789	829	40	5.07
Less: Provision for losses	**3,555**	**3,657**	**102**	**2.86**
Noninterest income	**19,083**	**22,634**	**3,550**	**18.60**
From fiduciary activities	2,280	2,429	150	6.57
Service charges on deposits	3,411	3,716	305	8.94
Trading revenue	1,204	1,187	(17)	(1.44)
From interest rate exposures	488	535	48	9.75
From foreign exchange exposures	629	634	5	0.79
From equity security and index exposures	48	37	(11)	NM
From commodity and other exposures	40	(19)	(59)	NM
Total other noninterest income	12,188	15,295	3,107	25.50
Gains/losses on securities	**464**	**219**	**(245)**	**NM**
Less: Noninterest expense	**28,457**	**30,671**	**2,215**	**7.78**
Salaries and employee benefits	11,279	12,094	815	7.23
Of premises and fixed assets	3,529	3,774	245	6.95
Other noninterest expense	13,649	14,804	1,154	8.46
Less: Taxes on income before extraordinary items	**5,568**	**6,240**	**671**	**12.06**
Income/loss from extraordinary items, net of income taxes	**(11)**	**(0)**	**11**	**(96.68)**
Memoranda:				
Net operating income	9,288	10,891	1,603	17.26
Income before taxes and extraordinary items	15,155	17,265	2,110	13.93
Income net of taxes before extraordinary items	9,587	11,025	1,439	15.01
Cash dividends declared	3,855	8,889	5,034	130.58
Net charge-offs to loan and lease reserve	3,359	3,240	(119)	(3.53)
Charge-offs to loan and lease reserve	4,342	4,165	(177)	(4.07)
Less: Recoveries credited to loan and lease reserve	984	925	(58)	(5.92)

* Includes mortgage indebtedness
NM indicates calculated percent change is not meaningful.

Year-to-date income and expenses of national banks
Through June 30, 1998 and through June 30, 1999
(Dollar figures in millions)

	June 30, 1998	June 30, 1999	Change June 30, 1998–June 30, 1999 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,546	2,409	(137)	(5.38)
Net income	**$19,552**	**$21,589**	**$2,036**	**10.41**
Net interest income	**54,534**	**57,468**	**2,934**	**5.38**
Total interest income	104,997	107,232	2,234	2.13
On loans	80,676	80,481	(195)	(0.24)
From lease financing receivables	2,930	3,758	828	28.27
On balances due from depositories	1,783	1,737	(46)	(2.57)
On securities	15,120	17,196	2,076	13.73
From assets held in trading account	1,663	1,342	(321)	(19.28)
On federal funds sold and securities repurchased	2,826	2,718	(108)	(3.84)
Less: Interest expense	50,463	49,763	(700)	(1.39)
On deposits	35,168	33,498	(1,670)	(4.75)
Of federal funds purchased and securities sold	6,072	6,083	11	0.18
On demand notes and other borrowed money*	7,649	8,505	857	11.20
On subordinated notes and debentures	1,574	1,677	103	6.52
Less: Provision for losses	**6,744**	**7,734**	**991**	**14.69**
Noninterest income	**37,366**	**45,166**	**7,800**	**20.87**
From fiduciary activities	4,415	4,726	312	7.06
Service charges on deposits	6,674	7,219	545	8.16
Trading revenue	2,356	2,728	372	15.79
From interest rate exposures	794	1,202	409	51.48
From foreign exchange exposures	1,364	1,352	(12)	(0.87)
From equity security and index exposures	140	166	26	18.95
From commodity and other exposures	58	7	(51)	(87.66)
Total other noninterest income	23,922	30,493	6,571	27.47
Gains/losses on securities	**1,083**	**587**	**(496)**	**(45.78)**
Less: Noninterest expense	**56,406**	**61,845**	**5,439**	**9.64**
Salaries and employee benefits	22,241	24,351	2,110	9.49
Of premises and fixed assets	6,953	7,705	752	10.81
Other noninterest expense	27,212	29,789	2,577	9.47
Less: Taxes on income before extraordinary items	**10,808**	**12,022**	**1,214**	**11.23**
Income/loss from extraordinary items, net of income taxes	**526**	**(32)**	**(558)**	**NM**
Memoranda:				
Net operating income	18,327	21,234	2,907	15.86
Income before taxes and extraordinary items	29,835	33,643	3,808	12.76
Income net of taxes before extraordinary items	19,027	21,621	2,594	13.63
Cash dividends declared	11,523	14,082	2,559	22.20
Net charge-offs to loan and lease reserve	6,547	6,926	379	5.79
Charge-offs to loan and lease reserve	8,511	8,811	300	3.52
Less: Recoveries credited to loan and lease reserve	1,964	1,885	(79)	(4.03)

* Includes mortgage indebtedness
NM indicates calculated percent change is not meaningful.

Assets of national banks by asset size
June 30, 1999
(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	2,409	1,237	987	138	47	8,675
Total assets	$3,193,021	$61,469	$259,935	$405,504	$2,466,113	$5,467,745
Cash and balances due from	197,351	3,254	12,117	21,791	160,189	330,182
Securities	546,637	17,214	70,782	90,379	368,262	1,007,111
Federal funds sold and securities purchased	106,183	3,279	7,678	11,803	83,423	259,238
Net loans and leases	2,007,053	34,908	156,992	249,882	1,565,270	3,250,839
Total loans and leases	2,044,316	35,386	159,305	255,958	1,593,666	3,308,430
Loans and leases, gross	2,046,147	35,497	159,621	256,032	1,594,997	3,311,982
Less: Unearned income	1,831	111	316	73	1,330	3,552
Less: Reserve for losses	37,263	478	2,312	6,076	28,396	57,591
Assets held in trading account	85,137	7	184	903	84,043	231,822
Other real estate owned	1,674	64	222	170	1,218	2,915
Intangible assets	70,403	215	1,553	9,520	59,115	85,539
All other assets	178,582	2,528	10,406	21,055	144,593	300,100
Gross loans and leases by type:						
Loans secured by real estate	770,457	19,957	95,632	118,352	536,516	1,373,189
1–4 family residential mortgages	378,174	9,510	43,955	59,126	265,581	663,159
Home equity loans	60,298	427	3,922	8,056	47,893	91,756
Multifamily residential mortgages	25,554	425	3,180	4,825	17,124	47,307
Commercial RE loans	205,312	5,748	32,752	33,989	132,822	391,134
Construction RE loans	62,609	1,510	7,854	10,858	42,388	118,124
Farmland loans	11,324	2,337	3,946	1,311	3,731	30,603
RE loans from foreign offices	27,186	0	24	186	26,977	31,105
Commercial and industrial loans	609,979	6,138	28,606	49,379	525,855	936,064
Loans to individuals	351,252	5,041	25,174	72,417	248,621	534,399
Credit cards	143,216	239	4,939	40,399	97,638	192,872
Installment loans	208,037	4,802	20,234	32,018	150,982	341,527
All other loans and leases	178,582	2,528	10,406	21,055	144,593	300,100
Securities by type:						
U.S. Treasury securities	61,187	2,342	7,774	7,851	43,220	118,365
Mortgage-backed securities	256,603	3,827	22,835	46,858	183,083	445,795
Pass-through securities	172,185	2,629	14,497	29,462	125,596	281,596
Collateralized mortgage obligations	84,418	1,197	8,338	17,397	57,487	164,199
Other securities	228,847	11,045	40,174	35,670	141,959	442,950
Other U.S. government securities	79,512	7,518	24,084	18,112	29,798	199,160
State and local government securities	39,392	2,823	11,776	7,806	16,986	87,971
Other debt securities	90,749	367	2,644	6,530	81,207	122,928
Equity securities	19,195	337	1,669	3,222	13,967	32,891
Memoranda:						
Agricultural production loans	20,475	3,775	5,251	2,495	8,954	46,017
Pledged securities	269,679	5,523	30,313	38,250	195,593	482,036
Book value of securities	554,174	17,373	71,494	91,355	373,952	1,018,180
Available-for-sale securities	498,596	13,655	57,099	75,264	352,577	872,951
Held-to-maturity securities	55,578	3,718	14,395	16,091	21,375	145,229
Market value of securities	546,310	17,201	70,688	90,237	368,184	1,005,920
Available-for-sale securities	491,059	13,496	56,387	74,289	346,887	861,882
Held-to-maturity securities	55,251	3,705	14,300	15,948	21,297	144,038

Past-due and nonaccrual loans and leases of national banks by asset size
June 30, 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,409	1,237	987	138	47	8,675
Loans and leases past due 30–89 days	$22,877	$468	$1,877	$3,411	$17,121	$36,972
Loans secured by real estate	8,088	221	868	1,082	5,916	13,950
1–4 family residential mortgages	4,279	134	480	583	3,082	7,563
Home equity loans	459	3	26	68	362	692
Multifamily residential mortgages	130	2	15	23	89	276
Commercial RE loans	1,979	43	249	288	1,399	3,361
Construction RE loans	730	18	65	106	541	1,335
Farmland loans	127	21	33	14	59	313
RE loans from foreign offices	384	0	0	0	384	410
Commercial and industrial loans	5,315	146	453	601	4,116	8,577
Loans to individuals	7,831	99	503	1,546	5,683	11,654
Credit cards	3,459	5	179	994	2,280	4,705
Installment loans	4,373	94	324	552	3,403	6,949
All other loans and leases	1,642	1	53	181	1,407	2,791
Loans and leases past due 90+ days	6,179	133	445	1,202	4,399	9,436
Loans secured by real estate	1,747	60	174	290	1,223	2,956
1–4 family residential mortgages	1,125	28	95	172	830	1,781
Home equity loans	82	1	7	19	55	130
Multifamily residential mortgages	46	1	4	7	35	73
Commercial RE loans	284	15	44	64	161	560
Construction RE loans	155	2	10	21	122	254
Farmland loans	42	13	15	5	9	142
RE loans from foreign offices	13	0	0	1	12	16
Commercial and industrial loans	727	54	98	73	502	1,378
Loans to individuals	3,315	20	158	819	2,318	4,592
Credit cards	2,226	3	110	681	1,432	2,776
Installment loans	1,088	17	48	138	886	1,816
All other loans and leases	390	0	15	20	355	510
Nonaccrual loans and leases	13,528	248	888	1,066	11,326	21,721
Loans secured by real estate	5,391	110	451	550	4,279	8,697
1–4 family residential mortgages	1,966	42	185	243	1,497	3,432
Home equity loans	124	1	9	16	97	197
Multifamily residential mortgages	166	1	11	14	140	257
Commercial RE loans	1,871	33	180	228	1,431	2,998
Construction RE loans	366	5	27	35	298	727
Farmland loans	165	28	39	14	85	309
RE loans from foreign offices	732	0	0	0	732	775
Commercial and industrial loans	5,454	119	331	296	4,708	8,999
Loans to individuals	1,598	17	70	139	1,373	2,531
Credit cards	283	0	20	100	162	839
Installment loans	1,316	16	51	38	1,210	1,692
All other loans and leases	1,085	2	35	81	966	1,494

Liabilities of national banks by asset size
June 30, 1999
(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	2,409	1,237	987	138	47	8,675
Total liabilities and equity capital	$3,193,021	$61,469	$259,935	$405,504	$2,466,113	$5,467,745
Deposits in domestic offices	$1,755,783	$52,377	$210,729	$255,898	$1,236,779	$3,086,707
Deposits in foreign offices	366,194	0	482	3,166	362,546	594,111
Total deposits	2,121,977	52,377	211,211	259,064	1,599,325	3,680,818
Noninterest to earnings	429,414	8,244	34,042	46,460	340,667	708,384
Interest bearing	1,692,564	44,133	177,169	212,604	1,258,658	2,972,434
Other borrowed funds	597,232	1,882	21,396	91,765	482,189	963,120
Subordinated notes and debentures	54,898	3	176	3,594	51,125	74,570
All other liabilities	141,988	566	2,927	9,014	129,481	283,050
Equity capital	276,926	6,640	24,224	42,069	203,992	466,187
Total deposits by depositor:						
Individuals and corporations	1,906,429	47,605	192,731	240,217	1,425,876	3,308,137
U.S., state, and local governments	72,417	3,957	14,481	11,216	42,763	141,532
Depositories in the U.S.	63,128	435	2,457	5,102	55,134	85,678
Foreign banks and governments	65,947	1	184	1,046	64,716	118,806
Certified and official checks	10,340	379	1,358	1,477	7,125	18,641
All other foreign office deposits	3,716	0	0	6	3,710	8,024
Domestic deposits by depositor:						
Individuals and corporations	1,636,042	47,605	192,437	237,608	1,158,391	2,870,656
U.S., state, and local governments	72,417	3,957	14,481	11,216	42,763	141,532
Depositories in the U.S.	33,044	435	2,397	5,086	25,126	48,118
Foreign banks and governments	4,806	1	56	510	4,240	8,731
Certified and official checks	9,474	379	1,358	1,477	6,259	17,670
Foreign deposits by depositor:						
Individuals and corporations	270,387	0	293	2,609	267,485	437,481
Depositories in the U.S.	30,084	0	60	16	30,008	37,560
Foreign banks and governments	61,141	0	129	536	60,476	110,075
Certified and official checks	866	0	0	0	866	971
All other deposits	3,716	0	0	6	3,710	8,024
Deposits in domestic offices by type:						
Transaction deposits	397,895	15,798	54,714	52,358	275,026	695,169
Demand deposits	327,578	8,241	32,446	41,725	245,166	541,477
NOW accounts	68,518	7,369	21,874	10,418	28,857	150,437
Savings deposits	761,272	11,018	61,346	108,730	580,178	1,228,026
Money market deposit accounts	526,829	5,757	36,949	69,441	414,682	819,592
Other savings deposits	234,444	5,261	24,398	39,289	165,496	408,434
Time deposits	596,616	25,561	94,670	94,811	381,575	1,163,512
Small time deposits	389,516	18,440	65,369	63,303	242,405	735,641
Large time deposits	207,100	7,121	29,301	31,508	139,170	427,871

Off-balance-sheet items of national banks by asset size
June 30, 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,409	1,237	987	138	47	8,675
Unused commitments	$2,710,232	$80,516	$165,961	$539,415	$1,924,340	$3,724,744
Home equity lines	90,716	366	4,184	10,222	75,944	127,247
Credit card lines	1,566,443	75,811	135,436	469,619	885,576	1,993,280
Commercial RE, construction and land	82,742	1,112	7,094	11,294	63,242	143,196
All other unused commitments	970,332	3,227	19,246	48,280	899,578	1,461,022
Letters of credit:						
Standby letters of credit	138,615	147	1,640	7,243	129,585	218,866
Financial letters of credit	111,164	95	1,023	5,654	104,392	180,158
Performance letters of credit	27,451	52	617	1,589	25,193	38,708
Commercial letters of credit	19,760	32	563	729	18,435	29,841
Securities borrowed and lent:						
Securities borrowed	17,035	22	475	4,232	12,305	23,069
Securities lent	59,130	0	1,307	6,378	51,445	396,847
Financial assets transferred with recourse:						
Mortgages—outstanding principal balance	23,071	107	173	5,489	17,303	41,960
Mortgages—amount of recourse exposure	4,227	52	161	547	3,467	8,465
All other—outstanding principal balance	244,227	1	1,622	74,762	167,842	272,867
All other—amount of recourse exposure	17,661	0	389	4,955	12,317	21,138
Spot foreign exchange contracts	255,281	0	2	24	255,255	496,528
Credit derivatives (notional value)						
Reporting bank is the guarantor	19,500	0	30	30	19,440	87,148
Reporting bank is the beneficiary	37,916	0	0	0	37,916	123,332
Derivative contracts (notional value)	10,982,091	73	2,986	41,891	10,937,140	33,003,585
Futures and forward contracts	3,857,041	48	170	3,275	3,853,547	9,917,536
Interest rate contracts	1,732,202	48	98	2,902	1,729,154	5,474,413
Foreign exchange contracts	2,074,334	0	72	374	2,073,888	4,339,685
All other futures and forwards	50,505	0	0	0	50,505	103,438
Option contracts	2,726,780	25	810	9,021	2,716,925	7,456,369
Interest rate contracts	2,115,394	25	806	9,018	2,105,546	5,653,749
Foreign exchange contracts	452,411	0	0	1	452,410	1,248,875
All other options	158,975	0	4	2	158,969	553,746
Swaps	4,340,855	0	1,977	29,565	4,309,312	15,419,199
Interest rate contracts	4,140,008	0	1,977	28,883	4,109,149	14,604,319
Foreign exchange contracts	170,359	0	0	667	169,692	717,663
All other swaps	30,488	0	0	16	30,472	97,217
Memoranda: Derivatives by purpose						
Contracts held for trading	10,002,971	48	111	5,704	9,997,109	31,325,743
Contracts not held for trading	921,704	26	2,846	36,157	882,675	1,467,362
Memoranda: Derivatives by position						
Held for trading—positive fair value	120,861	0	0	61	120,800	400,891
Held for trading—negative fair value	120,293	0	1	35	120,257	397,756
Not for trading—positive fair value	5,797	0	11	112	5,674	9,647
Not for trading—negative fair value	5,112	0	14	191	4,907	8,478

Quarterly income and expenses of national banks by asset size
Second quarter 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,409	1,237	987	138	47	8,675
Net income	$11,025	$173	$902	$1,926	$8,025	$16,962
Net interest income	28,741	625	2,666	4,334	21,116	47,780
Total interest income	53,312	1,097	4,669	7,425	40,120	89,894
On loans	39,633	792	3,465	5,653	29,724	64,959
From lease financing receivables	1,895	4	25	83	1,783	2,624
On balances due from depositories	890	11	31	50	798	1,601
On securities	8,883	244	1,036	1,458	6,145	15,644
From assets held in trading account	674	0	2	15	657	1,839
On federal funds sold and securities repurchased	1,338	47	111	165	1,015	3,227
Less: Interest expense	24,571	472	2,003	3,091	19,004	42,114
On deposits	16,505	450	1,755	1,953	12,346	29,183
Of federal funds purchased and securities sold	3,040	7	106	518	2,410	5,193
On demand notes and other borrowed money*	4,197	15	139	566	3,477	6,571
On subordinated notes and debentures	829	0	3	55	771	1,168
Less: Provision for losses	3,657	34	194	756	2,673	4,926
Noninterest income	22,634	395	1,357	4,218	16,663	34,513
From fiduciary activities	2,429	3	257	283	1,887	5,093
Service charges on deposits	3,716	71	273	426	2,946	5,371
Trading revenue	1,187	3	4	16	1,164	2,178
From interest rate exposures	535	3	4	8	520	794
From foreign exchange exposures	634	0	0	(1)	634	1,079
From equity security and index exposures	37	0	0	6	31	264
From commodity and other exposures	(19)	0	0	3	(22)	41
Total other noninterest income	15,295	318	824	3,487	10,666	21,865
Gains/losses on securities	219	1	4	23	191	141
Less: Noninterest expense	30,671	748	2,521	4,823	22,580	50,811
Salaries and employee benefits	12,094	307	1,090	1,451	9,246	21,694
Of premises and fixed assets	3,774	79	304	458	2,933	6,226
Other noninterest expense	14,804	362	1,127	2,914	10,400	22,892
Less: Taxes on income before extraordinary items	6,240	66	410	1,069	4,694	9,736
Income/loss from extraord. items, net of taxes	(32)	(1)	(0)	(6)	(26)	(34)
Memoranda:						
Net operating income	10,891	172	899	1,911	7,908	16,910
Income before taxes and extraordinary items	17,265	239	1,312	2,996	12,719	26,698
Income net of taxes before extraordinary items	11,025	173	902	1,926	8,025	16,962
Cash dividends declared	8,889	101	735	1,053	7,001	13,653
Net loan and lease losses	3,240	22	140	670	2,408	4,577
Charge-offs to loan and lease reserve	4,165	32	198	817	3,118	5,956
Less: Recoveries credited to loan and lease reserve	925	10	59	147	710	1,379

