Comptroller of the Currency
Administrator of National Banks

Quarterly Journal

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John D. Hawke Jr.

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The Administrator of National Banks

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Background

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

The OCC regulates national banks by its power to:

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

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

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

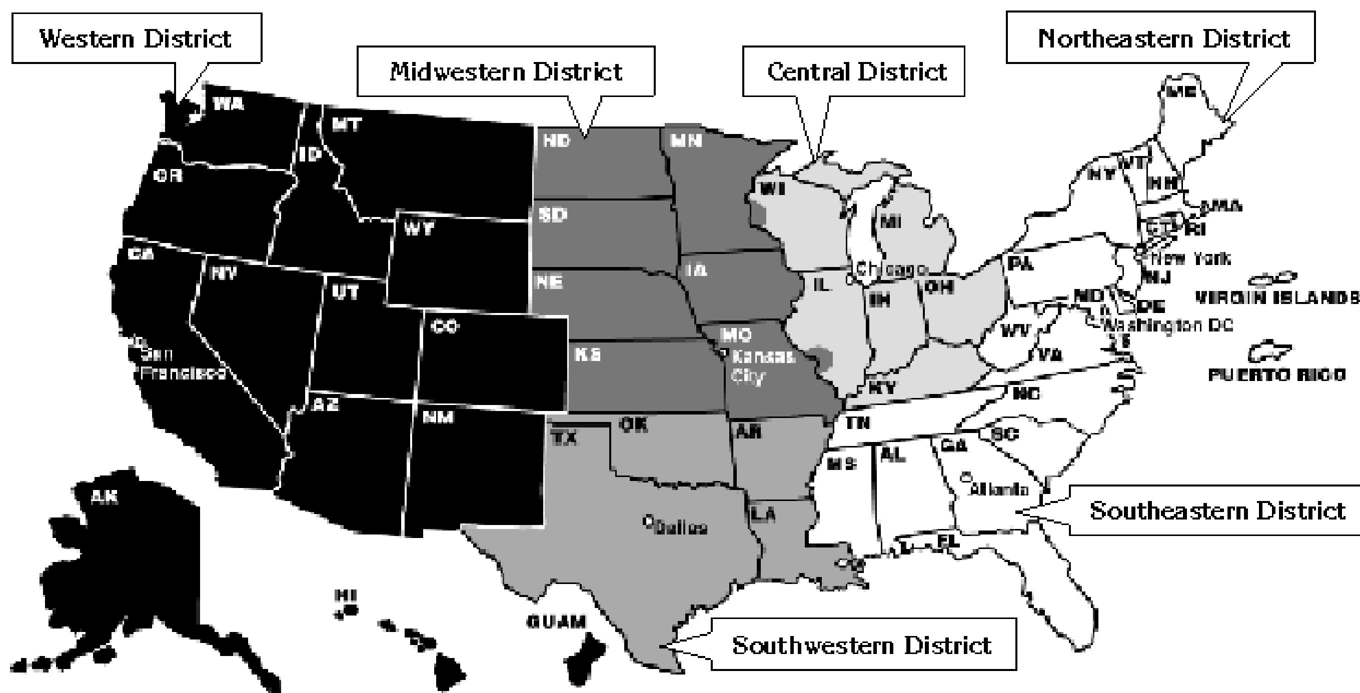
The Comptroller

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

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

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

The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and congressional testimony, material released in the interpretive letters series, statistical data, and other information of interest to the administration of national banks. 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.



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Condition and Performance of Commercial Banks

The banking industry remains highly profitable. A major contributor to the industry's profitability has been growth in noninterest income. Growing reliance on noninterest income as a percentage of operating revenue for banks means changes in the types of activities banks enter and may mean changes in the characteristics of the revenue stream which banks receive.

Summary of Condition and Performance

Banks continued to report strong profits in the first quarter 2000. Net income for commercial banks in the first quarter 2000 was $19.5 billion, a new record. Industry profitability measured by return on assets (ROA) and return on equity (ROE) increased from the first quarter a year ago, as shown in the top panel of Table 1. The percent of commercial banks with gains in earnings increased 16 percentage points from the first quarter 1999.

National banks also reported record profits in the first quarter, earning $11.5 billion. ROA and ROE both increased on a year-over-year basis and the percent of national banks with earnings gains also increased (Table 1, bottom panel.)

Table 1

All commercial banks		
	March 1999	*March 2000*
Net Income	$18.0 billion	$19.5 billion
ROA	1.32 %	1.35 %
ROE	15.4 %	16.1 %
Banks with earnings gains	52 %	68 %
National banks		
	March 1999	*March 2000*
Net Income	$10.5 billion	$11.5 billion
ROA	1.33 %	1.41 %
ROE	15.2 %	16.6 %
Banks with earnings gains	53 %	65 %

Large and small banks shared improved profitability. Reversing a recent trend of declining profitability, small commercial banks under $100 million reported their highest ROA in six quarters. The percent of small commercial banks with earnings gains increased dramatically to 66 percent from 46 percent in the March 1999 quarter.

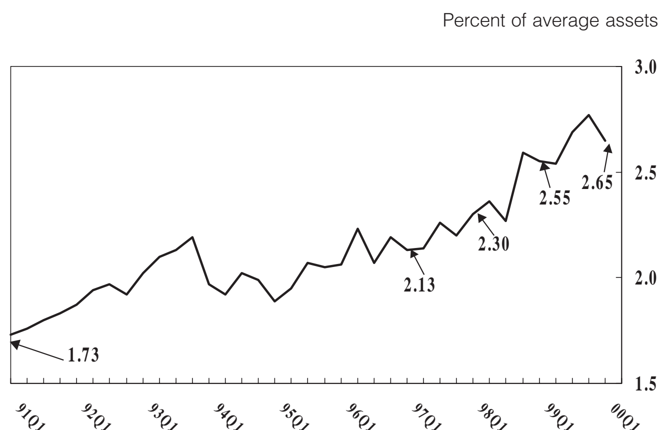
Assets of all commercial banks grew 8.0 percent from March 1999 while the number of banks fell by 204. Assets of national banks increased by 5.1 percent while the number of national banks declined by 107.

Key Trends

The industry's net income grew by 8.8 percent over net income in the first quarter 1999 as the result of strong noninterest income and flat expenses. Noninterest income grew by 10.6 percent—almost twice the growth rate of net interest income, 5.7 percent. On the expense side, loss provisions grew 6.7 percent and nonoperating expenses grew 4.6 percent.

Noninterest income. Noninterest income continued to be the primary source of revenue growth in commercial banks. As a percentage of average assets, noninterest income increased by 10 basis points compared to the first quarter 1999 and 35 basis points compared to the first quarter 1998 (Figure 1.) A more detailed discussion of sources of noninterest income growth is provided later in this report.

Figure 1—Noninterest income keeps growing (commercial banks)

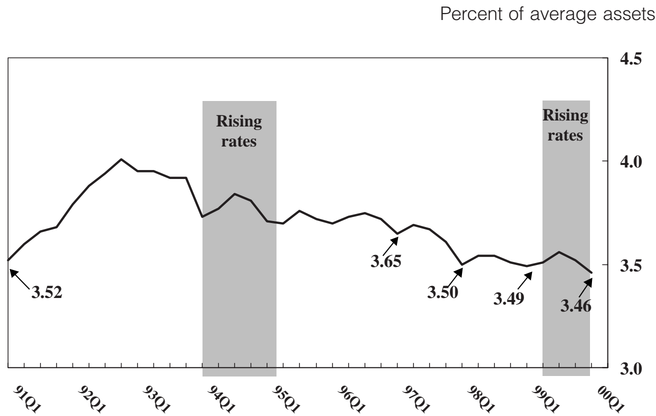


Source: Integrated Banking Information System

Net interest income. After stabilizing for several quarters, net interest margin (NIM) fell as a percentage of average assets in the first quarter to 3.46 percent, its lowest level in approximately 10 years. The compression of net interest margin (NIM) in commercial banks as shown in Figure 2 occurred during a period of rising interest rates, as the Federal Reserve Open Market Committee continued its efforts to moderate inflationary pressure spurred by strong U.S. economic growth and strong domestic demand.

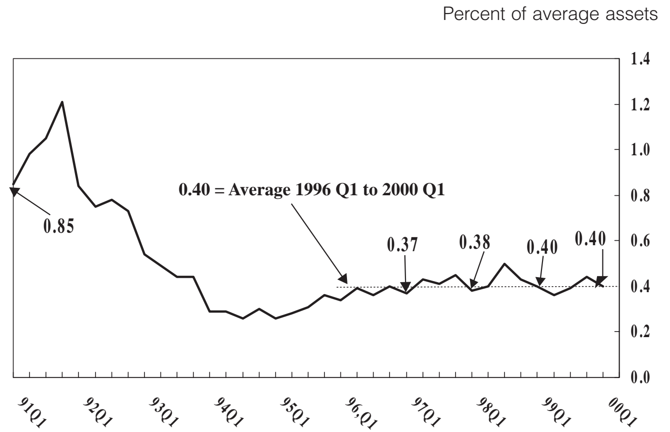
Security gains. Higher interest rates also resulted in losses (realized and unrealized) in securities held by commercial banks. Realized losses on sales of securities were $730 million compared to a $565 gain in the March 1999

Figure 2—Net interest margin falls (commercial banks)



Source: Integrated Banking Information System

Figure 3—Loss provisions stay level (commercial banks)



Source: Integrated Banking Information System

quarter. Banks also had a 2.47 percent depreciation in the value of security holdings in the first quarter. The depreciation in available-for-sale securities portfolios resulted in a 27 basis point reduction in the ratio of equity capital to average assets.

Equity capital. Despite the first quarter depreciation in available-for-sale securities, equity capital as a percentage of average assets grew by four basis points from December 1999. While remaining high by historical standards, the ratio of equity capital to average assets had fallen 31 basis points between March and December 1999 because of higher dividends and depreciation in available-for-sale securities portfolios.

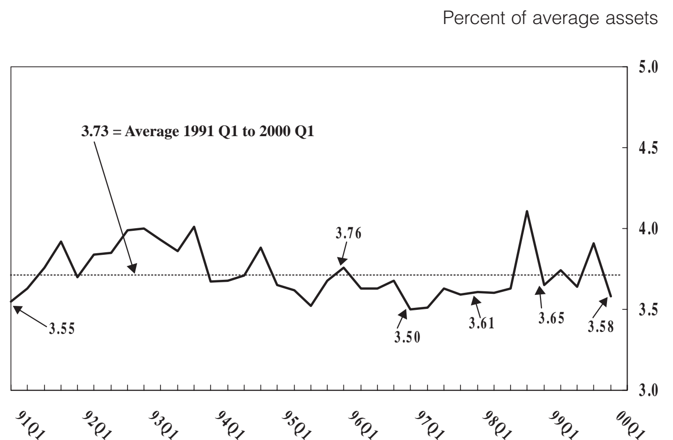
Provisioning and asset quality. High and stable asset quality has been an important element in maintaining high commercial bank profitability. Loss provisions in commercial banks as a percentage of average assets have remained low and stable for a relatively long period, as shown in Figure 3. Loss provisions were 0.40 percent of average assets in the first quarter, which is equivalent to the average of quarterly loss provisions since the first quarter 1996.

Low and stable provisioning reflected continuing strong asset quality in commercial banks. The percent of noncurrent loans for most loan categories declined in the first quarter on a year-to-year comparison, including noncurrent construction and commercial real estate loans, and noncurrent credit card and installment loans. The one negative trend continues to be the increase in noncurrent commercial and industrial (C&I) loans, particularly in large banks. The percent of noncurrent C&I loans increased by 18 basis points for all commercial banks and 26 basis points for banks over $10 billion compared with March 1999 levels.

Noninterest expense. Relatively flat noninterest expenses have also played an important role in boosting commercial bank profitability. As shown in Figure 4, noninterest expense as a percentage of average assets for all commercial banks dropped to 3.58 percent, its lowest level in almost three years. Part of the decline may reflect one-time expenses related to year-2000 compliance activities during 1999.

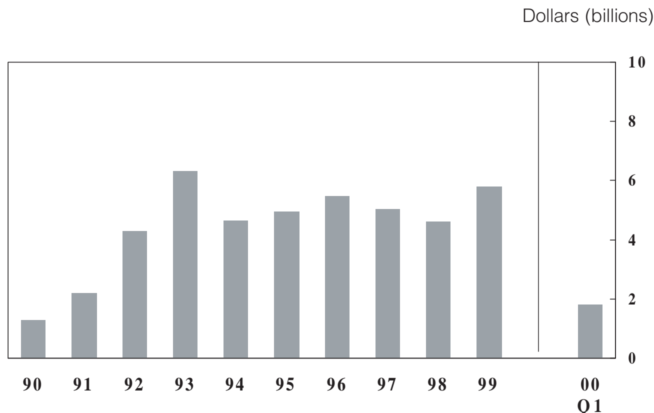
International income. Income from international sources continued to strengthen as a contributor to bank earnings. International income for large money center banks grew from $4.6 billion in 1998 to $5.8 billion in 1999, as shown in Figure 5, reflecting a strengthening in the international economy. In the first quarter, international income represented 35 percent of net income for these money center banks.

Figure 4—Noninterest expense has stayed relatively level (commercial banks)



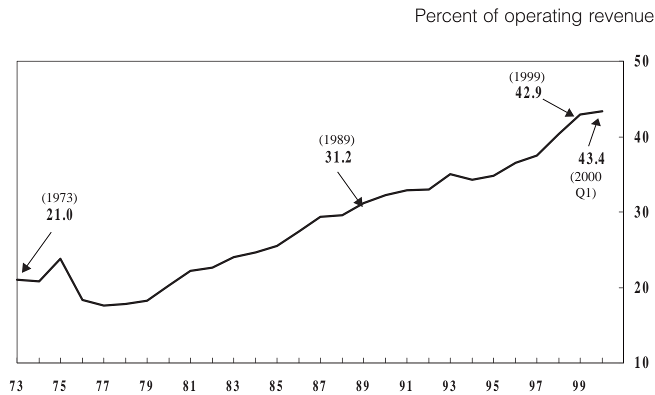
Source: Integrated Banking Information System

Figure 5—International income has strengthened at money center banks



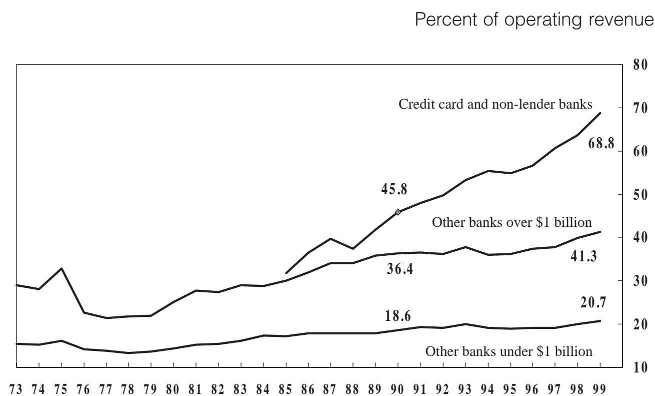
Source: NBSVDS/Call Report Data. Banks are: BofA/Nations, Bank One/First Chicago, Citibank, Chase/Chemical, Morgan, Bankers Trust

Figure 6—Noninterest income reliance keeps growing (commercial banks)



Source: Integrated Banking Information System

Figure 7—Noninterest income reliance varies by bank size (commercial banks)



Source: Integrated Banking Information System. Credit card banks have credit card loans (or securitized credit card credits) in excess of 25 percent of assets; non-lender banks have loans less than 10 percent of assets.

Greater Reliance on Noninterest Income

The major contributor to growth of commercial bank earnings during the 1990s has been noninterest income. In the rest of this report, we review the growth in noninterest income and the sources of its growth. We also examine the relationship between variability of noninterest income and levels of bank profitability.

Noninterest income has grown at the same time that banks have felt compression of net interest margin. From 1990 through 1995, noninterest income grew at the rate of 8.4 percent compared to a growth rate of 5.5 percent for net interest income. Since 1996, the growth rate for noninterest income has almost doubled to 15.1 percent, compared to a growth rate for net interest income that is essentially unchanged at 5.7 percent. As a result, the percent of operating revenue derived from noninterest income has steadily increased over the last 20 years as shown in Figure 6. As of the first quarter, noninterest income constituted over 43 percent of operating revenue, compared to 21 percent in 1973.

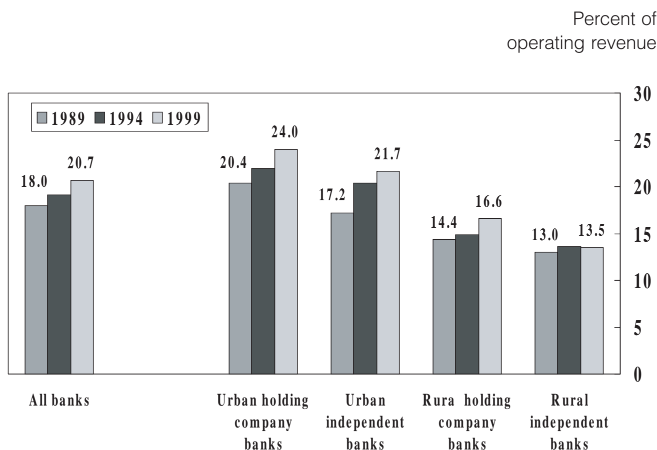
Large banks have increased their reliance on noninterest income to a greater extent than small banks. As shown in Figure 7, noninterest income for the average bank with over $1 billion in assets (not including credit card and other non-lender banks) was over 40 percent of its operating revenue in 1999. By comparison, for the average bank with less than $1 billion in assets, the share of noninterest income was 21 percent.

These percentages exclude the noninterest income earned by 176 credit card and non-lender banks, which reported an average of approximately 70 percent noninterest income to operating revenue in 1999. These specialty banks represented approximately 6 percent of the industry's assets, but earned approximately 26 percent of the industry's noninterest income in 1999.

In addition to size, the percent of noninterest income to operating revenue varies with holding company affiliation and with proximity to an urban location. Banks that are part of a one-bank or multi-bank holding company structure on average earn more of their operating revenue from noninterest income than independent banks, as shown in Figure 8. Holding companies can provide the size and investment necessary to build a broader product base.

Similarly, banks that are located in an urban setting on average earn more of their operating revenue from noninterest income than rural banks. Urban banks are subject to more demand for a broader variety of services and must perform a broader array of activities in order to compete successfully.

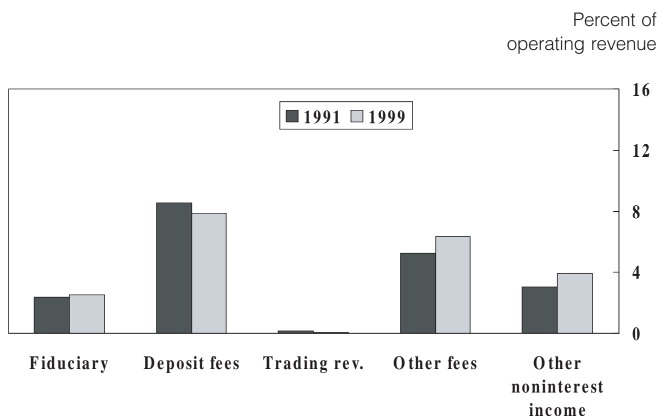
Figure 8—Noninterest income reliance varies by holding company affiliation and location (other commercial banks under $1 billion)*



*Excludes credit card banks and non-lender banks.

Bank size also has a strong effect on the components that make up noninterest income. Deposit fees are the most important source of noninterest income in smaller banks, as shown in Figure 9, while "other fees and "other noninterest income" are most important for larger banks, as shown in Figure 10.[1] However, for both small and large banks, the "other" categories are the largest sources of growth in noninterest income.

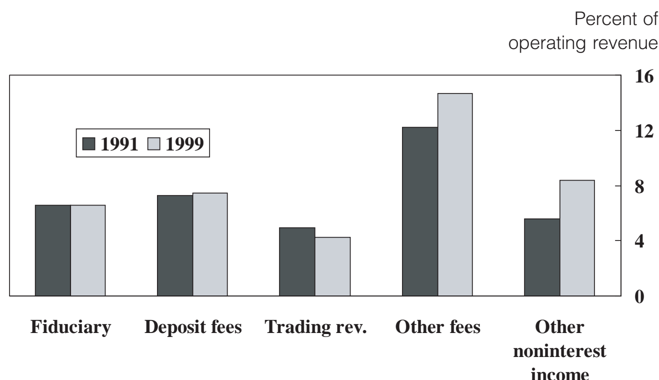
Figure 9—For small banks, "other" has most growth, deposit fees largest share (other commercial banks under $1 billions)*



*Excludes credit card banks and non-lender banks.

[1] "Other fees" include service charges, fees, and commissions other than service charges on domestic deposits (e.g., from foreign deposits, safe deposit boxes, insurance sales), plus credit card fees and loan commitment fees. "Other noninterest income" includes gross income from performing data processing services for others, net gains from asset sales, income from owned real estate, early withdrawal penalties, and income from check sales.

Figure 10—For large banks, "other" has most growth and largest share (other commercial banks over $1 billion)*

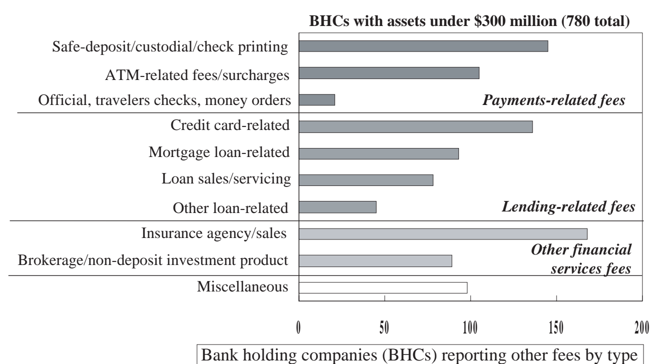


*Excludes credit card banks and non-lender banks.

Traditional and Nontraditional Sources of Noninterest Income

Bank holding company data can provide further insight into the types of activities generating noninterest revenues, including the "other" categories. As shown in Figure 11, small banking companies are involved in a spectrum of traditional and nontraditional activities reported as "other fee income." They include a number of activities considered traditional payment-related banking activities such as ATM-related and check processing. A relatively large number of small bank holding companies also reported receiving "other fees" from loan sales, loan securitization, and loan servicing in addition to traditional portfolio lending.

Figure 11—Ten most-cited sources of other fees by small bank holding companies in 1999



Source: Calculations from December 31, 1999 Y-9 data.

Perhaps surprising is the large number of small bank holding companies reporting "other fees" from other financial services, including agency insurance sales and brokerage and non-deposit investment fees and services. Although not uncommon among larger banks, these

activities indicate a broader participation among smaller bank holding companies in so-called nontraditional activities.

For large banking companies, we turn to public earnings reports for additional details regarding the growth in their noninterest income. Unlike small banking companies, large banking companies earn a significant percent of their noninterest income from nontraditional sources. Figure 12 shows noninterest income as reported by 12 of the largest domestic bank holding companies, which we have separated into three categories:[2]

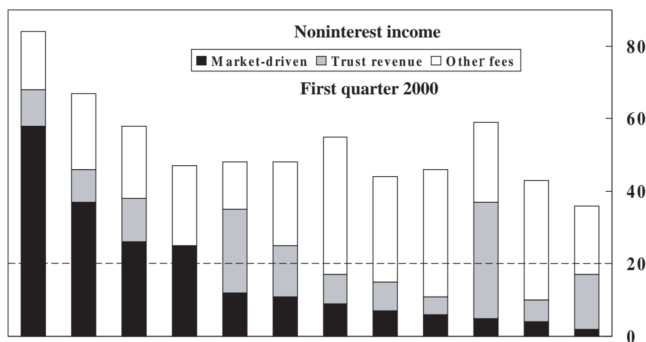
- "Market-driven revenues", which include brokerage, trading revenue, security gains, equity investment gains, and investment banking income
- "Trust revenues," which include investment, trust, and asset management fees
- "Other fees," which include all other sources of noninterest income, including mortgage banking, service charges on deposit accounts, and other fees for banking services

Four of the largest U.S. bank holding companies derived over 20 percent of their operating revenue in the first quarter 2000 from "market-driven" noninterest income. Seven of these companies derived over 20 percent of their operating revenue from a combination of "market driven" and trust revenues.

Market-driven revenues grew dramatically between the first quarters of 1999 and 2000 in the largest bank holding companies. As shown in Figure 13, market-driven revenues grew by more than 50 percent over this period in six of the largest bank holding companies. In all 12 companies, market-driven revenues grew an average 47 percent, trust revenues grew 35 percent, and income from other fees fell 10 percent. As a consequence, market-driven revenues grew from 30 percent to 39 percent of noninterest income for these companies.

Figure 12—"Market-driven" revenues above 20 percent in four of 12 bank holding companies

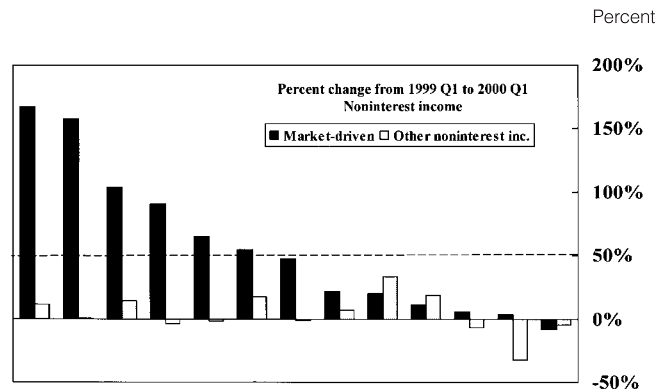
Percent of operating revenue



Source: 2000 Q1 quarterly earnings announcements for 12 of the largest BHCs (in asset size order): Bank of America, Chase, Bank One, J.P. Morgan, First Union, Wells Fargo, FleetBoston, SunTrust, National City, KeyCorp, U.S. Bancorp, and PNC

Figure 13—"Market-driven" revenues grew by more than 50 percent in six bank holding companies

Percent



Source: 2000 Q1 quarterly earnings announcements for 12 of the largest bank holding companies (in asset size order): Bank of America, Chase, Bank One, J.P. Morgan, First Union, Wells Fargo, FleetBoston, SunTrust, National City, Key Corp, U.S. Bancorp, and PNC

Banks and banking companies that have more noninterest income as a percent of operating revenue may have more variability in their earnings. We looked at the variability of returns for both small banks and large banking companies in relation to the percent that noninterest income contributed to operating revenue between 1994 and 1999. We found a positive correlation between a bank's reliance on noninterest income for operating revenue and the level and variability of bank profitability.

Conclusions

Commercial banks had strong earnings again in the first quarter 2000. Although net interest margin fell to its lowest level in 10 years, profitability in banks was sustained by continuing growth in noninterest income and flat expenses.

Banks have experienced unprecedented profitability during the past six years. Growth in noninterest income will play a major role in maintaining the industry's strong profitability in the future. Even smaller banks appear to be searching for additional sources of noninterest income, outside of traditional lending and payment-related activities. Large banking companies especially are accessing nontraditional sources of noninterest income, particularly sources that are driven by the equity markets. Although potentially highly profitable, these sources show greater variability.

[2] Bank of America, Chase Manhatten, Bank One, J.P. Morgan, First Union, Wells Fargo, FleetBoston, SunTrust, National City, KeyCorp, U.S. Bancorp, and PNC

Key indicators, FDIC-insured national banks
Annual 1996–1999, year-to-date through March 31, 2000, first quarter 1999, and first quarter 2000

(Dollar figures in millions)

	1996	1997	1998	1999	Preliminary 2000YTD	1999Q1	Preliminary 2000Q1
Number of institutions reporting	2,726	2,597	2,456	2,363	2,326	2,433	2,326
Total employees (FTEs)	850,737	912,463	974,871	983,163	963,487	963,085	963,487
Selected income data ($)							
Net income	$30,497	$35,782	$37,623	$42,590	$11,545	$10,534	$11,545
Net interest income	94,564	106,639	110,985	114,533	29,110	28,666	29,110
Provision for loan losses	9,598	13,065	15,243	15,545	4,110	4,081	4,110
Noninterest income	56,100	65,429	81,346	92,676	24,721	22,549	24,721
Noninterest expense	93,690	104,682	122,581	125,818	31,088	31,167	31,088
Net operating income	30,095	34,993	35,564	42,415	11,988	10,314	11,988
Cash dividends declared	25,279	28,587	25,414	29,875	6,732	5,181	6,732
Net charge-offs to loan and lease reserve	9,968	12,661	14,492	14,175	3,636	3,684	3,636
Selected condition data ($)							
Total assets	2,528,057	2,893,910	3,183,325	3,271,223	3,301,883	3,141,386	3,301,883
Total loans and leases	1,641,464	1,840,485	2,015,568	2,127,856	2,141,170	2,016,817	2,141,170
Reserve for losses	31,992	34,865	36,810	37,687	37,988	37,271	37,988
Securities	380,615	452,118	516,084	537,185	533,818	527,431	533,818
Other real estate owned	2,761	2,112	1,833	1,572	1,533	1,824	1,533
Noncurrent loans and leases	17,223	17,878	19,513	20,807	21,691	20,241	21,691
Total deposits	1,801,043	2,004,867	2,137,946	2,154,259	2,166,594	2,101,394	2,166,594
Domestic deposits	1,525,565	1,685,316	1,785,856	1,776,112	1,785,411	1,747,101	1,785,411
Equity capital	207,166	244,795	274,209	278,008	281,215	278,722	281,215
Off-balance-sheet derivatives	7,488,663	8,704,481	10,953,514	12,077,568	13,836,359	10,720,828	13,836,359
Performance ratios (annualized %)							
Return on equity	15.28	15.00	14.30	15.57	16.57	15.24	16.57
Return on assets	1.25	1.29	1.24	1.35	1.41	1.33	1.41
Net interest income to assets	3.88	3.83	3.67	3.63	3.55	3.63	3.55
Loss provision to assets	0.39	0.47	0.50	0.49	0.50	0.52	0.50
Net operating income to assets	1.24	1.26	1.18	1.35	1.46	1.30	1.46
Noninterest income to assets	2.30	2.35	2.69	2.94	3.02	2.85	3.02
Noninterest expense to assets	3.85	3.76	4.05	3.99	3.79	3.94	3.79
Loss provision to loans and leases	0.61	0.73	0.79	0.76	0.77	0.81	0.77
Net charge-offs to loans and leases	0.63	0.71	0.75	0.70	0.68	0.73	0.68
Loss provision to net charge-offs	96.29	103.19	105.12	109.67	113.04	110.80	113.04
Performance ratios (%)							
Percent of institutions unprofitable	4.77	4.89	5.94	6.98	5.55	5.88	5.55
Percent of institutions with earnings gains	67.83	67.96	61.69	62.25	65.69	53.06	65.09
Nonint. income to net operating revenue	37.24	38.02	42.29	44.73	45.92	44.03	45.92
Nonint. expense to net operating revenue	62.18	60.84	63.73	60.72	57.75	60.86	57.75
Condition ratios (%)							
Nonperforming assets to assets	0.80	0.70	0.68	0.70	0.71	0.71	0.71
Noncurrent loans to loans	1.05	0.97	0.97	0.98	1.01	1.00	1.01
Loss reserve to noncurrent loans	185.75	195.01	188.65	181.13	175.13	184.14	175.13
Loss reserve to loans	1.95	1.89	1.83	1.77	1.77	1.85	1.77
Equity capital to assets	8.19	8.46	8.61	8.50	8.52	8.87	8.52
Leverage ratio	7.40	7.42	7.43	7.50	7.60	7.52	7.60
Risk-based capital ratio	11.95	11.84	11.79	11.72	11.85	12.03	11.85
Net loans and leases to assets	63.66	62.39	62.16	63.90	63.70	63.02	63.70
Securities to assets	15.06	15.62	16.21	16.42	16.17	16.79	16.17
Appreciation in securities (% of par)	0.50	1.11	0.82	−2.45	−2.58	0.17	−2.58
Residential mortgage assets to assets	19.81	20.10	20.41	20.60	20.55	20.06	20.55
Total deposits to assets	71.24	69.28	67.16	65.85	65.62	66.89	65.62
Core deposits to assets	54.08	51.59	49.72	47.01	46.67	49.11	46.67
Volatile liabilities to assets	29.83	31.42	31.77	34.81	34.74	32.19	34.74

Loan performance, FDIC-insured national banks
Annual 1996–1999, year-to-date through March 31, 2000, first quarter 1999, and first quarter 2000

(Dollar figures in millions)