* Includes mortgage indebtedness

Year-to-date income and expenses of national banks by asset size
Through June 30, 1999
(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	2,409	1,237	987	138	47	8,675
Net income	**$21,589**	**$368**	**$2,011**	**$3,445**	**$15,764**	**$34,936**
Net interest income	**57,468**	**1,224**	**5,235**	**8,668**	**42,342**	**95,154**
Total interest income	107,232	2,163	9,220	14,835	81,014	180,134
On loans	80,481	1,555	6,837	11,476	60,614	130,804
From lease financing receivables	3,758	8	49	161	3,540	5,207
On balances due from depositories	1,737	22	55	101	1,558	3,182
On securities	17,196	479	2,042	2,712	11,962	30,598
From assets held in trading account	1,342	0	4	35	1,303	3,769
On federal funds sold and securities repurchased	2,718	99	233	350	2,036	6,574
Less: Interest expense	49,763	939	3,986	6,166	38,672	84,980
On deposits	33,498	897	3,502	3,932	25,167	58,921
Of federal funds purchased and securities sold	6,083	13	205	997	4,868	10,417
On demand notes and other borrowed money*	8,505	30	272	1,126	7,078	13,287
On subordinated notes and debentures	1,677	0	7	111	1,559	2,355
Less: Provision for losses	**7,734**	**61**	**392**	**1,694**	**5,587**	**10,336**
Noninterest income	**45,166**	**741**	**3,047**	**8,005**	**33,373**	**69,198**
From fiduciary activities	4,726	6	488	550	3,681	9,874
Service charges on deposits	7,219	139	525	836	5,718	10,435
Trading revenue	2,728	5	6	55	2,662	5,771
From interest rate exposures	1,202	5	5	36	1,156	2,228
From foreign exchange exposures	1,352	0	1	0	1,351	2,703
From equity security and index exposures	166	0	0	13	153	555
From commodity and other exposures	7	0	0	5	2	286
Total other noninterest income	30,493	590	2,028	6,564	21,311	43,118
Gains/losses on securities	**587**	**2**	**23**	**53**	**509**	**708**
Less: Noninterest expense	**61,845**	**1,407**	**4,955**	**9,657**	**45,825**	**100,396**
Salaries and employee benefits	24,351	601	2,166	2,903	18,681	42,907
Of premises and fixed assets	7,705	153	601	904	6,046	12,591
Other noninterest expense	29,789	654	2,188	5,850	21,097	44,897
Less: Taxes on income before extraordinary items	**12,022**	**129**	**947**	**1,925**	**9,021**	**19,359**
Income/loss from extraordinary items, net of taxes	**(32)**	**(1)**	**(0)**	**(6)**	**(26)**	**(34)**
Memoranda:						
Net operating income	21,234	367	1,995	3,416	15,456	34,533
Income before taxes and extraordinary items	33,643	498	2,958	5,376	24,811	54,329
Income net of taxes before extraordinary items	21,621	369	2,011	3,451	15,790	34,970
Cash dividends declared	14,082	237	1,275	1,989	10,581	22,705
Net loan and lease losses	6,926	37	282	1,377	5,229	9,574
Charge-offs to loan and lease reserve	8,811	59	397	1,678	6,676	12,360
Less: Recoveries credited to loan and lease reserve	1,885	22	115	300	1,447	2,786

* Includes mortgage indebtedness

Quarterly net loan and lease losses of national banks by asset size
Second quarter 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,409	1,237	987	138	47	8,675
Net charge-offs to loan and lease reserve	$3,240	$22	$140	$670	$2,408	$4,577
Loans secured by real estate	145	2	11	28	104	220
1–4 family residential mortgages	101	1	6	20	74	150
Home equity loans	29	0	1	4	24	37
Multifamily residential mortgages	1	0	1	1	(0)	1
Commercial RE loans	4	1	3	(1)	2	16
Construction RE loans	7	0	0	4	3	14
Farmland loans	2	0	1	1	0	3
RE loans from foreign offices	1	0	0	(0)	1	(1)
Commercial and industrial loans	836	12	32	50	741	1,282
Loans to individuals	2,108	8	90	582	1,428	2,868
Credit cards	1,584	1	64	519	1,000	2,131
Installment loans	524	7	26	63	428	736
All other loans and leases	151	0	7	10	134	207
Charge-offs to loan and lease reserve	4,165	32	198	817	3,118	5,956
Loans secured by real estate	261	3	16	42	201	392
1–4 family residential mortgages	126	1	9	24	92	191
Home equity loans	42	0	1	6	35	53
Multifamily residential mortgages	4	0	1	1	2	9
Commercial RE loans	63	1	5	6	51	96
Construction RE loans	12	0	0	4	7	24
Farmland loans	3	0	1	1	1	6
RE loans from foreign offices	13	0	0	(0)	13	14
Commercial and industrial loans	1,023	16	49	71	887	1,609
Loans to individuals	2,631	13	125	689	1,805	3,613
Credit cards	1,831	2	81	593	1,155	2,502
Installment loans	800	10	43	97	650	1,111
All other loans and leases	250	0	10	15	226	342
Recoveries credited to loan and lease reserve	925	10	59	147	710	1,379
Loans secured by real estate	116	1	5	14	96	172
1–4 family residential mortgages	25	1	3	4	17	41
Home equity loans	13	0	0	1	11	16
Multifamily residential mortgages	3	0	0	0	2	8
Commercial RE loans	58	0	2	7	49	80
Construction RE loans	5	0	0	1	4	10
Farmland loans	1	0	0	0	1	3
RE loans from foreign offices	11	0	0	(0)	11	14
Commercial and industrial loans	187	4	16	21	145	327
Loans to individuals	523	5	34	108	377	746
Credit cards	247	1	17	74	155	371
Installment loans	276	3	17	34	222	375
All other loans and leases	99	0	2	4	92	135

Year-to-date net loan and lease losses of national banks by asset size
Through June 30, 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,409	1,237	987	138	47	8,675
Net charge-offs to loan and lease reserve	6,926	37	282	1,377	5,229	9,574
Loans secured by real estate	285	3	16	52	213	393
1–4 family residential mortgages	180	1	9	37	132	265
Home equity loans	62	0	1	12	49	76
Multifamily residential mortgages	1	(0)	2	1	(2)	(1)
Commercial RE loans	12	2	4	(3)	10	19
Construction RE loans	11	0	1	4	6	21
Farmland loans	1	(0)	(0)	1	1	3
RE loans from foreign offices	17	0	0	(0)	17	11
Commercial and industrial loans	1,496	18	57	75	1,346	2,291
Loans to individuals	4,809	16	198	1,234	3,361	6,413
Credit cards	3,610	3	144	1,103	2,360	4,807
Installment loans	1,199	13	54	131	1,001	1,606
All other loans and leases	336	0	11	17	309	478
Charge-offs to loan and lease reserve	8,811	59	397	1,678	6,676	12,360
Loans secured by real estate	518	6	27	81	404	745
1–4 family residential mortgages	231	3	14	45	170	350
Home equity loans	86	0	2	16	69	106
Multifamily residential mortgages	6	0	2	1	3	12
Commercial RE loans	137	2	9	12	114	194
Construction RE loans	23	0	1	5	17	40
Farmland loans	5	0	1	1	2	11
RE loans from foreign offices	31	0	0	0	31	32
Commercial and industrial loans	1,842	28	87	115	1,612	2,907
Loans to individuals	5,949	26	268	1,454	4,201	8,004
Credit cards	4,173	5	180	1,255	2,733	5,625
Installment loans	1,776	20	88	200	1,468	2,378
All other loans and leases	502	0	15	27	460	705
Recoveries credited to loan and lease reserve	1,885	22	115	300	1,447	2,786
Loans secured by real estate	233	3	11	29	191	352
1–4 family residential mortgages	51	1	4	8	37	85
Home equity loans	24	0	0	4	20	30
Multifamily residential mortgages	5	0	0	0	4	13
Commercial RE loans	125	1	5	15	104	176
Construction RE loans	12	0	0	1	10	20
Farmland loans	4	0	1	1	2	7
RE loans from foreign offices	13	0	0	0	13	21
Commercial and industrial loans	346	10	30	40	266	615
Loans to individuals	1,140	9	70	221	839	1,591
Credit cards	563	2	36	152	373	818
Installment loans	577	7	34	69	467	773
All other loans and leases	166	0	4	10	151	228

Number of national banks by state and asset size
June 30, 1999

	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	2,409	1,237	987	138	47	8,675
Alabama	27	14	12	0	1	158
Alaska	3	1	0	2	0	6
Arizona	16	6	5	3	2	46
Arkansas	51	18	32	1	0	199
California	91	38	45	5	3	334
Colorado	60	42	15	2	1	191
Connecticut	8	3	5	0	0	25
Delaware	15	3	7	2	3	33
District of Columbia	5	2	3	0	0	6
Florida	85	34	38	13	0	259
Georgia	66	30	34	2	0	336
Hawaii	1	0	1	0	0	11
Idaho	1	0	1	0	0	17
Illinois	213	97	103	9	4	732
Indiana	36	9	22	3	2	165
Iowa	46	27	18	1	0	441
Kansas	110	82	26	2	0	391
Kentucky	61	30	27	3	1	255
Louisiana	20	12	5	1	2	155
Maine	5	1	4	0	0	16
Maryland	17	4	11	2	0	78
Massachusetts	12	4	6	1	1	44
Michigan	36	17	17	1	1	169
Minnesota	137	81	49	5	2	507
Mississippi	20	7	12	1	0	99
Missouri	50	26	19	4	1	378
Montana	18	14	2	2	0	88
Nebraska	93	69	21	3	0	309
Nevada	8	2	2	4	0	25
New Hampshire	6	1	4	1	0	20
New Jersey	26	2	17	6	1	74
New Mexico	20	6	11	3	0	55
New York	64	18	37	7	2	154
North Carolina	10	2	3	2	3	70
North Dakota	18	9	7	2	0	114
Ohio	93	45	36	7	5	216
Oklahoma	116	78	34	4	0	305
Oregon	4	1	3	0	0	44
Pennsylvania	97	27	62	5	3	194
Rhode Island	2	0	0	1	1	7
South Carolina	22	15	6	1	0	79
South Dakota	23	12	9	1	1	103
Tennessee	34	9	18	4	3	204
Texas	392	259	124	6	3	771
Utah	8	2	3	2	1	49
Vermont	10	3	6	1	0	20
Virginia	33	10	20	3	0	151
Washington	16	13	3	0	0	79
West Virginia	27	10	12	5	0	83
Wisconsin	57	30	24	3	0	343
Wyoming	20	12	6	2	0	49
U.S. territories	0	0	0	0	0	18

Total assets of national banks by state and asset size
June 30, 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
All institutions	$3,193,021	$61,469	$259,935	$405,504	$2,466,113	$5,467,745
Alabama	43,894	886	3,044	0	39,964	146,062
Alaska	4,445	51	0	4,395	0	5,341
Arizona	46,418	104	2,192	10,081	34,040	51,105
Arkansas	10,917	1,054	7,968	1,894	0	26,178
California	395,086	1,753	13,725	15,776	363,832	513,183
Colorado	21,706	1,935	3,409	5,008	11,353	39,166
Connecticut	1,053	175	878	0	0	3,598
Delaware	86,289	166	2,268	10,009	73,847	122,266
District of Columbia	497	57	440	0	0	601
Florida	44,443	2,088	9,867	32,488	0	83,407
Georgia	22,380	1,479	10,068	10,833	0	78,391
Hawaii	308	0	308	0	0	23,584
Idaho	203	0	203	0	0	1,936
Illinois	189,325	5,110	26,010	23,886	134,319	300,141
Indiana	44,836	402	9,005	6,428	29,002	69,483
Iowa	11,300	1,391	4,071	5,838	0	43,566
Kansas	13,381	3,654	6,688	3,038	0	33,780
Kentucky	26,293	1,930	5,020	9,198	10,145	52,287
Louisiana	34,671	648	1,061	5,192	27,770	49,361
Maine	1,286	36	1,250	0	0	4,985
Maryland	5,786	281	2,930	2,576	0	44,558
Massachusetts	72,627	227	1,150	1,075	70,175	144,804
Michigan	17,921	901	3,841	2,442	10,737	119,692
Minnesota	128,722	3,564	11,094	10,961	103,102	149,304
Mississippi	9,525	287	2,687	6,551	0	28,201
Missouri	45,880	1,228	5,374	16,316	22,961	79,718
Montana	3,353	558	304	2,491	0	9,861
Nebraska	15,658	3,158	4,872	7,627	0	27,329
Nevada	15,870	132	327	15,411	0	25,926
New Hampshire	9,772	43	977	8,753	0	18,624
New Jersey	53,146	54	6,499	18,109	28,484	104,386
New Mexico	11,921	287	3,706	7,929	0	15,926
New York	381,499	1,086	10,844	12,551	357,018	1,127,482
North Carolina	603,818	55	981	2,980	599,803	669,415
North Dakota	6,116	395	2,396	3,326	0	11,111
Ohio	225,380	2,279	12,469	25,107	185,525	275,071
Oklahoma	23,504	3,982	6,610	12,912	0	38,842
Oregon	523	4	519	0	0	6,655
Pennsylvania	156,112	1,500	18,432	13,065	123,115	196,836
Rhode Island	83,262	0	0	5,176	78,086	91,634
South Carolina	3,828	635	1,638	1,554	0	19,679
South Dakota	22,675	451	2,766	5,387	14,071	29,834
Tennessee	88,051	606	4,699	13,678	69,068	107,737
Texas	124,839	12,629	28,517	20,726	62,966	173,956
Utah	24,821	117	443	7,532	16,728	45,715
Vermont	3,577	178	1,596	1,804	0	7,547
Virginia	12,344	490	4,611	7,243	0	76,779
Washington	1,360	562	798	0	0	12,560
West Virginia	14,798	520	3,117	11,161	0	23,459
Wisconsin	21,999	1,758	7,252	12,989	0	85,033
Wyoming	5,605	584	1,011	4,009	0	8,427
U.S. territories	0	0	0	0	0	43,225

1998 Chief Financial Officer's Annual Report

Comptroller's Message

After 35 years of involvement with issues of financial regulation, both as a banking lawyer and a government official, I was honored and proud to be named the 28th Comptroller of the Currency in December 1998, under a recess appointment. I have long been a student of the national banking system, and have had the good fortune to know seven Comptrollers over the course of my public and private career. We all shared one fundamental goal, and that is the preservation of a strong and competitive national banking system.

Looking back on 1998, I would like to give special mention to several developments that signal the direction in which the OCC is headed this year in a number of key areas. First, we gave strong emphasis to safety and soundness issues, from credit underwriting to year-2000 and customer privacy protection. Second, we looked ahead at the effects of new technology and industry consolidation on the future of banking, particularly as they may affect the provision of fair access to financial services. And, third, the OCC recognized that it must hold itself to the same high standard of compliance integrity to which we hold national banks, and acted immediately to correct material weaknesses in financial internal controls found by a public accounting firm we hired to conduct an independent review.

Today, the United States is in the midst of the longest peacetime economic expansion in our history, and this is reflected in a banking sector that has never been healthier. Bank capital and profits are near record levels, and 93 percent of national banks received the highest supervisory CAMELS ratings of 1 or 2 at year-end 1998. Currently, only 22 national banks have the lowest supervisory ratings of 4 or 5, and they hold fewer than 1 percent of total assets. No national bank failed in 1998.

At the same time, the OCC has been sending out early warnings about the effects of a persistent safety and soundness concern. Our surveys show that national bank credit underwriting standards declined in 1998 for the fourth year in a row. While recent industry performance reflects low levels of credit losses, the relaxed underwriting our surveys found may lead to significant credit problems as U.S. economic growth eventually slows down.

To address these concerns, the OCC in 1998 enhanced its supervisory process by issuing comprehensive guidance on loan portfolio management. This guidance focuses on the effectiveness of credit risk management at the portfolio level as well as for individual transactions. Evaluating risk portfolio-wide, and enterprise-wide, becomes increasingly important as bank products and operations grow more complex.

We see this complexity on the trading side of banking as well, where some of the largest banks in the country were affected last year by problems in Asia and Russia, and by the collapse of a large hedge fund. The OCC has formed an International Working Group to analyze and monitor events in Asia.

The great focus of our supervisory attention in 1998 and 1999, however, is year-2000 readiness. The OCC conducted at least two on-site exams of every national bank in 1998, and 97 percent were in compliance with their supervisory requirements. At present, banks are completing a critical testing phase, and the OCC and other member agencies of the FFIEC are working together to promote a strong and confident message for the general public about the year-2000 preparations of depository institutions.

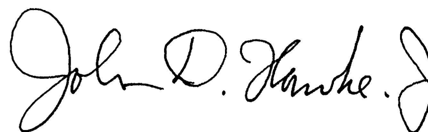
Over the last year, our unprecedented year-2000 examination commitments required that we significantly revise our overall supervisory strategy to direct additional resources to year-2000 requirements. In addition to the on-site exams, more than 500 examiners received specialized training and new examiners were hired nationwide. We recognized that these unprecedented demands on our resources would cause delays in our regularly scheduled safety and soundness examinations and we developed guidelines to assure that there would be no delays in examinations of institutions displaying high-risk characteristics. Following this process, only 70 percent of safety and soundness examinations began on schedule in 1998, although the late exams were usually completed within 90 days or, at the latest, the following quarter. In 1998, 360 of the OCC's 546 formal and informal enforcement actions were initiated for year-2000 deficiencies.

Last year, the OCC also began to act on bank customer privacy concerns, under the leadership of Acting Comptroller Julie L. Williams. Since then, we have issued guidance to assist national banks in identifying and solving several modern-day privacy problems—such as pretext calling, "opting out" of the sharing of marketing lists, and preparing Web-based privacy policies.

The OCC has been vocal in alerting banks to the growing public and congressional interest in how banks safeguard customer financial information. I see this as one more area in which the banking industry needs to improve its image as a provider of good customer service. As technology-driven products and services allow customers to take care of their banking needs without entering the bank, the industry will have to work harder to ensure that it is meeting its customers needs. In 1998, the OCC issued guidance on bank technology risks, PC banking, and acting as a digital signature service provider.

Lastly, the OCC recognized and began correcting material weaknesses found in our internal controls over financial reporting and related compliance with laws and regulations. This came to our attention as the result of a report filed by a public accounting firm the OCC hired to conduct a comprehensive internal control review and evaluate the OCC's administrative accounting and financial management information systems. To demonstrate that we have no higher priority at the OCC than curing these problems, I requested that I be given weekly in-person briefings by our chief financial officer on the progress being made.

To correct the weaknesses documented in the report, the OCC has established new accounting policies and procedures to ensure that expenditure account balances are reconciled on time, that accounting tasks and analyses are properly supervised and approved, and that the staff has the training needed to ensure that the agency meets deadlines established in the Prompt Payment Act, OMB Circular A–125, and the Federal Managers' Financial Integrity Act. The final changes in procedures will be completed by September 30, 1999.



John D. Hawke Jr.
Comptroller of the Currency

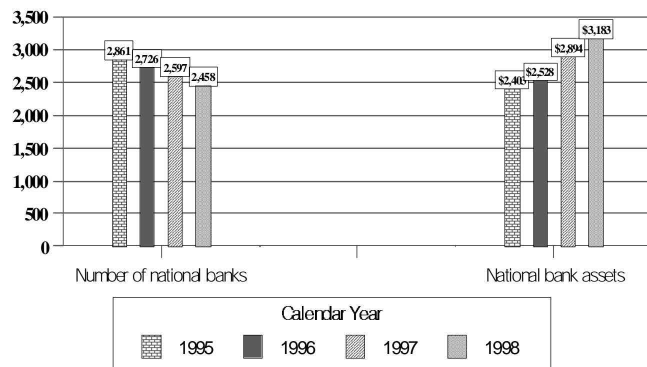
Management Overview

Bureau Profile

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 for a five-year term by the President, with the advice and consent of the Senate. John D. Hawke Jr. was named the 28th Comptroller of the Currency by President Clinton on December 8, 1998, under a recess appointment, and his formal nomination was resubmitted to the Senate in January 1999. The OCC is headquartered in Washington, D.C. At the end of 1998, the OCC had 2,999 employees nationwide.

The OCC is responsible for chartering, regulating, and supervising the national banking system. The OCC also supervises the federally licensed branches and agencies of foreign banks. In addition to supervising national banks, the OCC has continued its efforts to strengthen the banking industry by encouraging national banks to improve the quality of their loan portfolios, increase capital, diversify their sources of income, ensure Year 2000 compliance, and generally strengthen their operations.

Figure 1—Trends of national banks by number and assets (dollar value of assets in billions)



At year-end 1998, there were 2,458 federally chartered national banks representing about 28 percent of the 8,774 commercial banks in the United States. The national banking system had approximately $3.2 trillion in assets, accounting for about 58 percent of the commercial banking system's assets. During the past several years, national bank assets have increased significantly. Between 1994 and 1998, national bank asset growth averaged 8.7 percent annually.

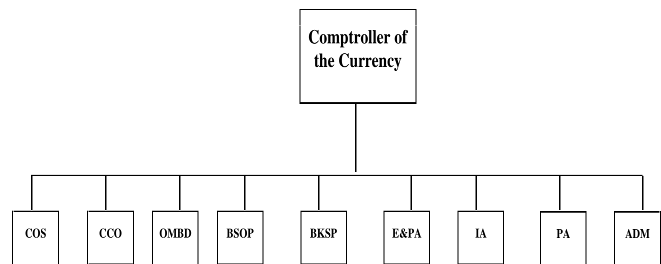
The decline in the number of national banks is primarily the result of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, which allowed banks to consolidate entities across state lines, as well as the intrastate consolidation of bank charters. A small part of this decrease has been offset by an increase in the number of conversions to national banks.

Organizational Structure

Office of the Comptroller

The Comptroller's office manages a nationwide staff of bank examiners and other professional and support personnel who examine and supervise federally chartered national banks and federally licensed branches and agencies of foreign banks. The Comptroller receives advice on policy and operational issues from an Executive Committee that consists of the chief of staff (COS), chief counsel (CCO), the ombudsman (OMBD), and six senior deputy comptrollers (SDCs) representing Bank Supervision Operations (BSOP), Bank Supervision Policy (BKSP), Economic and Policy Analysis (E&PA), International Affairs (IA), Public Affairs (PA), and Administration and Chief Financial Officer (ADM). The Comptroller serves as a member of the board of the Federal Deposit Insurance Corporation (FDIC), Federal Financial Institutions Examination Council (FFIEC), and the board of the Neighborhood Reinvestment Corporation (NRC).

Figure 2—Organizational structure



Chief of Staff

The chief of staff's office represents the Comptroller on a broad range of external and internal administrative, operational and policy matters. The chief of staff serves as a liaison between the Comptroller and OCC managers, program officials and other employees, as well as representing the Comptroller in dealings with government officials, banking industry representatives and other groups. The chief of staff also assists the Comptroller in overseeing the Information Technology Services (ITS) Department.

Chief Counsel

The chief counsel's office oversees legal matters arising from the administration of laws, rulings, and regulations

affecting national banks. Specific responsibilities include drafting and interpreting proposed legislation; responding to requests for interpretations of statutes, regulations, and rulings; defending the Comptroller's actions challenged in administrative and judicial proceedings; supporting the bank supervisory efforts of the office; and representing the OCC in all legal matters. The chief counsel also oversees the licensing corporate activities of national banks and has the Comptroller's delegated authority for deciding bank corporate applications. The chief counsel also supervises the Community Affairs area.

Ombudsman

The ombudsman's office oversees the national bank appeals process. The primary ongoing activities of the national bank appeals process include resolving individual appeals from national banks and administering the examination questionnaire process. The ombudsman also acts as liaison between the OCC and anyone with unresolved problems in dealing with the OCC regarding its regulatory activities. The ombudsman functions independently, outside of the bank supervision and examination area, and reports directly to the Comptroller. The ombudsman also oversees the Customer Assistance Group, a centralized function that handles all customer complaints.

Bank Supervision Operations

The Bank Supervision Operations office oversees examinations and other supervision activities in the OCC's six districts (see figure 3 for geographic districts); the Large Bank Supervision Department, which supervises the largest national banks and oversees operations of the OCC's London office; Compliance Operations; and OCC's Continuing Education and Supervision Support departments. Specific responsibilities include directing programs for the examination and regulation of national banks to promote the continuing existence of a financially strong and competitive national banking system and overseeing supervision of national trust companies, Federal branches and agencies of foreign banks, and the international activities of national banks with global operations.

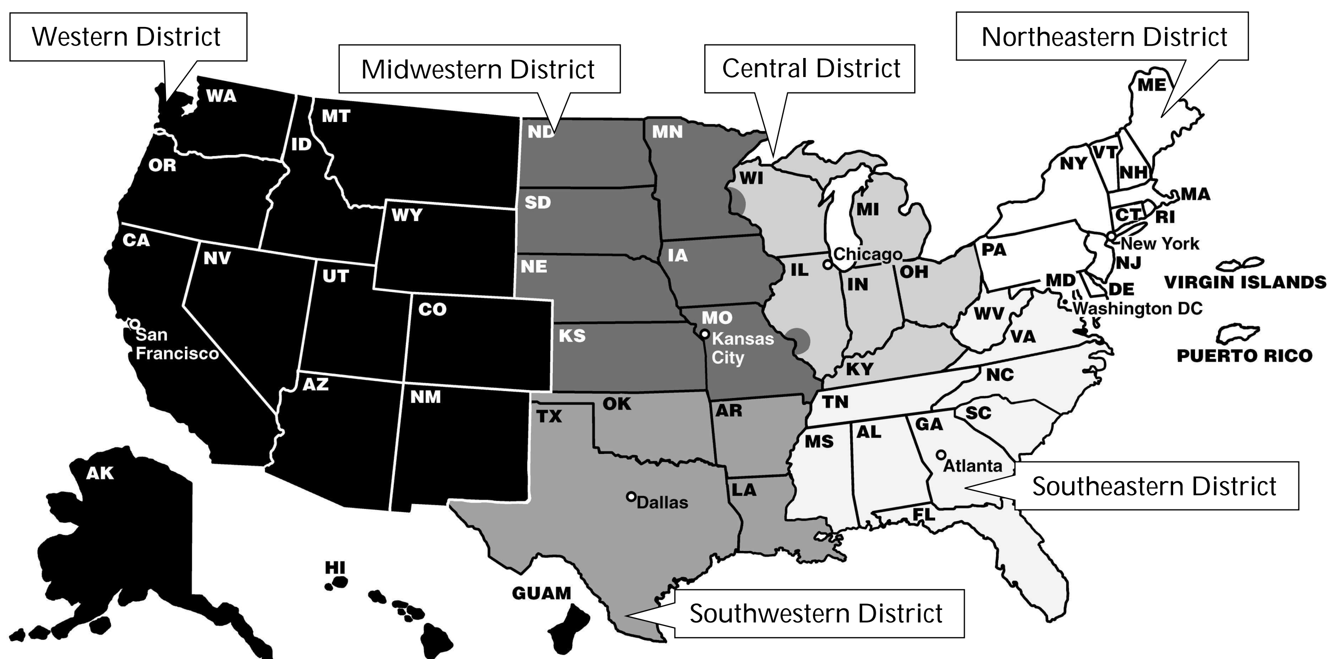
Bank Supervision Policy

The Bank Supervision Policy office formulates and disseminates the OCC's supervision policies to promote national banks' safety and soundness and compliance with laws and regulations. Specific responsibilities include issuing policy, guidance, and examination procedures related to national banks' commercial, consumer, asset management, capital markets, global banking activities, and bank information systems and consumer compliance; directing agency initiatives to address technology risks, including the risk from the year-2000 date change; assisting with specialized training and examination support to OCC examiners; and coordinating OCC participation in Federal Financial Institutions Examination Council activities and its task forces.

Economic and Policy Analysis

The Economic and Policy Analysis office manages the agency's economic research and analysis on the condition of the banking industry and trends in financial ser-

Figure 3—OCC district offices



vices. Other responsibilities include coordinating congressional testimony process for the Comptroller, supplying on-site technical support in sophisticated modeling techniques to OCC examiners, and assisting the Comptroller in the coordination of the Treasury Department's efforts to monitor electronic money and banking activities in the marketplace.

International Affairs

The International Affairs office oversees OCC's international activities. Specific responsibilities include providing policy advice and technical expertise and analyses to OCC and the Treasury Department on international banking and financial matters, including G–7 summit issues; formulating policies and procedures for the supervision and examination of federal branches and agencies of foreign banks; serving as liaison with foreign bank supervisors and various multilateral groups; and analyzing country risk and other internationally related issues. In addition, the senior deputy comptroller for International Affairs represents the OCC on the Basel Committee on Banking Supervision and the Joint Forum on Financial Conglomerates.

Public Affairs

The Public Affairs office advises the Comptroller on external relations with the news media, the banking industry, Congress, consumer and community organizations, other government agencies, and the public. Specific responsibilities include managing media relations for the agency; conducting outreach programs to foster and develop relationships with the external constituencies; tracking legislative developments and responding to congressional inquiries and requests for support; ensuring timely access to the agency's public information; and coordinating internal communications.

Administration and Chief Financial Officer

The office of Administration is responsible for the efficient and effective administrative functioning of the OCC. The office supervises the Human Resources, Administrative Services, Financial Services, Management Improvement, and Organizational Effectiveness divisions. The senior deputy comptroller for Administration also serves as the chief financial officer and oversees the OCC's Equal Employment programs. District Human Resources managers and Organizational Effectiveness staff located in OCC field locations provide assistance and guidance on all administrative functions to OCC field units and operations.

OCC's Mission

The OCC charters, regulates, and supervises national banks to ensure a safe, sound and competitive national banking system that supports the citizens, communities, and economy of the United States. The OCC's activities are predicated on four goals, referred to as pillars, that support the OCC's mission to ensure a stable and competitive national banking system. The OCC's four pillars are:

Ensure bank safety and soundness to advance a strong national economy. The OCC must maintain a proactive focus to identify potential problems in banking. The OCC should ensure its supervisory practices are both up-to-date and adaptable to the rapid evolution of highly complex new products and services being offered by the banking industry.

Foster competition by allowing banks to offer new products and services to their customers as long as banks have the expertise to manage the risks effectively and to provide the necessary consumer protections. At the same time, the OCC should act responsibly to understand, to monitor, and where appropriate, to limit the risks of new banking activities.

Improve the efficiency of bank supervision and reduce burden by streamlining supervisory procedures and regulations. The OCC must continue to introduce new examination procedures that reduce burden by focusing on banking activities that pose the highest risk. The OCC should ensure its regulations are clearly written to minimize regulatory burden and costs, and continuously eliminate regulations that are no longer necessary.

Ensure fair access to financial services for all Americans by enforcing the Community Reinvestment Act (CRA) and fair lending laws, encouraging national bank involvement in community development activities, and assuring fair treatment of bank customers and compliance with the consumer protection laws. The OCC should pursue initiatives that help to eliminate impediments to access to banking services for certain segments of the population, especially small businesses, low-income individuals, rural individuals and businesses, and victims of illegal discrimination, and that enhance the fair treatment of bank customers and compliance with consumer protection laws.

To help meet these the goals, the OCC identified four strategic objectives for 1998:

Strengthen Bank Supervision

- Use OCC supervisory processes to promote, and to require that banks follow, sound risk management fundamentals.
- Refine techniques for quantifying and responding to system-wide risk.

- Take timely and effective action with institutions characterized as high-risk outliers.

Make the OCC a Better Place to Work

- Continue to identify and respond to employees' work life needs.
- Address major issues raised by the cultural audit. Improve the credibility, clarity, timeliness, and accessibility of OCC communications.
- Ensure that OCC employees have timely and reliable access to OCC's information technology systems and automated data sources.

Monitor and Evaluate the Use of Technology in Bank Operations

- Assess the current extent of banks' reliance on technology and assess technology's impact on banks.
- Implement aggressive supervisory action to support national banking system readiness for year-2000 operation of automated systems.
- Identify key issues arising from the use of technology and develop appropriate supervisory responses.

Enhance and Institutionalize OCC Efforts to Ensure Fair Access to Financial Services for All Americans

- Enforce community reinvestment, fair lending, and consumer protection laws vigorously.
- Create opportunities for national banks and potential consumers of financial services to identify and realize mutually profitable relationships.
- Educate OCC personnel and external parties about the importance of fair access to financial services and the significance of OCC's access efforts to the agency's overall mission.

Management Discussion and Analysis—*Program Highlights and Performance*

Bank Supervision

The OCC found many ways to strengthen its supervision of national banks in 1998. The OCC's National Risk Committee helped the agency to identify primary and emerging risks to the national banking system and to stay abreast of evolving business practices and financial market issues. The Risk Committee informs the Executive Committee of any material risks facing the national banking system; recommends supervisory responses; and monitors and reports on OCC's responses to those risks.

The OCC also committed substantial resources for year-2000 preparedness. All initial risk identification examinations have been completed. More than 500 examiners received specialized training to ensure adequate knowledge and skills to assess the banks' testing activities under the next phase of the program.

To strengthen bank supervision and build specialized expertise, the OCC hired more than 200 examiners nationwide. The agency made sure that its examiners continually improved their skills by offering new and improved training programs. In 1998, such programs addressed external training, external certifications, and problem bank supervision.

Another way the OCC strengthened large bank supervision was having economists assist in examinations of large banks, focusing on the quantitative methods used to measure and analyze risks in bank portfolios and supervisory policies addressing those risks.

The OCC conducted economic research to assist in the bank supervision process, completed four quarterly reports on the condition and performance of the banking industry, and provided numerous economic and bank condition presentations to community bank groups through outreach programs. It also undertook several research projects in 1998 including ongoing research on derivatives markets, bank structure issues, bank risk-taking and returns, early warning models, international bank exposures, emerging market economic and financial issues and risks, *de novo* chartering activity, contingent modeling of bank earnings volatility, and technology issues. The OCC completed studies of the consumer market, energy markets, international trade issues and relationships, regional economic developments, credit-risk issues of the year-2000 transition, and health care industry developments and risks.

The OCC's Quality Assurance program helped all bank supervision units ensure that the objectives of bank supervision are achieved. During 1998, the community bank quality assurance reviews found that OCC's supervision of community banks remains effective. Ninety-nine percent of the bank examinations reviewed received an overall "satisfactory" rating. The large and mid-sized bank quality assurance program was piloted; overall risk assessments and ratings appeared reasonable for the sample banks.

As we head toward the millennium, bank supervision has become a greater challenge as banks continue to

consolidate, employ new technologies, and expand into nontraditional activities. In order to provide effective supervision, the OCC will continue to adapt its operations to allow flexibility and develop specialized expertise.

Examinations

To ensure the safety and soundness of banks and compliance with laws and regulations, the OCC conducts both on-site examinations and off-site reviews. The OCC sets its examination strategies to encompass safety and soundness matters, including specialty areas, and to fulfill the intent of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Over the past year, the OCC materially revised its supervisory strategy for the near term and redirected a large portion of supervisory resources to the unprecedented year-2000 examination needs of the national banking system.

Despite increasing staffing levels in the examination areas, resource constraints persisted as the OCC redirected resources to complete its initial round of on-site year-2000 examinations in all of the banks, federal branches, and data processing centers it supervises. Also, after the initial examinations were completed by June 30, 1998, the OCC again reallocated time from safety and soundness activities in order to provide examiners with training for the second phase of the supervisory process testing. This was followed in the last two quarters of 1998 by continuation of on-site examinations that focused on the year-2000 "testing" phase, with the OCC completing a second exam in virtually all institutions it supervises. In addition to these on-site examinations, year-2000 quarterly reviews were also conducted in every institution.