	1996	1997	1998	1999	Preliminary 2000YTD	1999Q1	Preliminary 2000Q1
Percent of loans past due 30–89 days							
Total loans and leases	1.39	1.32	1.27	1.16	1.12	1.19	1.12
Loans secured by real estate (RE)	1.45	1.39	1.33	1.22	1.18	1.17	1.18
1–4 family residential mortgages	1.63	1.65	1.50	1.61	1.41	1.20	1.41
Home equity loans	1.04	0.93	0.97	0.77	0.85	0.75	0.85
Multifamily residential mortgages	1.28	1.33	0.94	0.69	0.67	1.83	0.67
Commercial RE loans	1.25	0.95	1.02	0.70	0.80	0.98	0.80
Construction RE loans	1.63	1.63	1.82	1.07	1.41	1.63	1.41
Commercial and industrial loans*	0.89	0.76	0.81	0.71	0.78	0.85	0.78
Loans to individuals	2.46	2.52	2.44	2.36	2.10	2.28	2.10
Credit cards	2.70	2.75	2.52	2.53	2.36	2.35	2.36
Installment loans	2.26	2.34	2.37	2.24	1.91	2.22	1.91
All other loans and leases	0.41	0.46	0.46	0.50	0.56	0.57	0.56
Percent of loans noncurrent							
Total loans and leases	1.05	0.97	0.97	0.98	1.01	1.00	1.01
Loans secured by real estate (RE)	1.27	1.07	0.98	0.87	0.88	0.93	0.88
1–4 family residential mortgages	1.10	1.01	0.95	0.91	0.92	0.83	0.92
Home equity loans	0.47	0.43	0.41	0.28	0.35	0.36	0.35
Multifamily residential mortgages	1.47	1.01	0.88	0.44	0.43	1.21	0.43
Commercial RE loans	1.71	1.27	1.01	0.85	0.83	0.96	0.83
Construction RE loans	1.31	1.00	0.80	0.63	0.79	0.92	0.79
Commercial and industrial loans*	0.87	0.78	0.86	1.11	1.22	1.00	1.22
Loans to individuals	1.34	1.49	1.59	1.52	1.43	1.59	1.43
Credit cards	1.70	2.03	2.06	2.00	1.93	2.08	1.93
Installment loans	1.04	1.04	1.19	1.16	1.07	1.23	1.07
All other loans and leases	0.25	0.27	0.31	0.40	0.46	0.47	0.46
Percent of loans charged-off, net							
Total loans and leases	0.63	0.71	0.75	0.70	0.68	0.73	0.68
Loans secured by real estate (RE)	0.09	0.06	0.05	0.10	0.10	0.07	0.10
1–4 family residential mortgages	0.08	0.08	0.07	0.14	0.13	0.09	0.13
Home equity loans	0.24	0.18	0.16	0.19	0.21	0.20	0.21
Multifamily residential mortgages	0.09	0.01	0.07	0.02	−0.09	−0.01	−0.09
Commercial RE loans	0.02	−0.01	−0.02	0.03	0.06	0.02	0.06
Construction RE loans	0.16	−0.10	−0.01	0.03	0.01	0.03	0.01
Commercial and industrial loans*	0.22	0.27	0.38	0.54	0.59	0.45	0.59
Loans to individuals	2.45	2.86	2.92	2.65	2.75	2.88	2.75
Credit cards	4.25	4.95	5.03	4.51	4.69	4.90	4.69
Installment loans	1.04	1.20	1.23	1.27	1.32	1.28	1.32
All other loans and leases	0.34	0.30	1.58	0.93	0.19	0.26	0.19
Loans outstanding ($)							
Total loans and leases	$1,641,464	$1,840,485	$2,015,568	$2,127,856	$2,141,170	$2,016,817	$2,141,170
Loans secured by real estate (RE)	646,570	725,305	764,869	853,138	868,524	756,925	868,524
1–4 family residential mortgages	329,031	363,329	381,521	433,806	438,015	368,677	438,015
Home equity loans	55,022	67,669	66,091	67,266	70,299	65,105	70,299
Multifamily residential mortgages	20,480	23,346	23,201	26,561	28,363	24,475	28,363
Commercial RE loans	170,350	190,067	200,469	214,146	218,807	202,168	218,807
Construction RE loans	38,848	47,410	56,261	71,578	73,296	59,300	73,296
Farmland loans	9,046	10,178	10,930	11,957	12,112	10,991	12,112
RE loans from foreign offices	23,794	23,306	26,396	27,825	27,632	26,208	27,632
Commercial and industrial loans	425,148	508,589	583,929	622,008	633,126	601,791	633,126
Loans to individuals	356,067	371,477	386,410	348,556	342,377	364,844	342,377
Credit cards	161,104	168,236	176,408	147,114	144,540	157,438	144,540
Installment loans	194,963	203,241	210,003	201,442	197,836	207,406	197,836
All other loans and leases	216,194	237,326	282,399	306,044	298,842	295,179	298,842
Less: Unearned income	2,515	2,212	2,039	1,890	1,699	1,922	1,699

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

Key indicators, FDIC-insured national banks by asset size
First quarter 1999 and first quarter 2000

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1
Number of institutions reporting	1,254	1,180	992	975	143	126	44	45
Total employees (FTEs)	31,956	29,459	106,930	106,266	144,428	113,576	679,771	714,186
Selected income data ($)								
Net income	$205	$205	$802	$890	$2,318	$1,621	$7,209	$8,829
Net interest income	627	618	2,585	2,617	4,910	3,725	20,544	22,149
Provision for loan losses	29	31	212	194	1,017	468	2,823	3,416
Noninterest income	387	341	1,264	1,482	5,063	3,102	15,835	19,797
Noninterest expense	714	673	2,479	2,593	5,344	3,764	22,630	24,057
Net operating income	204	185	794	895	2,287	1,698	7,030	9,209
Cash dividends declared	142	139	539	505	1,134	1,881	3,366	4,208
Net charge-offs to loan and lease reserve	16	17	138	192	906	487	2,623	2,940
Selected condition data ($)								
Total assets	62,549	59,514	257,053	258,075	443,664	381,661	2,378,121	2,602,633
Total loans and leases	35,272	34,888	155,102	160,990	287,095	242,236	1,539,349	1,703,057
Reserve for losses	484	470	2,294	2,311	7,048	5,018	27,445	30,189
Securities	17,359	16,341	71,378	67,281	87,815	87,624	350,879	362,572
Other real estate owned	70	61	242	206	191	143	1,321	1,122
Noncurrent loans and leases	395	336	1,367	1,340	2,906	2,017	15,573	17,998
Total deposits	53,356	50,400	210,116	208,897	283,901	243,537	1,554,022	1,663,760
Domestic deposits	53,356	50,400	209,617	208,445	278,434	240,937	1,205,695	1,285,629
Equity capital	6,928	6,494	24,363	24,400	47,193	36,506	200,238	213,815
Off-balance-sheet derivatives	76	31	3,072	1,955	57,978	43,594	10,921,611	14,098,909
Performance ratios (annualized %)								
Return on equity	11.78	12.75	13.23	14.77	19.88	17.74	14.52	16.68
Return on assets	1.31	1.39	1.25	1.39	2.06	1.71	1.21	1.37
Net interest income to assets	4.01	4.18	4.03	4.09	4.36	3.93	3.43	3.43
Loss provision to assets	0.19	0.21	0.33	0.30	0.90	0.49	0.47	0.53
Net operating income to assets	1.30	1.25	1.24	1.40	2.03	1.79	1.18	1.43
Noninterest income to assets	2.48	2.31	1.97	2.32	4.49	3.27	2.65	3.07
Noninterest expense to assets	4.56	4.56	3.87	4.06	4.74	3.97	3.78	3.72
Loss provision to loans and leases	0.33	0.36	0.55	0.49	1.40	0.78	0.74	0.81
Net charge-offs to loans and leases	0.19	0.19	0.36	0.48	1.24	0.81	0.68	0.69
Loss provision to net charge-offs	178.55	188.32	153.10	101.10	112.16	96.21	107.67	116.18
Performance ratios (%)								
Percent of institutions unprofitable	9.41	9.07	1.81	1.64	4.20	2.38	2.27	6.67
Percent of institutions with earnings gains	46.57	63.64	60.18	67.18	58.74	66.67	59.09	53.33
Nonint. income to net operating revenue	38.18	35.54	32.83	36.16	50.76	45.43	43.53	47.20
Nonint. expense to net operating revenue	70.39	70.21	64.42	63.26	53.58	55.14	62.21	57.35
Condition ratios (%)								
Nonperforming assets to assets	0.74	0.67	0.63	0.60	0.70	0.57	0.72	0.75
Noncurrent loans to loans	1.12	0.96	0.88	0.83	1.01	0.83	1.01	1.06
Loss reserve to noncurrent loans	122.65	140.01	167.83	172.43	242.48	248.73	176.24	167.74
Loss reserve to loans	1.37	1.35	1.48	1.44	2.45	2.07	1.78	1.77
Equity capital to assets	11.08	10.91	9.48	9.45	10.64	9.57	8.42	8.22
Leverage ratio	10.74	11.09	9.03	9.44	8.97	8.63	7.00	7.19
Risk-based capital ratio	18.25	18.16	14.90	14.81	14.03	13.22	11.35	11.35
Net loans and leases to assets	55.62	57.83	59.45	61.49	63.12	62.15	63.58	64.28
Securities to assets	27.75	27.46	27.77	26.07	19.79	22.96	14.75	13.93
Appreciation in securities (% of par)	0.40	−2.40	0.53	−2.61	0.38	−2.36	0.03	−2.63
Residential mortgage assets to assets	21.67	21.48	25.96	24.93	24.40	27.36	18.58	19.09
Total deposits to assets	85.30	84.69	81.74	80.94	63.99	63.81	65.35	63.93
Core deposits to assets	73.84	72.78	70.08	68.82	54.82	54.49	45.13	42.73
Volatile liabilities to assets	12.81	14.20	16.71	18.15	26.52	28.17	35.44	37.82

Loan performance, FDIC-insured national banks by asset size
First quarter 1999 and first quarter 2000
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1
Percent of loans past due 30–89 days								
Total loans and leases	1.73	1.48	1.38	1.15	1.54	1.26	1.09	1.09
Loans secured by real estate (RE)	1.44	1.20	1.10	0.92	1.21	0.91	1.16	1.28
1–4 family residential mortgages	1.64	1.45	1.29	1.12	1.10	0.88	1.19	1.54
Home equity loans	0.68	0.48	0.76	0.59	0.85	0.73	0.73	0.89
Multifamily residential mortgages	0.52	0.76	0.80	0.55	0.68	0.43	2.41	0.75
Commercial RE loans	1.11	0.92	0.86	0.71	1.15	0.78	0.95	0.82
Construction RE loans	1.32	1.22	1.21	0.93	2.41	1.63	1.49	1.45
Commercial and industrial loans*	3.50	3.03	1.96	1.53	1.35	1.32	0.70	0.67
Loans to individuals	2.10	1.90	1.97	1.85	2.16	2.04	2.35	2.14
Credit cards	2.14	3.25	3.42	3.34	2.28	2.19	2.34	2.36
Installment loans	2.10	1.82	1.63	1.47	1.96	1.87	2.36	1.97
All other loans and leases	N/A	N/A	N/A	N/A	1.36	0.89	0.51	0.55
Percent of loans noncurrent								
Total loans and leases	1.12	0.96	0.88	0.83	1.01	0.83	1.01	1.06
Loans secured by real estate (RE)	0.89	0.79	0.69	0.63	0.75	0.64	1.01	0.97
1–4 family residential mortgages	0.74	0.65	0.65	0.59	0.72	0.53	0.88	1.04
Home equity loans	0.44	0.32	0.46	0.29	0.48	0.31	0.33	0.36
Multifamily residential mortgages	0.44	0.54	0.43	0.32	0.59	0.38	1.57	0.45
Commercial RE loans	0.88	0.76	0.71	0.73	0.88	0.80	1.05	0.86
Construction RE loans	0.65	0.72	0.62	0.43	0.66	0.86	1.07	0.84
Commercial and industrial loans*	2.86	2.40	1.63	1.51	0.85	0.96	0.96	1.22
Loans to individuals	0.76	0.61	0.88	0.98	1.61	1.18	1.68	1.55
Credit cards	1.63	1.40	2.37	3.14	2.19	1.64	2.00	1.96
Installment loans	0.71	0.57	0.54	0.44	0.64	0.68	1.47	1.24
All other loans and leases	N/A	N/A	N/A	N/A	0.42	0.61	0.48	0.45
Percent of loans charged-off, net								
Total loans and leases	0.19	0.19	0.36	0.48	1.24	0.81	0.68	0.69
Loans secured by real estate (RE)	0.03	0.01	0.02	0.02	0.07	0.10	0.08	0.12
1–4 family residential mortgages	0.02	0.02	0.04	0.03	0.12	0.12	0.09	0.15
Home equity loans	0.01	−0.03	0.03	0.03	0.38	0.21	0.18	0.22
Multifamily residential mortgages	−0.12	0.03	0.13	0.02	0.01	−0.03	−0.03	−0.13
Commercial RE loans	0.08	0.00	0.01	0.01	−0.07	0.08	0.04	0.07
Construction RE loans	0.05	0.03	0.02	0.00	0.00	0.04	0.04	0.00
Commercial and industrial loans*	0.42	0.42	0.42	0.27	0.21	0.40	0.48	0.62
Loans to individuals	0.66	0.80	1.64	2.70	3.62	2.75	2.77	2.79
Credit cards	2.89	4.70	6.09	11.00	5.20	4.30	4.67	4.52
Installment loans	0.55	0.53	0.59	0.53	0.84	0.98	1.49	1.51
All other loans and leases	N/A	N/A	N/A	N/A	0.15	0.17	0.27	0.19
Loans outstanding ($)								
Total loans and leases	$35,272	$34,888	$155,102	$160,990	$287,095	$242,236	$1,539,349	$1,703,057
Loans secured by real estate (RE)	19,930	20,077	93,186	98,107	122,371	121,297	521,438	629,043
1–4 family residential mortgages	9,616	9,422	43,281	44,000	61,065	60,310	254,715	324,283
Home equity loans	399	434	3,780	4,013	8,551	7,172	52,376	58,680
Multifamily residential mortgages	431	464	3,051	3,396	4,987	4,479	16,007	20,024
Commercial RE loans	5,711	5,814	31,735	34,004	35,016	35,689	129,706	143,301
Construction RE loans	1,464	1,597	7,488	8,532	11,193	11,893	39,155	51,274
Farmland loans	2,310	2,346	3,826	4,153	1,372	1,565	3,484	4,047
RE loans from foreign offices	0	0	25	9	187	189	25,996	27,433
Commercial and industrial loans	6,151	5,998	28,142	28,887	58,391	47,482	509,107	550,759
Loans to individuals	5,049	4,913	24,325	24,398	88,580	58,364	246,891	254,702
Credit cards	234	254	4,552	4,886	55,100	30,885	97,551	108,516
Installment loans	4,814	4,659	19,773	19,512	33,480	27,479	149,340	146,186
All other loans and leases	4,265	3,984	9,784	9,877	17,864	15,179	263,266	269,802
Less: Unearned income	123	85	335	280	111	85	1,353	1,249

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

Key indicators, FDIC-insured national banks by region
First quarter 2000
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	260	311	479	467	569	240	2,326
Total employees (FTEs)	267,491	293,357	162,774	76,328	71,249	92,288	963,487
Selected income data ($)							
Net income	$3,573	$3,666	$1,720	$929	$548	$1,109	$11,545
Net interest income	7,671	8,737	4,705	2,566	2,004	3,427	29,110
Provision for loan losses	1,627	704	629	464	139	547	4,110
Noninterest income	9,938	5,880	2,879	2,067	784	3,174	24,721
Noninterest expense	10,215	8,204	4,382	2,628	1,701	3,957	31,088
Net operating income	3,646	3,673	1,731	998	651	1,289	11,988
Cash dividends declared	1,786	1,976	899	819	268	984	6,732
Net charge-offs to loan and lease reserve	1,401	717	438	492	122	464	3,636
Selected condition data ($)							
Total assets	846,395	1,081,024	589,684	260,886	210,782	313,113	3,301,883
Total loans and leases	537,123	690,629	405,008	174,963	124,586	208,860	2,141,170
Reserve for losses	11,889	10,954	5,660	3,062	1,601	4,822	37,988
Securities	125,229	178,153	100,469	39,821	50,414	39,732	533,818
Other real estate owned	507	475	164	87	121	179	1,533
Noncurrent loans and leases	7,824	6,308	3,399	1,429	1,069	1,663	21,691
Total deposits	568,858	690,810	376,575	165,176	163,352	201,823	2,166,594
Domestic deposits	338,957	603,102	331,898	157,418	161,409	192,628	1,785,411
Equity capital	70,121	92,592	46,359	21,819	17,510	32,815	281,215
Off-balance-sheet derivatives	4,967,699	7,434,520	1,131,893	38,457	22,412	241,378	13,836,359
Performance ratios (annualized %)							
Return on equity	20.65	15.92	14.96	17.11	12.65	13.69	16.57
Return on assets	1.69	1.37	1.17	1.44	1.05	1.45	1.41
Net interest income to assets	3.62	3.27	3.21	3.97	3.83	4.47	3.55
Loss provision to assets	0.77	0.26	0.43	0.72	0.27	0.71	0.50
Net operating income to assets	1.72	1.37	1.18	1.55	1.24	1.68	1.46
Noninterest income to assets	4.69	2.20	1.97	3.20	1.50	4.14	3.02
Noninterest expense to assets	4.83	3.07	2.99	4.07	3.25	5.16	3.79
Loss provision to loans and leases	1.21	0.41	0.63	1.05	0.45	1.06	0.77
Net charge-offs to loans and leases	1.04	0.42	0.44	1.11	0.40	0.90	0.68
Loss provision to net charge-offs	116.09	98.09	143.49	94.35	113.90	117.75	113.04
Performance ratios (%)							
Percent of institutions unprofitable	2.31	12.22	4.59	2.14	5.10	10.00	5.55
Percent of institutions with earnings gains	65.77	62.06	61.17	63.38	69.60	68.75	65.09
Nonint. income to net operating revenue	56.44	40.23	37.96	44.61	28.12	48.08	45.92
Nonint. expense to net operating revenue	58.01	56.12	57.78	56.74	61.03	59.94	57.75
Condition ratios (%)							
Nonperforming assets to assets	1.00	0.63	0.62	0.58	0.56	0.62	0.71
Noncurrent loans to loans	1.46	0.91	0.84	0.82	0.86	0.80	1.01
Loss reserve to noncurrent loans	151.96	173.66	166.54	214.23	149.78	290.00	175.13
Loss reserve to loans	2.21	1.59	1.40	1.75	1.29	2.31	1.77
Equity capital to assets	8.28	8.57	7.86	8.36	8.31	10.48	8.52
Leverage ratio	7.47	7.48	7.36	7.69	7.89	8.62	7.60
Risk-based capital ratio	12.13	11.50	11.64	11.79	12.86	12.20	11.85
Net loans and leases to assets	62.06	62.87	67.72	65.89	58.35	65.16	63.70
Securities to assets	14.80	16.48	17.04	15.26	23.92	12.69	16.17
Appreciation in securities (% of par)	−1.36	−3.69	−2.39	−1.94	−2.98	−1.87	−2.58
Residential mortgage assets to assets	13.30	26.95	21.06	17.94	21.86	18.35	20.55
Total deposits to assets	67.21	63.90	63.86	63.31	77.50	64.46	65.62
Core deposits to assets	33.23	48.48	48.18	53.97	66.46	54.54	46.67
Volatile liabilities to assets	45.51	32.69	35.11	28.67	21.75	25.78	34.74

Loan performance, FDIC-insured national banks by region
First quarter 2000
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30–89 days							
Total loans and leases	1.13	0.99	1.22	1.37	1.12	1.13	1.12
Loans secured by real estate (RE)	1.25	1.27	1.19	1.14	1.12	0.82	1.18
1–4 family residential mortgages	1.48	1.67	1.04	1.17	1.13	0.99	1.41
Home equity loans	0.68	0.78	1.37	0.62	0.48	0.39	0.85
Multifamily residential mortgages	1.48	0.28	1.15	0.56	0.62	0.34	0.67
Commercial RE loans	0.80	0.61	1.01	0.90	1.04	0.71	0.80
Construction RE loans	0.70	1.11	2.28	1.91	1.44	1.04	1.41
Commercial and industrial loans*	0.50	0.56	1.08	1.32	1.24	1.08	0.78
Loans to individuals	2.43	1.84	2.06	2.11	1.27	2.04	2.10
Credit cards	2.62	2.06	1.71	2.23	0.89	2.19	2.36
Installment loans	2.16	1.77	2.12	1.98	1.29	1.76	1.91
All other loans and leases	0.48	0.24	0.87	0.90	0.50	0.79	0.56
Percent of loans noncurrent							
Total loans and leases	1.46	0.91	0.84	0.82	0.86	0.80	1.01
Loans secured by real estate (RE)	1.28	0.91	0.81	0.64	0.86	0.48	0.88
1–4 family residential mortgages	1.07	1.07	0.77	0.58	0.66	0.48	0.92
Home equity loans	0.33	0.25	0.59	0.28	0.32	0.20	0.35
Multifamily residential mortgages	0.98	0.40	0.43	0.34	0.17	0.26	0.43
Commercial RE loans	1.00	0.77	0.98	0.70	1.07	0.49	0.83
Construction RE loans	0.89	0.87	0.75	0.67	0.86	0.65	0.79
Commercial and industrial loans*	1.46	1.20	1.09	0.82	1.28	1.16	1.22
Loans to individuals	2.51	0.65	0.76	1.25	0.39	1.22	1.43
Credit cards	2.33	1.32	1.17	1.76	0.59	1.64	1.93
Installment loans	2.76	0.44	0.70	0.61	0.39	0.43	1.07
All other loans and leases	0.41	0.40	0.55	0.60	0.51	0.45	0.46
Percent of loans charged-off, net							
Total loans and leases	1.04	0.42	0.44	1.11	0.40	0.90	0.68
Loans secured by real estate (RE)	0.13	0.10	0.12	0.17	0.05	0.00	0.10
1–4 family residential mortgages	0.11	0.12	0.12	0.31	0.06	0.11	0.13
Home equity loans	0.12	0.23	0.27	0.23	0.56	0.07	0.21
Multifamily residential mortgages	−0.78	−0.02	−0.02	−0.01	0.02	0.00	−0.09
Commercial RE loans	0.12	0.04	0.10	0.04	0.04	0.00	0.06
Construction RE loans	−0.01	0.00	0.03	0.00	0.02	−0.01	0.01
Commercial and industrial loans*	0.70	0.53	0.48	0.56	0.59	0.70	0.59
Loans to individuals	3.46	1.99	1.67	3.92	1.00	3.14	2.75
Credit cards	4.60	3.77	4.48	6.46	3.29	4.21	4.69
Installment loans	1.79	1.41	1.20	0.74	0.91	1.11	1.32
All other loans and leases	0.05	0.20	0.19	0.27	0.12	0.66	0.19
Loans outstanding ($)							
Total loans and leases	$537,123	$690,629	$405,008	$174,963	$124,586	$208,860	$2,141,170
Loans secured by real estate (RE)	149,840	337,453	170,086	67,550	52,526	91,069	868,524
1–4 family residential mortgages	74,925	196,126	77,986	30,633	21,359	36,986	438,015
Home equity loans	13,364	24,743	18,283	4,483	1,016	8,408	70,299
Multifamily residential mortgages	2,774	10,646	7,259	2,232	1,814	3,639	28,363
Commercial RE loans	26,925	73,917	48,806	19,637	19,670	29,853	218,807
Construction RE loans	6,530	26,475	14,813	7,400	7,020	11,057	73,296
Farmland loans	495	2,774	2,914	3,165	1,647	1,117	12,112
RE loans from foreign offices	24,827	2,772	24	0	0	9	27,632
Commercial and industrial loans	174,781	208,699	115,535	46,502	36,270	51,339	633,126
Loans to individuals	118,526	64,892	52,905	38,945	23,850	43,259	342,377
Credit cards	70,715	15,968	7,254	21,504	893	28,207	144,540
Installment loans	47,811	48,924	45,651	17,441	22,957	15,051	197,836
All other loans and leases	94,759	80,020	66,612	21,993	12,082	23,376	298,842
Less: Unearned income	783	435	130	27	143	182	1,699

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

Key indicators, FDIC-insured commercial banks
Annual 1996–1999, year-to-date through March 31, 2000, first quarter 1999, and first quarter 2000

(Dollar figures in millions)

	1996	1997	1998	1999	Preliminary 2000YTD	1999Q1	Preliminary 2000Q1
Number of institutions reporting	9,527	9,142	8,774	8,580	8,518	8,722	8,518
Total employees (FTEs)	1,489,186	1,538,408	1,627,050	1,657,518	1,648,952	1,619,878	1,648,952
Selected income data ($)							
Net income	$52,350	$59,159	$61,799	$71,599	$19,549	$17,966	$19,549
Net interest income	162,754	174,506	182,757	192,200	50,079	47,383	50,079
Provision for loan losses	16,285	19,851	22,218	21,807	5,781	5,416	5,781
Noninterest income	93,569	104,498	123,700	144,408	38,416	34,733	38,416
Noninterest expense	160,698	169,982	194,117	204,157	51,945	49,641	51,945
Net operating income	51,509	57,931	59,245	71,365	20,013	17,618	20,013
Cash dividends declared	38,791	42,540	41,004	51,930	11,568	9,203	11,568
Net charge-offs to loan and lease reserve	15,500	18,318	20,730	20,361	5,043	4,998	5,043
Selected condition data ($)							
Total assets	4,578,314	5,014,951	5,442,531	5,734,747	5,847,134	5,411,797	5,847,134
Total loans and leases	2,811,279	2,970,742	3,238,338	3,491,245	3,568,368	3,251,097	3,568,368
Reserve for losses	53,458	54,685	57,275	58,823	59,885	57,884	59,885
Securities	800,648	871,868	979,821	1,046,349	1,057,255	995,651	1,057,255
Other real estate owned	4,780	3,795	3,150	2,794	2,763	3,138	2,763
Noncurrent loans and leases	29,130	28,542	31,248	33,005	34,593	32,218	34,593
Total deposits	3,197,136	3,421,726	3,681,444	3,830,775	3,878,291	3,637,338	3,878,291
Domestic deposits	2,723,556	2,895,532	3,109,410	3,175,186	3,238,803	3,062,613	3,238,803
Equity capital	375,269	417,777	462,169	479,774	491,784	469,603	491,784
Off-balance-sheet derivatives	20,035,444	25,063,799	33,005,109	34,817,487	37,631,929	32,662,313	37,631,929
Performance ratios (annualized %)							
Return on equity	14.45	14.69	13.93	15.32	16.08	15.40	16.08
Return on assets	1.19	1.23	1.19	1.31	1.35	1.32	1.35
Net interest income to assets	3.70	3.64	3.51	3.51	3.46	3.49	3.46
Loss provision to assets	0.37	0.41	0.43	0.40	0.40	0.40	0.40
Net operating income to assets	1.17	1.21	1.14	1.30	1.38	1.30	1.38
Noninterest income to assets	2.13	2.18	2.37	2.64	2.65	2.55	2.65
Noninterest expense to assets	3.65	3.54	3.73	3.73	3.58	3.65	3.58
Loss provision to loans and leases	0.61	0.69	0.72	0.66	0.65	0.67	0.65
Net charge-offs to loans and leases	0.58	0.64	0.67	0.61	0.57	0.62	0.57
Loss provision to net charge-offs	105.07	108.37	104.88	107.10	114.69	108.39	114.69
Performance ratios (%)							
Percent of institutions unprofitable	4.28	4.85	6.12	7.39	6.41	6.08	6.41
Percent of institutions with earnings gains	70.78	68.38	61.25	62.88	68.63	52.30	67.92
Nonint. income to net operating revenue	36.50	37.45	40.36	42.90	43.41	42.30	43.41
Nonint. expense to net operating revenue	62.69	60.92	63.34	60.65	58.70	60.45	58.70
Condition ratios (%)							
Nonperforming assets to assets	0.75	0.66	0.65	0.63	0.65	0.67	0.65
Noncurrent loans to loans	1.04	0.96	0.96	0.95	0.97	0.99	0.97
Loss reserve to noncurrent loans	183.51	191.59	183.29	178.22	173.12	179.66	173.12
Loss reserve to loans	1.90	1.84	1.77	1.68	1.68	1.78	1.68
Equity capital to assets	8.20	8.33	8.49	8.37	8.41	8.68	8.41
Leverage ratio	7.64	7.56	7.54	7.80	7.80	7.68	7.80
Risk-based capital ratio	12.53	12.23	12.23	12.17	12.25	12.42	12.25
Net loans and leases to assets	60.24	58.15	58.45	59.85	60.00	59.00	60.00
Securities to assets	17.49	17.39	18.00	18.25	18.08	18.40	18.08
Appreciation in securities (% of par)	0.51	1.10	1.07	−2.31	−2.47	0.39	−2.47
Residential mortgage assets to assets	19.79	20.03	20.93	20.77	20.81	20.49	20.81
Total deposits to assets	69.83	68.23	67.64	66.80	66.33	67.21	66.33
Core deposits to assets	52.45	50.06	49.39	46.96	46.84	48.78	46.84
Volatile liabilities to assets	30.71	31.92	31.68	34.94	34.95	32.36	34.95

Loan performance, FDIC-insured commercial banks
Annual 1996–1999, year-to-date through March 31, 2000, first quarter 1999, and first quarter 2000

(Dollar figures in millions)

	1996	1997	1998	1999	Preliminary 2000YTD	1999Q1	Preliminary 2000Q1
Percent of loans past due 30–89 days							
Total loans and leases	1.37	1.31	1.26	1.14	1.12	1.20	1.12
Loans secured by real estate (RE)	1.41	1.33	1.26	1.09	1.08	1.15	1.08
1–4 family residential mortgages	1.57	1.59	1.44	1.43	1.27	1.23	1.27
Home equity loans	1.06	0.96	0.98	0.75	0.77	0.79	0.77
Multifamily residential mortgages	1.19	1.11	0.86	0.58	0.58	1.36	0.58
Commercial RE loans	1.24	0.97	0.99	0.69	0.79	0.96	0.79
Construction RE loans	1.58	1.42	1.50	0.98	1.27	1.44	1.27
Commercial and industrial loans*	0.95	0.83	0.88	0.80	0.89	0.95	0.89
Loans to individuals	2.50	2.50	2.43	2.33	2.06	2.21	2.06
Credit cards	2.76	2.73	2.58	2.59	2.36	2.40	2.36
Installment loans	2.31	2.33	2.33	2.17	1.88	2.10	1.88
All other loans and leases	0.37	0.51	0.51	0.55	0.56	0.59	0.56
Percent of loans noncurrent							
Total loans and leases	1.04	0.96	0.96	0.95	0.97	0.99	0.97
Loans secured by real estate (RE)	1.20	1.01	0.91	0.79	0.79	0.88	0.79
1–4 family residential mortgages	0.99	0.94	0.88	0.82	0.82	0.80	0.82
Home equity loans	0.48	0.44	0.42	0.31	0.34	0.39	0.34
Multifamily residential mortgages	1.35	0.95	0.83	0.42	0.39	0.93	0.39
Commercial RE loans	1.61	1.21	0.95	0.77	0.77	0.92	0.77
Construction RE loans	1.38	0.97	0.81	0.67	0.73	0.89	0.73
Commercial and industrial loans*	0.98	0.86	0.99	1.18	1.28	1.10	1.28
Loans to individuals	1.36	1.47	1.52	1.42	1.35	1.51	1.35
Credit cards	1.91	2.18	2.22	2.05	1.98	2.21	1.98
Installment loans	0.97	0.98	1.06	1.03	0.97	1.08	0.97
All other loans and leases	0.22	0.25	0.34	0.39	0.42	0.45	0.42
Percent of loans charged-off, net							
Total loans and leases	0.58	0.64	0.67	0.61	0.57	0.62	0.57
Loans secured by real estate (RE)	0.10	0.06	0.05	0.08	0.07	0.05	0.07
1–4 family residential mortgages	0.08	0.08	0.07	0.11	0.10	0.07	0.10
Home equity loans	0.20	0.16	0.14	0.15	0.16	0.16	0.16
Multifamily residential mortgages	0.15	0.04	0.05	0.02	−0.04	−0.01	−0.04
Commercial RE loans	0.09	0.01	0.00	0.03	0.04	0.00	0.04
Construction RE loans	0.19	−0.02	0.01	0.04	0.02	0.03	0.02
Commercial and industrial loans*	0.26	0.28	0.42	0.58	0.52	0.44	0.52
Loans to individuals	2.28	2.70	2.69	2.32	2.36	2.53	2.36
Credit cards	4.35	5.11	5.19	4.46	4.56	4.93	4.56
Installment loans	0.89	1.04	1.04	1.04	1.03	1.01	1.03
All other loans and leases	0.25	0.32	1.55	1.02	0.17	0.25	0.17
Loans outstanding ($)							
Total loans and leases	$2,811,279	$2,970,742	$3,238,338	$3,491,245	$3,568,368	$3,251,097	$3,568,368
Loans secured by real estate (RE)	1,139,018	1,244,985	1,345,569	1,509,986	1,561,354	1,346,665	1,561,354
1–4 family residential mortgages	570,122	620,599	668,676	736,819	754,989	653,255	754,989
Home equity loans	85,300	98,163	96,647	102,335	108,079	95,535	108,079
Multifamily residential mortgages	38,162	41,231	43,242	53,135	57,274	45,466	57,274
Commercial RE loans	315,989	341,522	370,544	417,617	433,502	380,722	433,502
Construction RE loans	76,399	88,242	106,729	135,621	142,414	111,924	142,414
Farmland loans	24,964	27,072	29,096	31,900	32,731	29,576	32,731
RE loans from foreign offices	28,083	28,157	30,635	32,558	32,366	30,186	32,366
Commercial and industrial loans	709,600	794,998	898,662	970,999	1,001,637	921,574	1,001,637
Loans to individuals	562,291	561,329	570,876	558,348	556,487	548,611	556,487
Credit cards	231,664	231,096	228,781	211,984	207,463	207,998	207,463
Installment loans	330,626	330,233	342,095	346,364	349,024	340,614	349,024
All other loans and leases	405,678	373,898	427,349	455,583	452,143	438,095	452,143
Less: Unearned income	5,308	4,469	4,117	3,671	3,253	3,849	3,253