As a result, some safety and soundness examinations were not started on schedule in 1998. In order to minimize the supervisory risk of the late examinations, OCC issued examiner guidelines that allowed delays in safety and soundness examinations of community banks if the bank was rated 1 or 2, well managed, and had a low or stable risk profile.

Year-2000 Examinations

The OCC has an aggressive strategy to ensure that national banks are prepared for the year 2000. In pursuing this goal, the agency continues to work with the other federal banking agencies to ensure that the national banking system is making substantial progress on its year-2000 preparations. Most of the institutions supervised by the OCC are making good progress in addressing their year-2000 issues. As of December 31, 1998, approximately 97 percent of institutions were rated satisfactory, less than 3 percent were rated needs improvement, and less than 1 percent were rated unsatisfactory.

The OCC has assembled a comprehensive database and constructed analytic tools that enable the agency to monitor closely where national banks stand. These tools have enabled the agency to quickly and effectively focus our attention on banks that require closer scrutiny. The database has the results of quarterly surveys made by examiners regarding the year 2000. The OCC can systematically monitor not just national banks' overall year-2000 ratings, but also the status of specific activities and elements of their year-2000 preparations. One important way the OCC uses this information is to ensure the accuracy and consistency of the ratings examiners assign individual banks.

Although some national banks have experienced problems in meeting some of the interim target dates set by the FFIEC, the vast majority of national banks are making good progress towards being year-2000 compliant by the June 30 FFIEC target date.

CRA Examinations

Under the Community Reinvestment Act (CRA), 12 USC 2901, et seq., the OCC assesses a national bank's record of helping to meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with its safe and sound operation. The OCC also must consider the bank's record in its evaluation of an application for a deposit facility. A written performance evaluation describing the bank's activities, which includes the rating, is prepared at the end of each CRA examination and made available to the general public.

A bank's CRA performance in helping to meet its community's needs may be rated "outstanding," "satisfactory," "needs to improve," or in "substantial noncompliance." In 1998, the OCC conducted examinations in 818 national banks. The OCC considers CRA performance when deciding corporate applications.

The OCC and the other federal financial institution regulators continued to implement the revised CRA regulation that focuses on a bank's actual performance in helping to meet community credit needs. The four agencies completed a project aimed at enhancing consistency among their examiners. The project included a joint performance evaluation review, interagency examinations, and additional examiner training.

The OCC also conducted horizontal CRA examinations in seven of the largest banks it supervises in an effort to establish examination consistency, gain efficiencies in the exam process, and identify policies and procedures in need of revision. Staff continued a selective review of large bank performance evaluations to ensure consistency among the OCC district offices and to identify any areas requiring additional guidance.

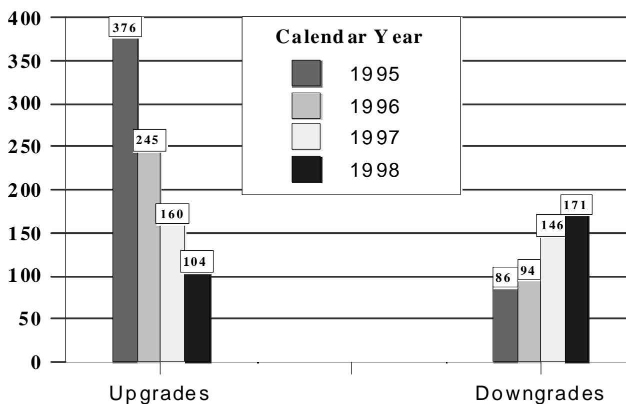
Condition of the Industry—Changes in Bank Ratings

In recent years, the improving condition of the national banking system was reflected in the overall positive trend in upgrades to banks' CAMELS ratings (capital, asset quality, management, earnings, liquidity, and sensitivity to market risk). Banks are rated on a scale of 1 to 5, with a bank rated 1 presenting the least supervisory concern. As of year-end 1998, 93 percent of the national bank population was 1- or 2-rated. Ratings are evaluated at least once during the supervisory cycle. For 1995–1997, rating upgrades exceeded downgrades.

In 1998, the number of downgrades (171) exceeded upgrades (104). The majority of downgrades during the year involved banks that remained in satisfactory condition, and only moved from a composite rating of 1 to a composite rating of 2.

While the overall health of the banking industry is good, the OCC remains vigilant in looking for any negative trend that may affect bank condition and result in an increase in the number of significant rating downgrades. During 1998, the OCC issued loan portfolio management guidance and the Comptroller once again cautioned banks about lax underwriting of new loans.

Figure 4—Levels of change in composite CAMELS rating



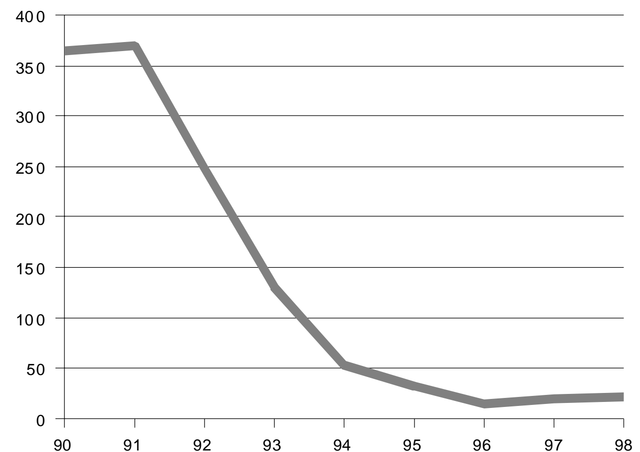
By taking these types of measures, the OCC hopes to avoid more serious problems that may result in significant rating downgrades in the future.

Problem National Banks

Under the Uniform Financial Institutions Rating System, national banks rated either 4 or 5 under the rating system are considered to be "problem banks." Currently, there are 22 problem banks that represent less than 1 percent of the national banking population. The assets of these banks total less than $1.5 billion or less than 1 percent of total national bank system assets. After reaching a high in the early 1990s, the number of problem banks has remained less than 1 percent of all national banks since the beginning of 1996, reflecting favorable economic conditions.

The average total asset size of problem national banks is $70 million; none have assets of more than $500 million. No national banks failed during 1998.

Figure 5—Problem national banks



Enforcement

The OCC uses a number of tools in addition to its examinations to carry out its supervisory responsibilities. These tools range from advice and moral suasion to specific types of enforcement actions. Enforcement actions correct weaknesses in safety and soundness or compliance and commit management and the board to enact specific measures addressing OCC concerns. Enforcement actions may be formal or informal, and may be taken against banks or individuals that are associated with banks.

In 1998, the OCC for the first time took enforcement actions to ensure national banks' compliance with interagency guidance on preparing their computer systems for the year-2000 conversion. The OCC developed a new type of enforcement action, a supervisory directive, that alerts national banks that have material deficiencies in their preparation for the year-2000 conversion of their deficiencies and summarizes the OCC's expectations of how the banks need to address them. In 1998, the OCC issued 330 year-2000 supervisory directives to national banks.

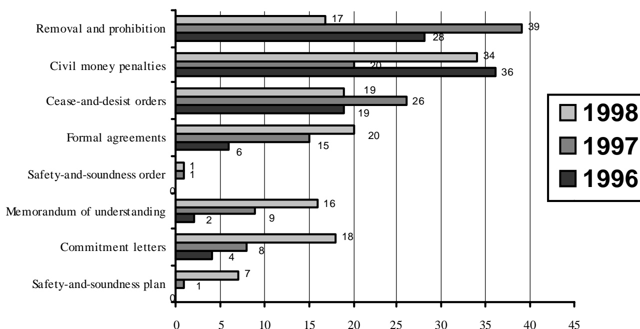
Using another new and effective supervisory tool (first used in 1997), the OCC issued seven notifications, under 12 CFR Part 30, to national banks that were not in compliance with the "Guidelines for Safety and Soundness" published as Appendices A and B to Part 30. The notifications required these banks to submit plans to bring themselves into

compliance with the guidelines. Of these seven notifications, six were based on year-2000 issues and one led to the issuance of a final order under Part 30.

In all, the OCC completed a total of 521 enforcement actions against banks and individuals in 1998 (this includes actions that were initiated in prior years), an increase from 203 in 1997. Of these, 355 actions were for year-2000 issues. At year-end 1998, the OCC had either formal or informal enforcement actions outstanding against approximately 6.1 percent of the institutions it supervises (national banks, federal branches and agencies); 1.1 percent of OCC-supervised institutions were under actions for year-2000 issues, and 5.0 percent for other matters. (A few institutions were under enforcement actions for both year-2000 issues and other matters.)

Informal enforcement actions against banks include safety and soundness plans (under Part 30), commitment letters, and memorandums of understanding. Generally, these actions give bank management direction and guidance in addressing weaknesses in management or procedures before such weaknesses become serious problems. Failure to correct practices identified by the OCC's informal actions are strong evidence that formal action is necessary. The OCC uses formal enforcement actions against banks to secure legally binding commitments when serious compliance or safety and soundness problems pose a threat to a bank's condition. Formal enforcement actions against banks include safety and soundness orders (under Part 30), formal written agreements, and cease-and-desist orders, which may be issued by consent or after litigation. Formal agreements are signed by a national bank's board of directors and the OCC, and require specific corrective and remedial measures to return the bank to a safe and sound condition. Cease-and-desist orders differ from formal agreements by being enforceable in federal district court.

Figure 6—Significant enforcement actions completed against individuals and banks, 1996–1998 [1, 2]



[1] This chart excludes the 330 Y2K supervisory directives.

[2] Statistics for prior years may be adjusted to reflect revised aggregate.

The OCC may also impose civil money penalties (CMPs) upon banks for failing to comply with laws, regulations, formal agreements, cease-and-desist orders, or conditions imposed in writing in connection with an application or request, or for engaging in unsafe or unsound practices. The OCC issued three CMPs against national banks in 1998, two in 1997, and one in 1996.

When appropriate, the OCC takes formal and informal actions against individuals at national banks—officers, directors, or other institution-affiliated parties. The primary informal enforcement tools used by the OCC for individuals are supervisory letters and letters of reprimand.

Formal actions against individuals include CMPs, removals, prohibitions, and personal cease-and-desist orders. CMPs are imposed for violations of laws, regulations, and rules, as well as for noncompliance with formal written agreements, final orders, and conditions declared in writing. In certain circumstances, CMPs are imposed for unsafe or unsound banking practices or breaches of fiduciary duty. During 1998, the OCC imposed CMPs against 31 individuals totaling $1,120,034.

The OCC is sometimes compelled to take action to remove an individual from his or her position, to prohibit that person from further involvement in the banking industry, or both.

Finally, cease-and-desist orders against individuals address such issues as requiring restitution to the bank and/or prohibiting or restricting activities in the banking industry. Figure 6 provides totals from 1996 through 1998 for some of the primary enforcement actions that the OCC completed against banks and individuals. During 1998, the OCC ordered restitution of $10.3 million, which is considerably higher than in prior years because of a single action ordering over $9.4 million in restitution.

Other Activities

Applications/Notifications

Licensing

National banks must, by law and regulation, seek OCC approval for certain types of structural changes and to commence certain new activities. These changes include new bank charters, conversions to national banks, corporate reorganizations, mergers, opening branches, bank relocations, operating subsidiaries, capital and

subordinated debt issues, and bank acquisitions. Most licensing requests are reviewed and decided in the licensing units located in the six district offices and in Washington, D.C. (federal branches and agencies file with OCC's International Banking and Finance Division). Complex or significantly precedential issues are forwarded to Bank Organization and Structure (BOS) in Washington, D.C., for analysis and decision by senior management.

The total number of applications filed with the OCC decreased from 2,886 in 1997 to 2,628 in 1998. This decline occurred in the number of branch, change-in-control, charter, conversion, operating subsidiary, merger, and reorganization filings received; however, capital and fiduciary powers filings increased (see table 1). The 1998 count does not include 99 operating subsidiary filings that were effected through after-the-fact notices, compared with 92 after-the-fact notices in 1997.

From 1997 to 1998, new charter applications decreased from 80 to 75. The OCC received 49 charter applications from independent groups during 1998. Of these, 41 were for full-service banks; six for trust banks, and two for credit card banks. The other 26 charter applications received in 1998 were sponsored by existing holding companies. Of this group, 18 were for full-service banks, seven for trust banks, and one for a credit card bank.

The OCC denied one application in 1998, compared with two in 1997 and none in 1996. Of the 2,482 decisions, 48 were conditional approvals. Conditional approvals increased from 1997, when 42 of 2,910 decisions were conditionally approved.

Change in Bank Control Act

Under the Change in Bank Control Act of 1978 (CBCA), any party wishing to acquire control of a national bank through purchase, assignment, transfer, pledge, or other disposition of voting stock must notify the OCC in writing 60 days prior to the proposed acquisition (unless a filing is required under the Bank Merger Act or the Bank Holding Company Act). Any party acquiring 25 percent or more of a class of voting securities of a national bank must file a change in bank control notice. Any party acquiring 10 percent or more (but less than 25 percent) must file a change in bank control notice under certain conditions. The acquiring party must also publish an announcement of the proposed change in control to allow for public comment.

The CBCA gives the OCC the authority to disapprove changes in control of national banks. The OCC's objective in its administration of the CBCA is to enhance and maintain public confidence in the national banking system by preventing identifiable, serious, adverse effects resulting from anti-competitive combinations or inadequate financial support and unsuitable management in national banks. The OCC reviews each notice to acquire control of a national bank and disapproves transactions that could have serious harmful effects. If the notice is disapproved, the disapproval letter contains a statement of the basis for disapproval. In 1998, the OCC received 17 change in bank control notices, down from 24 in 1997 (table 2). Of the 17 notices received in 1998, 12 were acted upon, with one disapproval.

Table 1—Corporate licensing activity in 1998

	Applications received		District decisions 1998			Washington decisions 1998			Total
	1997	1998	Approved	Conditionally approved	Denied	Approved	Conditionally approved	Denied	1998 Decisions
Branches	1,771	1,566	1,499	1	0	28	1	0	1,529
Capital/sub debt	93	108	71	0	0	5	0	0	76
Change in control	23	17	9	0	0	2	0	1	12
Charters	80	75	53	1	0	3	9	0	66
Conversions[1]	58	32	23	0	0	4	0	0	27
Federal branches	1	1	1	0	0	0	0	0	1
Fiduciary powers	24	40	31	0	0	0	0	0	31
Mergers	115	107	93	1	0	8	0	0	102
Relocations	243	236	217	0	0	2	0	0	219
Reorganizations	322	307	226	1	0	57	0	0	284
Stock appraisals	5	8	0	0	0	4	0	0	4
Subsidiaries[2]	151	131	74	26	0	23	8	0	131
Total	2,886	2,628	2,297	30	0	136	18	1	2,482

Note: Approved decisions include conditional approvals. Mergers include failure transactions where the national bank is the resulting institution.

[1] Conversions are conversions to national bank charters.

[2] Subsidiaries do not include 92 after-the-fact notices received in 1997 and 99 after-the-fact notices received in 1998.

Table 2—Change in Bank Control Act notices processed at OCC districts and headquarters, 1988–1998

Year	Received	Acted on	Not disapproved	Disapproved	Withdrawn
1998	17	12	11	1	0
1997	24	24	24	0	0
1996	17	15	13	0	2
1995	15	16	16	0	0
1994	15	16	15	1	0
1993	28	30	21	5	4
1992	30	29	21	4	4
1991	20	15	6	6	3
1990	31	42	32	5	5
1989	55	55	48	3	4
1988	45	42	34	4	4

Application/Processing Efficiency

One measure of the OCC's effectiveness in processing corporate applications is the percentage of applications processed within target time frames. To ensure applications are processed in a timely manner, Bank Organization and Structure measures processing time using benchmark time frames for routine applications and for more complex applications. Processing timeliness varies with the volume and complexity of applications, which vary with economic conditions and changes in banking law. The OCC meets target time frames for all application types more than 95 percent of the time. To provide consistent comparisons with results in prior years, the statistics in table 3 have been adjusted for regulatory and processing changes. Deviations from these time frames are primarily the result of applications' complexity, the need to acquire additional information, or the conflicts associated with peak workload demands.

The OCC's regulation governing all corporate applications, 12 CFR 5, establishes an "expedited review" process for certain applications from banks that are well capitalized, have a CAMELS rating of 1 or 2, have a CRA rating of "satisfactory" or better, and are not subject to an OCC formal enforcement action. For some routine transactions, OCC approval is no longer required.

Table 3—OCC licensing actions and timeliness, 1997–1998

		1997			1998			Annual change		
Application type	Target time frame in days[1]	Number of decisions	Within target	Percent	Number of decisions	Within Target	Percent	Number of decisions	Within target	Percent
Branches	45/60	1,772	1,762	99.4	1,529	1,519	99.3	–243	–243	–0.1
Capital/sub debt	30/45	82	71	86.6	76	71	93.4	–6	0	6.8
Change in control	NA/60	24	21	87.5	12	12	100.0	–12	–9	12.5
Charters [2]		79	63	79.7	66	54	81.8	–13	–9	2.1
Conversions	30/90	92	90	97.8	27	26	96.3	–65	–64	–1.5
Federal branches & agencies	NA/120	0	0	0.0	1	1	100.0	1	1	0.0
Fiduciary powers	30/45	39	38	97.4	31	31	100.0	–8	–7	2.6
Mergers	45/60	127	110	86.6	102	96	94.1	–25	–14	7.5
Relocations	45/60	241	236	97.9	219	218	99.5	–22	–18	1.6
Reorganizations	45/60	320	292	91.3	284	261	91.9	–36	–31	0.7
Stock appraisals	NA/90	3	1	33.3	4	0	0.0	1	–1	–33.3
Subsidiaries	30/60	131	112	85.5	131	85	64.9	0	´–27	–20.6
Total	NA	2,910	2,796	96.1	2,482	2,374	95.6	–428	–422	–0.4

Note: Most decisions (93 percent in 1997 and 94 percent in 1998) were decided in the district offices, International Banking and Finance, and Large Bank Licensing under delegated authority. Decisions include approvals, conditional approvals, and denials.

[1] Those filings that qualify for the "expedited review" process are subject to the shorter of the time frames listed. The longer time frame is the standard benchmark for more complex applications. New time frames commenced in 1997 with the adoption of the revised Part 5. The target time frame may be extended if the OCC needs additional information to reach a decision, permit additional time for public comment, or process a group of related filings as one transaction.

[2] For independent charter applications, the target time frame is 120 days. For holding-company-sponsored applications, the target time frame is 45 days for applications eligible for expedited review and 90 days for all others.

Source: Bank Organization and Structure, Comptroller of the Currency.

Electronic Money and Banking Issues

The OCC continued its Treasury-wide role on matters relating to electronic money and banking issues, and chaired periodic meetings with senior Treasury officials to focus on developments in e-commerce and banking. The interagency Consumer Electronic Payments Task Force, chaired by the Comptroller, continued its work to identify, in partnership with industry and the public, the consumer issues raised by emerging electronic money technologies and possible solutions to such concerns. The task force, which solicited public comment during the summer of 1997, issued its report in April 1998. The report identified four key areas of consumer concern: access, privacy, financial condition of issuers, and consumer protection and disclosures.

The OCC also worked as part of the Basel Committee on Banking Supervision on a paper, "Risk Management for Electronic Banking and Electronic Money Activities," issued in March 1998, that forged a common understanding among the member Central Bank Governors and bank regulators on the key questions posed by emerging electronic banking and money activities.

Special Studies staff gave numerous speeches at forums on technology, banking, and payments. The unit also prepared a study, "Technological Innovation in Banking and Payments: Industry Trends and Implications for Banks." The results of this study were presented to the OCC's Executive and Risk Management committees for their consideration and also appeared in the agency's *Quarterly Journal* (Vol. 17, No. 3).

Congressional Appearances

In 1998, the Comptroller and other senior officials participated in nine congressional hearings. Congress often asks the OCC to submit written statements or appear before the various House and Senate committees and subcommittees to address significant public policy issues and to answer questions affecting the national banking industry. The 1998 hearings were on the following topics: financial modernization legislation; mergers; hedge funds; year-2000 progress for the banking industry; regulatory review—twice; money laundering; financial privacy; and derivatives. The Comptroller also testified at a Community Reinvestment Act forum sponsored by Congresswoman Maxine Waters.

Year-2000 Date Transition

The OCC has been working to ensure internal systems are year-2000 compliant. The OCC identified 13 systems as mission-critical. The OCC retired one system and has remediated all of the remaining 12 mission-critical systems, well in advance of Treasury Department deadlines.

The OCC continues to monitor progress toward completion of the renovation, validation, and implementation phases of non-information technology (non-IT) systems at all nine primary sites as outlined in its "Non-IT Project Management Plan."

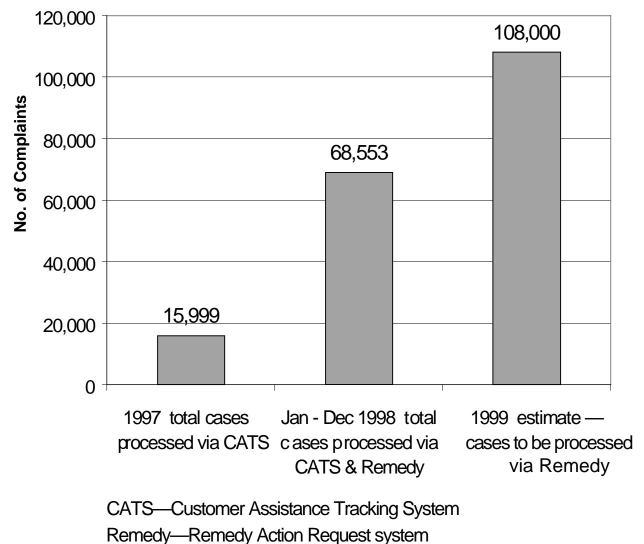
Consumer Complaints

The Federal Trade Commission Improvement Act of 1975 (15 USC 41, et seq.) requires the OCC to receive and take appropriate action on complaints directed against national banks and to report on them annually to Congress.

In April 1998, processing of consumer complaints was consolidated in Houston, Texas, under the Office of the Ombudsman. The resulting Customer Assistance Group (CAG) began operations using two consumer complaint-tracking systems—Remedy Action Request and the Customer Assistance Tracking System, commonly known as CATS. In September 1998, the group began relying solely on Remedy Action Request.

During 1998, the CAG processed 68,553 consumer complaints (compared with 15,999 in 1997) and 85,322 telephone inquiries (compared with 19,338 in 1997). The significant increase in consumer complaints is expected to continue in 1999. The installation of a state-of-the-art call center greatly enhances the public's access to the OCC and CAG's ability to handle more calls.

Figure 7—Customer assistance group complaint processing

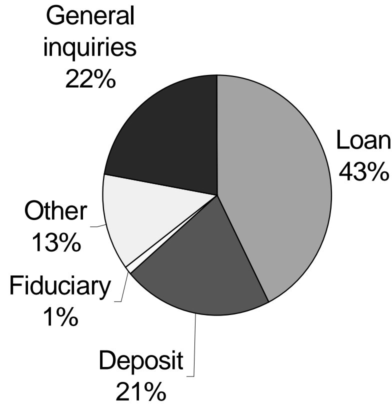


CATS—Customer Assistance Tracking System
Remedy—Remedy Action Request system

As of December 31, 1998, the CAG closed 55,121 consumer complaint cases (80 percent) received during 1998, compared with 12,248 cases closed (77 percent) in 1997. Figure 8 shows the major categories of consumer complaints processed in 1998. Forty-three per-

cent of total complaints processed by December 31, 1998 were about loans (see figure 8). Breaking the loans down further, credit cards were the subject of 68 percent of the complaints, with consumer and mortgage loans at 13 percent and 10 percent, respectively (see figure 9).

Figure 8—Consumer complaints by major categories, 1998



Complaints about deposits also comprised a significant amount of the total complaints (21 percent of total complaints). Breaking deposits down further, service issues and general deposit inquiries comprised two-thirds of the complaints (see figures 8 and 10).

Figure 9—Consumer complaints by loan categories, 1998

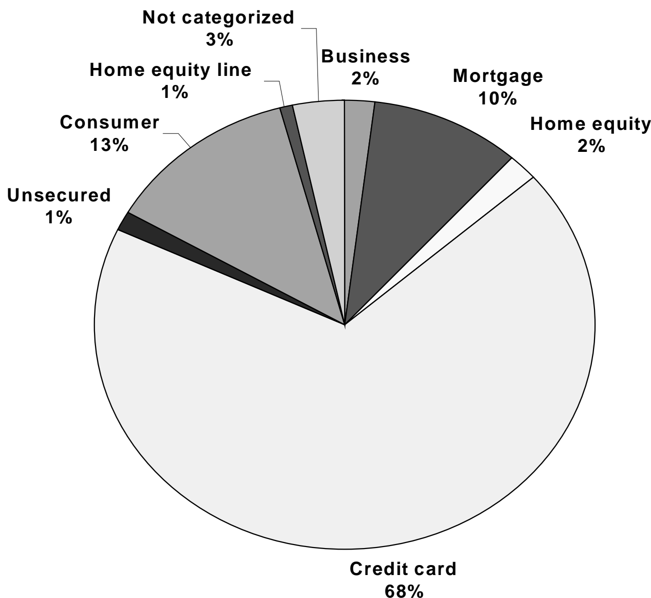
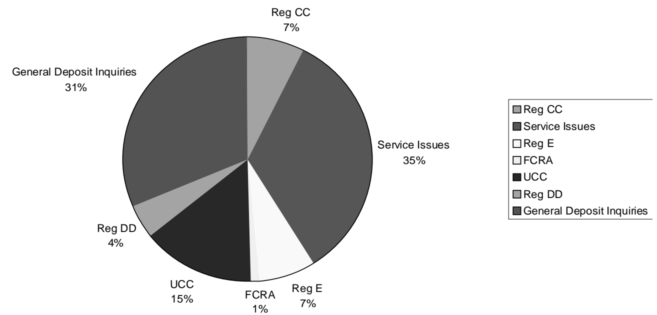


Figure 10—Consumer complaints by deposit type for 1998



Financial Highlights and Performance

Overview of Funding Sources and Uses

The financial statements that follow summarize the OCC's December 31, 1998 financial position, including the costs of its operations and all significant sources and uses of resources during 1998 compared to 1997. The OCC's revenue was $386.7 million in 1998 up from $374.6 million in 1997. Expenses totaled $379.3 million in 1998, up from $330 million in 1997. This resulted in a $7.4 million surplus in 1998, that is down from the $44.6 million 1997 surplus.

The 1998 surplus primarily results from staffing below the budgeted levels and increased revenue from a greater-than-expected increase in the assets of the national banking system. Table 4 provides a summary of the OCC's revenues and expenses for 1996–1998.

Table 4—OCC total revenue and expenses, 1996–1998 ($ in millions)

	1996	1997	1998
Revenue	$373.7	$374.6	$386.7
Expenses	$374.5	$330.0	$379.3
Surplus/(deficit)	($ 0.7)	$44.6	$7.4

Note: Totals may not add up because of rounding.

Funding Sources

The OCC does not receive any appropriations from Congress. The OCC's operations are funded primarily by semi-annual assessments from each national bank and each District of Columbia bank.

To carry out its responsibilities, the OCC may impose and collect assessments, fees, or other charges as necessary or appropriate (12 USC 482). Such assessments, fees, and other charges are set to meet the OCC's expenses.

Semiannual assessments account for 95.3 percent of the OCC's revenue for 1998. Other sources of revenue are investment and other revenue (3.9 percent), fees for corporate applications (0.8 percent), and sales of the agency's publications. The OCC's investment income comes from investing its operating funds in U.S. Treasury securities.

In accordance with the Chief Financial Officers Act, the OCC reviews its fee schedule annually to verify that these fees, along with investment income and other miscellaneous income, cover the full cost of the OCC's operations. The results of these reviews are incorporated in the annual notice of assessment fees. The OCC must provide notice of its assessment fees no later than the first business day in December of each year for fees to be charged during the upcoming year. These fees will be effective January 1 of that upcoming year. The agency has significantly reduced its fees over the past five years to reflect efficiencies being achieved.

Funding Uses

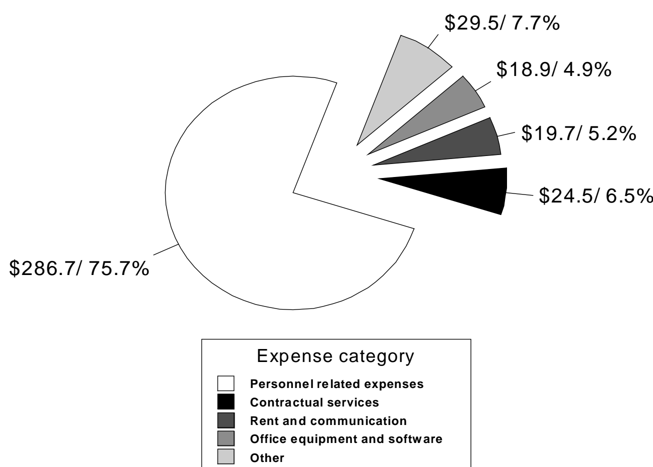
The OCC's operations are personnel-intensive. In 1998, the OCC's expenses were $379.3 million, with $286.7 million, or 75.7 percent of total expenses paying for personnel compensation and benefits, travel, education, and employee relocation.

Contractual services accounted for 6.5 percent of total expenses. A significant component of these expenses relate to year-2000 issues addressed during 1998.

Rent and communications expenses supporting the nationwide system of examiner offices and the headquarters location, represent 5.2 percent of total expenses.

Office equipment and software account for 4.9 percent of total expenses and include major technology enhancements and upgraded office software.

Figure 11—Major components of OCC's 1998 expenses



The remaining OCC expenses represent 7.7 percent of total expenses and include costs for interest on the capital lease for the headquarters building, postage and freight, repairs, maintenance and utilities, supplies and materials, depreciation and amortization, and printing and reproduction.

Revenue

Revenue—Prior Year Comparison: The OCC's 1998 revenue increased by $12.1 million, approximately 3.2 percent over 1997. This increase in revenue was primarily due to the growth in assets of national banks. Approximately 40 percent of the asset growth in 1998 over 1997 is due to net conversions/mergers of institutions into the national banking system.

Assessment revenue increased by $17.7 million, or 5.0 percent. This increase resulted from the growth in bank assets for existing national banks and from new bank assets for institutions converting or merging into the national banking system.

Corporate fees decreased by $339,000, or 10.3 percent during 1998. The decrease was due to an overall decline in the number of applications received in 1998 from 2,886 to 2,628 (a 9 percent reduction). During 1998, the OCC experienced a decrease in the number of branch, change-in-control, charter, conversion, operating subsidiary, merger, and reorganization filings received.

Investment income increased by $1.6 million, or 12.6 percent in 1998. This increase resulted primarily from an increase in the amount of investable funds.

Other revenue showed a decrease of $4.1 million, or 79.6 percent. The 1997 total included $3.3 million recovery of an unused liability established in 1994 to cover future expenses from the close of a former OCC-sponsored health benefits program. In addition, the 1997 total included $230,000 for securities-related fees that have been discontinued.

Figure 12—Percentage change in revenue from 1997 to 1998

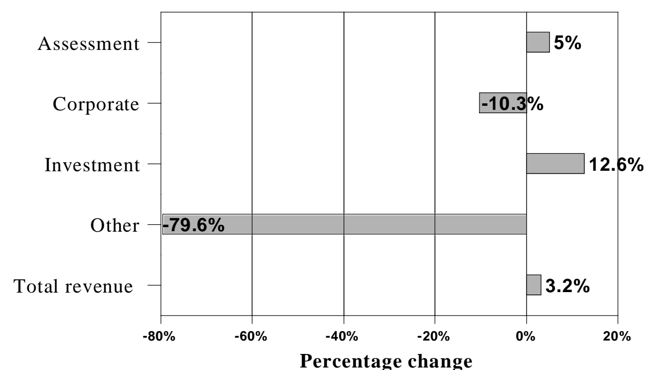


Table 5—1998 summary of revenue budget performance ($ in millions)

Revenue category	1998 actual	1998 budget	Dollar variance	Percent variance
Assessment revenue	$ 368.4	$ 353.0	$ 15.4	4.4%
Corporate fees	2.9	3.0	–0.1	–3.3%
Investment income	14.3	13.0	1.3	10.0%
Other revenue	1.1	2.0	–0.9	–45.0%
Total revenue	$ 386.7	$ 371	$ 15.7	4.2%

Note: Totals may not add up because of rounding.

In October 1997, the OCC also discontinued the examination fee for fiduciary activities. The 1997 revenue included $2.7 million for these fees.

Revenue—Budget Performance: Total revenue was over budget by $15.7 million, or 4.2 percent in 1998. Table 5 provides a summary of the OCC's budget performance for revenue.

Expenses

Expenses—Prior Year Comparison: The OCC's 1998 total expenses increased by $49.3 million, or 15 percent over prior year expenses. The major factors were the increased staff required to carry out the agency's year-2000 compliance efforts and technological enhancements.

Personnel compensation and benefits costs increased by $21 million, or 9.2 percent. The increase results primarily from the additional 200 field examiners who were hired during 1998.

Rent, communications, and utilities costs increased by $1.3 million, or 6.8 percent. The increase resulted from inflationary costs associated with utilities and the OCC's current lease agreements.

Travel expenses increased by $4.9 million, or 21.4 percent, primarily as a result of the costs incurred for the year-2000 compliance examination efforts, and the travel costs incurred for the additional field examiners who were hired during 1998.

Employee relocation expenses decreased by $1.9 million, or 28.7 percent. This decrease relates to the costs incurred during 1997 for the movement of employees and household goods resulting from the 1997 restructuring, which exceeded similar costs during 1998. In addition, accrued relocation expenses were reduced in 1998 to eliminate amounts previously accrued for relocations that were completed and for which no further expenses will be incurred.

Office supplies costs increased by $1.3 million, or 39.3 percent above the 1997 levels. This increase is due to the additional costs incurred to purchase supplies for more than 200 permanent employees hired during 1998. Also, this expense category increased because OCC's library was upgraded with new books, software, and a new research system.

Education and conferences expenses increased by $1.0 million, or 23.0 percent. The increase resulted from costs associated with maintaining a highly qualified workforce and the expanded External Training Program. During 1997, this program was initially available only to senior examiners. However, during 1998, the External Training Program was expanded to all OCC employees and expenses included the costs for tuition, registration, and course-related materials (e.g., books, disks, and cassettes).

Office equipment and software expenses increased by $8.1 million, or 74.6 percent. Major technology enhancements were made which included purchases such as personal computers (PCs), servers, credit-risk software, and office software.

Contractual services expenditures increased by $12.7 million, or 108.1 percent. The increase is primarily due to the additional costs incurred during 1998 for contractual services that provided technological knowledge and expertise required for OCC's year-2000 remediation efforts. Contractual services were also used to perform year-2000 compliance examinations at the banks.

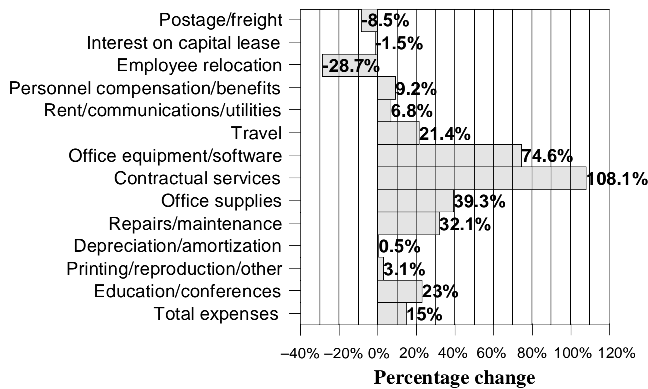
Repairs and maintenance expense increased by $1.2 million, or 32.1 percent. Office maintenance costs that include guard service, cleaning, repairs, and remodeling accounted for approximately one-half of the total increase. The remainder of the increase represents equipment repairs, replacement parts and maintenance of copiers, computers, and other equipment.

The following expense accounts had immaterial increases or decreases over prior period costs:

- Depreciation and amortization increased by $30,142, or 0.5 percent.
- Printing, reproduction, and other expenses increased by $42,851, or 3.1 percent.

- Interest on capital lease decreased by $157,215, or 1.5 percent.
- Postage and freight decreased by $152,040, or 8.5 percent.

Figure 13—Percentage change in expenses, 1997–1998



Expenses—Budget Performance: Table 6 provides a summary of the OCC's budget performance for expenses. In 1998, the OCC's expenses were over budget by $15.5 million or 4.3 percent.

Payments

Prompt Payment: The Prompt Payment Act and OMB Circular A–125 require agencies to make payments on time, to pay interest penalties when payments are late, and to take discounts only when payments are made on or before the discount date. Table 7 presents the OCC's compliance with the Prompt Payment Act between 1996 and 1998. The increase in reported late payments was due in part to management's increased emphasis on accurate reporting of Prompt Payment Act statistics and in part to employee turnover within the OCC's administrative accounting department. The increase in late payments is being addressed through a new payment process implemented in 1999.