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

Key indicators, FDIC-insured commercial banks by asset size
First quarter 1999 and first quarter 2000
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1
Number of institutions reporting	5,375	5,093	2,957	3,046	317	300	73	79
Total employees (FTEs)	115,739	105,986	301,231	301,989	292,775	262,044	910,133	978,933
Selected income data ($)								
Net income	$683	$682	$2,353	$2,509	$3,920	$3,320	$11,010	$13,038
Net interest income	2,479	2,454	7,431	7,889	9,346	8,511	28,128	31,224
Provision for loan losses	124	122	547	523	1,379	1,031	3,366	4,105
Noninterest income	832	664	2,846	3,069	7,471	5,776	23,585	28,907
Noninterest expense	2,265	2,102	6,355	6,803	9,370	8,056	31,650	34,984
Net operating income	681	669	2,327	2,519	3,874	3,398	10,736	13,427
Cash dividends declared	438	436	1,302	1,325	2,199	2,828	5,264	6,979
Net charge-offs to loan and lease reserve	63	58	377	377	1,199	923	3,358	3,684
Selected condition data ($)								
Total assets	250,512	238,723	727,326	761,268	901,421	858,942	3,532,537	3,988,202
Total loans and leases	144,498	143,831	445,860	488,198	580,482	545,387	2,080,256	2,390,951
Reserve for losses	2,135	2,049	6,782	7,089	11,955	10,143	37,011	40,605
Securities	69,085	64,862	197,317	190,494	198,519	202,757	530,730	599,142
Other real estate owned	277	266	759	664	493	401	1,609	1,432
Noncurrent loans and leases	1,597	1,376	3,885	3,840	5,730	4,672	21,006	24,706
Total deposits	214,195	202,773	598,318	620,623	618,999	581,031	2,205,827	2,473,864
Domestic deposits	214,160	202,770	596,232	618,579	604,095	568,897	1,648,127	1,848,556
Equity capital	27,724	25,783	69,809	70,810	88,205	77,281	283,865	317,910
Off-balance-sheet derivatives	248	208	8,975	6,899	111,733	91,523	33,077,511	38,022,802
Performance ratios (annualized %)								
Return on equity	9.88	10.66	13.59	14.35	17.78	17.29	15.64	16.61
Return on assets	1.09	1.15	1.30	1.33	1.71	1.56	1.24	1.32
Net interest income to assets	3.97	4.15	4.10	4.19	4.08	4.00	3.17	3.16
Loss provision to assets	0.20	0.21	0.30	0.28	0.60	0.48	0.38	0.41
Net operating income to assets	1.09	1.13	1.29	1.34	1.69	1.60	1.21	1.36
Noninterest income to assets	1.33	1.12	1.57	1.63	3.26	2.71	2.66	2.92
Noninterest expense to assets	3.63	3.55	3.51	3.62	4.09	3.78	3.57	3.54
Loss provision to loans and leases	0.35	0.34	0.50	0.44	0.94	0.76	0.65	0.69
Net charge-offs to loans and leases	0.18	0.16	0.34	0.31	0.82	0.68	0.65	0.62
Loss provision to net charge-offs	196.03	209.91	145.28	138.53	114.96	111.74	100.25	111.48
Performance ratios (%)								
Percent of institutions unprofitable	8.93	9.64	1.45	1.51	1.89	2.00	1.37	3.80
Percent of institutions with earnings gains	45.92	65.82	61.82	71.37	67.19	70.33	72.60	60.76
Nonint. income to net operating revenue	25.12	21.29	27.69	28.01	44.43	40.43	45.61	48.07
Nonint. expense to net operating revenue	68.43	67.42	61.84	62.08	55.72	56.38	61.20	58.18
Condition ratios (%)								
Nonperforming assets to assets	0.75	0.69	0.64	0.59	0.69	0.59	0.67	0.67
Noncurrent loans to loans	1.11	0.96	0.87	0.79	0.99	0.86	1.01	1.03
Loss reserve to noncurrent loans	133.71	148.95	174.58	184.63	208.65	217.10	176.19	164.35
Loss reserve to loans	1.48	1.42	1.52	1.45	2.06	1.86	1.78	1.70
Equity capital to assets	11.07	10.80	9.60	9.30	9.79	9.00	8.04	7.97
Leverage ratio	10.84	11.04	9.22	9.32	8.61	8.47	6.91	7.17
Risk-based capital ratio	18.19	17.81	14.87	14.32	13.44	13.00	11.46	11.51
Net loans and leases to assets	56.83	59.39	60.37	63.20	63.07	62.31	57.84	58.93
Securities to assets	27.58	27.17	27.13	25.02	22.02	23.61	15.02	15.02
Appreciation in securities (% of par)	0.42	−2.42	0.60	−2.51	0.34	−2.55	0.33	−2.43
Residential mortgage assets to assets	21.05	21.04	24.50	23.62	26.16	26.97	18.18	18.94
Total deposits to assets	85.50	84.94	82.26	81.52	68.67	67.65	62.44	62.03
Core deposits to assets	74.09	72.98	70.52	69.02	57.32	55.26	40.33	39.23
Volatile liabilities to assets	12.64	14.06	16.16	18.03	25.11	28.54	38.95	40.81

Loan performance, FDIC-insured commercial banks by asset size
First quarter 1999 and first quarter 2000

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1	1999Q1	2000Q1
Percent of loans past due 30–89 days								
Total loans and leases	1.85	1.60	1.37	1.19	1.38	1.25	1.07	1.04
Loans secured by real estate (RE)	1.55	1.33	1.11	0.98	1.12	0.89	1.14	1.16
1–4 family residential mortgages	1.78	1.60	1.36	1.23	1.13	0.94	1.16	1.36
Home equity loans	0.95	0.68	0.81	0.65	0.84	0.69	0.76	0.81
Multifamily residential mortgages	0.88	0.85	0.77	0.50	0.70	0.50	1.97	0.62
Commercial RE loans	1.17	1.00	0.85	0.74	1.00	0.78	0.96	0.80
Construction RE loans	1.20	1.17	1.05	1.07	1.70	1.19	1.52	1.41
Commercial and industrial loans*	2.21	1.88	1.64	1.39	1.27	1.35	0.68	0.66
Loans to individuals	2.27	2.10	2.02	1.86	2.10	2.16	2.29	2.06
Credit cards	2.40	2.40	3.49	3.34	2.33	2.56	2.36	2.23
Installment loans	2.26	2.09	1.73	1.58	1.85	1.83	2.25	1.95
All other loans and leases	N/A	N/A	N/A	N/A	1.15	1.00	0.55	0.55
Percent of loans noncurrent								
Total loans and leases	1.11	0.96	0.87	0.79	0.99	0.86	1.01	1.03
Loans secured by real estate (RE)	0.87	0.78	0.71	0.62	0.84	0.71	0.96	0.88
1–4 family residential mortgages	0.77	0.69	0.67	0.60	0.82	0.69	0.85	0.93
Home equity loans	0.48	0.26	0.44	0.31	0.50	0.34	0.36	0.35
Multifamily residential mortgages	0.62	0.53	0.64	0.43	0.58	0.47	1.24	0.34
Commercial RE loans	0.87	0.77	0.73	0.65	0.93	0.78	1.03	0.84
Construction RE loans	0.70	0.58	0.71	0.56	0.83	0.80	1.04	0.79
Commercial and industrial loans*	1.65	1.39	1.33	1.20	1.01	1.07	1.00	1.26
Loans to individuals	0.88	0.76	0.81	0.84	1.42	1.10	1.72	1.54
Credit cards	1.93	1.29	1.94	2.63	2.14	1.73	2.27	2.02
Installment loans	0.83	0.74	0.59	0.50	0.63	0.58	1.37	1.22
All other loans and leases	N/A	N/A	N/A	N/A	0.48	0.58	0.47	0.42
Percent of loans charged-off, net								
Total loans and leases	0.18	0.16	0.34	0.31	0.82	0.68	0.65	0.62
Loans secured by real estate (RE)	0.03	0.03	0.03	0.02	0.05	0.07	0.06	0.09
1–4 family residential mortgages	0.03	0.04	0.05	0.04	0.09	0.09	0.07	0.12
Home equity loans	0.01	0.03	0.03	0.05	0.25	0.17	0.16	0.18
Multifamily residential mortgages	−0.02	0.03	0.04	0.01	−0.03	0.02	−0.02	−0.07
Commercial RE loans	0.04	0.02	0.01	0.01	−0.03	0.03	0.01	0.06
Construction RE loans	0.04	0.03	0.02	0.00	0.01	0.05	0.03	0.01
Commercial and industrial loans*	0.24	0.22	0.39	0.27	0.30	0.48	0.47	0.56
Loans to individuals	0.61	0.59	1.63	1.77	2.97	2.62	2.63	2.48
Credit cards	2.34	3.36	6.97	7.91	4.88	4.60	4.81	4.31
Installment loans	0.52	0.47	0.60	0.55	0.81	0.98	1.23	1.21
All other loans and leases	N/A	N/A	N/A	N/A	0.19	0.22	0.28	0.18
Loans outstanding ($)								
Total loans and leases	$144,498	$143,831	$445,860	$488,198	$580,482	$545,387	$2,080,256	$2,390,951
Loans secured by real estate (RE)	81,676	82,698	277,836	310,689	282,269	289,244	704,883	878,724
1–4 family residential mortgages	38,754	38,421	120,190	127,922	133,950	131,456	360,361	457,189
Home equity loans	1,749	1,882	11,569	12,968	17,945	17,334	64,271	75,893
Multifamily residential mortgages	1,700	1,794	9,178	10,634	11,607	11,275	22,981	33,571
Commercial RE loans	22,725	23,275	99,114	113,685	87,936	94,378	170,947	202,164
Construction RE loans	6,132	6,577	26,314	32,482	27,302	30,887	52,176	72,468
Farmland loans	10,608	10,749	11,421	12,950	3,166	3,549	4,381	5,484
RE loans from foreign offices	7	0	50	47	364	365	29,765	31,954
Commercial and industrial loans	24,741	24,733	81,481	88,725	126,737	116,022	688,615	772,157
Loans to individuals	20,640	19,919	63,170	64,100	134,807	109,316	329,995	363,152
Credit cards	864	747	10,159	10,363	70,207	48,876	126,767	147,477
Installment loans	19,776	19,172	53,010	53,737	64,599	60,440	203,228	215,675
All other loans and leases	17,883	16,752	24,448	25,507	37,203	31,419	358,561	378,465
Less: Unearned income	442	271	1,075	823	534	614	1,798	1,546

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

Key indicators, FDIC-insured commercial banks by region
First quarter 2000
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	675	1,429	1,847	2,195	1,443	929	8,518
Total employees (FTEs)	482,831	472,377	282,652	127,210	116,473	167,409	1,648,952
Selected income data ($)							
Net income	$7,049	$5,258	$2,969	$1,394	$875	$2,004	$19,549
Net interest income	14,995	13,407	8,139	4,002	3,078	6,459	50,079
Provision for loan losses	2,153	1,070	836	558	200	965	5,781
Noninterest income	17,952	8,331	4,437	2,361	1,062	4,273	38,416
Noninterest expense	19,638	12,515	7,355	3,622	2,543	6,272	51,945
Net operating income	7,100	5,297	2,988	1,467	980	2,181	20,013
Cash dividends declared	3,858	3,314	1,496	1,143	392	1,364	11,568
Net charge-offs to loan and lease reserve	2,003	973	556	554	152	805	5,043
Selected condition data ($)							
Total assets	2,012,750	1,556,090	997,323	396,873	315,234	568,864	5,847,134
Total loans and leases	1,055,935	1,012,750	670,978	265,078	183,842	379,784	3,568,368
Reserve for losses	20,355	15,425	9,170	4,519	2,430	7,987	59,885
Securities	338,341	282,160	189,615	72,868	82,713	91,557	1,057,255
Other real estate owned	788	795	364	199	246	371	2,763
Noncurrent loans and leases	13,544	8,731	5,267	2,154	1,609	3,288	34,593
Total deposits	1,246,921	1,042,963	667,473	277,877	250,538	392,520	3,878,291
Domestic deposits	798,670	940,309	603,785	270,119	248,594	377,325	3,238,803
Equity capital	159,978	133,013	79,102	34,883	27,225	57,585	491,784
Off-balance-sheet derivatives	28,619,779	7,487,715	1,195,681	39,143	22,881	266,732	37,631,929
Performance ratios (annualized %)							
Return on equity	17.91	15.88	15.17	16.07	13.03	14.16	16.08
Return on assets	1.40	1.36	1.21	1.42	1.12	1.44	1.35
Net interest income to assets	2.99	3.47	3.31	4.07	3.93	4.64	3.46
Loss provision to assets	0.43	0.28	0.34	0.57	0.26	0.69	0.40
Net operating income to assets	1.41	1.37	1.22	1.49	1.25	1.57	1.38
Noninterest income to assets	3.57	2.16	1.81	2.40	1.36	3.07	2.65
Noninterest expense to assets	3.91	3.24	3.00	3.68	3.25	4.51	3.58
Loss provision to loans and leases	0.82	0.43	0.51	0.84	0.44	1.04	0.65
Net charge-offs to loans and leases	0.76	0.39	0.34	0.83	0.34	0.86	0.57
Loss provision to net charge-offs	107.59	109.96	150.27	100.66	131.48	119.95	114.69
Performance ratios (%)							
Percent of institutions unprofitable	8.44	10.15	5.68	3.42	5.20	9.58	6.41
Percent of institutions with earnings gains	67.11	68.09	65.46	67.61	68.40	73.09	67.92
Nonint. income to net operating revenue	54.49	38.32	35.28	37.10	25.66	39.81	43.41
Nonint. expense to net operating revenue	59.60	57.57	58.49	56.94	61.42	58.44	58.70
Condition ratios (%)							
Nonperforming assets to assets	0.73	0.61	0.57	0.59	0.59	0.66	0.65
Noncurrent loans to loans	1.28	0.86	0.78	0.81	0.88	0.87	0.97
Loss reserve to noncurrent loans	150.28	176.66	174.10	209.83	151.03	242.94	173.12
Loss reserve to loans	1.93	1.52	1.37	1.70	1.32	2.10	1.68
Equity capital to assets	7.95	8.55	7.93	8.79	8.64	10.12	8.41
Leverage ratio	7.42	7.73	7.67	8.37	8.29	8.94	7.80
Risk-based capital ratio	12.51	11.75	11.86	12.65	13.58	12.54	12.25
Net loans and leases to assets	51.45	64.09	66.36	65.65	57.55	65.36	60.00
Securities to assets	16.81	18.13	19.01	18.36	26.24	16.09	18.08
Appreciation in securities (% of par)	−2.17	−3.09	−2.38	−2.06	−2.81	−1.85	−2.47
Residential mortgage assets to assets	16.31	26.98	22.39	18.43	22.35	17.93	20.81
Total deposits to assets	61.95	67.02	66.93	70.02	79.48	69.00	66.33
Core deposits to assets	31.80	52.22	51.69	60.69	67.16	55.91	46.84
Volatile liabilities to assets	46.46	29.87	32.97	23.50	21.09	27.29	34.95

Loan performance, FDIC-insured commercial banks by region
First quarter 2000
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30–89 days							
Total loans and leases	1.04	1.06	1.18	1.38	1.23	1.12	1.12
Loans secured by real estate (RE)	1.08	1.17	1.08	1.11	1.18	0.80	1.08
1–4 family residential mortgages	1.20	1.54	1.02	1.18	1.35	0.90	1.27
Home equity loans	0.65	0.72	1.13	0.65	0.66	0.45	0.77
Multifamily residential mortgages	0.55	0.43	0.95	0.51	0.63	0.41	0.58
Commercial RE loans	0.86	0.66	0.89	0.87	1.01	0.70	0.79
Construction RE loans	0.97	0.99	1.99	1.62	1.27	1.11	1.27
Commercial and industrial loans*	0.52	0.74	1.13	1.66	1.47	1.29	0.89
Loans to individuals	2.31	1.95	1.99	2.13	1.43	1.84	2.06
Credit cards	2.53	2.62	1.82	2.46	1.11	1.93	2.36
Installment loans	2.10	1.75	2.01	1.83	1.44	1.71	1.88
All other loans and leases	0.47	0.31	0.92	0.68	0.41	0.77	0.56
Percent of loans noncurrent							
Total loans and leases	1.28	0.86	0.78	0.81	0.88	0.87	0.97
Loans secured by real estate (RE)	0.98	0.81	0.73	0.63	0.82	0.58	0.79
1–4 family residential mortgages	0.86	0.95	0.72	0.58	0.73	0.59	0.82
Home equity loans	0.36	0.25	0.49	0.30	0.34	0.23	0.34
Multifamily residential mortgages	0.32	0.42	0.48	0.31	0.25	0.41	0.39
Commercial RE loans	0.97	0.72	0.82	0.64	0.91	0.60	0.77
Construction RE loans	1.07	0.74	0.68	0.57	0.74	0.66	0.73
Commercial and industrial loans*	1.54	1.15	1.04	1.06	1.39	1.32	1.28
Loans to individuals	2.15	0.83	0.71	1.20	0.47	1.13	1.35
Credit cards	2.34	1.68	1.17	1.89	0.76	1.61	1.98
Installment loans	1.96	0.57	0.65	0.57	0.46	0.38	0.97
All other loans and leases	0.39	0.38	0.51	0.43	0.44	0.49	0.42
Percent of loans charged-off, net							
Total loans and leases	0.76	0.39	0.34	0.83	0.34	0.86	0.57
Loans secured by real estate (RE)	0.07	0.08	0.08	0.11	0.04	0.03	0.07
1–4 family residential mortgages	0.07	0.10	0.09	0.21	0.05	0.11	0.10
Home equity loans	0.09	0.17	0.21	0.19	0.48	0.12	0.16
Multifamily residential mortgages	−0.12	−0.01	−0.01	−0.03	0.03	0.00	−0.04
Commercial RE loans	0.05	0.03	0.06	0.03	0.03	0.02	0.04
Construction RE loans	0.01	0.03	0.02	0.01	0.01	0.02	0.02
Commercial and industrial loans*	0.57	0.46	0.38	0.50	0.55	0.84	0.52
Loans to individuals	2.82	1.74	1.40	3.42	0.89	3.01	2.36
Credit cards	4.50	3.94	4.23	6.52	2.83	4.16	4.56
Installment loans	1.17	1.06	0.99	0.58	0.82	1.16	1.03
All other loans and leases	0.08	0.19	0.21	0.18	0.10	0.53	0.17
Loans outstanding ($)							
Total loans and leases	$1,055,935	$1,012,750	$670,978	$265,078	$183,842	$379,784	$3,568,368
Loans secured by real estate (RE)	343,743	524,996	309,521	117,130	85,875	180,090	1,561,354
1–4 family residential mortgages	186,568	278,988	142,945	50,358	34,466	61,664	754,989
Home equity loans	24,646	36,540	27,540	5,781	1,224	12,348	108,079
Multifamily residential mortgages	15,021	15,297	12,016	3,655	2,667	8,617	57,274
Commercial RE loans	72,948	131,475	91,873	34,451	32,579	70,176	433,502
Construction RE loans	14,481	53,394	27,161	12,497	11,372	23,508	142,414
Farmland loans	1,285	6,530	7,953	10,390	3,565	3,010	32,731
RE loans from foreign offices	28,794	2,772	32	0	0	767	32,366
Commercial and industrial loans	330,287	273,122	192,264	63,334	48,795	93,834	1,001,637
Loans to individuals	203,883	117,628	77,420	49,979	33,387	74,190	556,487
Credit cards	100,475	27,457	9,122	23,720	1,269	45,418	207,463
Installment loans	103,408	90,171	68,297	26,258	32,118	28,772	349,024
All other loans and leases	179,348	97,764	92,082	34,695	16,068	32,187	452,143
Less: Unearned income	1,326	760	308	60	283	517	3,253

*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 1-4 family residential mortgages plus mortgage-backed securities.

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

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

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

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

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

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

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

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

Global Report

Summary of Global Outlook

The outlook for the global economy remains positive and favorable for U.S. banks. Growth has clearly revived in Europe and is picking up in other parts of the world. Bank earnings from international operations continue to be significant.

Despite this, the international environment does pose substantial risks. The U.S. current account deficit has now surpassed previous records and is projected to hit $400 billion, and over 4 percent of gross domestic product (GDP), this year. Financing the deficit will require continued large inflows of foreign investment. Although to date there has been no problem in attracting sufficient funds, the costs to the United States of servicing its international debt are building and the situation is not sustainable indefinitely.

Transition to a more sustainable balance may occur without major disruption. This would require a gradual slowing in U.S. domestic demand and an external environment that remains favorable. However, there is a risk that pressures to adjust could arise quickly and trigger a sharp downward move in the dollar. This would likely lead to further substantial upward pressure on U.S. interest rates.

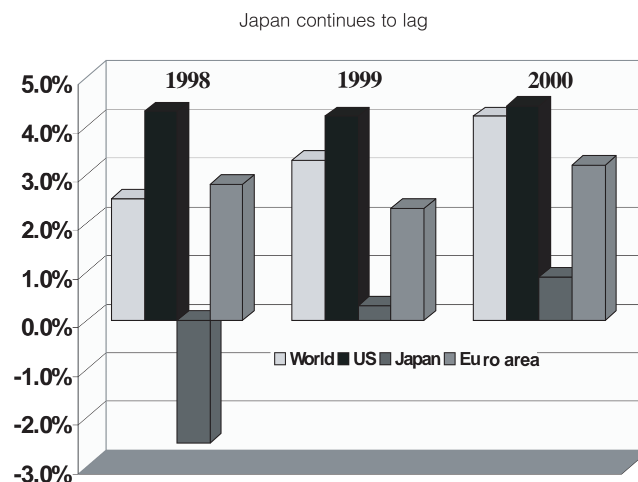
Such a scenario would likely be quite negative for U.S. securities markets, especially for equities. Foreign interest may be disproportionately affected by the prospect of losses from both a decline in principal value and from foreign exchange translation. Foreigners have been significantly increasing their investment in U.S. equities over the last few years and have become one of the most important sectors purchasing domestic stocks. A substantial diminution in their interest could exacerbate a downward correction in U.S. equity markets. There is also the potential for such developments to spillover into foreign stock markets.

Macroeconomic Outlook

The pace of world economic expansion is expected to pick up strongly this year. For the first time since the outbreak of the Asian financial crisis, global growth is likely to exceed the 4 percent level. Activity in the United States will continue to be robust and should again outstrip that in other industrial countries and the world as a whole. However, the improved outlook is primarily attributable to the strengthening in other parts of the world. Most importantly the European Union, with an economy roughly comparable to that of the United States, now appears poised to exceed 3 percent growth for the first time in over a decade. Japan remains an important laggard, but analysts have become more optimistic about prospects there. Emerging Asia looks set for another solid performance, after last year's much stronger than anticipated rebound. Latin America, having weathered substantial economic shocks in 1999, is set to return to positive growth this year; the pick up should be most evident in the second half of 2000.

Figure 1—World growth expected to strengthen in 2000

Japan continues to lag

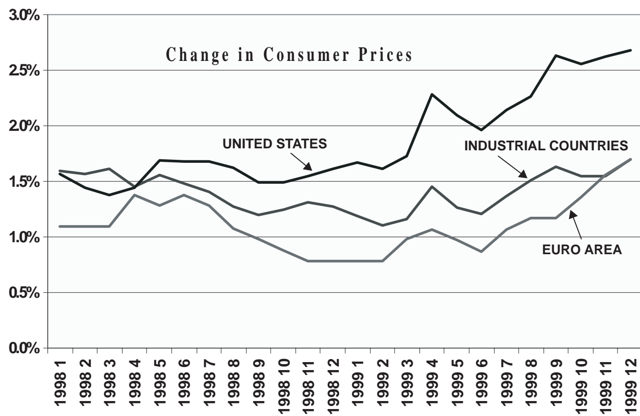


Source: IMF, World Economic Outlook, April 2000

Price Levels Rise

Stronger world growth and persistent robust U.S. demand are being reflected in rising price levels. The direct impact of the increase in petroleum prices is an important factor, but core inflation is also rising in the United States and Europe. The consensus among private sector analysts continues to point to moderate and contained increases in prices. However, the risk of a sharper upward move has increased. With its economy still lagging behind the rest of the industrialized world, Japan is an exception to the price trend.

Figure 2—Pace of Increase in Prices Picks Up In Most Industrial Countires (From Low Levels)

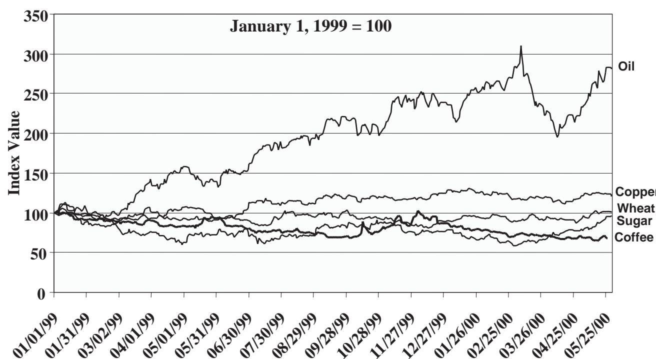


Source: IMF

Commodity Prices

The price of petroleum, which hit US$30 per barrel for the first time in a decade earlier this year, eased in the second quarter. Most analysts believe the peak has passed and anticipate that prices will stay in the US$22-US$28/ barrel range agreed upon by OPEC. Prices for other commodities have remained largely stagnant over the past year but, with world economic growth accelerating, are widely expected to firm. This should provide some benefit to a broader range of commodity exporting countries, although, their gains will not match those that have accrued to oil producers. For many emerging market economies, just as for industrialized countries, higher commodity prices will keep upward pressure on inflation and interest rates. Some producing countries are attempting to control production and thereby further lift prices. For example, there are indications that the new Chilean government is attempting to scale back copper production. This tactic is most likely to be appealing when there are a limited number of producers.

Figure 3—Sharp Rise in Oil Prices but Non-Oil Commodity Prices Remain Subdued January 1, 1999–May 30, 2000

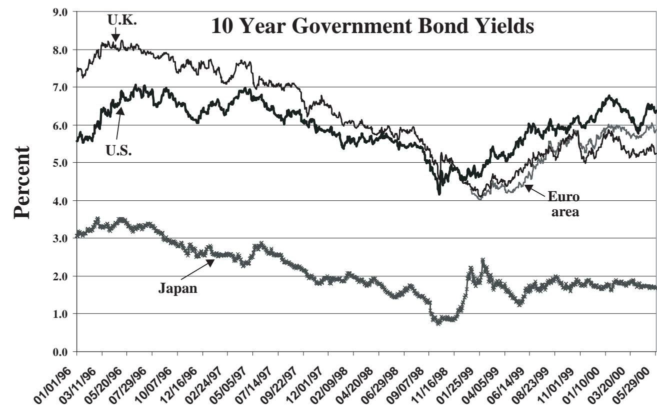


Data Source: Bloomberg Analytics

Interest Rates

Concern about inflationary pressure has led to higher interest rates in Europe and the United States. The upward move, which began in late 1998 and early 1999, when a number of countries were experiencing the lowest rates in decades, has continued. So far, the increase has been more pronounced for short-term rates, which has led to a flattening (and in some cases an inversion) of the yield curve. In part, the more limited rise in longer term rates reflects continued market confidence in the ability of monetary authorities to contain inflationary pressures.

Figure 4—Long-Term Interest Rates Up From Lows (But Confidence about Inflation Holds Down Increase)

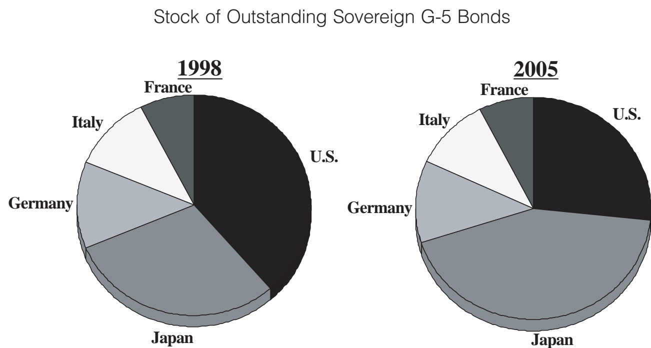


Source: Bloomberg Analytics

Another important factor has been a change in the supply of government bonds. This is most noticeable in the United States, where a substantial fiscal surplus has reduced funding requirements and allowed shrinkage in the stock of bonds outstanding. In continental Europe there has also been a drop in governments' needs for funds, as countries continue to benefit from the impact of fiscal reform undertaken to meet the criteria for a single currency. In recent years, this has been reinforced by strong growth in tax receipts flowing from buoyant security markets. Japan, however, remains subject to a different set of forces. With the private sector sluggish and price levels still on the decline, Japanese authorities continue to prescribe large doses of government spending for the country's economic ills. As a result, fiscal accounts have moved very deeply into the red financed by massive issuance of government bonds. These very different directions in fiscal policy will lead to significant alternations in the structure of global sovereign debt markets.

Figure 5—Japanese Issues to Dominate Sovereign Bond Market

Stock of Outstanding Sovereign G-5 Bonds

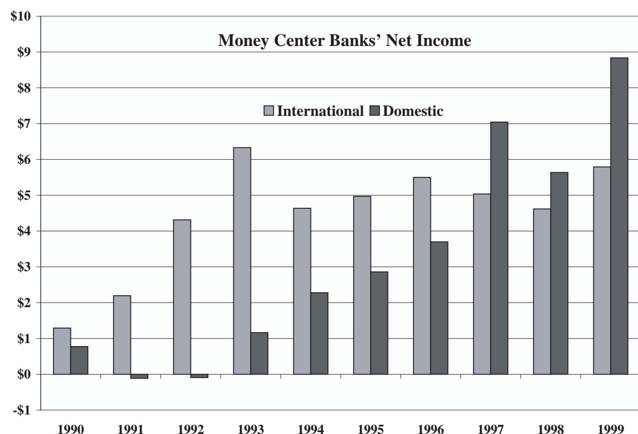


Source: Organization of Economic Cooperation and Development

Overall Environment Remains Positive for Banks

Despite the upward trend in interest rates, the operating environment for banks has been very favorable. Strong economic growth is producing rising incomes and healthy corporate profits. With business activity picking up, there has been an active global merger and acquisition business, which banks have helped finance. In addition, the significant appreciation in asset markets around the world has produced substantial increases in real wealth, thereby enhancing borrowers' ability to repay. These positive factors are reflected in buoyant income for U.S. banks from both domestic and international sources. As a result, last year U.S. banks' international income fully rebounded from the dip experienced as the result of the Asian and Russian financial crises.

Figure 6—Domestic Income Surges—International Income Remains Important



Banks include: BofA/Nations, Bank One/First Chicago, Citibank, Chase/Chemical, Morgan, Bankers Trust

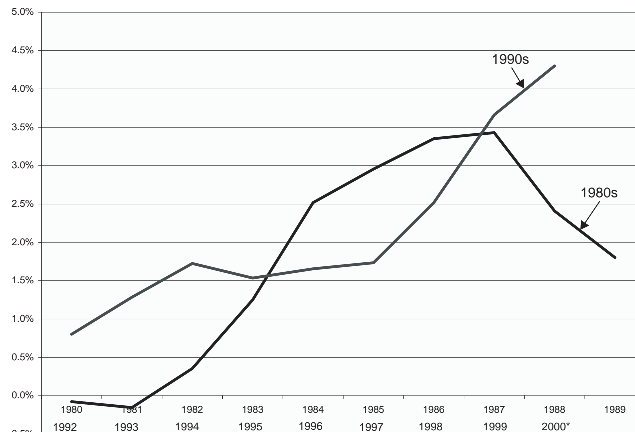
Source: NBSVDS/Call Report Data

Despite the positive environment, important risks remain on the international front. One of the most significant risks stems from the U.S. current account deficit.