Electronic Funds Transfer: Electronic funds transfer (EFT) provides safe and efficient transmission of payments as well as greater control over their timing. The cost of payments by EFT is lower than that incurred in the issuance of paper checks. The Debt Collection Improvement Act of 1996 requires government agencies to issue all payments electronically by January 2, 1999, except in cases where compliance would impose a hardship. Table 8 presents the OCC's percentage of use of EFT for payroll payments processed during 1996–1998.

The OCC initiated a program whereby many vendor, employee, and contractual payments were issued by EFT during 1998. The percentage of the OCC's payroll payments made by EFT has increased over the past three years. In 1998, the OCC surpassed OMB's goal for agencies to process 90 percent of their payroll payments through EFT that year.

Accounts Receivable: Table 9 identifies annual write-offs and delinquent accounts receivable (receivables 30 days or more past due). The percentage of delinquent accounts increased from 9.2 percent in 1997 to 92.5 percent in 1998.

Table 6—1998 summary of expense budget performance ($ in millions)

Expense category	1998 actual	1998 budget	Dollar variance	Percent variance
Personnel compensation/benefits	$ 248.7	$ 243.7	$ 5.0	2.1%
Rent/communications/utilities	30.0	36.3	–6.3	–17.4%
Travel	32.7	29.1	3.6	12.4%
Education/conferences	5.3	5.1	0.2	4.1%
Other expenses	62.6	49.7	12.9	26.0%
Total expenses	379.3	363.8	15.5	4.3%

Note: Totals may not add up because of rounding.

Table 7—Prompt payment comparisons, 1996–1998

Invoice payments—subject to the Prompt Payment Act	1996	1997	1998
Invoices paid on time as a percentage of total invoices	88	88	82
Invoices paid late as a percentage of total invoices paid	9.1	11.1	13.6
Interest penalties paid as a percentage of total dollars paid	0.026	0.034	0.048

Table 8—Percentage of use for electronic funds transfer, 1996–1998

	1996	1997	1998
Percentage of payroll payments issued by EFT	95.2	96.1	98.1

Table 9—Percentage of annual write-offs and delinquent accounts receivable, 1996–1998

	1996	1997	1998
Accounts receivable write-offs as a percentage of dollar volume in accounts receivable	0.14	1.11	4.16
Percentage dollar volume of accounts receivable 30 days or more past due	6.90	9.15	92.45

This increase is due primarily to the significant change in the composition of accounts receivable from 1997 to 1998. Specifically, the OCC no longer charges a separate fee for trust examinations. In 1997, 85 percent of the accounts receivables were trust fees and less than 2 percent were delinquent. While accounts receivables (net of trust billings) increased in 1998 by 75 percent to $519,692, this balance included $324,974 in receivables from other government agencies for which payment was received in early 1999. Exclusion of the government receivables, all of which were paid during January or February 1999, would reduce the delinquent percentage for 1998 to 29.9 percent. The significant increase in delinquent accounts receivable was a direct result of restructuring and employee turnover within the OCC's administrative accounting department. In recognition of the large percentage of delinquent receivables, OCC established an allowance for doubtful accounts in the amount of $110,239.

A majority of the OCC's delinquent accounts receivable were for $100 or less. Because of the nominal value of most of these accounts, they have not been referred to a collection agency. They were instead maintained at the OCC, with collection efforts continued by accounts receivable staff.

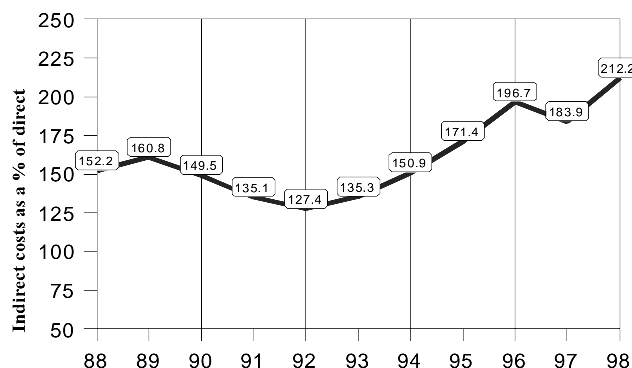
In accordance with the Debt Collection Improvement Act of 1996, the OCC continues to review delinquent accounts in order to determine if any are eligible for referral to the Treasury Department's Financial Management Services for debt collection.

Allocation of Indirect Cost

The OCC's indirect rate measures the relationship between the OCC's direct and indirect costs. Direct costs are salary and travel costs incurred to examine banks and costs to review and decide upon corporate applications. Indirect costs are costs incurred within the OCC to perform other related activities, including other bank supervisory functions and analyses, development of bank supervision policy, review of bank supervision and examination products, legal analyses, outreach to bankers, support operations, and training. Indirect costs also include overhead, such as facilities, supplies, telephone service, and information technology.

From 1992 to 1996, OCC's indirect cost rate has increased due to reduced numbers of field examiners as a result of industry consolidation. In 1998, the indirect/direct cost ratio moved upward because of the increase of indirect costs primarily due to investments to improve information technology.

Figure 14—Ratio of indirect costs to direct costs, 1988–1998



Financial Management Systems Initiatives

The OCC is committed to continuing its progress in:

- Maintaining an integrated OCC financial management system that complies with applicable accounting principles and standards, provides timely information, responds to the OCC's management needs, conforms to government-wide systems requirements, and provides timely monitoring of the budget through performance reports.
- Enhancing the ability of OCC systems to provide integrated reporting on the performance of programs, finances, and financial management.
- Streamlining processes to reduce data entry burdens through automatic uploads from other systems and more user-friendly screens.
- Eliminating outdated system components and replacing them with "off-the-shelf" system components that provide more efficient operations and a better integrated system.

Current Status: The OCC's financial system is accrual-based and provides monthly budget reports and financial statements to management. The system operates on a

calendar-year basis. Financial personnel have on-line access to OCC's mainframe computer through remote terminals.

The primary financial information system is integrated with the following modules:

Accounts Payable/Cash Disbursements

Accounts Receivable/Cash Receipts

Budget/Planning

Capital Expenditures

Investments

Payroll

During 1998 the OCC engaged a public accounting firm to conduct a comprehensive internal control review and evaluation of OCC's financial systems as a prelude to developing functional requirements for replacing financial systems that cannot meet current accounting standards. The results of this review are discussed in the next section of this report.

Future Plans: The OCC will seek to acquire new financial systems with a goal of late 2000 implementation. The systems will provide for enhanced delivery of financial and resource information by taking full advantage of modern technology. These efforts are synchronized with OCC's technical architecture and data architecture efforts.

Compliance with Financial Management Laws—FMFIA/FFMIA Program Summary

The OCC evaluated its systems of internal control for the fiscal year ending September 30, 1998, according to the procedures and standards prescribed by the Office of Management and Budget (OMB) and the U.S. General Accounting Office (GAO). At that time, management concluded that no material weaknesses existed to undermine the assurances referenced below.

Pursuant to Sections 2 and 4 of the Federal Managers' Financial Integrity Act of 1982 (FMFIA) and Section 803(a) of the Federal Financial Management Improvement Act of 1996 (FFMIA), the OCC reviewed its internal control and administrative financial management information systems. In accordance with the guidance, management's review of internal control systems is meant to provide reasonable assurance that:

- Expenditures and costs comply with applicable law.
- All assets are safeguarded against waste, loss, unauthorized use, and misappropriation.
- Revenues and expenditures applicable to agency operations are recorded and accounted for properly.
- The financial management/information accounting system conforms to generally accepted accounting principles, relevant standards, and requirements of the Comptroller General and the OMB.

Although the OCC found no material weaknesses during its FMFIA and FFMIA assessment during 1998, OCC management did note conditions that warranted a more in-depth review. With this in mind, the OCC began a series of actions in the fourth quarter of 1998 to achieve assurance that OCC's internal financial management conforms to the same high standards expected of national banks. Specifically, we:

- Selected a new external auditor to examine our 1998 financial results and assess our compliance with accounting standards and federal financial management regulations. The OCC also adopted an explicit policy limiting the duration of the OCC's contract with an external auditor to five years.
- Retained a public accounting firm to conduct a comprehensive review of the OCC's internal control procedures and practices.
- Elevated the OCC's chief financial officer function to the senior deputy comptroller level to strengthen accountability for financial management and internal controls.

The results of the comprehensive internal control review were presented to OCC management in January 1999. The OCC immediately undertook a series of short-term actions to remedy all internal control weaknesses identified by this review. Specifically, the OCC:

- Closed all OCC imprest and petty cash funds and issued revised procedures for handling small purchases and other transactions.
- Restructured the accounts payable function and reassigned staff resources to eliminate the payables backlog.
- Completed an audit of travel vouchers and instituted best-practice voucher audit procedures throughout OCC.
- Reviewed all General Ledger entries and documentation to ensure full compliance with applicable accounting standards, and issued new policies and procedures governing General Ledger entries.
- Revamped airline billing and accounting procedures to ensure prompt reconciliation and bring contrac-

tor air travel into compliance with recent changes in federal policy.

- Made process and staffing changes, including implementation of a PC-based system, to ensure timely processing of receivables and more effective tracking and management reporting.
- Completed an interim restructuring of the OCC's financial management function to enhance management accountability and internal controls.

Finally, with assistance from its internal control consultant, the OCC has nearly completed the detailed analysis necessary to select and install a new, integrated financial management system.

In addition to these reforms to its overall internal controls processes and management structure, the OCC is acting to correct the specific material weaknesses reported in the Independent Auditors Reports on Internal Control over Financial Reporting and Compliance with Laws and Regulations. More specifically, by the end of 1999, the OCC will have taken the corrective actions necessary to ensure:

- Timely reconciliation of fund balance with Treasury account with U.S. Treasury records.
- Effective performance of account analyses and other significant accounting tasks, with appropriate supervisory reviews.
- Effective review and evaluation of the accounting treatment for unusual or nonroutine financial events.

In addition to these three areas, the OCC is giving prompt attention to all other findings and recommendations by our internal control consultants and independent auditors. All recommendations will be implemented during the current fiscal year, except that pertaining to the replacement of the OCC's automated financial management system. A detailed plan and schedule for modernization of the OCC's financial systems will be published in the first quarter of 2000.

Last year, the OCC reported the potential for a materially negative finding in regard to the OCC's procurement practices. Since then a professional services firm and the Treasury Department's procurement office conducted reviews. The most significant compliance issue found was related to the OCC's process for obtaining printing, and that process is now compliant.

During 1998, the GAO issued numerous reports on the OCC, including reports on the OCC's closure of a particular national bank, the OCC's efforts to comply with the requirements of the Government Performance and Results Act, and the OCC's activities to ensure that the financial services industry is prepared for the year-2000 date change. Action is being taken on the GAO's suggestions and recommendations. Similarly, the Department of the Treasury Office of Inspector General's (OIG) suggestions to the OCC on year-2000 efforts are being addressed. In addition, the OIG made recommendations designed to improve the OCC's supervision of small banks for compliance with the provisions of the Community Reinvestment Act. None of the OIG's findings, suggestions, or recommendations represent material weaknesses in OCC's internal controls.

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Washington, D.C. 20036

Independent Auditors' Report on Financial Statements

The Comptroller of the Currency:

We have audited the accompanying statement of financial position of the Office of the Comptroller of the Currency (OCC) as of December 31, 1998 and the related statements of operations and changes in net position and cash flow for the year then ended. These financial statements are the responsibility of the management of the OCC. Our responsibility is to express an opinion on these financial statements based on our audit. The accompanying financial statements as of and for the year ended December 31, 1997, were audited by other auditors whose report thereon dated April 3, 1998, expressed an unqualified opinion on those financial statements, before the restatement described in note 7 to the accompanying financial statements.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 1998 financial statements referred to above present fairly, in all material respects, the financial position of the Office of the Comptroller of the Currency as of December 31, 1998, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued reports dated May 7, 1999 on our consideration of the Office of the Comptroller of the Currency's internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations.

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Our audit was conducted for the purpose of forming an opinion on the 1998 financial statements of the OCC taken as a whole. The information in the *Overview* is not a required part of the financial statements but is presented for purposes of additional analysis. We have considered whether this information is materially inconsistent with the 1998 financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the 1998 financial statements, and accordingly, we express no opinion on it.

KPMG LLP

May 7, 1999

2001 M Street, N.W.
Washington, D.C. 20036

Independent Auditors' Report on Internal Control over Financial Reporting

The Comptroller of the Currency:

We have audited the financial statements of the Office of the Comptroller of the Currency (OCC) as of and for the year ended December 31, 1998, and have issued our report thereon dated May 7, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The management of the OCC is responsible for establishing and maintaining internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

- Transactions are executed in accordance with laws and regulations that could have a direct and material effect on the financial statements, and certain other laws, regulations, and government-wide policies identified by the OMB as applicable to the OCC;

- Assets are safeguarded against loss from unauthorized acquisition, use or disposition; and

- Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in internal controls, fraud may nevertheless occur and not be detected. Also, projection of any evaluation of internal controls to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit, we considered the OCC's internal control over financial reporting by obtaining an understanding of the OCC's significant internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not

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to provide assurance on the internal control over financial reporting. Consequently, we do not provide an opinion on internal controls.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be reportable conditions under standards issued by the American Institute of Certified Public Accountants and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the OCC's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

An audit of financial statements conducted in accordance with generally accepted auditing standards and *Government Auditing Standards* is not designed to detect whether OCC's financial management systems are Year 2000 compliant. Further, we have no responsibility with regard to the OCC's efforts to make its systems, or any other systems, such as those of the OCC's vendors, service providers, or any other third parties Year 2000 compliant, or provide assurance on whether the OCC has addressed or will be able to address all of the affected systems on a timely basis. These are responsibilities of the OCC's management.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters, discussed in Exhibit 1, involving the internal control over financial reporting and its operation that we consider to be reportable conditions. We believe the matters identified as items 1, 2, and 3 are material weaknesses.

We also noted other matters involving internal controls and their operation that we have reported to the management of the OCC in a separate letter dated May 7, 1999.

This report is intended solely for the information and use of the Comptroller of the Currency, the Executive Committee and management of the OCC, the U.S. Department of the Treasury Office of the Inspector General, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

May 7, 1999

Exhibit 1 – Reportable Conditions

Material Weaknesses

1. ***Timely reconciliation of Fund balance with Treasury account with U.S. Treasury records was not performed.***

Finding
Fund Balance with Treasury is the aggregate amount of funds in the Office of the Comptroller of the Currency's (OCC's) accounts with Treasury from which it is authorized to make expenditures and pay liabilities. The controls over capturing and reconciling the appropriate information for inclusion in the financial statements are essential to ensure that the related balances are complete and accurate.

The OCC is not performing Fund Balance with Treasury reconciliation procedures in an effective or timely manner, as evidenced by the fact that reconciliations for the months of August 1998 through December 1998 were not completed until March and April 1999. As a result, differences between records of the two agencies were not resolved timely. For example, unreconciled differences in excess of $100,000 originating in March 1998 were not resolved until the December 1998 reconciliation was completed in April 1999. Further, although TFS-6652 Statement of Differences reports from Treasury had been received for five of the six months between June and November 1998, correcting SF-224 Statement of Transaction reports were not submitted until March 1999.

Not reconciling and documenting the reconciliation of Fund Balance with Treasury could result in material misstatements in the financial statements and increases the risk that data in the general ledger is inaccurate or incomplete. In addition, the absence of such procedures increases the risk that a misappropriation of cash could remain undetected and hinders effective cash management. An effective monthly reconciliation would identify and resolve all differences between the OCC's Fund Balance and the balance per Treasury.

Recommendation
The OCC should reemphasize the importance of timely reconciliation procedures to those responsible for their performance and enforce reasonable deadlines for their completion after each month end. The task of performing the reconciliations (including identification of reconciling differences and research and resolution of those differences) should be assigned to an individual with appropriate training, skills, and resources. Correction and resolution of reconciling items should be reviewed by appropriate supervisory personnel and documented.

Management's Response
Management concurs with the finding and recommendation. The fund balance with

Treasury reconciliation was delayed due to the Treasury fiscal-year audit and accounts payable/receivable issues. The cash reconciliation was completed and reconciling items researched and posted to the December statements. OCC has initiated an interim organizational structure that will address the timely reconciliation issue. By the end of 1999, OCC will finalize an organizational structure for Financial Services that will assure all necessary internal controls. The task has been assigned to an employee in General Accounting whose responsibilities are appropriately segregated from other accounting functions related to the cash reconciliation. The cash reconciliation will be reviewed and approved by the Acting Associate Director, General Accounting. The newly revised cash reconciliation process will highlight reconciling items and they will be cleared through the Treasury reporting process timely.

The differences on the TFS-6652 were adjusted in March 1999. A delay in the reporting was due to not having corresponding documentation from outside sources and the delay in cash reconciliation. All items were reported and cleared by the March Treasury submission.

Reconciling differences will be resolved within two months after the end of the reconciled period. (March 1999 differences will be reconciled by June 30, 1999). Cash has been reconciled for January through March 1999. Documentation files are being assembled and will be reviewed and approved by the Acting Associate Director, General Accounting by May 28.

2. Account analyses and other significant accounting tasks were not performed and/or were not subject to adequate supervisory review

Finding

A key control in detecting and correcting accounting errors and preventing misstatements of the financial statements is the performance of periodic, effective account analyses, reconciliation of subsidiary ledgers to general ledger control accounts, and supervisory review and approval of these accounting tasks and related general ledger journal entries.

Several account balances were not accurately stated in the accounting records, prior to audit adjustment, because the OCC accounting staff did not routinely perform these accounting tasks during fiscal year 1998. Further, effective supervisory review and approval of necessary accounting procedures was not always performed and documented. These weaknesses are evidenced by the following:

1. The accrual balance for employee relocation expenses was overstated by more than $1 million because individual accruals were not compared to supporting documentation on a timely basis to identify completed and/or canceled moves and to remove these items from the account. Responsibility for reviewing and ensuring that these accruals were accurately recorded was not clearly assigned.

2. A significant quantity of vouchers were not forwarded to Contracting Officer Technical Representatives (COTRs) by an accounts payable technician for formal approval to post the vouchers to the CAP accounts payable and general ledger systems. As a result, $771,000 in liabilities for unpaid goods and services received and accepted prior to year-end were not accrued.

3. Financial Services personnel coded approximately $406,000 of invoices accrued at year-end to incorrect expense accounts because an independent review was not performed to detect and correct the errors. Although overall expenses were not overstated, the individual expense categories were incorrect, rendering cost-related reports less useful to management.

4. The "Invoice Aging Report" at December 31, 1998, indicated $755,000 of invoices were included in "error status". Invoices in "error status" lack necessary information required to be posted into the CAP payables and general ledger systems. The status of these items was not resolved on a timely basis, leaving the OCC vulnerable to misstatement of the accounting records and related financial statements, as well as to liability for prompt payment penalties when valid invoices are eventually identified and processed for payment.

5. Established policies and procedures for account receivable write-offs as documented in the OCC AP-93-01, "Accounting Policy Write-offs of Accounts Receivable" were not followed during fiscal year 1998. Likewise, delinquency notifications were not mailed to customers because a detailed, timely review and reconciliation of accounts receivable records to supporting documentation to identify delinquencies was not performed.

6. A reconciliation of monthly general ledger postings of payroll and benefits expenses to the payroll data received from the National Finance Center is not performed on a timely basis. The December 1998 reconciliation was not completed until late March 1999. Without timely monthly reconciliation of payroll postings to supporting records, the OCC risks failing to detect and correct payroll errors and related variances from budget.

7. Federal and state withholding tax liability accounts for employee relocation payroll expenses were not reconciled to supporting documentation. Prior to adjustment, each of these accounts carried unusual debit balances as of December 31, 1998. Failure to properly account for tax liability accounts increases the risks of failure to detect and correct errors and of noncompliance with tax laws. Upon becoming aware of the situation, management level personnel had to take several days away from their normal tasks to analyze, review and correct the transaction postings (some dating back more than two years) in order to properly adjust the balances.

8. The accrual for the overnight travel allowance program was understated by $114,000 because newly established guidelines for payment of the travel allowance were not taken into consideration. Management review of the accrual for this program was not effective in detecting the computational error.

9. A reconciliation of the OCC records of advances to the Treasury Working Capital Fund (WCF) to the WCF statement received from Treasury is not performed on a timely basis because responsibility for its performance was not specifically assigned and due dates for completing the task had not been set. As of December 31, 1998, an unreconciled difference of $77,824 existed. Lack of timely review of this account balance increases the risk that errors could go undetected resulting in incorrect payments and reporting.

10. The semi-annual reconciliation of assessment receipts to the general ledger for the June 30, 1998 call period and supervisory review for the December 31, 1997 call period was not performed on a timely basis because the responsibility for supervisory review was not reassigned once the former supervisor left the OCC. Without timely supervisory review of the semi-annual reconciliation of assessments, management cannot be assured that assets are properly safeguarded and errors and omissions are prevented or detected on a timely basis. Without prompt reassignment of a departing employee's duties, the risk of non-performance of important accounting tasks and a

build up of backlogged work could disrupt the effective and efficient operation of the OCC.

Material adjustments to the OCC accounting records and financial statements were required to correct the effect of the foregoing material weaknesses.

Recommendation 1
A Reconciliation of relocation accruals to supporting documentation should be performed in a consistent and timely manner. Accruals for canceled moves should be reversed and accruals for stale dated accruals should be reviewed monthly to determine whether the moves are still in progress or should be cancelled and closed in the system.

Management's Response
Management concurs with the finding and recommendation. A correction to the accrual was made as of December 31, 1998 to eliminate the accrual for moves initiated prior to 1997. A separate accrual is maintained for the mortgage related expenses still remaining from moves prior to 1997.

Going forward, open relocations will be closed when it is not likely that future payments will be made. This will be accomplished by closing moves that are two years old on June 30 and December 31 each year. Therefore, as of June 30, 1999 only moves with effective dates after July 1, 1997 will be included in the accrual.

Effective with April 1999 transactions, an employee in General Accounting has been assigned responsibility for performing account analysis on all expense and liability accounts related to relocation. This includes the monthly and year-end accruals and the tax liability accounts.

Recommendation 2
A Supervisor should review the open records in the CAP payables system to determine whether vouchers have been processed and posted timely. Management should reassign key financial tasks when employee performance problems are noted and key functions must be completed.

Recommendation 3
The importance of proper account coding of expenses should be reemphasized to all applicable personnel. Accruals should be spot checked for accuracy and all large amounts should be subjected to supervisory review.

Recommendation 4
A monthly review of accounts payable invoices in "error status" should be performed in order to ensure appropriate documentation is obtained and the invoices are cleared from "error status" on a timely basis.

Management's Response to Recommendations 2, 3, 4
Management concurs with the finding and recommendations. Financial Services has revamped its Accounts Payable process. This includes setting up an invoice control desk. This process will ensure effective internal controls are maintained over invoices so OCC does not make erroneous or late payments. It will also ensure accounting records are accurate and balances are correct. Classification also will be completed by the Accounts Payable staff.

Effective with April 1999 transactions, each expense account is being assigned to an employee of General Accounting for monthly and year-end account analysis. At year-end those employees will review subsequent transactions in the following year, pull documentation and determine whether an expense should have been accrued in the previous year.

A reporting tool has been developed to assist in the account analysis which provides a listing of all expenses in dollar amount sequence by budget code. This will assist General Accounting employees in identifying significant transactions and in ensuring that they are properly classified.

The Acting Associate Director for Accounts Payables and Receivables will conduct a weekly review of invoices in error status and will follow through to ensure timely processing for the following week's report.

Recommendation 5
Established policies and procedures related to accounts receivable write-offs and debt collection should be reviewed and implemented. The level of effort to be given to the collection of delinquent accounts receivable should be evaluated and proper write-off of accounts that are no longer deemed collectible should be made. Further, an allowance for uncollectible amounts for accounts receivable that are no longer current should be recorded, and a consistent procedure for the mailing of delinquent account notifications should be established.

Management's Response
Management concurs with the finding and recommendation. Financial Services is in the process of implementing the final version of FPP-2003, which addresses accounting policy regarding write-offs of accounts receivable. Accounts receivable processes will be reviewed to ensure the timely reconciliation of the accounts receivable accounts. Financial Services (FS) is presently taking steps to ensure adherence to the Debt Collection Act of 1996. Collection letters are being rewritten and accounts are being reviewed to bring FS into compliance with the act. Delinquency letters have been sent and the entries aged within compliance of the Debt Collection Act. An adjustment to the allowance for doubtful accounts was completed in the 1998 financial statements to address the near term write-off issue. Going forward, Financial Services will closely monitor the accounts receivable accounts and adhere to the recently completed and implemented write-off

policy.

Recommendation 6
Management should make a priority of documenting procedures and assigning payroll tasks to individuals with appropriate training and functional skills, so that a match of the clearly defined tasks with appropriate supervisory review can bring improved accountability to the payroll accounting process.

Management's Response
Management concurs with the finding and recommendation. By June 30, 1999, the Acting Associate Director, General Accounting will ensure that easily understood desk procedures for the payroll accounting process are developed and will ensure that the procedures are properly performed by the employee in General Accounting responsible for payroll accounts.

Recommendation 7
Responsibility for accounting for federal and state withholding tax liabilities for employee relocation payroll expense accounts should be clearly assigned, procedures to be performed should be documented along with appropriate supervisory review of their performance, and reasonable deadlines for completion of the procedures should be established and enforced.

Management's Response
Management concurs with the finding and recommendation. A senior accountant in the Employee area has been assigned to review and sign off on all tax related transactions. An employee in General Accounting has been assigned responsibility for performing account analysis for all relocation accounts, including tax liability accounts each month. As part of that account analysis, balances in the tax liability accounts will be reconciled with balances maintained in the Employee area. The relocation reconciliation will be documented and approved by the manager of the Employee area and the Acting Associate Director, General Accounting each month.

By June 30, 1999 procedures for reconciliation of the accounts will be documented to outline the steps to be performed. The procedures will be developed jointly by the senior accountant assigned to relocation in the Employee area and by the employee in General Accounting assigned for relocation account analysis.

In addition, effective with the April 1999 transactions, the documentation supporting each journal entry posted to the general ledger is being reviewed either by a senior systems accountant in General Accounting or by the Acting Associate Director, General Accounting.

Recommendation 8
Formal procedures for a documented supervisory review of all significant journal entries should be implemented.

Management's Response
Management concurs with the finding and recommendation. Effective with April 1999 transactions, the documentation supporting each journal entry posted to the general ledger is being reviewed either by a senior systems accountant in General Accounting or by the Acting Associate Director, General Accounting.

Recommendation 9
A timely reconciliation of the advances to working capital fund account balance to Treasury reports and to supporting documents should be consistently performed.

Management's Response
Management concurs with the finding and recommendation. The general ledger account was adjusted as of December 31, 1998 to reflect the Treasury balance. Effective with April 1999 transactions, a General Accounting employee has been assigned account 1530 who will be responsible for assuring that the account is reconciled monthly and at year-end. In addition, that employee will assure that the general ledger balance is fully supported by documentation identifying advances to the Working Capital Fund and documentation for all charges against the Working Capital Fund. Reconciliation documentation will be maintained to support monthly and year-end entries to the 1530 account. In addition, the documentation supporting each journal entry posted to the general ledger is being reviewed either by a senior systems accountant in General Accounting or by the Acting Associate Director, General Accounting.

Recommendation 10
A reconciliation of the semi-annual assessments revenue detail to the general ledger accounts should be performed and supervisory review of the reconciliation should be documented in a timely manner. Prompt reassignment of significant accounting tasks should be made when an employee departs.

Management's Response
Management concurs with the finding and recommendation. The manager for Banks will establish procedures by June 30, 1999 to address the timeframe and the proper supervisory review. Financial Services has completed an interim organizational restructuring to address the duties vacated by departing employees in the accounts receivable area and establish clear responsibility for supervisory review. The semi-annual reconciliation is being approved by the acting manager for the Bank area.

3. *An adequate process was not in place for review and evaluation of the accounting treatment for unusual or nonroutine financial events*

Finding

The appropriate treatment of unusual or nonroutine accounting transactions may require reference to accounting literature and/or consultation with accounting and auditing specialists, to ensure financial records are accurately maintained. The OCC did not have an adequate process in place to identify instances when additional assistance might be required to validate the proposed accounting treatment. As a result, improper accounting decisions were made and materially incorrect adjustments were posted to the accounting records in the following two instances:

- A liability in excess of $1 million was accrued in 1997 related to a transfer of Life Insurance Plan reserve funds between the former and current Life Insurance companies. This accrual was not appropriate because the OCC simply performed the transfer of funds between the insurance companies and did not incur an additional liability or expense as a result of the transfer.

- A liability and related expense in the amount of $2,262,500 was accrued as of December 31,1997, based on forecasted remodeling costs that the OCC planned to incur in making physical changes to district and field offices to accommodate a realigned work force. Since the accrual was not based on an event which had already taken place, it did not represent a valid accrued expense at fiscal year end.

Recommendation
Unusual and/or nonroutine financial transactions and significant journal entries should be subject to close scrutiny by management for propriety of accounting treatment. If deemed necessary, appropriate consultation with accounting and auditing specialists such as independent public accountants or the Treasury Office of Inspector General should be considered.

Management Response
Management concurs with the finding and recommendation. The 1997 accruals were reversed and we have restated the 1997 financial statements. Effective with the April 1999 transactions, the documentation supporting each journal entry posted to the general ledger is being reviewed either by a senior systems accountant in General Accounting or by the Acting Associate Director, General Accounting. Unusual financial transactions and significant journal entries will be given close scrutiny by Financial Services management prior to posting to the general ledger.

Reportable Conditions (Not considered material weaknesses)

4. Policies and procedures are not adequately documented

Finding

The Comptroller's Office lacks adequate written procedures for many of its accounting and financial processes. In many areas, the unwritten institutional knowledge of employees is relied upon to ensure that transactions are accounted for and reported properly in the financial statements. However, in some cases, the persons with full knowledge of certain processes have been reassigned to other areas or have left the Comptroller's Office. The absence of sufficiently written procedures and guidelines increases the risks of inconsistent or inaccurate implementation of accounting and financial processes by employees. Without well documented procedures it is difficult for management to succeed at achieving an appropriate match of individuals to clearly defined tasks, training, functional skills, and supervisory review to bring improved accountability to the financial processes.

The following are examples of areas that lack adequately documented policies and procedures:

1. *Cash receipts and accounts receivable*. Written procedures for handling of receipts from bank assessments, as well as recording of accounts receivable for other goods and services, including receivables from employees, are not in place. A draft memo on the debt collection process was prepared in 1997, but the memo has not been finalized.

2. *Payroll and benefits accounting process*. Undocumented payroll processing functions include: reconciliation of general ledger postings of salary and benefits expenses to National Finance Center payroll data, calculation of payroll and benefits accruals, accounting for life insurance plan benefits, and reconciliation and posting procedures for accruals and payments of federal, state, and FICA withholdings for employee relocation salary gross-ups.

3. *Accounting for bulk purchases of property and equipment*. Procedural guidance for the identification, processing, and recording of quantity purchases of items that, in aggregate, represent items that must be capitalized under the Comptroller's Office bulk purchase capitalization policy, is not available for employee reference. Without such procedures, assets may be expensed rather than capitalized because individual items with costs below the capitalization threshold can be difficult to recognize as part of a bulk purchase.

4. *Accounts Payable and Disbursement process.* Adequately documented procedures for the accounts payable and disbursements processes, including processing of accounts payable at headquarters and the field offices and disbursements made by Treasury checks, OPAC, and checks drawn on bank accounts are not in place.

Recommendation 1
OCC should develop thoroughly written and easily understood desk procedures for the receivables and receipts processes.

Management Response
Management concurs with the finding and recommendation. The manager for Banks will establish procedures by June 30, 1999 to address the timeframe and the proper supervisory review. Financial Services is in the process of implementing the final version of FPP-2003, which addresses accounting policy regarding write-offs of accounts receivable.

Recommendation 2
OCC should develop thoroughly written and easily understood desk procedures for the Payroll accounting process.

Management Response
Management concurs with the finding and recommendation. By June 30, 1999, the Acting Associate Director, General Accounting will ensure that easily understood desk procedures for the payroll accounting process are developed and will ensure that the procedures are properly performed by the employee in General Accounting responsible for payroll accounts.

Recommendation 3
OCC should prepare adequate documentation for the policies and procedures regarding bulk purchases and make them readily available to pertinent employees including personnel likely to request such purchases, the procurement offices, and financial services personnel.

Management Response
Management concurs with the finding and recommendation. Financial Services is revising FPP-9001, *Capitalization*. This FPP addresses bulk purchases and the FPP will be provided to all units that procure capital items. It will be also provided to Acquisitions. Staff from both the budget and accounting areas will be instructed in its application. In addition, the Accounts Payable staff will classify payments. This will ensure items are properly classified prior to entry into the system.

Recommendation 4
OCC should document its procedures for the accounts payable and disbursements process. The procedures should be evaluated periodically by management for efficiency and effectiveness.

Management Response
Management concurs with the finding and recommendation. OCC now has a new manual which documents the basic accounts payable process. The new manual describes the recently revised accounts payable procedures in great detail and documents the new control desk database and reports. The author of the manual will now begin incorporating changes necessary to address issues for General Accounting, such as the proper use of accounting codes and description fields, identification of items to be capitalized, etc. General Accounting staff will be assigned additional chapters to cover expense and liabilities areas that relate strictly to accounting. The finished product will be completed in final format by September 30, 1999.

These procedures will be reviewed as part of quality assurance reviews of the payables/disbursement function to assure their continued efficiency and effectiveness as well as compliance with the procedures in accounts payable/disbursement processing.

5. ***Adequate controls and procedures for payment of Prompt Payment Act penalties are not in place***

Finding
The Prompt Payment Act requires Federal agencies to pay monthly compounded interest on applicable invoices that are greater than 30 days overdue. The Comptroller's Office lacks adequate controls and procedures for the proper payment of such penalties when required. At present, only simple interest is paid on invoices paid late because the automated *Prompt Payment Detail Report* and *Prompt Payment and Interest Calculation Form* reports were not programmed to calculate penalty payments on a monthly (30-day) compounding basis.

Further, as a result of inadequate supervisory review, prompt payment penalties were inaccurately computed or not paid at all, as evidenced by the following:

- No interest was paid on two invoices paid late. For one of these items, a negative penalty payment was erroneously calculated on the automated *Prompt Payment and Interest Calculation Form*. The error was not detected and corrected by accounts payable staff or supervisors. OCC personnel stated that the automated calculation problem was resolved in early fiscal year 1999.
- A penalty amount below the correct penalty amount was computed on one invoice because the invoice dates entered into the *Prompt Payment and Interest Calculation Form* were incorrect.

Recommendation
OCC should comply with the monthly (30 day) compounding of penalty payments required in Prompt Payment Circular A-125. OCC should implement a process of supervisory review to ensure that prompt payment penalties are accurately computed and properly paid.

Management's Response
Management concurs with the finding and recommendation. New accounts payable (AP) personnel received training on the Prompt Payment Act and its requirements in May 1999. Employees responsible for the calculation of the interest penalty will be trained in the process and underlying principles of this calculation. Effective in May 1999, we have implemented procedures for documenting when an interest calculation is not required, so that the reason for missing interest is clear.

Interest penalties will be calculated by the AP contractors. Calculations will be reviewed by the AP control desk staff. Any interest penalties calculated by the control desk staff will be reviewed by a different control desk employee.

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Washington, D.C. 20036

Independent Auditors' Report on Compliance with Laws and Regulations

The Comptroller of the Currency:

We have audited the financial statements of the Office of the Comptroller of the Currency (OCC) as of and for the year ended December 31, 1998, and have issued our report thereon dated May 7, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The management of the OCC is responsible for complying with applicable laws and regulations. As part of obtaining reasonable assurance about whether the OCC's financial statements are free of material misstatement, we performed tests of the OCC's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit, and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed instances of material noncompliance with laws and regulations. These instances, which are required to be reported under *Government Auditing Standards,* are as follows:

- Reportable condition numbers one, two, and three in our Report on Internal Control over Financial Reporting are material weaknesses in internal controls. These material weaknesses are instances of material nonconformance under Office of Management and Budget Circular No. A-127, *Financial Management Systems*, section 7J, *Internal Controls,* and the Federal Managers' Financial Integrity Act (FMFIA). OCC did not identify and report these instances of material nonconformance in its fiscal year ending September 30, 1998 FMFIA report.

We also noted the following instance of reportable noncompliance with laws and regulations that does not represent an instance of material noncompliance:

- Reportable condition number five in our Report on Internal Control over Financial Reporting describes OCC's noncompliance with certain provisions of the Prompt Payment Act.

KPMG LLP KPMG LLP, a U.S. limited liability partnership, is a member of KPMG International, a Swiss association.