Current Account Imbalance

Surging domestic demand, which has been the principal force behind U.S. growth, continues to outstrip expansion of total domestic production. As a result, U.S. consumers and businesses have increasingly come to rely on foreign countries to supply an important part of their goods and services. Last year, the United States recorded the largest current account deficit in its history, surpassing its previous high hit in the mid 1980s. Projections are for continued expansion of the red ink, which some analysts anticipate will approach 5 percent of GDP by the end of the year, despite growing overseas demand for U.S. exports from strengthening foreign economies. Analysts believe that as long as U.S. domestic demand continues to expand strongly, additional sales of U.S. goods abroad will not be sufficient to significantly reduce the current account deficit.

Figure 7—Current Account Deficit Exceeds 1980s Levels



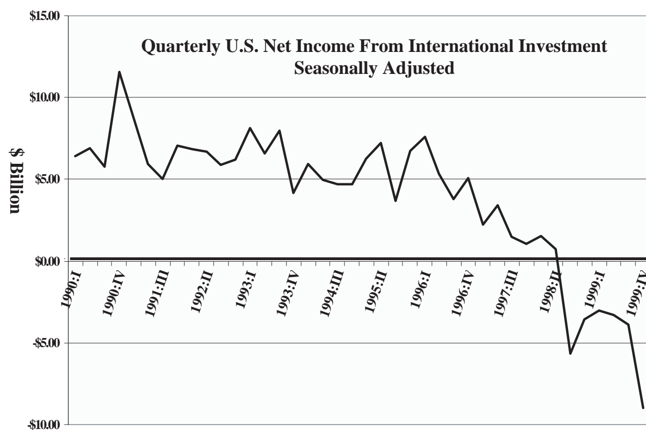
*IMF April 2000 World Economic Outlook Projection

International Investment Income

The current account deficit is primarily financed by inflows of foreign investment. As the U.S. external deficits have grown, so have foreign holdings here and the earnings accruing to foreigners. From 1914 through 1997 earnings on U.S. assets abroad more than covered payments to foreigners on their American investments. However in the last half of 1998, as the stock of foreign investment in the United States continued to swell, foreigners' income on investments exceeded returns to U.S. residents on their holdings abroad for the first time in almost 85 years. Net

payments to foreigners grew further last year reflecting additional increases in their holdings in the United States. Financing of this year's current account deficit will further expand the stock of foreign debt and will generate growing net income payments to foreigners. In the absence of other changes, the additional payments will further extend our current account deficit. This will require a corresponding increase in the size of inflows of foreign investment and subsequently further boost net investment income payments to foreigners. There is general agreement among analysts that this process cannot continue indefinitely; at some point the United States must curtail the size of its current account deficit.

Figure 8—Shift in International Investment Income Complicates Adjustment



Source: U.S. Bureau of Economic Analysis

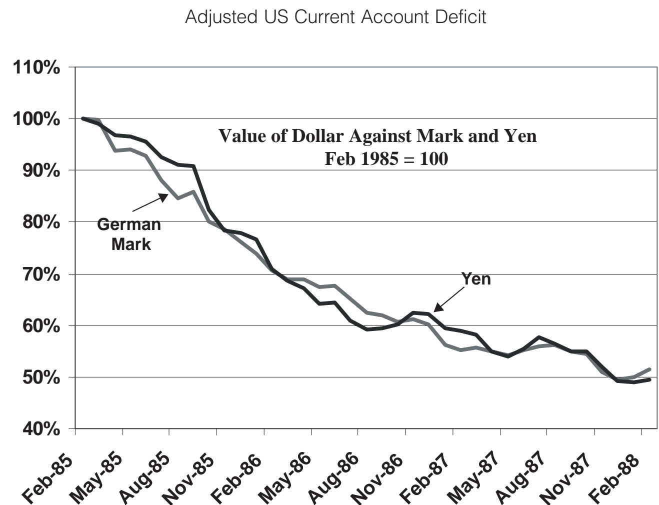
Soft-Landing Scenario

It is possible that economic adjustments in the United States could result in a lowering of the current account deficit without significant disruption to financial markets or the overall macroeconomic environment. In part, this outcome would be dependent on favorable external developments. A slowing in the growth of U.S. domestic demand, as the result of higher interest rates or a decline in stock market valuations for example, would curb the acceleration in import purchases and allow for expansion of exports. An improved international environment would enhance demand for U.S. exports and buffer the impact of the deceleration in internal demand. (Europe would need to have a period of sustained strong growth, the Japanese economy would need to rebound, and the emerging world would have to avoid a major crisis.) Under this scenario, the adjustments would occur gradually and the resulting U.S. economy would be expanding at a slower but sustainable pace. The U.S. output mix would be more oriented toward exports and replacements for imports, as higher import prices induced some shifting of consumption towards domestic goods and services.

Comparison of Current Environment With that of Mid 1980s

A soft landing also presumes the continued availability of foreign financing at close to current conditions during the adjustment process. If there is a significant decrease in foreigners' willingness to provide funding, sharp movements in financial markets are likely, with potentially important macroeconomic consequences. In the mid 1980s, the last time that we had very large imbalances in our external accounts, trade flows shifted after a sizable realignment of exchange rates. This occurred when it became clear that the large U.S. trade account deficit would not continue to be tolerated and the dollar began a significant depreciation. The currency moved down by 40 percent against both the German mark and the Japanese yen within 18 months of its peak and shed another 10 percent the following year. The decline was relatively steady and gradual, and the adjustment did not prove especially disruptive for overall U.S. economic growth.

Figure 9—Sizable Dollar Correction in MId 1980s

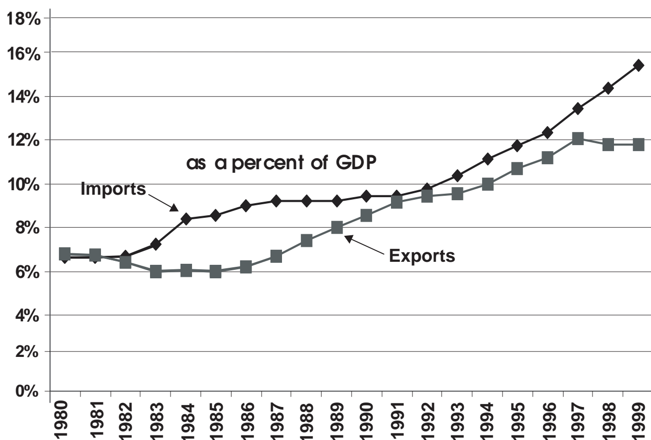


It is unlikely that we would experience a replay of such a large, and relatively benign adjustment in relative prices. The impact on the U.S. economy and on world financial markets of a comparable exchange rate adjustment is likely to be more significant and disruptive now. The current account deficit now is larger relative to U.S. GDP and trade is more significant to the domestic economy. Most

importantly in the 1980s there was a combination of slack in the U.S. economy, declining domestic interest rates, and our securities markets were trending up. In contrast, U.S. monetary officials are now worried about overheating. Interest rates are rising. Securities markets are off their highs, and investors are apprehensive about the possibility of a sharper correction.

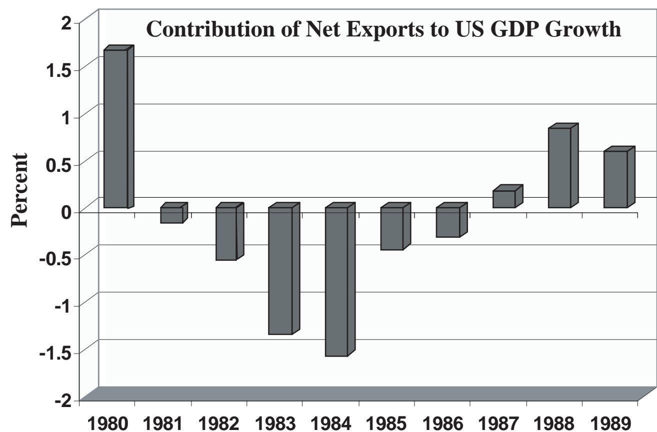
Trade's growing share of the U.S. economy will magnify the impact of a movement of exchange rates. Since 1985 exports and imports have almost doubled as a percentage of GDP. In part, this reflects significant reductions in trade barriers and a more market-oriented approach to policy-making in foreign countries. This has produced important benefits for the United States and the rest of the world. However, it also increases the effect of any exchange rate adjustments. A sizable decline in the U.S. dollar's value would first be felt in upward pressure on prices. The dollar value of imports and exports would rise to reflect the now more expensive foreign currency prices. For example, a 12 percent depreciation in the dollar translated into corresponding increases in the dollar price of exports and imports would lift aggregate U.S. prices by approximately 3 percent. (In practice the impact would be altered by, among other things, adjustments in the volume of exports and imports.) A rise of this magnitude in the price index would probably produce secondary effects as workers and property owners try to catch up via higher wages, rent, and profits.

Figure 10—Foreign Trade More Important in the U.S. Economy



In the 1980s, large swings in the external sector induced by the depreciation of the dollar had important positive implications for the overall economy. In 1984 the United States was a large net importer. The imbalance between exports and imports subtracted almost 1.5 percent from U.S. GDP. Following the exchange rate adjustment (and after a lag), export sales rose sharply in reaction to the relatively lower prices for U.S. goods. In addition, American consumers shifted away from higher priced imports towards domestic products. Between 1984 and 1988, the swing in net exports totaled 2 percent of GDP. To meet this additional demand for its products, the United States had to be able to increase its production of goods and services (or correspondingly reduce its domestic consumption). In the mid 1980s, the economy could accommodate the extra demand stemming from the exchange rate movement. The United States was only a few years removed from the steep recession of the early 1980s. Unemployment remained over 7 percent and adequate capacity existed to enlarge overall production without major strain.

Figure 11—Export Sector Shifts From Drag to Boost to Economy After Dollar Weakens

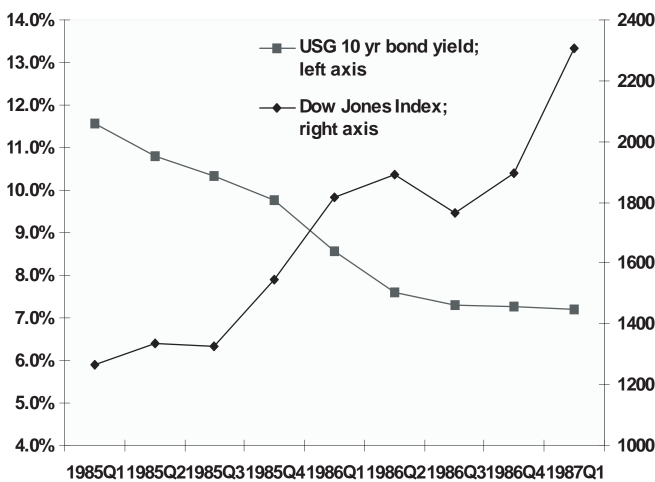


In contrast, in 2000 the United States is enjoying the longest economic expansion on record, and the unemployment rate is at its lowest level in decades. Concern about the economy's capacity to meet existing demand is leading to higher interest rates. Any significant additional stimulus from the external side is likely to add to the pressures on labor supply and on interest rates. For example, the Federal Reserve model of the economy indicates that an increase of about 100 basis points in interest rates would be necessary to offset the income effect of a 12 percent dollar depreciation. This increase would be on top of any other upward moves in rates based on the current high level of domestic demand.

This likely upward move of interest rates in reaction to a weaker dollar is in sharp contrast to events in the mid 1980s. Then interest rates dropped despite the currency's weakness. That led to gains in securities markets, which largely offset translation losses from dollar holdings. This may explain, in part, why the depreciation of the dollar

was fairly smooth in financial markets. At that point, inflation, which had hit double digits in the late 1970s, was in retreat and U.S. interest rates were still adjusting to the changed environment. As borrowers (lenders) were steadily lowering their expectations of future price rises, they were willing to pay (demanding to receive) less of an inflation premium for long term funds. In addition, monetary policy, which had been tightened in the beginning of the decade to check inflation, was accommodative. The dollar's depreciation did not re-ignite concern about inflation because trade was a relatively small percentage of the U.S. economy. As a result, the decline in interest rates continued even as the dollar weakened through early 1987.

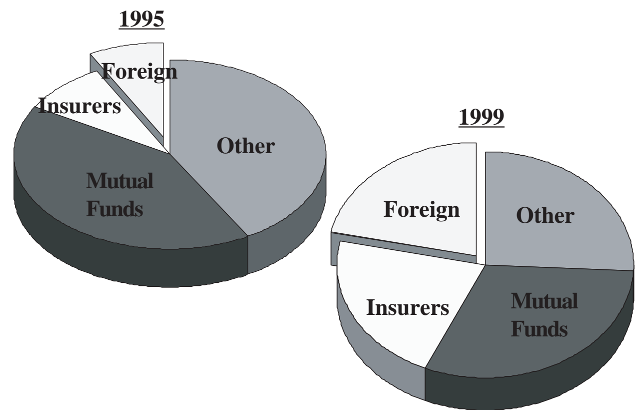
Figure 12—In Mid 1980s U.S. Securities Markets Strengthened Offsetting Much of Dollar's Decline



Hard-Landing Scenario

If foreigners decide not to further expand holdings of dollar denominated assets, for example out of concerns about the sustainability of the U.S. current account deficit or as a result of deteriorating prospects for returns on U.S. assets, this could produce significant movement in financial markets and have important macroeconomic implications. As illustrated above, as the dollar weakened, the inflationary implications of higher priced tradable goods and the pressure of extra demand for U.S. products would likely lead to additional interest rate hikes, beyond those already being driven by current domestic considerations. The U.S. securities market would be likely to drop in response, which could further discourage the holding of dollars. In this environment, a significant downward move in financial markets is possible.

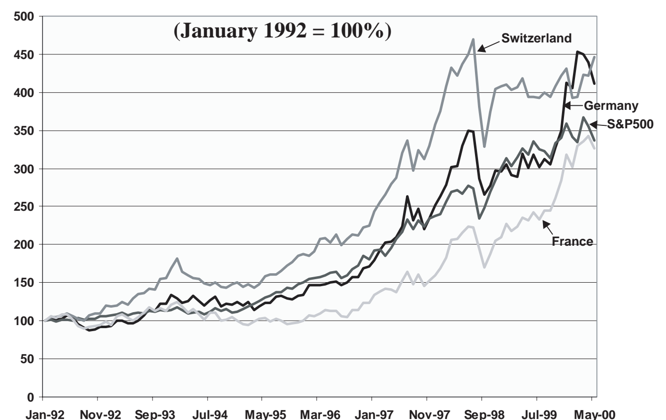
Figure 13—Foreign Purchases Increasingly Important to U.S. Equities Markets (Share of Net Purchases of U.S. Equities)



Source: Fed Reserve; Flow Of Funds, March 2000

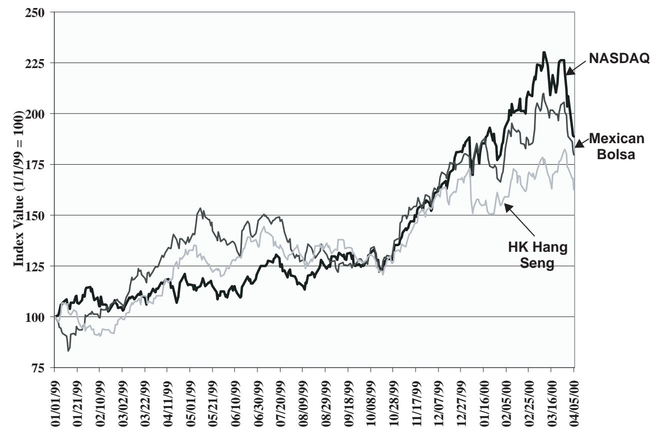
The equities market may be especially affected by a change in overseas sentiment towards the dollar, since foreign purchases have become increasingly important to U.S. stocks. In effect, the United States has been financing a growing share of its current account deficit by sales of equities to foreigners. Some of this is connected to mergers and acquisitions, but high rates of return have attracted many foreign investors in U.S. equity markets. A drying up of foreign interest will likely have a notable depressing effect on U.S. equity prices.

Figure 14—U.S. Equity Markets Considered Vulnerable but European Stocks Also Near All Time Highs



There is also a potential for significant spillover impacts on other stock markets if the prices of U.S. equities tumble. European markets are also near or at all-time highs, although based on historic price earnings relationships they tend not to be as extended as U.S. equities. A sizable correction in the United States could spark sales in Europe. Equities in emerging markets may be even more vulnerable. In a number of important cases, they have been tracking developments in the Nasdaq. In some cases, this reflects the growing importance of high tech companies in local equity markets. A sharp slowdown in global equities could negatively affect confidence and investment.

Figure 15—Major Emerging Market Stocks Moving With NASDAQ



Data Source: Bloomberg's

Special Studies on Technology and Banking

Who Offers Internet Banking?

by Karen Furst, William W. Lang, and Daniel E. Nolle[1]

1. Introduction

Banking over the Internet has attracted increasing attention over the past several years from bankers and other financial services industry participants, the business press, regulators, and lawmakers, both in the United States and in other countries. In part, this is due to the rapid and significant growth in electronic commerce ("e-commerce"), and the notion that electronic banking and payments will likely advance more or less in tandem with e-commerce. In addition, industry analyses outlining the potential impact of Internet banking on cost savings, revenue growth, and increased customer convenience have also generated considerable interest and speculation about the impact of the Internet on the banking industry. The public policy issues emerging with the development of Internet banking are also generating increased attention from banking regulators and other government officials. To date, however, because there is little systematic information on the nature and scope of Internet banking, much of the analysis of the benefits and impact of Internet banking has been based on anecdotal evidence and conjecture.

The main purpose of this article is to help fill significant gaps in existing knowledge about the Internet banking landscape. Using information drawn from a survey of national bank examiners, we present data on the number of national banks offering Internet banking and the products and services being offered. In addition, we project the extent of Internet banking at the beginning of 2001 implied by the survey. We also investigate how national banks offering Internet banking perform relative to other national banks with respect to profitability, cost efficiency, and other characteristics. We separately examine *de novo* (newly chartered) national banks to investigate the extent to which new entrants are embracing Internet banking technology to a different degree than existing banks.

Our main findings are:

- Only 20 percent of national banks offered Internet banking in the third quarter of 1999. However, as a group, these "Internet banks" accounted for almost 90 percent of national banking system assets, and 84 percent of small deposit accounts.[2]
- All of the largest national banks offered Internet banking, but only about 7 percent of the smallest size banks offered it. Among institutions offering Internet banking, large banks are much more likely than small banks to offer a broader range of services via the Internet.
- Banks in all size categories offering Internet banking tend to rely less on interest-yielding activities and core deposits than do non-Internet banks.
- Institutions with Internet banking outperformed non-Internet banks in terms of profitability. However, small *de novo* banks offering Internet banking performed more poorly than non-Internet *de novos*.
- Projecting from banks' plans as of the third quarter of 1999, 45 percent of all national banks will be offering Internet banking by the beginning of 2001. Those banks will account for 95 percent of the assets and 93 percent of the small deposit accounts at national banks.
- Most of the growth in new Internet banking will be due to small banks coming on-line. At the same time, almost half of all national banks had no plans to offer Internet banking.
- Customer use of Internet banking is disproportionately concentrated among a few large banks. Based on our analysis of data from private sector studies, we find that the five banks with the greatest number of on-line customers account for almost 36 percent of all Internet banking users. By comparison, these same five banks account for only 20 percent of small deposit accounts.

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[1] The authors thank Steven Egli for excellent research assistance and Rebecca Miller for expert editorial advice. This article is based on Furst, Lang, and Nolle (2000). The data on Internet banking activities of national banks was compiled based on responses to a questionnaire OCC examiners completed between mid-August and mid-September 1999. We thank Bernard Locey for his help with that data.

[2] In this paper, we use the term "Internet bank" to mean a bank offering its customers the ability to transact business with the bank over the Internet. We do not confine the term to Internet-only or "virtual" banks. Customer transactions of Internet banking can be as simple as on-line balance inquiry or credit application, but also include such services as electronic bill presentment, insurance, and brokerage. "Non-Internet banks" refer to those banks that do not offer transactional Internet banking, even if they have a Web site.

The next section of this article defines Internet banking and provides context for our analysis. The third section describes our database and gives a description of the number and size distribution of national banks offering Internet banking. That section also provides information on the particular nature of Internet banking products and services offered by national banks. The fourth section compares the structure and performance of banks offering Internet banking with other banks, and the fifth section projects the extent of Internet banking at the beginning of 2001 based on the stated plans of national banks. The fifth section also discusses current and potential future demand for Internet banking using bank and industry estimates of customer use. The concluding sixth section summarizes our major findings.

2. Internet Banking: Definitions and Background

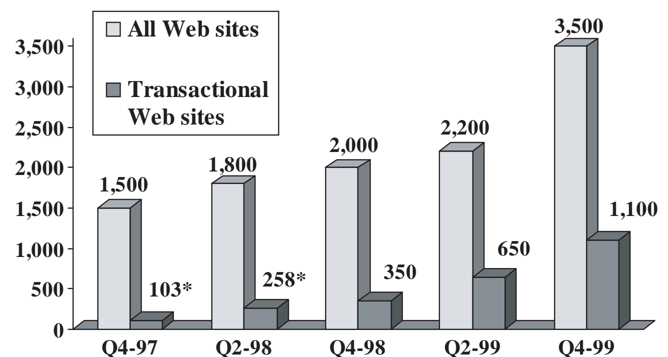
Internet banking refers to the use of the Internet as a remote delivery channel for banking services. Such services include traditional ones, such as opening a deposit account or transferring funds among different accounts, and new banking services, such as electronic bill presentment and payment, allowing customers to receive and pay bills via a bank's Web site.

Banks offer Internet banking in two main ways. An existing bank with physical offices can establish a Web site and offer Internet banking to its customers in addition to its traditional delivery channels. A second alternative is to establish a "virtual," "branchless," or "Internet-only" bank. The computer server that lies at the heart of a virtual bank may be housed in an office that serves as the legal address of such a bank, or at some other location. Virtual banks may offer their customers the ability to make deposits and withdraw funds via automated teller machines (ATMs) or other remote delivery channels owned by other institutions.

To date, it has been difficult to assemble comprehensive information on the Internet banking activities of commercial banks in the United States. In part this is because there are no special reporting requirements for a bank electing to reach customers via this new delivery channel, and hence there is no regularly compiled set of data about this attribute of banking.[3] In the recent past, at least two studies have appeared on the number of banks offering Internet banking, and some of their characteristics, but these relied on sampling methods for a banking industry profile, rather than an actual count of banks.[4] To our knowledge, only Egland, Furst, Nolle, and Robertson (1998), and Furst, Lang, and Nolle (2000) (from which this article is drawn) provide both an actual count of banks offering Internet banking and an analysis of major structure and performance characteristics of these banks.[5]

With this in mind, Figure 1 offers an approximation of the number of Internet banking sites from the end of 1997 through the end of 1999. During that time, according to estimates by the Federal Deposit Insurance Corporation (FDIC), and Couch and Parker (2000), the number of banks and thrifts with Web sites more than doubled from approximately 1,500 to 3,500; by year-end 1999, approximately one-third of the 10,000 U.S. banks and thrifts had Web sites. Approximately 1,100 of those Web sites were transactional, i.e., allowed customers to conduct business on-line, while the remainder were information-only sites.[6]

Figure 1—Estimated bank and thrift Web sites, and transactional Internet banking Web sites



*Actual.

Source: Office of the Comptroller of the Currency using data from the FDIC, Couch and Parker (2000), and bank and thrift Web sites

[3] Banks are also not required to report information about other delivery channels, such as ATMs and telephone banking. Note that beginning in 1999 the OTS has required prior notice for federally chartered thrifts, and in the third quarter of 1999 a line was added to the call report for all banks and thrifts to report their uniform resource locator (URL) (or Internet address).

[4] See United States General Accounting Office (1998), and the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and the Office of Thrift Supervision (1999) (henceforth referred to as the "Interagency Web Site Privacy Report").

[5] As Egland, Furst, Nolle, and Roberston (1998) explain, there is an element of estimation even in that study. This is due to the fact that a single Web site may cover more than one bank that is a member of a multibank holding company. As a consequence, the authors distinguish between the number of Web sites and banks covered by those Web sites. See Egland, Furst, Nolle, and Robertson (1998), footnote 5.

[6] In the second quarter of 1998, Egland, Furst, Nolle and Robertson (1998) found that 223 Web sites represented 374 banks. Extrapolating from this ratio of 1.68 banks-per-banking company Web site, 18 percent of banks and thrifts offered true Internet banking as 2000 began.

While "virtual banks" have generated considerable attention in the press and within the banking industry, there were only nine separately chartered virtual banks at the beginning of 2000. Virtual banks are arising via several routes. One route is for new investors in the banking industry to obtain a charter from state or federal supervisory authorities to establish a new, independent virtual bank. Existing banking companies have also created virtual banks as separately capitalized subsidiary banks of a bank holding company. A third route that is beginning to be pursued by investors is to purchase the existing charter of a traditional bank, and then to recast the bank as a virtual bank under the existing charter.

As an alternative to seeking a separate charter for an Internet-only bank, "tradename" Internet banks have been established as separate divisions of an existing bank.[7] At the beginning of 2000, there were roughly 20 tradename virtual "banks" in the United States. A tradename virtual bank typically operates independently from the rest of the bank in terms of staffing, marketing, and integration of computer systems into the existing bank's legacy systems. This corporate strategy is based on a desire to capture advantages in operating style that many believe flow from having a virtual bank, and the desire to project a fresh image and thereby attract new customers. Both tradename and separately chartered virtual banks may find it difficult to attract customers without providing some form of physical contact with the bank.[8] Some virtual banks are considering establishing kiosks, limited-service offices, or other forms of physical presence in order to retain and attract customers.[9] Such a "clicks and bricks" approach could emerge as another main way to offer Internet banking.[10]

[7] For business press accounts of Internet-only banks, including several tradename banks, see Hallerman (1999a), Costanzo and Senior (1999), Daudelin (2000), *Financial Service Online* (2000), Giesen (2000), and O'Sullivan (2000a and b).

[8] See O'Sullivan (2000b) and Costanzo (2000) for discussions of the difficulties virtual banks face in the marketplace. O'Sullivan (2000b) reports on research evaluating the performance of virtual banks relative to traditional banks offering Internet banking. See also *Bank Technology News* (2000), which compares studies by CheckFree Corp. and GartnerGroup showing that consumers wishing to engage in electronic billing have a significantly stronger preference for dealing with a bank with a physical presence rather than an Internet-only bank.

[9] See, e.g., *Financial Service Online* (1999), *Bank Network News* (2000), Day (2000), and Toonkel (2000b).

[10] The option of moving away from an Internet-only strategy is receiving attention in businesses besides banking. See, for example, McIntyre and Christensen (1999) and Hamilton (2000).

3. Internet Banking in the National Banking System

The Data Set

The data set for the current study is unique in a number of respects. First, it covers the Internet banking offerings of every national bank. That information was compiled based on responses to a questionnaire OCC examiners completed between mid-August and mid-September 1999 for 2,535 national banks. The questionnaire covered whether a bank had a Web site, and, if so, whether the Web site was transactional. For banks with transactional sites, examiners provided a more detailed set of information on the nature of their sites, including information on the range of products offered. Examiners also answered questions about banks' plans for offering Internet banking in the future.

We matched the examiner-response data with financial data for the 2,517 national banks that filed a third quarter 1999 Report of Condition and Income (the "call report"), and we added banking structure data contained in the OCC's Integrated Banking Information System database. In addition, we included supervisory information on banks' CAMELS ratings, as well as on their information technology (IT) practices. While our data set is confined to national banks, we believe it is broadly applicable to the banking system at large.[11]

Number and Size Distribution of Internet National Banks

Based on daily articles in the business press, one might easily conclude that most banks offer Internet banking.[12] In fact, as Table 1 shows, while slightly more than half of all national banks had Web sites in the third quarter of 1999, only 464 national banks—just under 20 percent of all FDIC-insured national banks—offered transactional Internet banking to their customers.[13]

Although only a minority of institutions offer Internet banking, Table 2 shows that banks offering these services

[11] As of the third quarter of 1999, national banks accounted for 28 percent of all banks and 59 percent of all banking system assets. On average, national banks are larger than state banks but national banks are widely distributed across asset size categories, and by size category they exhibit the same performance characteristics as state banks. Egland, Furst, Nolle, and Robertson (1998) found no evidence of significant differences in the structural attributes of national and state banks offering Internet banking.

[12] For example, during the week of March 20–24, 40 percent of the articles in the *American Banker* dealt with Internet banking.

[13] As noted at the bottom of Table 1, this figure excludes credit card banks.

Table 1—Internet banking and national banks (Q3 1999)

	Number	Percent of national banks
National banks with Web sites	1,364	54.2
National banks with transactional Web sites *of which:*	541	21.5
FDIC-insured commercial national banks with transactional Web sites [a] *of which:*	464	19.9 [b]
Virtual banks [c]	1	[d]
Memorandum:		
Total national banks [e]: 2,517		
Total FDIC-insured national banks: 2,334 [a]		

Source: Office of the Comptroller of the Currency

[a] Excluding credit card banks.

[b] FDIC-insured commercial national banks with transactional Internet banking as a percent of all FDIC-insured national banks, excluding credit card banks.

[c] See the text for a definition of "virtual bank."

[d] Less than 1 percent.

[e] All national banks for which a third quarter 1999 call report was filed.

Table 2—Internet banks few in number, but dominant in key characteristics (Q3 1999)

	Transactional Internet national banks as a percent of all national banks	
Number of banks	19.9	
Assets [a]	89.2	
Small deposit accounts [b]	84.1	
	Transactional Internet national banks	**Non-Internet national banks [c]**
Average size (assets in $ millions)	5,880	180
Average number of employees	1,659	69
Average number of offices per bank [d]	61	5
Average number of employees per office	27	15
Percent of banks in urban areas [e]	72.2	42.6

Source: Office of the Comptroller of the Currency.

[a] Dollar value of assets.

[b] Percent of number of deposit accounts under $100,000.

[c] Includes banks with Web sites that are not transactional.

[d] Includes headquarters, branches, and non-branch offices.

[e] "Urban area" is defined as a Standard Metropolitan Statistical Area.

accounted for most of the assets in the national banking system. In addition, transactional Internet banks accounted for almost 85 percent of all deposit accounts under $100,000 in the national banking system. Such deposits are a reasonably good measure of consumer accounts at banks, and by implication, we can say that most consumers have accounts at banks that offer Internet banking. Virtually all of the evidence from market surveys indicates that consumer use of the Internet for banking transactions is currently quite limited. Those data suggest that this limited usage is primarily due to a lack of consumer demand for the current set of Internet banking products, rather than a lack of availability. The infrastructure is in place to allow for very rapid growth in the use of Internet banking if consumers become convinced that the services offered via the Internet are superior to the services offered through more traditional delivery channels.[14]

As a group transactional Internet banks had, on average, 33 times more assets, 24 times more employees, and 12 times more offices than non-Internet national banks. In addition, although Internet banking can enable a remotely located bank to reach potential customers anywhere, to date transactional Internet banks were more than one-and-a-half times more likely to be located in urban areas as were non-Internet banks.

Table 3 illustrates the size distribution of Internet and non-Internet banks. All of the largest banks (i.e., those with $10 billion or more in assets), and almost two-thirds of mid-to-large-size banks (i.e., those with between $1 billion and $10 billion in assets) offered Internet banking. By contrast, only 7 percent of small banks (i.e., those with under $100 million in assets) did. Nevertheless, it is clear that while large banks are far more likely to be transactional, small size is not a prohibitive barrier to offering Internet banking.

Key Internet Banking Services

Egland, Furst, Nolle, and Robertson (1998) showed that in mid-1998, most transactional Internet banks offered the services of balance inquiry and funds transfer between accounts. That generalization still applied in the third quarter of 1999, as Table 4 shows, although small transactional banks were somewhat less likely to offer these

[14] Recent analyses indicate that a large percentage of customers who sign up for Internet banking discontinue using it. See, e.g., Redman (1999), who summarizes the findings of a Cyber Dialogue study. Craig (1999) presents a theoretical analysis of the obstacles to changes in payment patterns. Also see Marks (1999), who compares the relative success of on-line brokerage to on-line banking.