This report is intended solely for the information and use of the Comptroller of the Currency, the Executive Committee and management of the OCC, the U.S. Department of the Treasury Office of the Inspector General, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

May 7, 1999

Office of the Comptroller of the Currency
Statements of financial position

	Years ended December 31, 1998	1997 (Restated)
Assets		
Fund balance with Treasury and cash:		
Fund balance with Treasury	$7,443,320	$7,997,719
Cash	121,793	74,442
Subtotal, fund balance with Treasury and cash	7,565,113	8,072,161
Receivables:		
Accrued interest	330,362	435,177
Accounts receivable (net)	409,451	1,995,342
Travel advances	34,548	12,836
Subtotal, receivables	774,361	2,443,355
Prepayments	2,956,946	2,374,449
Investments (Note 3)	211,915,574	192,665,669
Property, plant, and equipment (Note 4)	94,646,204	96,058,914
Total assets	$ 17,858,198	$ 301,614,548
Liabilities and net position		
Accrued expenses	$15,905,172	$16,383,663
Accounts payable	7,548,146	3,499,426
Accrued payroll and benefits	16,995,284	12,251,064
Accrued annual leave	18,144,190	16,631,920
Post-retirement benefit liability (Note 6)	5,796,858	5,135,948
Capital lease liabilities (Note 5)	99,662,885	101,298,238
Total liabilities	164,052,535	155,200,259
Net position	153,805,663	146,414,289
Total liabilities and net position	$ 317,858,198	$301,614,548

The accompanying notes are an integral part of these statements.

Office of the Comptroller of the Currency
Statements of operations and changes in net position

	Years ended December 31, 1998	1997 (Restated)
Revenue from goods sold/services provided		
Semiannual assessments	$ 368,387,870	$ 350,687,810
Corporate fees	2,941,258	3,280,167
Investment income	14,316,836	12,711,392
Examination fees	0	2,720,886
Other	1,051,461	5,151,881
Total revenues and financing sources	386,697,425	374,552,136
Operating expenses		
Personnel compensation and benefits (Note 6)	248,652,326	227,664,526
Travel	27,925,624	23,005,636
Employee relocation expenses	4,820,220	6,759,366
Education and conferences	5,297,867	4,306,188
Rent and communications (Note 5)	19,672,637	18,413,267
Office equipment and software (Note 4)	18,948,655	10,850,200
Contractual services	24,535,317	11,790,572
Interest on capital lease (Note 5)	10,328,109	10,485,324
Depreciation and amortization (Note 4)	6,428,516	6,398,374
Repairs, maintenance, and utilities	5,003,732	3,786,838
Office supplies	4,613,622	3,312,350
Postage and freight	1,632,951	1,784,991
Printing, reproduction, and other	1,446,475	1,403,624
Total expenses	379,306,051	329,961,256
Excess of revenue over operating expenses	7,391,374	44,590,880
Net Position, Beginning Balance		
As previously reported	139,842,996	100,123,409
Prior period adjustments (Note 7)	6,571,293	1,700,000
As adjusted	146,414,289	101,823,409
Net Position, Ending Balance	$ 153,805,663	$ 146,414,289

The accompanying notes are an integral part of these statements.

Office of the Comptroller of the Currency
Statements of cash flow

	Years ended December 31, 1998	1997 (Restated)
Cash flows from operating activities		
Excess of revenue over operating expenses	$7,391,374	$44,590,880
Adjustments affecting cash flow		
Decrease (increase) in receivables	1,668,994	1,504,903
Decrease (increase) in prepayments	(582,497)	(301,065)
(Decrease) increase in accrued expenses	(478,491)	(3,754,905)
(Decrease) increase in accounts payable	4,048,720	1,051,664
(Decrease) increase in accrued payroll and benefits	4,744,220	(25,590,727)
(Decrease) increase in accrued annual leave	1,512,270	(1,451,568)
(Decrease) increase in post-retirement benefit liability	660,910	802,213
Depreciation and amortization	6,428,516	6,398,374
Net cash provided by operating activities	25,394,016	23,249,769
Cash flows from investing activities		
Proceeds from sales of investment securities	517,336,603	563,054,749
Purchases of investment securities	(536,586,508)	(592,190,150)
Purchases of property, plant, and equipment	(5,015,806)	(3,789,604)
Net cash provided (used) by investing activities	(24,265,711)	(32,925,005)
Cash flows from financing activities		
Principal payments on capital lease obligation	(1,635,353)	(1,443,075)
Net cash used by financing activities	(1,635,353)	(1,443,075)
Increase (decrease) in Fund Balances with Treasury and cash	(507,048)	(11,118,311)
Fund Balances with Treasury and cash, beginning	8,072,161	19,190,472
Fund Balances with Treasury and cash, ending	$ 7,565,113	$ 8,072,161

The accompanying notes are an integral part of these statements.

Notes to Financial Statements

Note 1—Organization

The Office of the Comptroller of the Currency (OCC) was created by an act of Congress for the purpose of establishing and regulating a national banking system. The National Currency Act of 1863, rewritten and reenacted as the National Bank Act of 1864, created the OCC and provided for its supervisory functions and the chartering of banks.

No funds derived from taxes or federal appropriations are allocated to or used by the OCC in any of its operations. The revenue of the OCC is derived principally from assessments and fees paid by the national banks and income on investments in U.S. government obligations. The OCC is exempt from federal and state income taxes.

The OCC is a bureau within the Department of the Treasury. The Department of the Treasury provides certain administrative services to the OCC, which pays the Department of the Treasury for services rendered pursuant to its interagency agreements. Periodically, payments are made in advance for anticipated services in accordance with instructions from the Department of the Treasury. Administrative services provided by the Department of the Treasury totaled $3,094,633 and $2,869,204 for the years ended December 31, 1998 and 1997, respectively.

Note 2—Significant Accounting Policies

Basis of Accounting

The accounting policies of the OCC conform to generally accepted accounting principles. Accordingly, the financial statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to cash receipt or payment.

Fund Balance with Treasury and Cash

Cash receipts and disbursements are processed primarily by the U.S. Treasury. The funds with the U.S. Treasury are primarily trust funds that are available to pay current liabilities and finance authorized purchase commitments. The OCC considers demand deposits and overnight certificate investments to be cash equivalents.

Receivables

Receivables represent monies owed to the OCC for services or goods provided and interest on U.S. Treasury investments. Accounts receivables are shown net of an allowance for doubtful accounts of $110,239 as of December 31, 1998. The OCC wrote off receivables totaling $21,633 as uncollectible during 1998.

Liabilities

Liabilities represent the amount of monies or other resources that are likely to be paid by the OCC as the result of a transaction or event that has already occurred. Liabilities represent the amounts owing or accruing under contractual or other arrangements governing the transactions, including operating expenses incurred but not yet paid. Payments are made promptly to take discounts offered by vendors when the discount terms are cost effective.

Annual, Sick, and Other Leave

Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. Sick leave and other types of leave are expended as taken.

Use of Estimates

The preparation of financial statements, in accordance with generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Reclassifications

Certain 1997 amounts have been reclassified to conform to the 1998 presentation.

Note 3—Investments

Investment securities reflect maturities through May 15, 2006 and are U.S. Treasury obligations stated at amortized cost, which is an approximation of fair value. The OCC plans to hold these investments to maturity. Premiums and discounts on investment securities are amortized over the term of the investment using the straight-line method, which approximates the effective yield method. The fair value of investment securities is estimated based on quoted market prices for those or similar investments. The cost and estimated fair value of investment securities as of December 31, 1998 and 1997 are as follows:

	1998	1997
Investments, amortized cost	$211,915,574	$192,665,669
Gross unrealized holding gains	3,161,778	1,868,501
Market value	$215,077,352	$194,534,170

Investments mature as follows:

During 1999	$192,000,000
During 2006	25,000,000

Note 4—Property and Equipment

Property and equipment, including assets under capital leases, are stated at cost. Depreciation and amortization are calculated on a straight-line basis over the estimated useful lives of the assets. Leasehold improvements are stated at cost less accumulated amortization computed over the terms of the related leases (including renewal options) or their estimated useful lives, whichever is shorter. Expenditures for furniture and fixtures, machines and equipment, portable computers, and motor vehicles costing less than $25,000, for computer software and leasehold improvements costing less than $50,000, and for all maintenance and repairs, are expensed as incurred.

Note 5—Leases

Office Space Leases

The OCC occupies office space in Washington, D.C., under a lease agreement with an initial lease period of 15 years. The lease provides for two consecutive five-year renewal options which will provide for occupancy through the year 2016. The lease qualifies as a capital lease.

The district and field offices lease space under agreements which expire at various dates through 2008. These leases are treated as operating leases.

Future lease payments under operating leases, as well as the capital lease for the Washington, D.C., office are shown in the following table:

Year	Washington, D.C., capital lease	District operating leases
1999	$ 12,006,958	$ 9,385,333
2000	12,049,208	8,150,332
2001	12,093,570	7,450,899
2002	12,140,150	5,441,468
2003	12,189,059	3,386,681
2004 & after	156,444,467	3,331,550
Total minimum lease payments	$216,923,411	$ 37,146,263
Less:		
Amount representing interest	(117,260,526)	
Present value of net minimum lease payments	$ 99,662,885	

Certain of these leases provide that annual rentals may be adjusted to provide for increases in taxes and other related expenses. Total rental expense under operating leases and taxes and other related expenses for all leases was $12,721,836 and $11,538,398 for the years ended December 31, 1998 and 1997, respectively.

Note 6—Retirement and Benefit Plans and Accrued Annual Leave

Retirement Plans

The OCC employees are eligible to participate in one of two retirement plans. Employees hired before January 1, 1984 are covered by the Civil Service Retirement System (CSRS) unless they elected to join the Federal Employees Retirement System (FERS) and Social Security during the

The following table summarizes property and equipment balances as of December 31, 1998 and December 31, 1997 (See Note 7 regarding prior period adjustments to Leasehold Improvements):

Classes of Assets	Service life (years)	Acquisition value	Accumulated depreciation/ amortization	1998 net book value	1997 net book value
Leasehold improvements	5–20	$ 28,050,609	$ 14,451,205	$ 13,599,404	$ 12,012,940
ADP software	5–10	2,021,763	1,995,326	26,437	44,086
Equipment	3–10	9,001,918	5,463,500	3,538,418	1,993,903
Building under capital lease	25	107,558,539	30,625,492	76,933,047	81,350,256
Furniture and fixtures	5–10	1,464,213	915,315	548,898	657,729
Totals		$148,097,042	$ 53,450,838	$ 94,646,204	$ 96,058,914

election period. Employees hired after December 31, 1983, are covered by FERS and Social Security. For employees covered by CSRS, the OCC contributes 8.51 percent of their gross pay to the plan. For employees covered by FERS, the OCC contributes 10.7 percent of their gross pay. The OCC contributions totaled $17,785,508 and $16,505,465 in 1998 and 1997, respectively.

Other Benefit Plans

Employees are allowed to participate in the Federal Thrift Savings Plan (TSP). For employees under FERS, the OCC contributes an automatic 1 percent of basic pay to TSP and matches employee contributions up to an additional 4 percent of pay, for a maximum OCC contribution amounting to 5 percent of pay. Employees under CSRS may participate in the TSP, but do not receive the OCC automatic (1 percent) and matching contributions. The OCC contributions for the savings plan totaled $4,147,661 and $3,957,365 in 1998 and 1997, respectively. The OCC also contributes for Social Security and Medicare benefits for all eligible employees.

Employees and retirees of the OCC are eligible to participate in the Federal Employees Health Benefits (FEHB) plans and Federal Employees Group Life Insurance (FEGLI) plan, which are cost sharing employee benefit plans administered by the Office of Personnel Management (OPM). The OCC contributions for active employees who participate in the FEHB plans were $7,547,410 and $7,233,138 for 1998 and 1997, respectively. The OCC contributions for active employees who participate in the FEGLI plan were $148,930 and $137,608 for 1998 and 1997, respectively.

The OCC sponsors a life insurance benefit plan for current and former employees who are not enrolled in FEGLI plans. This plan is a defined benefit plan, and the OCC is fully responsible for the associated liability. Premium payments made during 1998 totaled $115,962. The following table shows the unfunded accrued post-retirement benefit cost for this plan at December 31, 1998 and the post-retirement benefit expenses for 1998:

Accumulated post-retirement benefits obligation	$(7,289,441)
Fair value of assets	–
Funded status	$(7,289,441)
Unrecognized transition obligations	2,419,728
Unrecognized net gain (loss)	(927,145)
Accrued post-retirement benefit cost	$(5,796,858)

Net periodic post-retirement benefit cost for 1998	
Service cost	$ 265,134
Interest cost	467,585
Amortization of gain	(22,054)
Amortization of transition obligation over 20 years	172,837
Net periodic post-retirement benefit cost	$ 883,502

The weighted-average discount rate used in determining the accumulated post-retirement benefit obligation was 7.5 percent. Gains or losses due to changes in actuarial assumptions are fully recognized in the year in which they occur.

Contribution to Office of Personnel Management Retirement Fund

During 1998, the OCC recorded a liability of $2,445,815 to the Civil Service Retirement and Disability Fund which represents estimated retirement contributions for employees who accepted early retirement, resigned, or voluntarily retired during 1996 and 1997 after accepting buyout incentives offered by the OCC under 12 USC 481. This liability is included in accrued payroll and benefits in the accompanying statement of financial position. The liability and related expense was considered a contingency until 1998 when a final legal determination for the probability of its payment was made.

Workers' Compensation Liability

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease. Claims incurred for benefits for OCC employees under FECA are administered by the Department of Labor (DOL) and later billed to the OCC.

The OCC accrued $3,733,654 of workers' compensation costs as of December 31, 1998. This amount includes unpaid costs and an estimated unfunded liability for unbilled costs incurred as of year-end, as calculated by DOL.

Note 7—Prior Period Adjustments

The OCC's prior period adjustments consist of the following for the year ended December 31, 1998:

1. Correction of accrual for payroll benefits	$ 1,211,528
2. Correction of accrual for projected reorganization costs	1,462,500
3. Reclass 1997 remodeling expenses as leasehold improvements	1,507,265
4. Reclass 1996 remodeling expenses as leasehold improvements	1,700,000
5. Correction of accrued remodeling expenses in 1997	690,000
Total prior period adjustments	$ 6,571,293

1. The correction of accrual for payroll benefits was made to correct an error in the accounting for a transfer of funds that occurred when OCC switched life insurance administrators for the OCC life insurance benefit plan.

2. The correction of accrual for projected reorganization costs was made to correct an error in applying generally accepted accounting principles (GAAP). The correction reverses an accrual made in 1997 for expenses that had not actually been incurred as of December 31,1997.

3. The correction to reclass 1997 remodeling expenses as leasehold improvements was made to conform with GAAP by capitalizing leasehold improvements that had been expensed during 1997.

4. The correction to reclass 1996 remodeling expenses as leasehold improvements was made to conform with GAAP by capitalizing leasehold improvements that had been expensed during 1996.

5. The correction of accrued remodeling expenses in 1997 was made to reverse expenses that had not actually been incurred as of December 31, 1997.

In addition to the above prior period adjustments, OCC made a reclassification adjustment to reverse an error in recording $800,000 in leasehold improvements and an accrued liability in the same amount as of December 31, 1997. The $2,407,265 net effect of this adjustment and prior period adjustments numbers three and four above represents the amount of the increase in the restated net book value of leasehold improvements from the previously issued 1997 financial statements.

The personnel compensation and benefits expense and other revenue line items on the Statement of Operations and Changes in Net Position for the year ended December 31, 1997 were restated to reflect a decrease of $15,469,019 for each line item. This restatement was made to eliminate the effect of imputed financing revenue and expense which under GAAP should not be recorded on OCC's financial statements because they will be borne by the United States Office of Personnel Management.

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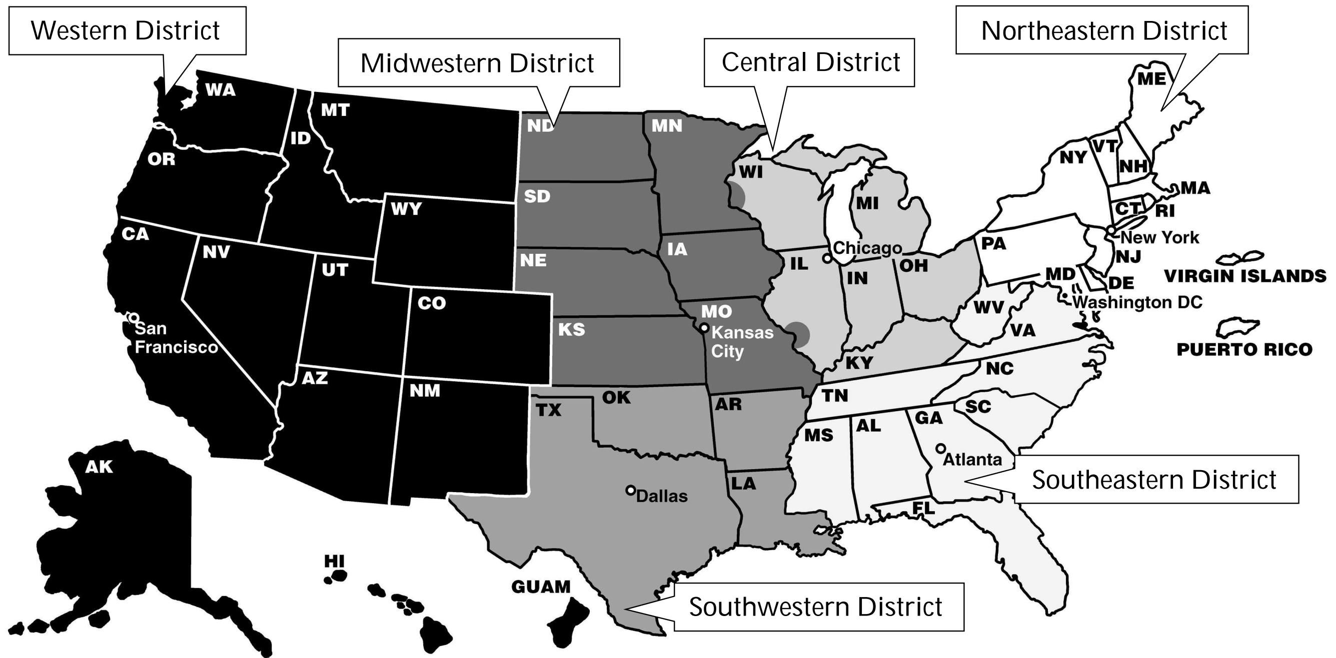

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