Table 3—National banks offering transactional Internet banking: size distribution
(Q3 1999)

	Number of Internet banks	Internet banks as a percent of banks in size category	Average asset size of Internet banks relative to non-Internet banks [a]
Less than $100 million	85	7.1	0.95
$100 million to less than $1 billion	265	27.1	1.45
$1 billion to less than $10 billion	73	61.3	1.40
$10 billion and over	41	100.0	n.a.
Total	464	19.9	32.67

Source: Office of the Comptroller of the Currency.

[a] Non-Internet banks include those with a Web site that is not transactional.

n.a.: not applicable.

services.[15] There is a more significant divergence by size category in the proportion of banks offering electronic bill payment.[16] All of the very largest banks, and over 90 percent of banks in the $1 billion to $10 billion asset class, offer electronic bill payment. This drops to 77 percent for banks between $100 million and $1 billion, and to 60 percent for the smallest size category.

Looking at Internet banking services beyond balance inquiry, funds transfer, and bill payment, patterns of what is offered by banks of different sizes diverge greatly. In general, larger banks are more likely to accept credit applications on-line, but except for the smallest size category, there is no relationship between size and the ability to set up a new account via the Internet.

One notable feature of Table 4 is that banks of all sizes were roughly equally likely to offer on-line cash management services. Cash management is a key business-oriented service, and the Internet would seem to offer significant opportunities for banks to create value by improving the efficiency of cash management systems. Thus, offering this line of business may be an important determinant for how well small banks compete with larger institutions for business customers. As of the third quarter of 1999, it appeared that small banks were giving this business line as much focus as large banks. However, as Table 4 makes clear, only about 16 percent of all transactional banks offered this service, a percentage far below that for most other on-line products for which we collected data.[17]

Table 4 also contains information on the extent particular business lines—brokerage, fiduciary, and insurance

[15] Most of the banks that did not offer balance inquiry or funds transfer at a minimum offered on-line credit applications.

[16] Electronic bill payment allows a bank's customers to instruct the bank to make payments electronically. The bank then either sends an automated clearinghouse (ACH) payment or a paper check. In either case, the customer's account is debited for the amount of the payment.

[17] In the first quarter of 1999, Pizzani (1999) reported that "banks have largely ignored the online banking needs of small businesses." As we discuss in the section on banks' plans (below), it appears that bankers are planning to increase dramatically their emphasis on business Internet banking services.

Table 4—Key services offered by transactional Internet national banks
(Q3 1999)

	Percent of transactional Internet banks offering selected services (by asset size category)				
Type of service	All banks	Less than $100 million	$100 million to less than $1 billion	$1 billion to less than $10 billion	$10 billion and over
Balance inquiry and funds transfer	88.8	74.1	90.2	94.5	100.0
Bill payment	78.2	60.0	77.4	90.4	100.0
Bill presentment	10.6	7.1	7.9	16.4	24.4
Credit applications	60.0	51.8	51.7	75.3	80.5
New account set-up	36.6	29.8	43.9	45.2	43.9
Cash management	15.7	14.1	16.2	15.1	17.1
Brokerage	21.6	10.6	14.7	41.1	53.7
Fiduciary	11.9	3.5	9.8	12.3	41.5
Insurance	5.4	2.4	2.3	6.8	29.3

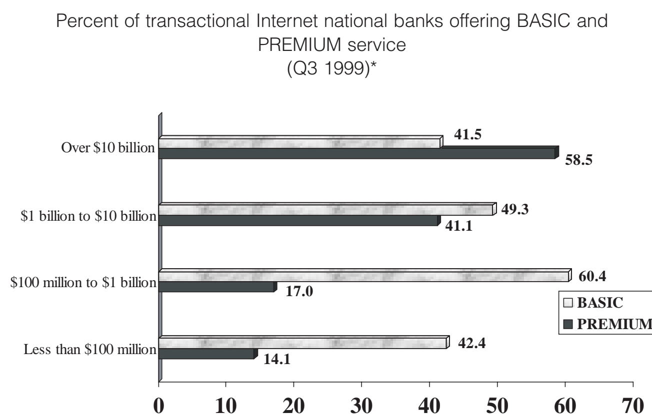
Source: Office of the Comptroller of the Currency.

services—were offered on-line. Consistent with their practices in the physical world, larger banks are much more likely to offer brokerage services than smaller banks; the on-line pattern is less clear for offerings of insurance and fiduciary services, although banks under $100 million in assets are least likely to offer any of these services.[18]

To gain a clearer picture of the typical range of Internet services available at banks in different size categories, we defined two alternative "menus" of Internet banking services. "BASIC" Internet banking is defined as the three core Internet banking services of balance inquiry, funds transfer, and bill payment. We define "PREMIUM" Internet banking as BASIC plus at least three other services. Figure 2 compares the proportion of banks by size category that offer just BASIC services to those that offer a PREMIUM set of Internet banking products. In the smaller size categories, Internet banks are more likely to offer just the BASIC range of services, compared to the larger size categories of Internet banks. But almost 60 percent of the largest banks offer PREMIUM Internet banking services, whereas only 14 percent of the smallest banks have extended product menus. More generally, banks over $1 billion in assets are at least two-and-a-half times more likely than banks under $1 billion in size to offer customers a PREMIUM package of services. Hence, the evidence indicates that, while small banks can establish an on-line presence, they are currently less likely to compete with large banks on the basis of the range of product offerings. To the extent product variety is a key factor in attracting and maintaining a strong customer base, small banks may be at a disadvantage relative to large banks.

Figure 2—Larger banks offer a greater range of Internet banking services

Percent of transactional Internet national banks offering BASIC and PREMIUM service (Q3 1999)*



*BASIC service includes balance inquiry, funds transfer, and bill payment. PREMIUM service includes BASIC and at least three other on-line services.

Source: Office of the Comptroller of the Currency

Web Site Privacy Statements

Both banks and their customers stand to benefit substantially from the increased ability to collect and analyze information obtained via the Internet. In particular, both banks and customers can benefit from the collection and integration of large amounts of personal information that enhance the ability of banks to offer a wide range of products tailored to individual demands. However, these same information collection, analysis, and distribution activities raise questions related to personal privacy protection.[19] A basic step many banks are taking to address on-line privacy issues is to post a statement of their policies about the collection and use of customer information. Our database includes information on how many transactional banks had such a statement on their Web site. Table 5 summarizes that information.[20]

More than four-fifths of transactional Internet banks included a privacy policy statement on their Web site in the third quarter of 1999. That represents a large increase

Table 5—Substantial increases in number of Web site privacy policy statements

	Percent of transactional Internet national banks with a privacy policy statement on the Web site		
Asset size category	Second quarter 1998	Fourth quarter 1998	Third quarter 1999
All	40.9	54.5	83.8
Under $100 million	21.4	35.7	75.0
$100 million to less than $1 billion	32.6	41.3	79.5
$1 billion to less than $10 billion	37.5	62.5	97.7
$10 billion and over	75.0	95.0	100.0

Source: Office of the Comptroller of the Currency; Egland, Furst, Nolle, and Robertson (1998).

[18] As Table 4 shows, 41.5 percent of the largest transactional banks offer fiduciary services on-line. That percent is lower than the percent of the largest banks offering 6 of the other 10 on-line services. This relatively low percentage appears to be consistent with more general findings about the somewhat lackluster competitive position of large banks in offering retirement services, both on-line and via traditional channels. See Robertson, Cambruzzi, Jacques, Nigro, Pate, Rich, and Steele (2000) for a detailed study of this issue.

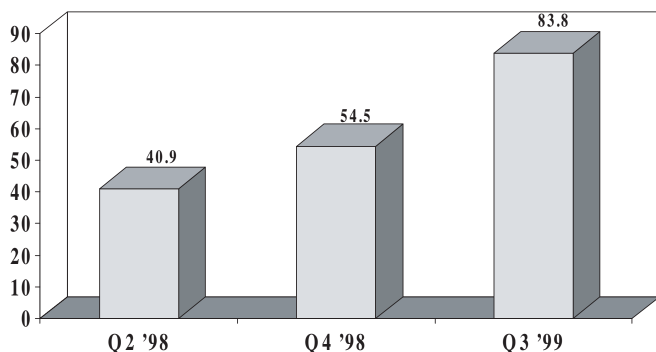
[19] See Office of the Comptroller of the Currency (1999a) for a discussion of privacy issues facing banks offering Internet banking.

[20] Note that our data is confined to whether or not transactional Internet banks posted an on-line privacy statement; it does not include an evaluation of the nature of banks' privacy statements. For an analysis of attributes of the on-line privacy statements of depository institutions, see the Interagency Web Site Privacy Report (1999).

from just over 50 percent at the end of 1998, and more than a doubling since mid-1998.[21] Large banks were more likely to post an on-line privacy policy than small banks. Indeed, 100 percent of the largest banks included on their Web sites a statement about the collection and use of customer information, and almost all banks over $1 billion in asset size did so, as compared to 75 percent of the smallest banks. However, the discrepancy between large and small bank practices in this respect narrowed considerably during 1999. Figure 3 illustrates the fact that on-line privacy statements have become more common for transactional Internet banks over time.

Figure 3—Most transactional Internet national banks have an on-line privacy statement

Percent of transactional Internet national banks with an on-line privacy statement



Source: Office of the Comptroller of the Currency

4. Internet and Non-Internet Banks: Performance Comparisons

In comparing transactional Internet banks in mid-1998 to non-Internet banks, Egland, Furst, Nolle, and Robertson (1998) found little besides relative size to distinguish the two groups. As Tables 6, 7, and 8 illustrate, by the third quarter of 1999, differences between Internet and non-Internet banks had begun to emerge in balance sheet composition and funding, in sources of income and expenditures, and in measures of performance.[22]

Portfolio Composition, Income, and Expenses

Table 6 shows major lending and funding characteristics for Internet and non-Internet banks.[23] Overall, on the asset side, Internet banks have a relatively greater focus on business lending (commercial and industrial loans) and credit card lending. On the liability side, Internet banks generally are less reliant on core deposits for funding and make greater use of purchased funds relative to deposits. For small banks, this result is consistent with recent business press reports that they are concerned about traditional sources of funding, and that small banks have begun to view the addition of Internet banking as a way to offer products that reduce their dependence on core deposits.[24]

Differences in business strategies between Internet and non-Internet banks are also evident in Table 7. The first column in Table 7 shows the ratio of noninterest income to net operating revenue. This ratio is a rough proxy for the amount of revenue being generated by "non-traditional" activities. Internet banks generated a substantially higher proportion of their income from non-traditional activities compared to non-Internet banks. Roughly speaking, Internet banks received about 50 percent more of their revenue from noninterest income when compared to non-Internet banks. That pattern is consistent with a business strategy of using the Internet to target businesses and more affluent consumers, in the belief that these customers will be interested not only in loans but in other services that yield fee income.[25]

[21] See Egland, Furst, Nolle, and Robertson (1998) for further information on the 1998 figures.

[22] We make extensive use of univariate comparisons between Internet and non-Internet bank characteristics. Because the importance of bank size has already been established, we "control" for differences in bank size, roughly speaking, by stratifying the data by asset size categories. This "first-step" approach is useful for an initial investigation to establish a foundation of stylized facts. Furst, Lang, and Nolle (2000) include multivariate statistical methods.

[23] In the tables throughout the remainder of the paper comparing structure and performance characteristics of Internet to non-Internet banks, we calculated a difference of means test to ascertain the likelihood that Internet banks and non-Internet banks were different with respect to a given characteristic. For each pair of observations in a table, we provide a probability value (p-value) for the hypothesis that the means in the Internet and non-Internet samples are the same. A lower p-value indicates a greater likelihood that the two figures being compared represent real differences between categories of banks (i.e., Internet vs. non-Internet, etc.). A common practice in empirical economics is to consider p-values at or below 0.05 as indicating a statistically significant difference, while some studies (particularly ones with small samples) use a cut-off point of 0.10 for asserting statistical significance.

[24] See, e.g., Winig (2000), who reports that 85 percent of community bank CEOs who participated in a recent Grant Thornton survey agreed with the statement that "Funding with core deposits will be more difficult in three years," because consumers continue to look for higher-yielding alternatives to bank accounts. Correspondingly, the same survey reveals a surge in community banker interest in offering Internet banking.

[25] See Gold (2000) for example. *Bank Technology News* (1999d) sites a Forrester Research Inc. study showing that higher income individuals are more likely to be active Internet banking users.

Table 6—Internet and non-Internet national banks: selected balance sheet ratios [a, b]
(Q3 1999)

	Loan composition ratios (in percent)		Funding ratios (in percent)	
Asset size category	C&I loans/loans	Credit card loans/loans	Deposits/assets	Fed funds purchased/deposits
Less than $100 million:				
Internet banks	20.4	0.5	82.1	2.1
Non-Internet banks	16.9	0.4	85.1	1.5
(p-value)	(0.001)***	(0.691)	(0.000)***	(0.276)
$100 million to $1 billion:				
Internet banks	17.9	1.7	78.9	7.4
Non-Internet banks	18.1	0.9	82.3	3.9
(p-value)	(0.209)	(0.000)***	(0.000)***	(0.000)***
$1 billion to $10 billion:				
Internet banks	24.5	4.2	68.6	20.4
Non-Internet banks	17.8	0.9	71.8	12.1
(p-value)	(0.003)***	(0.011)**	(0.299)	(0.023)**
$10 billion and over:				
Internet banks	34.1	2.8	66.1	11.7

Source: Office of the Comptroller of the Currency

[a] Numbers in parentheses are probability values (p-values) for a statistical test of the hypothesis that the mean values in each cell are equal. Thus, a smaller p-value indicates a greater likelihood that the true mean value of the Internet sample differs from the non-Internet sample. Asterisks indicate the statistical significance of the difference of means test with:

*** = significant at the 1% level

** = significant at the 5% level

* = significant at the 10% level

[b] Non-Internet banks include banks with non-transactional Web sites.

C&I = commercial and industrial

In addition to revenue enhancement, Internet banking could enable banks to reduce costs of operation. In particular, greater reliance on Internet banking might allow banks to reduce expenditures on "bricks and mortar." To the extent this is so, Internet banking would be considered a *causal* factor in generating lower expenses related to maintaining physical branches. On the other hand, one might expect that banks with relatively high expenses in maintaining their branch networks might have the greatest incentive to adopt Internet banking. From this perspective, the adoption of Internet banking would be the *effect* of existing characteristics of banks. The data in Table 7 shows that, consistent with the first hypothesis, Internet banks over $100 million in asset size had lower expenses on building and equipment relative to net operating revenue. However, among the smallest size Internet banks—the majority of which adopted Internet banking after the second quarter of 1998—building and equipment expenditures were higher than for non-Internet banks. This might indicate that smaller banks with high costs of maintaining a branch are motivated to adopt Internet banking by the prospect of future cost savings. However, because the call report data aggregates expenditures on buildings and equipment, this result might be due to high initial costs of equipment for small banks seeking to establish an on-line presence. Further research is necessary to establish whether Internet banking will likely reduce costs associated with physical branch networks, and whether relatively high branch-related expenses is a causal factor in the adoption of Internet banking.

Performance Measures

Even the banks most successful at offering Internet banking currently serve a relatively small share of their customer base with this delivery channel.[26] As a result, it has been difficult for banks and industry analysts to determine yet if Internet banking has had a significant impact on

[26] The penultimate section of this article discusses "demand" for Internet banking in more detail.

Table 7—Income and expenses: Internet and non-Internet national banks [a, b]
(Q3 1999)

Asset size category	"Non-traditional" income: Noninterest income/net operating revenue [c] (percent)	Expenses: Premises and fixed assets/net operating revenue [c] (percent)
Less than $100 million:		
Internet banks	22.0	11.7
Non-Internet banks	14.6	9.3
(p-value)	(0.000)***	(0.000)***
$100 million to $1 billion:		
Internet banks	23.1	8.2
Non-Internet banks	16.8	9.1
(p-value)	(0.000)***	(0.000)***
$1 billion to $10 billion:		
Internet banks	36.8	7.2
Non-Internet banks	23.0	8.0
(p-value)	(0.000)***	(0.111)
$10 billion and over:		
Internet banks	40.1	8.1

Source: Office of the Comptroller of the Currency

[a] Numbers in parentheses are probability values (p-values) for a statistical test of the hypothesis that the mean values in each cell are equal. Thus, a smaller p-value indicates a greater likelihood that the true mean value of the Internet sample differs from the non-Internet sample. Asterisks indicate the statistical significance of the difference of means test with:

*** = significant at the 1% level

** = significant at the 5% level

* = significant at the 10% level

[b] Non-Internet banks include banks with non-transactional Web sites.

[c] Net operating revenue = net interest income plus noninterest income.

bank performance.[27] For example, in their comparison of Internet and non-Internet banks in mid-1998, Egland, Furst, Nolle, and Robertson (1998) observed that they did not find significant differences in profitability, efficiency, or credit quality. But, as our new information shows, by the third quarter of 1999, differences between Internet and non-Internet banks in performance had emerged.

Table 8 compares the performance of Internet banks with non-Internet banks in the third quarter of 1999. What stands out most distinctly in this table are the performance differences between the Internet banks and non-Internet banks in the smallest size category compared to larger banks. For example, while Internet banks over $100 million in assets were more profitable than non-Internet banks, Internet banks in the smallest size category were significantly less profitable than non-Internet banks.[28] The smallest size banks were also less efficient than non-Internet banks, as measured by the ratio of noninterest expense to net operating revenue ("accounting efficiency"), a commonly used measure of cost efficiency.[29] There was no statistically significant difference between the accounting efficiency of Internet and non-Internet banks in the larger size categories. The smallest size Internet banks had better credit quality than non-Internet banks; for the larger size banks there is a less distinct pattern. As we will discuss further, the differences for small banks were likely due to the relative performance of *de novo* banks that offered Internet banking.

Interestingly, noncurrent loans were significantly higher for Internet banks in the $1 billion to $10 billion assets size category. This is consistent with our previous results in Table 6 that showed that these banks were more heavily concentrated in credit card and business lending than similarly sized non-Internet bank. Internet banks in the smallest size category have relatively fewer noncurrent loans as compared to their non-Internet peers. This suggests that the relatively poor profitability and accounting efficiency ratios at these banks are due to factors not associated with credit losses.

De Novo Banks

To investigate further the performance differences of small banks, we focused on two different groups of Internet banks: *de novo* Internet banks, i.e., those banks that offered Internet banking and had been in operation a year or less as of the third quarter of 1999; and "mature" Internet banks, i.e., those banks which Egland, Furst, Nolle, and Robertson (1998) had determined offered Internet banking at least as far back as the second quarter of 1998. Segmenting our data this way allowed us to investigate two possible reasons small Internet banks per-

[27] See, for example, Azarchs (2000) and Jordan and Katz (1999). In a recent study, Moody's Investors Service (2000a) says that "Moody's does not foresee much impact from the Internet on large U.S. banks' core profitability or competitive position—at least in the intermediate term." Somewhat in contrast, Azarchs (2000) cites a Booz Allen & Hamilton Inc. study arguing that "a mature Internet bank could operate at a 15%–20% expense-to-revenue ratio" compared to a ratio of about 60 percent for most banks. Hitt, Frei, and Harker (1999) found that banks' investment in Internet banking had not resulted in "new, profitable customers to the firm, as many banks had hoped. Rather, it seems to be to retain high-value customers" (p. 132), a result echoed in Hitt and Frei (1999).

[28] We also used return on assets as a measure of profitability and found very similar results.

[29] Following DeYoung (1999), we use the term "accounting efficiency" for this measure of cost efficiency.

Table 8—Internet banks and non-Internet national banks: performance comparisons [a, b]
(Q3 1999)

Asset size category	Profitability: Return on equity (percent)	Accounting efficiency: Noninterest expense to net operating revenue [c] (percent)	Credit quality: Noncurrent loans to total loans [d] (percent)
Less than $100 million:			
Internet banks	6.34	77.90	0.52
Non-Internet banks	10.13	65.52	0.87
(p-value)	(0.000)***	(0.000)***	(0.002)***
$100 million to $1 billion:			
Internet banks	14.15	59.59	0.68
Non-Internet banks	13.03	60.57	0.73
(p-value)	(0.000)***	(0.282)	(0.249)
$1 billion to $10 billion:			
Internet banks	18.26	56.26	0.81
Non-Internet banks	15.68	54.74	0.56
(p-value)	(0.003)***	(0.256)	(0.003)***
$10 billion and over:			
Internet banks	15.35	57.84	0.82

Source: Office of the Comptroller of the Currency

[a] Numbers in parentheses are probability values (p-values) for a statistical test of the hypothesis that the mean values in each cell are equal. Thus, a smaller p-value indicates a greater likelihood that the true mean value of the Internet sample differs from the non-Internet sample. Asterisks indicate the statistical significance of the difference of means test with:

*** = significant at the 1% level

** = significant at the 5% level

* = significant at the 10% level

[b] Non-Internet banks include those with non-transactional Web sites.

[c] A higher ratio indicates lower efficiency.

[d] A higher ratio indicates lower credit quality.

formed more poorly than small non-Internet banks: "newness" of banks, and "newness" of Internet banking.

De novo banks as a rule perform more poorly than established banks, a pattern that generally holds for at least their first three years.[30] Because most *de novo* banks fall into the small size category (i.e., banks with less than $100 million in assets), we reasoned that their performance could have affected the measures of performance for the entire group of small banks.[31] That suspicion was heightened by our discovery that, among small banks, *de novo* banks as a group were three times more likely to offer Internet banking than mature small banks.[32] In addition, it is reasonable to conjecture that the performance of a *de novo* bank might be significantly affected by its choice to offer Internet banking. On the cost side, there may be one-time set-up expenses as well as ongoing expenses for advertising and operating this delivery channel.[33] On the revenue side, *de novo* banks offering Internet banking may have difficulty in attracting customers via the Internet. In light of this, we separated *de novo* national banks from the rest of the small national banks.

Table 9 compares the nine *de novo* Internet national banks and 47 *de novo* non-Internet national banks in the third quarter of 1999 across key performance characteristics. The *de novo* Internet banks had much lower profitability, and greater inefficiency, than did *de novo* non-Internet banks. In a proximate sense, one key contributing factor to these results was that *de novo* Internet banks exhibited a much higher expense ratio than did non-Internet *de novo* banks. As discussed previously, the data

[30] See DeYoung (1999) for a recent analysis of the performance of *de novo* banks.

[31] Fifty-six of the 59 (one year or younger) *de novo* national banks in the third quarter of 1999 were in the under $100 million asset size category.

[32] As the memorandum item in Table 9 shows, 19.2 percent of small *de novo* banks offered Internet banking, while only 6.1 percent of "mature" small banks offered Internet banking.

[33] This may be true even if much of the set-up and operation of the bank's Internet banking is outsourced to third-party vendors.

Table 9—Performance comparisons of *de novo* national banks: Internet banks performed worse than non-Internet banks [a, b] *(Q3 1999)*

	Internet *de novo* banks		Non-Internet *de novo* banks [c]
Number of banks	9		47
Profitability [d]	−14.70		−8.64
(p-value)		(0.082)*	
Accounting efficiency [e]	238.09		133.14
(p-value)		(0.024)**	
Premises and fixed assets-to-net operating revenue (percent)	33.36		19.60
(p-value)		(0.002)***	
"Traditional" income [f]	87.86		75.99
(p-value)	(0.253)		

Memorandum: Among small banks, *de novo* banks are more than three times as likely to offer Internet banking as banks in existence three years or more:

Percent of de novo banks that offered Internet banking: 19.2

Percent of mature small banks that offered Internet banking: 6.1

Source: Office of the Comptroller of the Currency.

[a] *De novo* banks are those in the $100 million or less asset size category operating for one year or less as of the third quarter of 1999.

[b] Numbers in parentheses are probability values (p-values) for a statistical test of the hypothesis that the mean values in each cell are equal. Thus, a smaller p-value indicates a greater likelihood that the true mean value of the Internet sample differs from the non-Internet sample. Asterisks indicate the statistical significance of the difference of means test with:

*** = significant at the 1% level

** = significant at the 5% level

* = significant at the 10% level

[c] Non-Internet banks include those with Web sites that are not transactional.

[d] Return on equity, in percent.

[e] Noninterest expense to net operating revenue, in percent. A higher ratio indicates lower efficiency.

[f] Net interest income to net operating revenue, in percent.

do not allow us to ascertain the composition of the expenditures for premises and fixed assets. Nevertheless, it is possible that expense ratios were higher for *de novo* Internet banks in part because of costs incurred to set up Internet banking.[34]

Internet Experience and Bank Performance

Clearly, the combination of being a new bank and of offering Internet banking results in relatively poor performance. But it is also possible that the poor performance of small Internet banks versus non-Internet banks is the result of short-run costs of making an investment in Internet banking, one that could be expected to yield substantial gains in the longer run. Few banks have had Internet banking for more than several years, so it is difficult to ascertain what the "long run" is with respect to Internet banking. Nevertheless, our data allow us to explore whether, among *mature* small banks offering Internet banking, those that have offered it for a relatively long time outperformed those that only recently began to offer it.[35] Making such a comparison separates "newness of bank" from "newness of Internet banking."

The results of subtracting *de novos* and then segmenting mature small Internet banks by "Internet experience" are presented in Tables 10 and 11. Table 10 shows that there is no statistically significant difference between the profitability of the 1,009 non-Internet small national banks and the 61 Internet small national banks. That is, the lower profitability for non-Internet banks compared to small Internet banks, displayed in Table 8, completely disappears as a result of excluding *de novo* banks. However, small Internet banks still exhibit greater inefficiency than small non-Internet banks, despite the exclusion of *de novo* banks. Hence, it is not the newness of the bank that explains this aspect of worse performance for small Internet banks.

In order to investigate whether "newness of offering Internet banking" might explain the poorer efficiency results for small Internet banks, we divided the 61 small Internet banks into two groups. "Internet-experienced" banks are those that offered Internet banking no later than the second quarter of 1998, and "Internet-inexperienced" banks are those that began to offer Internet banking sometime between the beginning of the third quarter of 1998 and the end of the third quarter of 1999.[36] We then

[34] Table 9 also shows that *de novo* Internet banks received a higher proportion of their revenue from traditional interest income than did non-Internet *de novos*. While the statistical significance of this result is weak, it stands in marked contrast to the significantly lower reliance on traditional income by Internet banks in other size categories. That outcome could reflect difficulties for *de novo* Internet banks in successfully attracting customers who generate fee income.

[35] We define "mature" banks as those in operation for more than three years as of the third quarter of 1999. We compared the performance of "Internet-experienced" banks (i.e., those offering Internet banking since at least the second quarter of 1998) to that of banks that began offering Internet banking after the second quarter of 1998, for all size categories. We found no statistically significant difference in performance between those two "vintages" of Internet banks in the banks over $100 million in assets. Hence, our discussion in the text is confined to the smallest size banks.

[36] As indicated previously, we have no record of the exact date banks began offering Internet banking to their customers.

Table 10—Mature small national banks: Internet banks are less efficient, but not less profitable [a,b] *(Q3 1999)*

	Non-Internet banks		Internet banks
Number of banks	1,009		61
Profitability [c]	11.13		10.36
(p-value)		(0.232)	
Accounting efficiency [d]	64.50		70.50
(p-value)		(0.000)***	
Premises and fixed assets-to-net operating revenue	9.02		10.41
(p-value)		(0.000)***	
"Traditional" income [e]	85.51		78.24
(p-value)		(0.000)***	

Source: Office of the Comptroller of the Currency.

[a] "Mature" small banks are those in the $100 million or less asset size category in operation for more than three years as of the third quarter of 1999. Non-Internet banks include those with Web sites that are not transactional.

[b] Numbers in parentheses are probability values (p-values) for a statistical test of the hypothesis that the mean values in each cell are equal. Thus, a smaller p-value indicates a greater likelihood that the true mean value of the Internet sample differs from the non-Internet sample. Asterisks indicate the statistical significance of the difference of means test with:

*** = significant at the 1% level

** = significant at the 5% level

* = significant at the 10% level

[c] Return on equity, in percent.

[d] Noninterest expense to net operating revenue, in percent. A higher ratio indicates lower efficiency.

[e] Net interest income to net operating revenue, in percent.

compared both the small Internet-experienced and the Internet-inexperienced banks to small non-Internet banks.

The results of those comparisons are summarized in Table 11. That table shows that there is no statistical difference between the accounting efficiency of Internet-experienced banks compared to non-Internet banks. However, those small banks only recently offering Internet banking exhibited statistically significant poorer accounting efficiency than non-Internet banks. Hence, the lower efficiency of small Internet banks as a group is attributable to those small Internet banks just recently beginning to offer Internet banking; i.e., it appears that Internet experience does matter for small banks.

Table 11 also shows that, for a key measure of "input" costs—the ratio of premises and fixed assets to net operating revenue—Internet-inexperienced banks were significantly worse than non-Internet banks. This fact helps explain the greater inefficiency of small banks for which Internet is relatively new. However, the results in Table 11 also suggest that higher expense ratios and lower efficiency may disappear as small banks gain experience in offering Internet banking, inasmuch as Internet-experienced banks showed no statistical differences in those two performance measures compared to non-Internet banks. It is possible that the expense and efficiency disadvantages may be a temporary consequence of investing in Internet banking.[37] It is interesting to note that neither the Internet-experienced nor the Internet-inexperienced banks exhibited statistically different profitability compared to non-Internet banks, but both groups of Internet banks were less reliant on traditional interest-yielding activities compared to non-Internet banks. Those results suggests that small banks that have only recently begun to offer Internet banking are not performing poorly on the "output" side of operations.

Safety, Soundness, and Information Technology

Federal bank regulators regularly examine for safety and soundness and issue composite CAMELS ratings for each bank. The rating is based on capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS). The CAMELS ratings can range from 1 (best rating) to 5 (worst rating). Similarly, there are separate bank examinations that evaluate key aspects of the information technology (IT) risk management practices of banks, using the Uniform Rating System for Information Technology (URSIT).[38] As with the CAMELS ratings, IT exam scores can range from 1 to 5.

Table 12 compares the composite and management components of the CAMELS and IT ratings for Internet and non-Internet banks by size category. The table shows that, overall, Internet banks have similar ratings to non-Internet banks. Because relatively few banks offered Internet banking, one might expect that the "early adopters" would be more forward-looking and astute with

[37] The statistical results do not allow us to say for certain that "newness of Internet" for small banks causes poorer efficiency. It is possible that another set of factors explains both why some small banks chose not to be in the vanguard of banks offering Internet banking, and why they had poorer accounting efficiency ratios than did the 11 Internet-experienced banks that were among the "early adopters" of Internet banking.

[38] See the *Federal Register*: January 20, 1999 (volume 64, number 12, pp. 3109–3116) for a detailed description of the URSIT, which is "an internal supervisory examination rating system used by federal and state regulators to assess uniformly financial institution and service provider risks introduced by information technology and for identifying those institutions and service providers requiring special supervisory attention." Note, therefore, that URSIT exams are given to service providers over which regulators have supervisory authority, as well as to banks.

Table 11—Mature small national banks: Does Internet experience matter? [a, b]
(Q3 1999)

	Non-Internet banks	Internet-experienced banks	Internet-inexperienced banks
Number of banks	1,009	11	50
Profitability [c]	11.13	9.95	10.58
(p-values)		(0.400)	(0.434)
Accounting efficiency [d]	64.50	63.10	71.61
(p-values)		(0.641)	(0.000)***
Premises and fixed assets-to-net operating revenue	9.02	7.99	10.85
(p-values)		(0.233)	(0.000)***
"Traditional"income [e]	85.51	75.94	75.25
(p-values)		(0.000)***	(0.000)***

Source: Office of the Comptroller of the Currency.

[a] "Mature" small banks are those in the $100 million or less asset size category in operation for more than three years as of the third quarter of 1999. Non-Internet banks include those with Web sites that are not transactional. "Internet-experienced" banks are those that have offered Internet banking since at least the second quarter of 1998. "Internet-inexperienced" banks are those that began to offer Internet banking after the second quarter of 1998.

[b] Numbers in parentheses are p-values for the difference of means tests for Internet-experienced banks compared to non-Internet banks, and for Internet-inexperienced banks compared to non-Internet banks, respectively. The p-values are probability values for a statistical test of the hypothesis that the mean values in each cell are equal. Thus, a smaller p-value indicates a greater likelihood that the true mean value of the Internet sample differs from the non-Internet sample. Asterisks indicate the statistical significance of the difference of means test with:

*** = significant at the 1% level

** = significant at the 5% level

* = significant at the 10% level

[c] Return on equity, in percent.

[d] Noninterest expense to net operating revenue, in percent. A higher ratio indicates lower efficiency.

[e] Net interest income to net operating revenue, in percent.

respect to technology than non-Internet banks, and that this astuteness would be reflected in examiner ratings. The figures displayed in Table 12 provide weak support for this conjecture, inasmuch as Internet banks generally had lower (better) IT and CAMELS ratings than non-Internet banks. But, because the p-values generally are above 0.10, there is little statistical significance to the difference in the ratings.[39]

[39] The relative weakness of these results might be due to the overall strength of national banks during this period, and the resultant relatively strong supervisory ratings. See Office of the Comptroller of the Currency (1999b) for an analysis of national banking industry performance during the third quarter of 1999.

There is evidence showing that banks that effectively manage IT realize greater stock prices. See *Bank Technology News* (1999a), which cites a Barents study comparing stock prices of "well-run IT banks" to the banking industry average, 1992–1998. See also O'Sullivan (1998), who summarizes research suggesting that IT spending on technology staff boosts profitability.

5. Internet Banking: Plans and Prospects

The allure of Internet banking is a strong one, to which many banks are responding.[40] In this section we present information on banks' plans for offering Internet banking. Our data set includes OCC examiners' responses to questions about the Internet banking plans of national banks through the end of 2000. Combining information about banks' future plans with the information on third quarter 1999 Internet banking activities allows us to project the "supply" of Internet banking in the United States as 2001 begins.[41] We then contrast this projected

[40] See, for example, *Retail Delivery News* (2000). A recent Ernst & Young study estimated that for the first time, bankers rated investment in Internet technology as their top technology spending priority. For a summary of the results of that study see *Bank Technology News* (1999e). In addition, Rhoads and Portanger (2000) report that pursuing an Internet-based strategy was a principal motivation behind the recent announcement of the merger of Deutsche Bank and Dresdner Bank, a combination that could create the largest bank in the world.

[41] Of course, our projections are accurate only to the extent that banks carry through with their plans.

Table 12—Safety and soundness, and information technology examination ratings: Internet banks similar to non-Internet banks [a]
(Q3 1999)

	CAMELS ratings [b]		IT ratings [c]	
Asset size category	Composite	Management	Composite	Management
Less than $100 million:				
Internet banks	1.72	1.73	1.66	1.81
Non-Internet banks	1.75	1.84	1.81	1.84
(p-value)	(0.676)	(0.135)	(0.155)	(0.803)
$100 million to less than $1 billion				
Internet banks	1.52	1.58	1.64	1.66
Non-Internet banks	1.63	1.68	1.74	1.77
(p-value)	(0.009)***	(0.023)***	(0.059)**	(0.055)**
$1 billion to less than $10 billion				
Internet banks	1.50	1.63	1.70	1.80
Non-Internet banks	1.64	1.70	1.61	1.68
(p-value)	(0.182)	(0.132)	(0.539)	(0.510)
$10 billion and over				
Internet banks	1.63	1.56	1.81	1.89

Source: Office of the Comptroller of the Currency

[a] Numbers in parentheses are probability values (p-values) for a statistical test of the hypothesis that the mean values in each cell are equal. Thus, a smaller p-value indicates a greater likelihood that the true mean value of the Internet sample differs from the non-Internet sample. Asterisks indicate the statistical significance of the difference of means test with:

*** = significant at the 1% level

** = significant at the 5% level

* = significant at the 10% level

[b] CAMELS ratings range from 1 (highest) to 5 (lowest).

[c] IT ratings (Uniform Rating System for Information Technology) range from 1 (highest) to 5 (lowest).

"supply" of Internet banking with information about possible future use of, or "demand" for, Internet banking.

Internet Banking Plans of National Banks

Table 13 summarizes key aspects of these projections. Based on responses to the examiner questionnaire, the number of national banks offering Internet banking would more than double from third quarter 1999 levels, so that by the beginning of 2001, 45 percent of national banks will be offering Internet banking. Banks offering transactional Internet banking would then account for more than 95 percent of national banking system assets. Because the largest banks already had Internet banking in the third quarter of 1999, most of the growth in the number of banks offering Internet banking will be from the smallest size banks. In the third quarter of 1999, only 7 percent of small banks (i.e., those with less than $100 million in assets) offered Internet banking, but our projections indicate that by year-end 2000 more than one-quarter of small banks will offer Internet banking. In addition, by the beginning of 2001, almost all national banks over $1 billion will offer Internet banking. Together, national banks offering Internet banking could account for almost 93 percent of consumer-type deposits in national banks. To the extent the national banking industry is representative of the entire banking industry, that suggests that more than 9 out of 10 banking industry customers will have access to Internet banking by the beginning of 2001.

In addition to an increase in the number of banks offering Internet banking, many banks plan to increase their range of on-line services. Banks' plans indicate a 125 percent increase in the number of banks offering Internet banking by year-end 2000, and a 150 percent increase in the number of transactional Internet banks offering a PREMIUM set of multiple on-line services.[42] Three planned product increases in particular stand out. As illustrated in Figure 5, the number of banks offering cash management services could increase by over 500 percent, on-line insurance offerings by banks may increase 280 percent, and there may be more than a 200 percent increase in the number

[42] See Furst, Lang, and Nolle (2000) for details on planned increases in Internet banking offerings by national banks.

Table 13—Internet banking in 2001?

	Third quarter 1999	Fourth quarter 2000 [a]
Number of national banks offering Internet banking [b]	464	1046
Percent of national banking system assets	89.2	95.2
Percent of small deposit accounts in the national banking system [c]	84.1	92.8
Percent of national banks in asset size category:		
All	19.9	44.9
Less than $100 million	7.2	25.3
$100 million to less than $1 billion	27.4	61.1
$1 billion to less than $10 billion	64.1	89.9
$10 billion and over	100.0	100.0

Memorandum:
46.2 percent of national banks had no plans as of the third quarter of 1999 to offer Internet banking in 2001 or beyond.

Source: Office of the Comptroller of the Currency

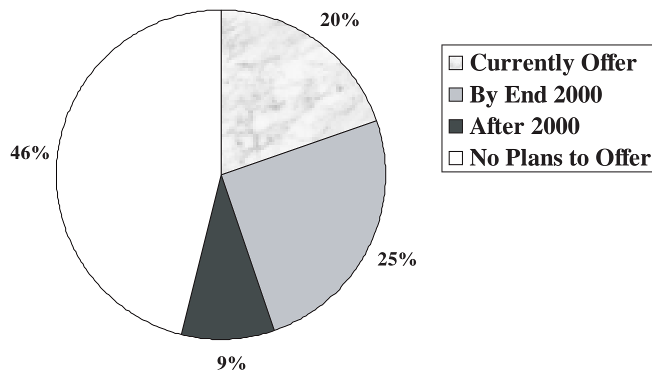
[a] Based on OCC examiners' knowledge of the Internet banking plans of national banks, as of the third quarter 1999. Percentage figures for assets, small deposit accounts, and banks per size category for fourth quarter 2000 were calculated by taking banks offering Internet banking as of the third quarter 1999, plus banks with plans to offer Internet banking by the end of 2000, relative to third quarter 1999 assets, small deposits, and numbers of national banks, respectively.

[b] FDIC-insured commercial banks excluding credit card banks.

[c] Percent of number of deposit accounts under $100,000.

Figure 4—Internet banking and national banks: potential growth

Percent of FDIC-insured national banks with transactional Internet banking

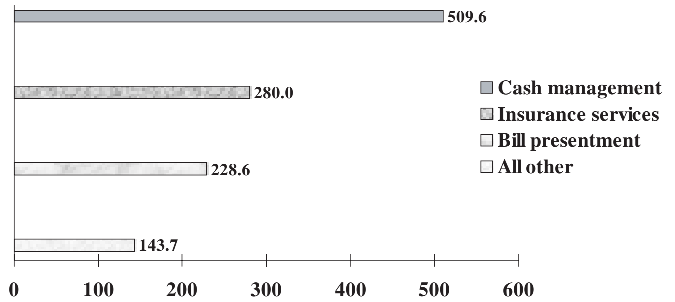


Source: Office of the Comptroller of the Currency

of banks offering electronic bill presentment. Significantly, large banks' plans to offer on-line business services (cash management) are more aggressive than those of smallest

Figure 5—Biggest percentage increase planned for on-line cash management, insurance services, and bill presentment

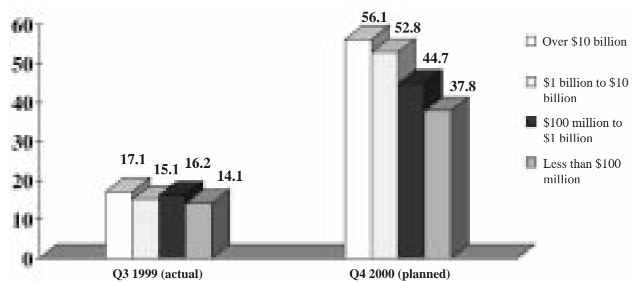
Planned percentage increases in the number of national banks offering selected on-line services by year-end 2000



Source: Office of the Comptroller of the Currency

Figure 6—Small banks may lag larger banks in offering business Internet banking

Percent of transactional Internet national banks offering on-line cash management services



Source: Office of the Comptroller of the Currency

banks.[43] Such developments might represent increased large bank competition for community banks' business customers, who some analysts believe are enthusiastic about using Internet-based banking services.[44]

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[43] Indeed, several large banks have recently launched Web-based services targeting small businesses. See, for example, Hallerman (1999b), Marlin (1999), O'Brien (2000), Ptacek (2000 a and c), and Marjanovic (2000). O'Connell (2000) reports on a Meridien study which estimates costs for banks to install Internet-based cash management channels.

Some industry observers have begun to speculate that servicing the needs of business customers, rather than consumer customers, is likely to be a relatively more profitable Internet strategy for banks. See, e.g., Ptacek (2000b), O'Brien (2000), and Toonkel (2000a). For an analysis of possible roles banks could play in business-to-business commerce, see Wenninger (2000).

[44] For example, see *Bank Technology News* (1999c). See Wenninger (1999) for the growing importance of e-commerce in serving business bank customers.

Current and Future Demand for Internet Banking

The level of "demand" for Internet banking in the future is an open question. One interesting aspect to banks' perceptions about future demand is that just under half of all national banks (46.2 percent) had no plans to offer Internet banking. Almost all of the banks without plans to offer Internet banking were in the smallest size category.[45] Clearly, some bankers have questions about how widespread and intense customer demand for Internet banking will be, and about the value of incurring the added expenses associated with offering another delivery channel.[46]

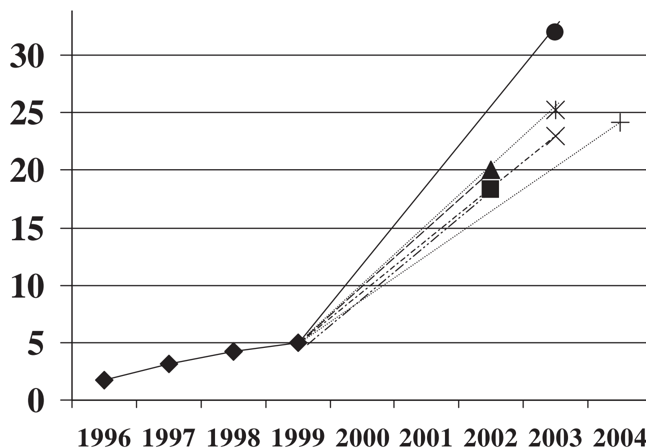
Another perspective on customer demand for Internet banking comes from considering projections about future use made by various industry analysts. Figure 7 shows that from an estimated 5.0 million U.S. households banking on-line in 1999, analysts expect growth in use of 4- to 6-fold over the next several years, i.e., perhaps to as much as 32 million households. While substantial, that level of usage would represent only about one-third of the 93 million U.S. households with a banking relationship.[47] Such growth would mean that only a minority of the household customers of banks that currently offer Internet banking, or that plan to offer it by year-end 2000, would actually choose to do their banking on-line.

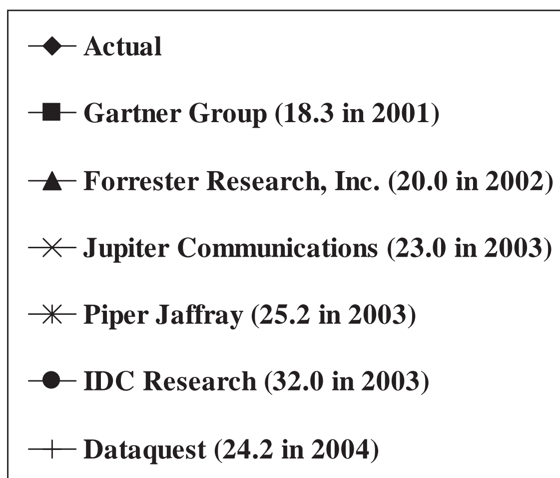
Market Share of Internet Banking Customers

While opinions on the overall growth in demand for Internet banking vary widely, questions also arise about which banks will be winners and losers in the contest to secure on-line customers. The Internet is an extremely efficient device for banks of all sizes to collect and manage information in order to meet the various financial needs of individuals and businesses, in particular by integrating services or "bundling" them together.[48] On the one hand, the Internet allows financial firms of different sizes, including the smallest banks, to enter markets and

Figure 7—Industry forecasts of Internet banking

Millions of U.S. households banking on-line





Source: Office of the Comptroller of the Currency using data from various industry sources

[45] About 9 percent of national banks planned to offer Internet banking after 2000.

[46] For summaries of a recent survey by Grant Thornton LLP on the Internet banking plans of community banks, see Winig (2000) and Agosta (2000). That survey revealed that 64 percent of the 638 community bank CEOs questioned responded that they expected to offer Internet banking by year-end 2000. The discrepancy between that result and our projections could be due to the inclusion of banks over $100 million in assets in the community banks surveyed by Grant Thornton. It is also possible that community banks are in the process of re-evaluating the relative desirability of offering Internet banking as more and more competitors go on-line. Agosta (2000) includes information from the Grant Thornton survey on small bank attitudes toward the Internet. See Carlson (2000) for a discussion of possible reasons some small banks are making the choice not to offer Internet banking.

[47] The Federal Reserve System's "1998 Survey of Consumer Finances" shows that 9.5 percent of U.S. households did not have any type of transaction account at a financial institution. See Kennickell, Starr-McClure, and Surette (2000).

[48] It should be noted, however, that data management problems are likely to continue to challenge banks of all sizes. In part this is due to the difficulties of dealing with a variety of customer databases built up over many years. See, e.g., Hallenborg (1999), and *Bank Technology News* (1999b), which summarizes a study by Innovative Systems Inc. on data management difficulties for banks. See also Horsfield (2000), who reports that an Ernst & Young survey shows that "30% of financial service companies have less than 20% of their systems integrated to show and exchange related customer information across channels and . . . 41% believe that customers will not get a consistent answer across electronic delivery channels." In addition, see the American Banker (2000b) for a discussion of Speer & Associates studies in November 1999 and March 2000 on the degree to which banks may be lagging behind nonfinancial companies in electronically collecting and using data about customers.

reach customers previously out of reach to them. On the other hand, there are substantial economies of scale and scope in data storage and data processing, and larger banks are better positioned to exploit such scale and scope economies than smaller banks. In addition, the proliferation of Internet Web sites means there may be a substantial advantage for banks able to distinguish their products from those of other banks (i.e., to engage in "branding"). Doing so will require significant resources for advertising and marketing, a fact that is likely to work to the advantage of large firms.[49]

Independent industry estimates of the current usage of Internet banking among the top five banks in terms of numbers of customers on-line are displayed in Table 14.[50] These estimates show a disproportionate concentration of Internet banking customers among a handful of large banks. In particular, as shown in the "market shares" columns, the top five Internet banks account for almost 36 percent of all U.S. customers using Internet banking; by comparison, these same five banks accounted for just over 20 percent of all small deposit accounts.[51] Indeed, the top two Internet banks together account for almost one quarter of all Internet banking customers in the United States. And, as a group, the top five Internet banks experienced more than a doubling of the number of customers using Internet banking between mid-1998 and the end of 1999. That rate was more than five times the estimated percentage increase in customer usage of Internet banking overall in the United States.[52]

Even among the top five Internet banks, however, there is evidence of differences in success at attracting custom-

[49] See Toonkel (2000c) for a report on Internet banking advertising strategies being employed by several large banks, and estimates from an Ad Relevance Inc. study of the advertising expenditures of three large banks. Some banks are choosing to focus on niche markets or "affinity groups" as an Internet banking strategy. For a report on how several banks are pursuing this strategy, see Weitzman (2000).

For a discussion of the strategic choices facing banks, and the possible consequences of Internet banking choices on banking industry structure and competition, see DeYoung (2000). See also Radecki, Wenninger, and Orlow (1997), Mishkin and Strahan (1999), and Jordan and Katz (1999) for analyses of possible effects of Internet banking and other retail payment system innovations on banking industry structure.

[50] As indicated in the source note in Table 14, the information in the table on Internet banking usage is from industry analysts, not from data supplied by OCC examiners. See especially O'Sullivan (2000b), who summarizes data from a November 1999 survey by Gomez Advisors Inc. on Internet banking usage.

[51] Recent reports and analyses suggest that some banks in other countries have been at least as successful as U.S. banks in securing on-line customers. For example, see Moody's Investors Service (2000b), Rhoads and Portanger (2000), and Power (2000a and b).

[52] See Figure 7.

Table 14—Top five Internet banks: estimated growth in number of Internet banking customers, and market shares of on-line customers

	Customers using Internet banking				Market shares	
Banking company	Second quarter 1998	Fourth quarter 1999	Growth from second quarter 1998 to fourth quarter 1999 (percent)	Bank's "active" on-line customers as a percent of bank's total number of on-line customers [a]	Bank's share of all U.S. on-line banking customers (percent) [b]	Bank's share of all small deposit accounts [c]
Wells Fargo	655,000 [d]	1,454,100	122.0	55.7	13.1	5.0
Bank of America	700,000 [e]	1,176,600	68.1	46.5	10.6	8.4
Bank One Corp.	144,200 [f]	488,400	238.7	47.3	4.4	2.6
Citibank	350,000	432,900	23.7	63.1	3.9	1.4
First Union Corp.	70,000	421,800	502.6	39.9	3.8	3.8
Top five total	1,919,200	3,973,800	107.1	51.1	35.8	21.1

Source: Office of the Comptroller of the Currency using data from Faulkner & Gray (1998); O'Sullivan (2000b); and Federal Financial Institutions Examination Council, Report of Income and Condition

[a] "Active" customers are defined as those who bank on-line at least once a month.

[b] Fourth quarter 1999.

[c] Second quarter 1999.

[d] For comparability with fourth quarter 1999 figure, includes pre-merger on-line customers at Norwest bank.

[e] For comparability with fourth quarter 1999 figure, includes pre-merger on-line customers at NationsBank.

[f] For comparability with fourth quarter 1999 figure, includes pre-merger on-line customers at First Chicago NBD.

ers to use Internet banking. For example, from the second quarter of 1998 through the fourth quarter of 1999, growth in customer usage varied widely. One bank saw its Internet banking customer base increase by less than 25 percent, while another experienced a six-fold increase in customer usage of Internet banking. In addition, there is variation among the banks in the percent of their "active" on-line customers who use Internet banking at least once a month. Only two of the five Internet banks have more than a 50 percent active customer rate.

6. Summary and Conclusions

Our analysis indicates several significant differences in the profile of banks offering Internet banking relative to non-Internet banks. Broadly speaking, Internet banks rely more heavily on noninterest income and less on core deposits for funding than do non-Internet banks. For all but the smallest size banks, Internet banks have higher returns on equity than non-Internet banks. Internet banks with assets under $100 million had significantly worse accounting efficiency and profitability ratios compared to non-Internet banks in the same size category. Those differences in performance were primarily due to the influence of *de novo* small banks offering Internet banking.

The current low level of customer usage of Internet banking, as well as the relatively modest cost of setting up an Internet banking Web site, makes it unlikely that Internet banking is having a sizeable direct impact on the bottom line of most institutions. We interpret our results as explaining the characteristics of banks that decide to become early adopters of Internet banking, rather than as an indicator of the impact of Internet banking on bank performance. One exception to this general rule might be found among the handful of large banks with a disproportionately large share of Internet banking.

It is also possible that Internet banking is having a causal impact on the bottom line of small banks, particularly *de novo* institutions. Some of these institutions are relying heavily on an Internet-based business strategy, and the full costs of offering Internet banking, while not prohibitive, may be significant for these banks. In addition, while *de novo* Internet banks had poorer performance ratios than non-Internet *de novos*, further investigation will be needed to determine whether these banks' performance improves as e-banking and e-commerce expand over time. Indeed, further research is required to give a more definitive answer to the questions of whether, and how, Internet banking affects bank performance for banks of all sizes and ages.

On the demand side, while only one out of five national banks offered Internet banking as of the third quarter of 1999, our estimates indicate that a large majority of banking customers has accounts with institutions offering Internet banking. Thus, the availability of Internet banking is currently sufficient to accommodate the kind of sudden and rapid growth that has occurred in other information-intensive industries such as securities brokerage, book selling, and travel. So far, however, bank customers have not been convinced that Internet banking products and services provide sufficient value to warrant a substantial change in their banking habits.[53]

There is no doubt that the revolutionary developments in information and communications technology is having, and will continue to have, a profound impact on the banking and financial industry. Internet banking will be an important component of these developments, and as such, analyzing developments in this market will be extremely important for understanding developments in the banking industry. This article attempts to provide a useful picture of the current market for Internet banking, as well as information on the Internet banking plans of national banks. We believe this is an important initial step in analyzing the current and likely future impact of Internet banking on the banking industry.

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[53] Furst, Lang, and Nolle (1998) argue that the likely method for increasing the value added from Internet banking for banking customers is to develop improved on-line methods for bundling information into a smooth end-to-end electronic process that eliminates relatively costly paper components of transactions. They also argue that the value proposition from such improvements would likely be, at least initially, most evident for businesses rather than individual households.

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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 first quarter of 2000, 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 that should be referenced in inquiries to the OCC regarding the decision.

Charters

In the first quarter of 2000, the OCC began imposing a new standard condition on all newly chartered banks. Through the condition the OCC requires that a new bank provide prior notification, and in some cases obtain prior approval, of any significant deviation or change from the operating plan upon which the charter is approved. This condition remains in effect for a new bank's first three years of operation.

On January 29, 2000, the OCC granted preliminary conditional approval to a proposal by AeroFund, Inc. to charter a national bank titled AeroBank.com, National Association, San Jose, California. The bank will deliver small business-oriented loan and deposit products and services through electronic channels such as the Internet and telephone. The bank will employ business development officers in major metropolitan areas and plans to establish deposit-taking ATMs in the areas served by the business development officers. The strategy also centers on building an electronic commerce page with links to third-party Web sites offering financial and non-financial products and services considered useful to small businesses. Approval was granted subject to certain pre-opening requirements and ongoing conditions addressing capital, credit risk, contingency planning, and Internet security. [Conditional Approval No. 347]

On March 8, 2000, the OCC granted preliminary conditional approval to ReliaStar Financial Corporation, Minneapolis, Minnesota, to charter an uninsured national trust bank titled ReliaStar National Trust Company, Minneapolis, Minnesota. ReliaStar Financial is a diversified financial company primarily engaged in insurance. This is the first charter proposal approved by the OCC under the provisions of the Gramm-Leach-Bliley Act of 1999. Approval was granted subject to ongoing conditions addressing capital and prior notice requirements for significant deviations from the proposed operating plan. [Conditional Approval No. 370]

Corporate Reorganizations

On March 8, 2000, the OCC granted approval of six applications by Peoples Heritage Financial Group, Inc., Portland, Maine. The applications, three charter conversions and three mergers, would accomplish a corporate reorganization of Peoples' subsidiary banks after it acquires Banknorth Group, Inc, Burlington, Vermont. Peoples concurrently applied to the Federal Reserve System to merge the two bank holding companies, with the resulting company having eight subsidiary banks located in Massachusetts, New Hampshire, and Vermont. The OCC's approved corporate reorganization of the subsidiary banks will occur after the merger of the two bank holding companies. [Corporate Decision No. 2000-03]

On March 28, 2000, the OCC granted approval for NBC Bank, F.S.B., Knoxville, Tennessee, a $1 billion federal savings bank, to convert to a national bank and then merge with and into its affiliate National Bank of Commerce, Memphis, Tennessee. Under provisions in the Gramm-Leach-Bliley Act, upon converting to a national bank, NBC may retain its banking offices in North Carolina, Georgia, West Virginia and Virginia. And after merging the two banks, National Bank of Commerce would retain and operate NBC's banking offices, as well as its own banking offices in Tennessee and Arkansas. [Corporate Decision No. 2000-05]

Operating Subsidiaries

On January 28, 2000, the OCC granted conditional approval for First Tennessee National Association, Memphis, Tennessee, to expand the activities of an existing operating subsidiary to include underwriting and dealing activities with respect to all types of debt and equity securities, other than interests in open-end investment companies, under 12 CFR 5.34(f). The OCC noted that the bank's proposed activities would be permissible under the standards of the Gramm-Leach-Bliley Act. The conditions of

approval are similar to those imposed in the OCC's decisions approving the application by a national bank for a subsidiary to underwrite and deal in debt securities. (Conditional Approval No. 331, November 3, 1999). However, upon section 121 of the Gramm-Leach-Bliley Act becoming effective, the 25 percent revenue limitation and other conditions specified in the approval will no longer apply. At that time, the subsidiary will be deemed to be a 'financial subsidiary" subject to the conditions and requirements of the Gramm-Leach-Bliley Act and relevant OCC implementing regulations. [Conditional Approval No. 351]

On January 29, 2000, the OCC granted approval for EFS National Bank, Memphis, Tennessee, to acquire Virtual Cyber Systems, Inc. and establish it as an operating subsidiary. The operating subsidiary will engage in the sale of Web site editing software as part of a bundle of Internet-based Web site hosting services for bank customers. The bank will also use the operating subsidiary to develop new software products to be used by the bank in conjunction with its transaction processing services and in developing its own Internet-based services. [Corporate Decision No. 2000-01]

On February 25, 2000, the OCC granted conditional approval for UMB Bank, National Association, Kansas City, Missouri, to expand the activities of its existing operating subsidiary, eScout.com, L.L.C., to operate an Internet Web site for its small business customers that supports and facilitates electronic commerce. The bank established the LLC in 1999 to begin research and development in connection with a planned future operation of this national bank-permissible activity. The approval was granted subject to the OCC's standard conditions for noncontrolling investments by national banks. [Conditional Approval No. 369]

On February 25, 2000, the OCC granted approval for Capital Bank, N.A., Sylvania, Ohio, to establish an operating subsidiary that will provide, as agent, private placement and related advisory services. While performance-linked compensation, including warrants, may be accepted as the compensation for such services, neither the bank nor the subsidiary may exercise any warrants. [Corporate Decision No. 2000-02]

On March 3, 2000, the OCC granted conditional approval for Bank One, National Association, Chicago, Illinois, and Mercantile Bank, N.A., St. Louis, Missouri (collectively, the banks) to expand the activities of Anexsys, L.L.C., to include certain electronic finder, custodian, record-keeping, and financial agent services primarily to government entities. As part of the transaction, Bank One increased its ownership stake in Anexsys to a controlling one, making it an operating subsidiary with respect to Bank One. Mercantile Bank continues to hold its noncontrolling stake through a wholly owned operating subsidiary. The LLC's existing activities are comprised of cash management, electronic payment, and data processing services primarily to government entities, including services to the banks in connection with the Electronic Federal Tax Payment System. Mercantile Bank's approval was granted subject to the OCC's standard conditions for noncontrolling investments by national banks. Bank One's approval did not contain conditions. [Conditional Approval No. 361]

Community Reinvestment Act Decisions

On February 1, 2000, the OCC granted approval for an affiliated merger of certain Fleet Financial Group Inc. bank and thrift subsidiaries, including those banks previously owned by BankBoston Corporation. While the OCC did not receive any direct protest on the application, the OCC investigated the concerns received by the Federal Reserve Board in connection with the application to merge Fleet Financial Group, Inc. and BankBoston Corporation. The OCC's investigation and analysis of the issues raised indicated no basis for denying or conditionally approving the application. The OCC's approval letter addresses the issues. [Community Reinvestment Act Decision No. 103]

On February 3, 2000, the OCC granted conditional approval for Far East National Bank, Los Angeles, California, to relocate a branch office. In early 2000, OCC examiners identified weaknesses in the bank's CRA performance. The OCC determined that the imposition of an enforceable condition and a pre-opening requirement were appropriate and consistent with the Community Reinvestment Act and OCC policies thereunder. [Community Reinvestment Act Decision No. 104]

Appeals Process

Appeal 1—Appeal of a Violation of the Legal Lending Limit

Background

The ombudsman received a second tier formal appeal of a violation of 12 USC 84, the Legal Lending Limit. The supervisory office combined the loans to six individual borrowers under 12 CFR 32.5 (b) "Direct Benefit" and 12 CFR 32.5 (c) "Common Enterprise" rules. After the violation was cited in the report of examination (ROE), the bank initially appealed the violation to the Office of the Chief Counsel in Washington, D.C. The Office of the Chief Counsel opined that a violation of the legal lending limit had occurred; bank management then opted to appeal the cited violation to the ombudsman.

The legal lending limit violation cited in the ROE resulted from the combining of unsecured loans to six individual borrowers. The loan proceeds were invested in a real estate development limited liability company. Collectively, these six individuals own 100 percent of the company. The appeal letter stated the bank was not relying on the real estate development entity for repayment of the debt, hence there was no performance risk associated with the company. Bank management stated the loans were made to the individuals based on each individual's credit worthiness and capacity to repay the loan.

The appeal letter outlined the following as the basis for the bank's appeal:

- Only two of the individuals have "voting rights or voting interest," except in certain limited situations, and the limited liability company structure does not require a person to have voting rights in equivalent proportion to their investment. To the extent that the prior decisions relied upon by the Office of the Chief Counsel were based on corporate structures or more traditional partnership structures where dollars of investment equaled voting power, a different analysis should be applied here and a different conclusion reached.
- Given the fact that each loan was underwritten based on the individual borrowers' creditworthiness, coupled with the limited exposure of each borrower under the limited liability company structure, the credit diversification goal of 12 USC 84 is met.
- Under the facts of this situation there is no risk related to undo industry concentration, nor are the technical requirements of "common enterprise" met.

Discussion

Generally, a national bank's total outstanding loans to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of capital and surplus if the amount over the 15 percent general limit is fully secured by readily marketable securities. See 12 USC 84 (a); 12 CFR 32.3 (a). A "borrower" includes a person who is named a borrower or debtor in a loan or extension of credit. 12 CFR 32.2(a). Also, loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed a borrower (1) when the proceeds are used for the *direct benefit* of the other person, or (2) when a *common enterprise* is deemed to exist between the persons. See 12 CFR 32.5 (a).

The proceeds of a loan or an extension of credit to a borrower will be deemed to be used for the *direct benefit* of another person and will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services. 12 CFR 32.5 (b)

A *common enterprise* will be deemed to exist and loans to separate borrowers will be aggregated when:

(1) the expected source of repayment for each loan is the same and neither borrower has another source of income from which the loan and the borrower's other obligations can be repaid;

(2) the borrowers are related through common control and there is substantial financial interdependence between or among the borrowers;

(3) the borrowers use the loan proceeds to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests of that enterprise;

(4) the OCC determines that a common enterprise exists based on the facts and circumstances of a particular transactions.

See 12 CFR 32.5 (c). Thus in determining whether a loan to one borrower should be attributed to another borrower for lending limit purposes, one must apply each of the five loan combination/attribution tests set forth above—the direct benefit test and the four common enterprise tests—to the specific facts of each loan relationship.

Conclusion

Direct Benefit

In determining the applicability of the "direct benefit" test under 12 CFR 32.5(b), the OCC has long considered an equity investment in a company to be a direct benefit to that company, since the equity investment, at a minimum, provides the company with additional working capital. In this case the loan proceeds represented the initial working capital for this newly formed business and while this was a bona fide transaction, there was no property, goods, or services acquired from the company. Given these facts, the ombudsman found the provisions of the 12 CFR 32.5(b) and the precedent letters relied on in citing the violation of 12 USC 84 in the ROE were applicable to this case and appropriately applied.

Common Enterprise

The four tests for common enterprise under 12 CFR 32.5(c) are independent of one another. That is, all four tests do not have to be met to determine that a common enterprise exists, if one test is met then a common enterprise is deemed to exist. While in some scenarios, independent sources of repayment prevent combining loans to different borrowers, in this case, the individual financial capacity of the six borrowers was not relevant to the violation cited in the ROE.

The operating agreement, referenced in the appeal, designated two of the six borrowers as managers and empowered them to act extensively in a decision-making capacity. The agreement also provided all owners of the company with voting authority for certain actions. The voting privileges specified in the operating agreement were associated with the individuals' percentage of ownership interest in the company, in that an affirmative vote from a certain percentage of the ownership interest was required for passage. Therefore, it is reasonable to conclude that the borrowers' investment in the company was commensurate with their voting interest.

The appeal did not dispute that the six borrowers used the borrowed funds to acquire the business enterprise and collectively owned 100 percent of the company. Considering the conclusion reached regarding voting interest of the six owners based on the operating agreement, the ombudsman determined the criteria for "common enterprise" under 12 CFR 32.5(c)(3) was applicable to this case. The combined ownership of the six individuals that borrowed to invest in the company exceeded the 50 percent voting interest threshold in the regulation. Based on these facts, the ombudsman confirmed that a "common enterprise" exists and the precedent letters relied on in that determination was appropriate. Therefore, the ombudsman did not reverse the citing of the violation of the bank's legal lending limit under 12 USC 84.

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- Given the fact that each loan was underwritten based on the individual borrowers' creditworthiness, coupled with the limited exposure of each borrower under the limited liability company structure, the credit diversification goal of 12 USC 84 is met.
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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.

Introduction

Mr. Chairman and members of the committee, I appreciate this opportunity to participate in today's hearing. The Office of the Comptroller of the Currency (OCC) believes that this hearing and other efforts to review the circumstances surrounding recent bank failures serve an important role in helping to improve the bank supervisory process.

In my testimony today, I will discuss the three national bank failures that occurred in 1999 and our estimates for bank failures in 2000. I will also highlight supervisory initiatives undertaken by the OCC and the other banking agencies to address emerging risks in the banking system. Finally, I will discuss our examination policies and practices regarding coordination with the Federal Deposit Insurance Corporation (FDIC) and provide our comments on H.R. 3374, the "FDIC Examination Enhancement and Insurance Fund Protection Act."

National Banks' Ability to Weather an Economic Downturn

Before I discuss these matters, however, I would like to respond to the committee's requests that we assess how the national banking industry would withstand an economic downturn, and that we contrast the industry's current condition with its condition during the period leading up to our last national recession, which began in 1990.

During the ten years that preceded that recession, the banking system suffered a degree of disruption that had not been seen in the United States since the Great Depression. Significant portions of the banking industry were hurt by the financial and economic turbulence of the 1980s. Banks took substantial losses on their commercial loan portfolios, particularly on their real estate, energy, and agriculture loans. Hundreds of banks failed as a result, severely depleting the FDIC's insurance fund.

Although the banking industry was slow to recover from many of these problems, improvements in supervisory and regulatory processes, increased sophistication in risk management practices, and sustained economic growth have allowed the banking industry to rebound and to prosper. For example, in 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which significantly revised many aspects of bank regulation. FDICIA placed greater emphasis on the maintenance of high levels of bank capital and called for prompt supervisory intervention when bank capital levels fall below pre-specified thresholds.

Thus, although I believe it is appropriate to understand and analyze the causes of bank failures in 1999, we should do so within the context of the overall fundamental strength of the banking system today. National banks now are in a far better financial position to weather an economic downturn than they were a decade ago. Banks have obviously benefited from the economic recovery that began in the early 1990s and the expansion that is still ongoing today.

Compared with the period leading up to the last recession, inflation and interest rates are lower, bank capital and earnings are at record high levels, and risk management practices are better. In addition, most quantitative measures of credit quality are stronger now than they were a decade ago.

Today, banks are also generally more diversified in their product offerings and in their geographic coverage than they were a decade ago. In short, while every bank failure can be a blow to the community it serves, and should be studied carefully, improvements in regulations, in bank supervision, and in the economy as a whole have reduced the number of bank failures to very low levels.

We do not regard the three national bank failures that occurred during 1999 as foreshadowing a much larger number of failures in 2000. The OCC currently has identified 13 banks as "critical banks," with a total of 144 banks identified as problem banks, up from 121 at year-end 1998. The 13 critical banks are less than 1 percent of all national banks, and they hold only a tiny fraction of the assets of all national banks. Based on the current state of the national banking system and the consensus outlook for the economy, we do not expect a significant increase in bank failures in 2000.

Causes of National Bank Failures in 1999

Despite the overall healthy condition of the banking industry, we remain vigilant in our supervision of national banks. Currently, a number of risks concern us. Generally, banks now rely more on expensive, and typically more volatile, non-core deposits. The loan loss reserves within the banking industry are at a generational low and recent loan loss provisions have not kept pace with loan growth. Loan underwriting standards, which banks tightened dramatically in the early 1990s, have again slipped. Further, while charge-offs remain low, we are closely watching banks' loan portfolios for signals of future deterioration of credit quality. Intense competitive pressures—both from banks and from non-banks—are leading banks to reach for revenue by taking on more risks and cutting expensive, but essential, control mechanisms. The OCC is committed to identify and address risks at the earliest possible stages, when supervisory actions are most effective. As highlighted earlier, the number of banks receiving special supervisory attention by the OCC, beyond those on the critical list, has increased over the past year. Many of these institutions are receiving this increased attention because of their higher risk profile or deficiencies in their risk management, not because they are financially impaired. As I will discuss in more detail later in my testimony, the OCC has already undertaken, and has underway, a number of direct actions to deal with the pressures I discussed above and to further enhance our ability to identify and deal with risks in the banking industry at the earliest possible stages.

Pressures such as those I discussed earlier contributed to the three national bank failures in 1999, the first failures of national banks in over three years. In fact, history has shown that problem banks typically have weak management and controls. Two of these failed banks demonstrated poor lending and/or credit underwriting practices and one became heavily dependent on securitizing subprime loans. At two banks, there was apparent fraud on the part of insiders, indicating inadequate attention to internal controls and ineffective audits. In viewing the entire population of recent bank failures, both state and national, fraud appears to have played a significant role in the most costly bank failures.

Let me now move to a discussion of the specifics of the three bank failures in 1999. These banks were Peoples National Bank of Commerce in Miami, Florida; East Texas National Bank in Marshall, Texas; and First National Bank of Keystone in Keystone, West Virginia.

Peoples National Bank of Commerce, Miami, Florida, was closed on September 10, 1999. The bank had $37.6 million in assets and was located in Liberty City, one of Dade County's largest minority communities. The bank failed because of poor lending practices, particularly in its management of risks in the purchase of automobile loans originated by dealers; improper record keeping and accounting; an ineffective board; and frequent turnover in management and key staff. Although the bank did lend to some customers with poor credit histories or no credit histories, it was not primarily engaged in widespread subprime lending, nor was the bank involved in securitizations. The OCC placed a cease-and-desist order on the bank in 1997. After two recapitalizations by the bank's owners, the bank became critically undercapitalized for the third and final time in June 1999 as a result of continuing losses. At the time of closing, the FDIC estimated that the failure would cost the Bank Insurance Fund approximately $2.2 million.

East Texas National Bank of Marshall, Texas, was closed on July 9, 1999. The bank had $125 million in assets. This bank failed because of poor credit underwriting and loan administration practices, apparent fraudulent activities, and inadequate supervision by the board of directors. East Texas National Bank was not involved in subprime lending or asset securitization.

The board of East Texas National Bank failed to exercise sufficient supervision over the operations and management of the bank, failed to correct violations of the legal lending limits, and failed to establish policies or procedures to prevent such violations from recurring. The bank failed to maintain adequate internal audit and loan review systems, and, to a large extent, had no external audit or loan review. As a result of this lack of controls, the president was able to combine interest and overdrafts into new notes. He also consistently failed to obtain adequate credit information or collateral documentation on loans that he supervised. When the bank did engage external audit and external loan review, the president apparently concealed the results of those reviews from the board. In August 1998, following an examination that disclosed these problems, the OCC placed a cease-and-desist order on the bank that, in part, prohibited the president from having any lending authority or supervising the lending function.

The president was removed from his position in February 1999 after the board discovered that he had violated the cease-and-desist order by exceeding the institution's legal lending limit. Following his departure, it was discovered that he had apparently changed the due dates and maturity dates on notes that would otherwise have been delinquent on the bank's books and records, thereby hiding the borrower's inability to repay. He also appears to have granted loans to nominee borrowers in order to extend additional credit to entities that already had loans in excess of the bank's legal lending limit. Loan losses recognized during the first quarter of 1999, and the resulting

loan loss charge, depleted the bank's capital. At the time of closing, the FDIC estimated that the failure would cost the Bank Insurance Fund $6.2 million.

First National Bank of Keystone, Keystone, West Virginia, was closed on September 1, 1999. The bank's books showed $1.1 billion in assets at the time of closure. Keystone's business was centered in originating and securitizing subprime, high-loan-to-value home equity loans. The cause of the bank's failure was capital insolvency resulting from apparent fraud. The OCC discovered, through direct verification with the bank's loan servicers, that $515 million in loans being carried on the bank's books were not owned by the bank. When these assets were charged off as a loss, the bank was rendered insolvent. The FDIC estimates that the failure could cost the Bank Insurance Fund $750 million.

On November 10, 1999, a federal grand jury in the southern district of West Virginia returned an indictment against two of the officials of the bank and its mortgage subsidiary, charging that these officials conspired to corruptly obstruct the examination of the bank by the OCC and the FDIC in violation of 18 USC 371 (conspiracy) and 18 USC 1517 (obstruction of an examination of a financial institution). These cases are currently set for trial in April. In addition, investigations into the circumstances underlying the bank's failure are ongoing. Because of the indictment and pending trial, the U.S. attorney's office has requested that we not discuss publicly matters relating to the failure of Keystone. In light of this request, I would respectfully ask that if the committee seeks details relating to Keystone, we provide that information in executive session or in private briefings, consistent with the U.S. attorney's request.

The OCC has learned several lessons from these failures. These include the need for greater emphasis on effective audit and internal controls; the need to improve our training of examiners to identify the warning signs of fraud; and the need to press forcefully for information we deem necessary when confronted by a recalcitrant management. We have also learned more about the risks in subprime lending and the complexities of asset securitization and residual valuations. We are incorporating these lessons into many of our supervisory practices and procedures.

OCC Initiatives to Address Emerging Risks

Fraudulent activities, poor risk management practices for subprime and high-loan-to-value lending and asset securitization, and ineffective audits were important factors in the three national bank failures of 1999. The Committee has expressed an interest in the supervisory initiatives that address some of these activities and in any other proposals that we believe could reduce risks in banks and, therefore, losses to the FDIC insurance funds.

Fraudulent Practices

Fraudulent management practices contributed to several recent bank failures. By its very nature, fraud is difficult to detect. Nonetheless, it is imperative that examiners and auditors maintain a vigilant lookout for the possibility of fraud. The First National Bank of Keystone and East Texas National Bank episodes underscore our concerns in this regard.

The OCC is taking a number of steps to increase our ability to detect fraud and to build on our past initiatives, such as the establishment of a special fraud unit in 1997. This unit, together with our enforcement and compliance division and our special supervision division, is the focal point for the OCC's fraud investigations. The specialists in this unit already are active in educating examiners and bankers on fraud prevention and detection, coordinating fraud examination activities and working with other regulators and law enforcement on anti-fraud efforts.

We are increasing our emphasis on fraud detection. Last month, we issued guidance to examiners addressing situations in which banks refuse to provide the OCC with access to staff or bank documents, or otherwise attempt to obstruct the OCC's examination process. We also are establishing a comprehensive database of verification procedures. These procedures will assist examiners in verifying assets, evaluating the reliability of financial records, and testing internal controls. Also, the OCC has been encouraging and supporting our employees to pursue the training necessary to become certified fraud specialists. Special training has been developed to aid our examiners in fraud detection, identifying problem banks, and in testifying in law enforcement proceedings.

Subprime Lending

The term "subprime" lending describes credit that is extended to borrowers exhibiting higher delinquency or default risk characteristics than those of traditional bank borrowers. Borrowers within these categories represent a broad range of risk, but typically include those with blemished or unproven credit performance, repayment problems resulting from an adverse event such as job loss or medical emergency, or a history of mismanaging their finances and debt obligations.

In order to assess national bank involvement in subprime lending practices, the OCC in 1998 conducted a series of examinations designed to evaluate the risk management practices that national banks employ in this area. These

examinations uncovered a number of serious weaknesses in the business and control processes used to manage the risks associated with subprime lending activities. The deficiencies were most pronounced in two types of banks: those that purposefully engaged in subprime lending activities but lacked an adequate understanding of the risks involved, and those that unwittingly entered the market by relaxing underwriting standards or loosening credit-grading criteria.

In response to bank involvement in subprime lending and the weaknesses we identified in some bank programs, the OCC took the lead in drafting new interagency guidance for bankers and examiners on subprime lending. That interagency guidance, issued in March 1999, discusses the credit and other risks of subprime lending and establishes uniform risk management expectations for depository institutions that engage in subprime lending. This guidance also highlights subprime loan securitization issues. In light of some of the identified weaknesses, the guidance directs banks to take a conservative approach when developing assumptions and capitalizing future income flows from subprime lending pools. The projected cash flows used in the initial valuation and required periodic impairment analyses must be realistic and all assumptions must be well supported. OCC Bulletin 99-15 (Subprime Lending, April 5, 1999) provides further guidance to bankers and specific examination procedures for examiners to use at national banks that engage in this activity.

High-Loan-to-Value Lending

A high-loan-to-value (LTV) residential real estate loan is any loan, line of credit, or combination of credits secured by liens on, or interests in, owner-occupied one- to four-family residential property that equals or exceeds 90 percent of the real estate's appraised value, unless the loan has appropriate credit support.

In response to the recent growth in the volume of high LTV loans at some depository institutions, the OCC took the lead in drafting the "Interagency Guidance on High LTV Residential Real Estate Lending," issued October 9, 1999. That guidance alerts bankers to the credit risks associated with such loans. It also clarifies that high LTV residential real estate loans are subject to the agencies' uniform rules and guidelines on real estate lending. These rules establish an aggregate bank limit for this type of lending.

Asset Securitization

Asset securitization is the process whereby loans and other receivables are pooled and interests in the pool are sold through underwriters in the form of "asset backed" securities. From the perspective of credit originators, this market facilitates the transfer of some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the funding markets at debt ratings higher than their overall corporate ratings, which generally gives them access to broader funding sources at more favorable rates. Further, by removing the assets and supporting debt from their balance sheets, they are able to save some of the costs of on-balance-sheet financing and to better manage potential asset liability mismatches and credit concentrations. Asset securitization can be a valuable tool for banks to manage their balance sheets and to more efficiently meet customer needs. In fact, many large commercial banks have been prudently using asset securitization as an alternative method for funding assets, improving financial performance, and generating fee income for a number of years. However, the activity is appropriate only when properly managed.

As of December 31, 1999, there were 29 community national banks and 20 large national banks actively involved in securitizations. Collectively, these banks represent less than 2 percent of all national banks—although the large banks obviously represent a significant portion of the assets of the national banking system.

In 1997 we published the "Asset Securitization" booklet of the *Comptroller's Handbook*, providing detailed guidance on securitization structures and the systems and controls needed to manage this activity. Subsequent to this publication, our examiners noted that some banks had risk management systems or internal control infrastructures that were not sufficient to support the institutions' securitization activities.

In response, last fall, the OCC took the lead in drafting the "Interagency Guidance on Asset Securitization Activities," which was subsequently issued on December 13, 1999. This guidance describes the range of securitization activities being conducted by depository institutions and presents recent findings of weakness in risk management practices. The guidance also reiterates and expands on existing supervisory statements that the agencies consider appropriate for engaging in this activity.

One area of emphasis in the December guidance is the valuation of residual interests that may be created in securitization activities. Under current accounting rules, institutions may recognize an immediate gain (or loss) when they sell or securitize assets. In a typical securitization, the institution sells assets and retains an interest in future cash flows relating to those assets. Such retained interests are recognized as an asset on the bank's books and measured based on their fair value. This results in recognition of a gain by the bank at the point of sale, even though the cash flows will not occur until some future

period. This recorded gain has an immediate impact upon the institution's capital level. Because of this, any weakness in the valuation or marketability of the retained interest can have an adverse effect on the bank's capital and safety and soundness. This is of particular concern for institutions that securitize high-yielding assets with long durations, because of the more dramatic potential shifts in values associated with such assets. Serious problems can arise for institutions that distribute these earnings as dividends or other payments and then incur a downward valuation requiring a charge-off of part or all of the retained interests.

Our examinations have disclosed weaknesses in the methods used by some banks to value their retained interests—particularly where quoted market prices are not available. In the latter cases, banks are tempted to use assumptions resulting in a high valuation of the retained interest (such as low loss severity factors, low market discount rates, low default rates, and low prepayment rates). This has the effect of inflating earnings and capital and delaying the recognition of losses. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, substantial write-downs of retained interests, and, if interests represent an excessive concentration of the institution's capital, the demise of the sponsoring institution.

In response to these concerns, the December 1999 interagency guidance directs examiners to classify as a loss any residual interest where bank management cannot provide objective and verifiable support for their valuation methodology and assumptions. Those assets will also be disallowed for regulatory capital purposes.

The agencies are also considering potential changes to their risk-based capital regulations to better address the risks associated with subprime lending and residual interests from securitizations. In addition, the agencies are considering changes to depository institutions' quarterly call reports to collect greater information on subprime and securitization activities. The multidisciplinary nature of asset securitization also has prompted the OCC to form its own asset securitization working group to help ensure that all issues related to securitization activities in national banks are addressed in a consistent and timely manner.

Audit

The OCC believes that effective internal and external audit programs are essential to managing risk and maintaining safety and soundness within the banking industry; they are also the best defense against fraud. It seems clear that some of the bank failures of 1999 are traceable, at least in part, to deficiencies in the audit functions of the banks. Effective and independent audit functions should give reasonable assurance of timely detection of weaknesses and deficiencies and their root causes.

The OCC is very concerned that the integrity, independence, and thoroughness of some external auditors have been weakened in recent years. We believe this is due to the cost and competitive pressures facing the accounting industry and some shifting in emphasis from bank auditing to bank consulting. We highlighted our concerns in our recent response to the Public Oversight Board's Panel on Audit Effectiveness survey. A copy of that response is attached to my testimony.

To emphasize our concerns, the OCC, along with the other bank and thrift regulators, has issued two interagency policy statements over the last two years reiterating the importance of a strong audit function: "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" and the "Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations." These statements highlight director and senior management responsibilities and provide guidance on effective audit programs.

In 1999, as part of our ongoing quality assurance program, we conducted a supervisory study of selected large and mid-size banks to assess the effectiveness of OCC supervision of banks' internal audit functions over the past 2 years. The study was designed to identify areas where OCC audit supervision needed strengthening and to surface innovative and helpful practices that could be shared with other examiners. Many of the findings and recommendations from that study have been incorporated into a revised audit booklet, "Internal and External Audits," which will be part of the *Comptroller's Handbook.* This booklet will help examiners and bankers assess the quality and effectiveness of internal and external audit functions. The booklet incorporates and expands upon the recently issued interagency policy statements. We anticipate publishing and distributing the booklet early in the second quarter.

In addition, one of the OCC's objectives in 2000 is to assess the adequacy and effectiveness of audit and internal control programs at national banks. This initiative will include training, examinations, and quality assurance for large, mid-sized, and community banks. We will also implement additional audit-related examination procedures for use in all community banks. We anticipate that these initiatives will be completed by April 2000.

Upon completion of the training, all subsequent examinations will include a focused assessment of internal audit and controls. The OCC's quality assurance unit will assess the quality of audit and internal control examinations by coordinating a targeted review of these examinations.

Findings from the quality assurance reviews will be used to fine tune our examination processes to assure quality supervision of audit and internal controls.

Other Initiatives to Address Supervisory Risks

In addition to these efforts, we have also undertaken a number of other initiatives to address risk and reduce the losses to the FDIC insurance funds. The OCC established a national risk committee in 1996. The purpose of that group is to identify and analyze potential significant risks to the national banking system, and make recommendations to OCC senior management as to appropriate supervisory responses. The group meets every two weeks to discuss various issues and, every six weeks, it makes a detailed presentation to our executive committee on current economic conditions and key trends in the banking industry. These presentations highlight emerging risks and identify economic factors that could have an adverse effect on the industry's performance. A synopsis of these trends, their implications for banks, and areas that may require closer supervisory attention is sent to all examiners after each presentation and is maintained on the OCC Intranet Web site.

We also developed and will soon implement a series of computer-based analytical tools that OCC field and headquarters staff and management can use to identify banks that exhibit increasingly high-risk characteristics that potentially warrant additional supervisory attention. Finally, to complement these early warning tools, we also have developed comprehensive guidance for examiners to assist them in identifying and resolving problem banks in the most timely and effective manner. This guidance is currently under senior-level review in the agency and should be issued this spring.

Coordination with the FDIC

Your invitation letter requested that we describe the OCC's policies and practices regarding coordination with the FDIC when it requests to exercise its special examination authority with respect to national banks.[1] The OCC has a long history of working effectively with the FDIC and recognizes that agency's responsibilities as the deposit insurer for the nation's banks and its role as the receiver for failed insured banks. Consequently, the OCC and FDIC have historically shared supervisory information, and cooperated and coordinated our examination activities. OCC supervisory personnel communicate regularly with their counterparts at the FDIC and we hold periodic meetings with the FDIC to discuss general trends as well as specific bank information. In problem bank situations, such as First National Bank of Keystone, such communication can occur almost daily.

In the early 1980s, as the number of problem banks increased, the OCC established with the FDIC a program to invite the FDIC to participate in examinations of 4- and 5-rated national banks and in selected examinations of other community banks. This program built upon the already existing programs under which the two agencies shared information derived from bank examinations and other supervisory activities. Since that time the FDIC has participated in hundreds of OCC examinations.

Since 1995 alone, the FDIC has requested to participate in 59 OCC examinations, including some of banks with CAMELS ratings of 2 or 3. During this time, the OCC offered the FDIC the opportunity to participate in every OCC examination for which it requested participation. While the FDIC's request to participate in the 1998 examination of First National Bank of Keystone was initially denied by OCC staff, that decision was reversed before the examination took place, and FDIC examiners participated in the 1998 examination and the subsequent examination, just as they did in prior examinations of that bank. It should be noted that no delay in the examination resulted from the reversal of the initial decision.

To ensure that our coordination and cooperation with the FDIC remains productive, I have stressed to my staff the importance of keeping the FDIC fully informed about serious concerns that we may have about any national bank and of maintaining mutually supportive working relationships between our two agencies at all levels. We have just reiterated to our supervisory staff the desirability of inviting FDIC participation in our examinations when deterioration in a bank's condition gives rise to concerns about the potential impact of that particular institution on the deposit insurance fund, even if the FDIC has made no request for participation. Further, I have rescinded all delegations to disapprove FDIC requests to participate in OCC examinations. That authority resides only with me.

Comments on H.R. 3374

Finally, your invitation letter requests our comments on H.R. 3374, which would amend section 10(b)(3) of the Federal Deposit Insurance Act (12 USC 1820(b)(3)) by transferring authority to authorize an FDIC special examination to determine the condition of a depository institution for insurance purposes from the board of directors of the FDIC to the chairperson of the board of directors. The proposed bill would also require the federal banking agencies to establish procedures for providing the FDIC

[1] 12 USC 1820 (b)(3) authorizes the FDIC to conduct a "special examination" of a national bank when the Board of Directors deems such examination necessary to determine the condition of the bank for insurance purposes.

with access to such additional information as may be needed by the agency for insurance purposes.

I recognize that the FDIC has a legitimate need for information to carry out its mandates and, as the primary regulator of national banks, the OCC has an obligation to provide that information. Having said this, however, it is important to strike the proper balance between the role of the primary supervisor and the FDIC's role as insurer. The FDIC's backup examination authority has historically been viewed as authority to be exercised to obtain information in connection with banks in which there is some demonstrable concern about a threat to the insurance fund. It was not intended to duplicate the role of the primary supervisor, or to result in additional examination burdens, and potentially inconsistent supervisory messages to the bank or thrift in question.

The clear intent of H.R. 3374 is to make the OCC and FDIC examination coordination smoother and efficient, and I believe this objective has already been achieved without the need for legislative changes. Further, we are aware of no other instance in which Congress has imposed such a special rule relating to FDIC governance, and we believe that in those rare cases where an issue of backup examination is presented, the entire FDIC board of directors should participate in the decision. Since the board meets regularly, and can call telephonic meetings on moments' notice, it would appear that authorization of an FDIC special examination can occur in a timely fashion under the current laws. I believe a board discussion of the issues surrounding an institution's condition that may necessitate a FDIC special examination would be useful to staff and provide guidance as to how they should proceed. I hasten to add, however, that there should be little or no occasion for such issues to reach the board level, since we fully recognize the appropriateness of involving the FDIC in an early stage in any bank whose deteriorating condition raises concerns of importance to the FDIC.

Conclusion

In summary, the number of national bank failures in 1999 was relatively small, but in one case the failure was quite costly to the FDIC fund. In all three cases, we believe the failures can be attributed to poor management, diminished internal controls that allowed fraud to occur, and poor underwriting decisions. We do not believe these failures present systemic implications, and they do not foretell a large number of failures during 2000. However, these failures do illustrate risks about which we are concerned. The OCC has taken many steps to address these issues, and we are committed to working with the other agencies to better understand and control risks in the banking industry.

Attachment

Date: September 27, 1999

Mr. Shaun F. O'Malley
Chair
Panel on Audit Effectiveness
C/O Public Oversight Board
One Station Place
Stamford, CT 06902

Dear Mr. O'Malley:

Comptroller Hawke has asked me to respond on his behalf to the questionnaire you enclosed in your September 1, 1999, letter concerning audit effectiveness. The OCC encourages all national banks to obtain audit coverage from qualified independent auditors. The agency believes that independent audits assist bank boards of directors in meeting their responsibilities and contribute to the overall safe and sound operation of banks and the banking system

Our responses to certain of the specific questions in the questionnaire are included as an attachment to this letter. We hope they prove helpful in your efforts to improve audit effectiveness. We appreciate the opportunity to provide you our views on these important issues.

If you need further information or clarification on any of our responses, please contact Zane D. Blackburn, Chief Accountant, at (202) 874-5180.

Sincerely,

Emory W. Rushton
Senior Deputy Comptroller
Bank Supervision Policy

Attachment

OCC RESPONSES QUESTIONNAIRE ON AUDIT EFFECTIVENESS

The Business Environment

Are auditors devoting sufficient attention to the areas where management discretion and judgment are re-

quired in financial reporting? If not, please explain why you believe this.

Auditors generally exercise more care and a more stringent materiality concern when management has discretion over an accounting treatment. However, this is an area of growing concern to financial regulators. Increasingly, in an effort to reduce audit costs, auditors are relying on client representations to document areas when no supporting evidence is available. While this may at times be appropriate, there have been situations where auditors appear to have relied blindly on management's assertions or audit judgments have been inappropriately influenced.

To what extent do analysts' earnings estimates influence management's judgments in preparing financial statements, and what are the effects on the auditor? If you see any effects, please elaborate on their importance.

Our experience seems to suggest that analysts' earning estimates do in fact exert pressure on management's financial reporting. We believe this can impact financial reporting or require special audit attention if clients improperly value assets, change accounting practices or make other inappropriate adjustments to meet analysts' projections. Unfortunately, the lack of stringent materiality criteria or the existence of alternative accounting principles is a factor that may cause auditors to overlook or tolerate minor adjustments or management choices in selecting accounting principles. Adjustments and the use of less preferable accounting principles in these situations may potentially result in the misinterpretation of earning trends and other analytical data that is based on comparisons.

Do accounting standards issued in recent years help or hinder auditors in meeting the needs of users of financial statements? If they hinder auditors, how do they do so and what should be done?

The OCC fully supports the Financial Accounting Standards Board efforts to improve financial reporting. While we may not always be in complete agreement with all aspects of an accounting standard, we do not believe that recent accounting standards have hindered auditors in meeting the needs of users of financial statements. However, there may be an impact on users if new standards require excessive or overly complex disclosures or present too much latitude in their application.

Responsibilities for Detecting Financial Statement Fraud

Are auditors' responsibilities with respect to the detection of deliberate misstatements of earnings appropriate? Please explain your view.

Yes, auditors should be responsible for the detection of deliberate, material misstatement of earnings as well as other aspects of fraud in financial statements. Auditors should be alert to situations or transactions that could be indicative of fraud, errors, or deliberate misstatements. We believe this is consistent with the auditor's ultimate objective to report on the fairness of the financial statements.

What are users' views of those responsibilities and are they realistic? Please feel free to elaborate on differing views of various types of users, such as individual investors and institutional investors.

As users of financial statements and related reports of independent accountants, we believe auditors should be responsible for the detection of errors, deliberate misstatements, or fraud when the effect is material. Auditors provide assurance that financial statements are not materially misstated. However, we recognize that auditors use statistical sampling and there are time and cost considerations that limit the extent of audit work performed. Consequently, there is a risk that material errors or irregularities will not be detected.

Investors and other users of audited financial reports have very high expectations concerning the accuracy of audited financial statements. However, it appears that many users may lack a full understanding of the inherent limitations of an audit under generally accepted auditing standards. Often investors and other users may presume that an audit will detect all instances of fraud or other misstatement.

What, if anything, should be done to change these views, or to change auditors' responsibilities for detecting fraud?

As a general matter, we do not believe it is practical or cost effective for auditors to expand their audit coverage to eliminate this expectation gap. However, certain steps should be considered to address this issue. An attempt should be made to inform financial statement users of audit objectives and how they are impacted by time restraints and cost limitations so that this misunderstanding about the auditors' responsibility for the detection of fraud may be eliminated. Additionally, auditors should consider the routine use of transaction testing and verification in areas particularly susceptible to fraud.

The Audit Risk Model

Is this model, where auditors are encouraged to use their judgment in selecting their audit approach based on the individual company's nature and circumstances, appropriate? Please elaborate on your point of view.

A risk-based audit approach can be appropriate and can contribute to the efficiency of audits when properly used. However, risk-based auditing must include periodic testing of low-risk areas and comply with specific procedures required under generally accepted auditing standards. OCC examiners use a risk-focused examining process, but examination activities include appropriate testing and validation.

What are the best safeguards to make sure that auditors exercise this judgment in ways that protect shareholders and other investors?

The best safeguard is for auditors to be knowledgeable about their client's systems, management process, and overall business environment. To ensure that an audit approach is appropriate in the circumstance, auditors should document the client's control environment and its risk assessment in the audit workpapers. The assessment should include management's philosophy and operating style and be based on the substance rather than the form of the client's policies and procedures. Moreover, as noted above, an important additional safeguard to an audit risk model is the periodic testing by auditors of low-risk areas of bank operations.

Breadth of Auditors' Involvement

Do you believe auditors should be more involved in and familiar with their clients' business and operational matters and ongoing communications with the investment community? Please explain why you feel the way that you do.

First, there needs to be a common understanding of appropriate auditor involvement in client business and operational matters. We believe the independence of auditors is essential to establishing and maintaining an effective audit process. When auditors are too closely involved in the daily operational activities of the client or in communications with the client's investors, auditor independence may be impaired. Auditor independence could be impaired also if they become too involved in client press releases or analysts' interviews or other management releases. Also, a danger exists that the appearance of such involvement may potentially cause an auditor's independence to be questioned. Despite those concerns, auditors must be sufficiently familiar with their clients' business and operational activities to effectively audit such activities. These factors influence financial reporting and impact audit risk.

Should auditors be more or less involved with:

- *Internal controls*
- *Interim financial statements*
- *Forecasts*
- *Management's discussion and analysis*
- *Non-financial data*

While auditors have professional responsibilities with supplemental financial information included in annual reports, we believe that becoming more actively involved in internal controls, interim financial statements, forecasts, and non-financial data, may be construed as being part of management and involved in the decision-making process. For instance, an auditor's objectivity may be diminished if they directly participate in making earnings forecasts for the client. Further, this may create the appearance that the auditor is verifying the accuracy or achievability of the forecast. Additional, direct involvement in these functions could interfere with the auditor's ability to objectively assess client activities.

- *Should auditors be required to report on such matters? If so, which matters and why?*

Currently, auditors may review and report on internal controls. Further, FDICIA requires independent auditors to report on management's assertion on the effectiveness of internal control over financial reporting for banks with $500 million or more in assets. We believe that reporting on the internal control system is very useful. Accordingly, it might be appropriate to expand auditors' responsibilities to cover internal and other operating controls as well as other kinds of information. This can be done separately or as an integral part of the audit. For example, we think it might be beneficial to investors if auditors reported on interim financial statements. Reporting on interim financial statements would better meet the needs of security holders and provide support for the annual financial statements if auditors extended their work to report on quarterly financial results. However, we believe the professional requirements for performing a review engagement need to be significantly expanded.

Management discussion and analysis (MD&A) is another area that should be considered for expanded reporting by auditors. MD&A is included with the financial statements presented to investors and other users. Therefore, it may be appropriate for auditors to review and report on this information if cost effective.

Audit Committees and Auditors' Communications

Do you believe auditors currently communicate effectively with:

- *Management*
- *Audit committees*

- *Boards of directors*
- *Stockholders (feel free to elaborate on institutional versus individual investors)*

We encourage open and candid communications between auditors and the board or audit committee. However, increasing competition among audit firms appears to be impacting audit effectiveness and may at times discourage auditors from complete and straightforward communications with client management, board or audit committees.

Are audit committees effective in promoting quality audits? How can audit committees be more effective in that regard? Do audit committees do enough to seek our auditors' opinions and input?

We believe that audit committees perform an important function in overseeing bank operations and promoting the effectiveness of audits. The OCC encourages the board of each institution to establish an audit committee consisting entirely of outside directors, if practicable. One of the principal oversight duties of the board or audit committee should be to review the scope of audit work performed at least annually and determine whether the external auditor is independent, competent, and knowledgeable about banking. Also, the audit committee should have access to examination reports and other communications between regulators and the institution. Further, they should have the power to conduct any investigation relating to its duties and have independent access to the bank's counsel for advice.

The Auditing Profession

What are your views on audit personnel taking jobs with clients?

We realize that audit personnel may not spend their entire career in public accounting. However, the profession should ensure that no conflict of interest or even the appearance of a conflict of interest exists when its employees leave to work for an audit client. Further, auditors should refrain for participating in any matter relating to a prospective employer when seeking a position or they are contacted about a possible job opportunity and, instead of rejecting it, they express an interest in finding out more.

The Business of Auditing

The Effects of Competition

What are your views about the effects of competition and pricing on the quality of audits?

We believe that the long-term effects of competition and pricing on audits warrants further study. We are concerned that such factors may weaken the professionalism and independence of auditors and potentially lead to substandard audits. This increased competition places greater importance on audit committee oversight and effective peer reviews to ensure audit work is in compliance with professional auditing standards.

How do you see time and budget pressures affecting the quality of audits?

Time and budget restraints may potentially result in an audit staff not performing sufficient work in order to meet deadlines. Further, excessive cost cutting may cause audit work to be inappropriately reduced. It also raises concerns as to whether adequate staff resources will be devoted to audit engagements.

Scope of Services Offered by Audit Firms

What are your impressions of the importance (stature, compensation, advancement, investment, etc.) audit firms place on audit work relative to the other services they offer, and how, if at all, does this affect the quality of audits?

Accounting firms are increasingly offering new services and expanding into other consulting areas to grow and meet client needs. Audit firms must ensure that the availability of these services does not impair their objectivity or otherwise impact the provision of core audit services. To serve the public interest and promote quality audits, auditors must be careful not to become business partners.

Do you believe non-audit services offered to audit clients affect the independence or perceived independence of auditors? If so, how do they do so and what should be done about this?

Whether non-audit services impact an auditor's independence is a complex issue. We believe that the performance of non-audit services for audit clients may cause the independence of auditors to be questioned by users, especially where the fees for such services significantly exceed the client's audit fee. This may be mitigated by mandated peer reviews and the establishment of an audit committee to approve all services provided.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before a Conference on Agricultural Credit Risk Management, on agricultural bank lending practices, St. Louis, Missouri, February 17, 2000

Ever since its founding, St. Louis has been the gateway between urban and rural America. This is where the West—and the farm belt—begin. And so it's fitting that we launch our discussion of agricultural lending and risk management in the twenty-first century here, too.

As a business and as a way of life, farming in America has never been for the lazy or timid. The risks are great; the rewards at best uncertain.

The risk/reward ratio for farmers has been most unfavorable of late. At a time of remarkable growth in the nonfarm economy—with most Americans enjoying record prosperity—net farm income was down last year, for the second year in a row. Too many American farmers are hurting today.

Their pain stems from some familiar factors—and some not so familiar ones. Recession in East Asia. One of the worst droughts on record. Foreign competition. A strong dollar. Silos bulging with years of surplus.

Not surprisingly, people are wondering aloud whether a repeat of the early 1980s is in the offing. Then, too, we saw declining crop and livestock prices, shrinking foreign markets, and a rising dollar. And the cost—to individual farmers and the financial institutions that served them—was immense.

Between 1980 and 1988, some 200,000 to 300,000 farmers underwent bankruptcy, foreclosure, or financial restructuring. Agricultural banks failed in numbers not seen since the 1920s, when they were harbingers of the more widespread financial devastation of the Great Depression. Three hundred and four agricultural banks went under between 1984 and 1989, representing at their peak nearly 60 percent of all bank failures—at a time when there were many.

So it's natural that questions should be raised about the current distress in the agricultural economy, and whether it points to another bitter harvest of agricultural bank failures to follow.

Like most questions about the future, it's not one that can be answered easily or definitively. But the evidence gives us real basis for optimism that the financial system may well be spared the spillover effects of the current farm distress.

That would be a great blessing, and not only for the agricultural banks themselves, their owners, and employees. During the 1980s, agricultural bank failures made the farm crisis more painful and more personal. Fewer lenders meant fewer choices and higher costs for borrowers. That was often enough to spell ruin for farmers who were already operating close to the edge.

Credit availability could prove just as decisive today. Farmers may be able to ride out the hard times if they are able to obtain the financing they need to tide them over until better times return. If not, heartbreak may once again become a commonplace on our farms. It's an irrefutable fact: the condition of our agricultural banks is inextricably linked to the health of America's agricultural economy.

One of this great city's most famous adopted sons, Cardinals' pitcher Jay Hanna Dean—better known as Dizzy—was sometimes accused of tooting his own horn too loud and too often. He saw things differently. "If you've done it," he reasoned, "it ain't braggin'." Agricultural bankers today *can* brag, about the successes they've achieved to date and the things they're doing to safeguard the future. Many of the traditional benchmarks of bank health look good right now. In 1998—the last full year for which reliable statistics are available—farm banks reported increased earnings, strong loan growth, good asset quality, and capital at historically high levels, both in absolute dollar terms and as a percentage of assets. Preliminary 1999 statistics show only a slight deterioration in these numbers.

Yet these trends tell only half the story—and that story demands both qualification and explanation. First, we cannot ignore the fact that some indicators of agricultural bank health *are* trending down—only slightly, in most cases, but down nonetheless. The proportion of farm banks that had nonperforming loans greater than 25 percent of capital increased from 3 1/2 percent to 5 percent between 1998 and 1999. The Office of the Comptroller of the Currency's (OCC) most recent survey of credit underwriting practices predicts rising credit risk in agricultural lending for 2000. Farm loan restructurings and renewals are up. More and more commercial lenders are resorting to subsidized Farm Service Agency financing to cope with a rising number of weakened borrowers.

Like bankers all over the country, agricultural bankers have to deal with dwindling core deposits and a growing reliance on higher cost wholesale funds in order to sustain

loan growth. And, while agricultural banks—defined as banks with agricultural loans to total loans greater than 25 percent—have made some progress toward product and geographic diversification in recent years, they are still inordinately exposed to the perils of concentration inherent in their business.

The second caveat concerns the future. There is simply no guarantee that agricultural banks will continue to perform as they have should farm conditions worsen—or even if they get no better. If we should experience still another year of declining farm income—which is exactly what the official projections call for—then all bets are off.

The USDA estimates that government payments to farmers—which reached a record $22 billion in 1999—will drop by almost 20 percent this year. New production capacity is coming on line from countries like China and even India—countries that not very long ago were big net importers of grain. The possible combination of lower government payments and still-depressed crop prices will surely test the resourcefulness of farmers and farm lenders. With all of these trials looming, the worst thing we could do today is to get caught up in an excess of self-congratulations.

Yet some cautious optimism *is* in order. That the future is unknowable and that significant risks lie ahead does not change the fact that agricultural banks have shown much greater resilience during this agricultural downturn than in previous ones. The question we want to consider is why.

There's no short answer. A long list of macro and micro factors has helped blunt the impact of today's farm income shortfall. As analysts have noted, the parallels between agricultural conditions in the early 1980s and those of today are valid only up to a point. In the earlier period, many farmers were undone by rising interest rates, which doubled or even trebled the cost of financing and automatically deflated the value of the land that secured that debt. By comparison, largely as a result of today's benign interest rate environment, land values are holding firm, despite depressed commodity prices. That's a big reason why farmers' total equity rose last year for the tenth straight year even as real farm income was trending downward.

Farmers are also benefiting from the general economic prosperity and low inflation of our times, which stand in sharp contrast to the deep recession of the early 1980s. Credit is just one farm input whose cost has been stable of late. In 1998, total farm expenses dropped for the first time in more than a decade, and the preliminary 1999 data suggest an increase for last year of barely 1 percent. Even the recent run-up in energy prices should affect operating balance sheets only at the margin.

But perhaps the key variable is the fact that, no matter how you choose to measure it, farmers today are substantially less leveraged than they were in the early eighties. In 1981, farmers carried debt equal to about five and a half times their cash income. Today the ratio is about three to one. Adjusted for inflation, farm debt today stands at about the same level that it was in 1965. And farmers' debt-to-assets ratio, which peaked at 23 percent in 1985, is now about 16 percent. If one of the lessons of the farm crisis of early 1980s was to avoid excessive debt, it's a lesson that American farmers have clearly taken to heart. It's a lesson that other Americans businesses and consumers could benefit from, as well.

That's not the only lesson farmers have had to internalize in order to stay afloat. In today's challenging environment, they're learning to be just as attentive to their finances as to their fields and crops. That's why the most sophisticated farmers are increasingly taking advantage of forward sale and marketing arrangements for their crops and livestock, as well as hedging, production controls, and other stratagems to help offset price volatility and assure themselves a predictable income stream. Indeed, the most prosperous farmers today are those who had the acumen to lock in grain prices at a profit. By contrast, today's most troubled farmers are those who decided to operate on a current basis, in hopes of a price recovery-a recovery that obviously hasn't occurred and, frankly, is unlikely to occur any time soon.

Farm lenders deserve considerable credit for the relative health of today's agricultural balance sheet—and for their customers' more sophisticated approach to risk management. After the experience of the 1980s, many agricultural bankers vowed to change the way they did business. Many have. There's proof of that to be had in the terms of the loans they make—as well as in the loans they refuse to make. Agricultural bankers today are more likely to insist on higher down payments and extensive financial analysis to determine the borrower's ability to generate adequate cash flow. No longer are bankers so willing to extend a loan based on collateral values or speculative expectations. No longer are they so quick to offer new loan products—or to enter new markets—without having the necessary managerial expertise on board. They increasingly use external risk reviews to augment internal risk identification procedures. More and more, they've become leaders in the use of government guarantee programs to control credit risk while allowing their weaker borrowers to continue farming.

So, although much more remains to be done, the best agricultural bankers have become some of the best risk managers in the entire banking industry. In this challenging agricultural climate, they've had no choice. I can tell you this: tomorrow's challenges will demand no less.

As I've already suggested, one of the most impressive developments of recent times is the way agricultural bankers are working with their farm customers to help them manage their own credit risk. With us here today are bankers who have adopted a variety of creative approaches to help their customers become better risk managers. We've heard about one bank that requires borrowers to develop and submit marketing plans as part of the loan application process. Loan officers complete break-even analyses on cattle borrowers, and routinely require hedging as a condition for loans. This is a bank that even operates its own 80-acre farm to help it stay abreast of developments in the field.

Then there's the bank that's organized a club for farm borrowers. The bank brings in local university experts to discuss such topics as marketing alternatives, price risk, business planning and budgeting, financial risk management, production risk, international conditions, and human resource management. And then it makes these university experts available as a kind of financial extension service to borrowers who need them. We'll hear more about this innovative arrangement tomorrow morning.

The OCC applauds these trends, which we view as critically important to maintaining the health of agricultural banks in these difficult times and into the challenging future that we now face.

We support these risk management initiatives in various ways. We believe that holding conferences such as this will help spread the word about the exciting developments that we see and promote better communication between agricultural bankers and their examiners. For our part, we view your input as crucial in helping us understand current conditions and the impact of our policies on your business.

As supervisors, we, too, have tried to make constructive use of the lessons of the recent past. The experience of the 1980s underscored the need to avoid broad swings between the extremes of excessive forbearance and rigor in classifying farm loans—or any other loans. It highlighted the importance of a balanced, flexible, and consistent approach to supervision—one that encourages examiners to judge each loan relationship on its merits while ensuring that banks adhere to prudent lending practices and accurate disclosure of the risks embedded in their loan portfolios. And we also learned from experience that supervisors should encourage bankers to work with borrowers—farmers and others—who may be experiencing temporary difficulties, so that credit—the lifeblood of our entire economy—is not unduly restrained.

The OCC's supervisory policies, recently memorialized in our *Agricultural Lending* handbook, emphasize that examiners *must* take into account prudent efforts by bankers to work with their troubled farm borrowers when classifying credit risk. It advises examiners not to automatically criticize loans solely due to negative cash flows, or because farmers may need more time to service their loans, or because previous debt has been carried over.

And it advises examiners to carefully weigh the full range of relevant factors affecting the condition of the farm credit. Is the loan performing according to its original or reasonably modified terms? Is the collateral sufficiently liquid and controlled to protect the loan? Is the borrower's financial condition—and financial track record—fundamentally sound?

The answers to these questions—rather than some arbitrary framework—are supposed to guide our examiners in determining the appropriate supervisory response to take. If we get it right—and I believe that we do, most of the time—we can avoid both unnecessary overreaction to adverse conditions *and* the excessive latitude that can lead to more serious problems later on.

Obviously, you and your customers are the two key parties to the lending transaction. But the law—and the needs of our general economy—prescribe an important role for us as supervisors, as well. In the spirit of communication that brings us together here in St. Louis, I wanted to take this opportunity to explain to you why we take the approach we do and what we aim to achieve by it.

And what we aim to achieve is this: a safe, sound, and competitive banking system fully capable of fulfilling its historic role in financing our nation's agricultural sector. If banks are to remain a reliable source of agricultural loans in both good times and bad, they must remain financially strong. That's the goal that I as Comptroller am committed to achieving.

I want to thank you for *your* commitment to that goal and encourage you to continue working creatively to safeguard the health of the farm economy and the agrarian way of life. These are things that mean much to our people—all of our people. We're counting on you.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Independent Community Bankers of America, on bank internal controls, San Antonio, Texas, March 7, 2000

Let me begin by acknowledging two important anniversaries: the Independent Community Bankers of America's (ICBA) 70th as the voice of independent community banking in America and Ken Guenther's 20th anniversary as executive director. Congratulations to everyone—especially to you, Ken, and to all your colleagues who've had a hand in the extraordinary record of success the ICBA has built over these many years.

In recognition of these milestones, I bring you a concession. Those of you who are bracing for another Office of the Comptroller of the Currency (OCC) speech about increasing credit risk and deteriorating loan underwriting standards can relax. In the spirit of the occasion, I will *not* discuss those subjects with you this morning.

Please don't misunderstand. Things haven't suddenly turned rosy on the credit risk front. The competitive and earnings pressures affecting credit risk are not abating, and as long as these pressures continue to adversely affect the quality of credit risk selection and underwriting standards, we will continue to be concerned.

Judging by the numbers, 1999 was an outstanding year for the banking business. Virtually every aggregate measure of bank performance was up. And while bankers continue to face challenges, I think most bankers—community bankers and megabankers alike—would agree that the past few years have been a good time to be in the banking business.

The late Congressman Wright Patman, who chaired the House Banking Committee during the 1960s, used to say that if there were no bank failures, it meant that bankers weren't doing their job. While I can appreciate the thought underlying that statement—that banks that are too risk averse may not be serving their communities properly—I would be perfectly content in my present position to have a zero failure rate. In fact, for several years during the 1990s, we had *no* national banks fail.

Three national banks did fail in 1999, however. Two were small community banks. The third was a community bank with ambitions to be a player in the highly sophisticated securitization market. One could easily view these as isolated cases in an otherwise healthy bank universe.

Yet beneath the surface lie some troubling similarities—similarities with a message for the banking system as a whole. Each of the three failed banks evidenced some weakness or combination of weaknesses in management and internal controls. In one case, improper record keeping and accounting and ineffective board oversight contributed to the bank's failure. In the second case, the bank largely lacked external audit or loan review systems, and so fell victim to fraud orchestrated by the bank's president. In the third case, there was apparent fraud on an even larger scale activity—that our examiners brought to light only a few months after a national auditing firm gave the bank a completely clean audit opinion.

Quite apart from these three cases, we have been increasingly concerned about the quality of audit and internal control functions at many other banks, large and small. When Acting Comptroller Julie Williams addressed this subject in a speech less than two years ago, she called attention to the warning signs of a weakening control environment. She and other OCC officials since then have cited the rising number of cases of bank fraud—fraud that might have been detected if sound audit and control procedures had been followed. We've noted with dismay cutbacks in the size, status, independence, and proficiency of many banks' internal audit departments. And we've identified—and criticized—the emerging subculture in bank management that, under pressure to maximize earnings, accepts a higher risk of operational losses stemming from weak internal controls in return for whatever quick savings might be realized by failing to make those controls more robust. Such an approach, we've argued, sacrifices long-term strength and stability to short-term profits, and jeopardizes bank safety and soundness.

It is essential that bankers keep firmly in mind—and the three 1999 failures should serve as a reminder—that a vigorous, independent control and audit program is essential to a bank's safety and soundness.

The OCC philosophy of internal controls is simple. We believe that effective internal control is the foundation of a bank's management of risk. When properly designed and consistently enforced, a good system of internal controls will help management to safeguard the bank's resources, to produce reliable financial reports, and to comply with laws and regulations. It will also reduce the possibility of significant errors and irregularities, and assist in their timely detection when they do occur.

Three basic rules guide our approach to internal control supervision. First, boards of directors and senior bank management cannot delegate their responsibilities for es-

tablishing and maintaining an effective system of internal control. Second, bankers and examiners must each verify the integrity of internal control systems. Finally, the OCC will perform an internal controls assessment during every regular on-site examination using minimum core assessment standards.

What core policies and procedures are we looking for? Let me offer some thoughts on that subject—and some additional examples of what can occur when these policies and procedures are neglected.

The first element of an effective internal controls program is a *control environment* that provides the discipline and structure to bank activities. A positive control environment is one that reflects management's commitment to the importance of effective internal controls, and sets the tone for the control activities that are undertaken to carry out management directives. It's an environment that allows—indeed, expects—bank employees and others performing internal control functions to do so objectively, recognizing that evaluations must be candid and accurate if they're to be of genuine value to management.

A hostile control environment, by contrast, is one in which management pays lip service to the concept of an independent control function, but acts in a way that compromises that principle. I'm thinking of one institution—admittedly, an extreme case—that wrote a model set of control procedures and then cancelled the internal auditors' stock options when the auditors had the audacity to challenge a management decision. Clearly, this was an institution whose heart was not in its own policies. But managers can create a hostile control environment by less overt means: by not listening to the auditors, or by not acting on their findings, or by not providing the audit function with adequate resources to do its job.

A truly independent internal audit function should, first and foremost, exist in an atmosphere that encourages speaking up without fear of retribution. To that end, the board of directors should be involved in such matters as fixing the compensation, reviewing the performance, and approving the budget of the internal auditor. The audit function should, moreover, have direct access to the audit committee of the board—or, in cases where there is no audit committee, to the outside directors.

Bankers should ask themselves whether they're fostering an atmosphere in which people know that it's wrong *not* to identify and surface problems, and in which those involved in the process can be assured that no negative repercussions will be suffered if they do. That's certainly a question that OCC examiners will be asking when *they* assess an institution's internal controls.

The second element of an effective internal controls program is *risk assessment.* This refers to the identification and analysis of relevant risk, both internal and external, that can jeopardize a bank's operations or prevent it from achieving its objectives. Risk assessments help determine what risks exist, what their magnitude is, how they should be managed, and what types of controls are needed. It means understanding the business you're in—or the business you're about to enter.

Too many banks, in their zeal for income growth and new markets, have ignored this basic precept. Several banks can speak with unhappy authority on this subject, after absorbing large losses in acquisitions of businesses that senior management did not understand.

The third element consists of *control activities*, including policies, procedures, and practices that help bank personnel carry out board and management directives. Control activities include reviews of operating performance, approvals, and authorizations for transactions and activities, segregation of duties, vacation requirements for officers and employees in sensitive positions, and the design and use of documents to ensure that transactions are properly recorded. Policies should ensure that bank officers who perform internal control functions as an adjunct to their operational duties not be put in a position of evaluating their own work. They should also ensure that duties other than the performance of control functions do not conflict with or compromise those functions.

When these policies and practices do not exist, it can cost banks dearly. Unreconciled accounts mount—and so do losses. Fraud goes undetected until it's beyond the point of effective repair. The veteran employee entrusted with special access to the bank's records abuses the privilege. The bank that outsourced its construction loan disbursements to a title company winds up having its capital nearly wiped out as the result of the title company's failure to ensure that the work being funded was actually completed.

Such tales of woe have become an unfortunate commonplace in today's financial world.

The fourth element in an effective internal controls program covers *accounting, information, and communication systems.* These systems must capture and deliver pertinent and timely information that enables bank officers to carry out their responsibilities. Management must have the proper tools to effectively manage risk.

But we see an alarming increase in the number of "surprises"—problems that don't come to light until they have already had a sizeable impact on the bank's financial condition. Recently, a number of banks have had to

restate earnings as the result of inadequate attention to accounting controls.

Finally, effective internal review programs such as *self-assessment or monitoring* can provide oversight of a bank's control system performance. Self-assessment, in the form of periodic evaluations of a department's controls by a person responsible for that area, is one type of oversight mechanism. For community banks, a clear and focused internal audit program can be a key defense against fraud by providing independent assessments of a control system's quality and effectiveness.

This is the kind of review that bankers should be performing every day, and it's critical. Auditors, loan reviewers, and bank examiners can be a good backstop against risk. But nothing can replace front-line accountability.

The principles I've just outlined apply to banks across the board, and they apply to every phase of a bank's operations. In the loan production area, for example, all banks, regardless of size, should have an effective process for approving and monitoring loan policies and practices. They should have clear and consistent policies and procedures. They should have information systems that provide appropriate reporting to line management, senior management, and the board. And they should have a loan review function that provides *independent* evaluation of the risk and quality of the loan portfolio, to avoid the inherent conflict of interest that would arise if the person who made a loan is also charged with reviewing it.

In the compliance area, an effective internal control environment features a board and senior management active in approving and monitoring compliance policies and practices. It has a designated compliance officer or compliance committee, sound operational controls, and training appropriate to the institution's activities. It has policies and procedures that address all relevant compliance issues. And it includes an independent audit program that tests compliance with the various consumer protection laws and adherence to bank policies.

I know that your responsibilities for compliance are burdensome, and that full compliance with every law and regulation is challenging, no matter how good your compliance program might be. But the burden of compliance may be insignificant compared to the risks and losses that can result if compliance is not carried out properly. An effective internal control program that keeps an eye on compliance is cheap insurance against such loss. Unfortunately, too many banks today are choosing to run that risk without the protection that internal controls can provide.

The time has come, therefore, to reconcentrate our supervisory focus on internal controls and audit, and the OCC is doing just that. Where effective policies and procedures, and the will to enforce them, strike us as lacking, we will bring our concerns to the attention of management and the board, and make clear their responsibilities in this area.

Large banks may have more to lose in dollar terms when internal controls slip. But community banks' smaller margins for error make them no less vulnerable to such slippage. Many community banks have enjoyed impressive growth recently, and that's a tribute both to the skill and vision of their managers and to the rapid development of the financial marketplace. But for all organizations, growth brings challenge. It brings staff turnover, and, occasionally, the need to throw newcomers into the breach before they've been fully trained. Rapid growth can overwhelm both information systems designed to process a much smaller number of transactions, and managers accustomed to a narrower span of responsibility and control.

In other words, control procedures that might have been perfectly adequate to a bank at one stage in its development may no longer be sufficient once that institution has evolved into a larger, more complex operation.

The federal bank regulatory agencies recently adopted a common policy relating to outside audit that recognizes this fact. The Federal Financial Institutions Examination Council's interagency policy statement affirms that examination procedures should be geared to the differing needs and risk characteristics of the bank population. In keeping with this policy, our examiners have the discretion to tailor procedures to each individual bank. For example, while we strongly believe that all community banks should have the benefits of an external audit—and we fully appreciate the costs involved—we recognize that there are a number of means to that end, ranging from full financial statement audits by independent public accountants to directors' examinations performed by other independent parties.

Right now, we are reemphasizing the minimum core objectives for internal controls and audit in our community bank examination procedures. These objectives require examiners to evaluate the quality of board oversight of the bank's audit programs; the adequacy of audit policies, procedures, and programs; the competence and independence of the internal audit staff; and the effectiveness of outsourced internal audit arrangements, if applicable.

For internal controls, our minimum objectives require examiners to evaluate each of the five control elements I discussed earlier: the control environment; internal risk assessments; control activities; accounting, information, and

communications systems; and the bank's self-assessment and monitoring capabilities.

For external audit, the objectives require an assessment of the adequacy, independence, and reliability of the auditor's work. And in all three instances, examiners are required to include their conclusions about the bank's performance in this area in the report of examination and in their summary discussions with bank management.

But our emphasis continues to be on results rather than process, and on matching requirements to the size and complexity of each bank. So we rely on the examiners' judgments in determining what steps need to be taken to meet those objectives. Examiners on the scene determine what documents need to be gathered and analyzed, what discussions need to be initiated, and what kind of validations need to be performed to draw reliable conclusions. For example, if questions arise about the internal or external auditors' competence or independence, or if longstanding audit exceptions exist, examiners will probe more deeply to determine the cause of these weaknesses—including conducting verification procedures, if necessary. If their evaluations point to concerns, our examiners are expected to make recommendations for corrective action.

But communication is most effective when it goes both ways. We want to hear from you. Banker input is critical in improving all phases of our examinations, to make them more useful and less burdensome. In fact, an effective program of internal controls is probably the best way I know to preserve the proper balance between bank managers and supervisors, enabling both of us to do what each does best.

One veteran banker used to diagram his conception of the appropriate system of checks and balances for banks by drawing three concentric circles. The innermost circle represented bank management, the second the audit or other control function, and the outermost circle, the bank supervisor.

I think that framework offers a reasonable approximation of what our respective roles should be. Proper internal controls and an effective audit function must be management's first line of defense against the unpleasant surprises that can cause severe, even irreparable damage. A strong and effective internal controls program will help ensure a bank's success—and help its managers get a good night's sleep.

Finally, as for the supervisor's role, I would say this: that while supervisory *oversight* is critical, supervisory *intervention* should always be the last resort. We bring a useful outside perspective to your business. But if we find weaknesses in your audit or control environment or have the ability to catch a problem before you do, then you may have an issue requiring your board's attention.

Let me leave you with this challenge: to do whatever it takes to make sure that your bank has effective internal controls and audit in place. If they are, your shareholders will be better off, and we as supervisors can step back and let you do the job you were hired to do, as you'd prefer to do it, without undue interference. That's *our* goal, and it should be yours, too.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Neighborhood Housing Services of Chicago 25th Anniversary Awards Dinner, on extending banking services, Chicago, Illinois, March 15, 2000

Mayor Daley, Cardinal George, and distinguished guests, it's a great pleasure to be with you to join in the celebration of Neighborhood Housing Services (NHS) of Chicago's silver anniversary. And in recognizing *that* milestone, of course, we also mark Bruce Gottschall's 25-year tenure as NHS of Chicago's executive director—the longest serving executive director in the whole NHS network. Bruce, best wishes for many more years of success in serving the people and the communities of this great city.

I could easily devote my entire few minutes at the podium to extolling what Bank One, LaSalle, Bank of America, and many other national banks are accomplishing in Chicago's neighborhoods. We've already heard about some of these accomplishments this evening. Suffice it to say that every day our banks are making important contributions to the well-being of the communities in which they do business. I'm proud of that fact, and proud of the work of NHS of Chicago in arranging the partnerships that have done so much good for so many over these past 25 years.

For nearly that long, we at the Office of the Comptroller of the Currency have provided active support of these partnerships. We recognize the important role financial institutions have to play in community redevelopment. I've seen firsthand what a difference it can make for communities when credit and banking services are available—and what the consequences can be when they're not.

One of the keys to NHS' record of success in rebuilding Chicago neighborhoods has been its ability to identify and pull together *all* of a community's strengths and assets to a common purpose. The program this evening illustrates the power of inclusiveness.

Although banks have an important role to play in community reinvestment, Roger Joslin's excellent presentation reminds us that many nonbank financial firms already—are and must increasingly become—equal partners in that effort. So, Roger, congratulations are in order to you, too, and to State Farm, for all of the fine support you've provided to NHS over the years.

An anniversary like the one we're celebrating tonight is an occasion to look forward and look back, at the successes of the past 25 years as well as the challenges that lie ahead. Because my time tonight is short, I would simply like to touch on two related issues that seem to be on most everyone's list of obstacles to community revitalization efforts.

The first is what's sometimes called predatory lending. It's a term that currently lacks a common definition. But it's something we all know when we see it. It involves significant overreaching, deceptive marketing practices, exorbitant charges, abusive collection practices, and more. We see it especially in our poorest neighborhoods, where people are most desperate and most vulnerable.

Where predatory practices violate existing law, we are prepared to take appropriate supervisory action against institutions within our jurisdiction, and we will heighten our supervisory scrutiny wherever we suspect such activity is taking place.

But the enforcement of consumer protection laws is only part of the solution. We must also address those circumstances that provide the seedbed for such operations to flourish. That means encouraging responsible competition from mainstream institutions in markets targeted by predatory lenders. And it means educating borrowers to understand their obligations and options, legal and financial. Predatory lending and financial illiteracy go hand in hand. Teach people what they need to know to make smart financial decisions, and the predators are likely to go elsewhere.

The NHS of Chicago is playing a critically important role in both areas. I'm particularly impressed by its efforts to generate investment to support alternative lending products that don't stretch people beyond their means. NHS' efforts to provide refinancing options for people facing foreclosure in predatory relationships will give them renewed hope, and discourage the predators. And in this connection, let me also commend Mayor Daley and the city of Chicago for taking the initiative to establish a similar refinancing pool for people victimized by predatory lenders.

Obviously, banks need to do their part, too. Eliminating deceptive practices within the industry's ranks and encouraging expanded access to financial services are critical. I'm convinced that financial institutions that stay the course and work to develop relationships in currently underserved neighborhoods will be rewarded for their patience with loyal customers who have the capacity to become *good* customers.

That brings me to my second point. Access to mortgage credit is only a subset of a much larger problem. Right now, 13 percent of American households do not have a deposit account at a financial institution, and thus are outside the financial mainstream.

While there are a variety of reasons for this, one important reason is the high cost of a conventional checking account for low-income families. Yet, paradoxically, many such families continue to use check cashers and other fringe providers as their principal source of payment services, frequently at an even higher cost. Surely, our great advances in financial technology can be brought to bear here.

As under secretary of the Treasury for Domestic Finance in the late 1990s, I oversaw the development of the Electronic Transfer Account, or ETA, which we viewed as a means of linking direct deposit with an all-electronic account that would provide recipients of federal payments with the safety, convenience, and efficiency of a low-cost bank account.

But the ETA was not an end in itself. Done properly, it could be an important stepping stone to a broader banking relationship—a means of bringing users into the financial mainstream. Our goal was to encourage banks to develop their own low-cost products, adding more and more useful features, and to compete more aggressively to attract the business of those millions of families who need banking services but have remained outside the system.

Where free market solutions work, I believe that they should be the solutions of choice. But the problems I've mentioned this evening require a more concerted response by all the concerned parties: banks, community organizations, and government working together. Only through such partnerships—partnerships of the sort for which NHS of Chicago is so renowned—can we begin to make equal financial opportunity a reality for all of our citizens.

Again, my heartiest congratulations on your anniversary.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before a Seminar for National Bank Chief Executive Officers, on banking and financial modernization, Dallas, Texas, March 16, 2000

I often hear bankers talk with nostalgia about "the good old days"—days when banking was a simpler business, with less government hassle; days of afternoon golf, enjoyable conventions, and guaranteed profits. A few of you may still remember those days.

But the good old days were overrated. True, they were simpler, and less demanding. But they were also a lot less interesting. They didn't bring out the best in us. Young people searching for a challenge were likely to take their talents and energy to other lines of work. Innovation carried no premium.

But I believe the best days in this business are not behind us. The best days for the banking business are the ones at hand—and the days that lie ahead. I've never seen a better time than today to be a banker—and especially a national banker.

Think about it—and feel good about the charter you chose. National banks continue to enjoy all their traditional advantages: a single set of rules that apply uniformly, wherever national banks operate; immunity from state law that would interfere with the exercise of powers granted under federal law; and the benefit of consistent treatment by just one set of examiners. National banks continue to benefit from the prestige and the connotation of strength that comes with the word "national" in their corporate title. And, as always, national banks enjoy the benefits of supervision carried out by examiners who know the lay of the land, backed up by the broad expertise of a national organization—an approach we like to characterize as combining a local presence with a national perspective. And then think about this: banks generally—and national banks particularly—have never been safer, sounder, or more prosperous. Returns are at historic highs. Problem assets are at a low level—in the last quarter of 1999, the ratio of nonperforming assets to total assets for national banks equaled a mere seven-tenths of one percent. Loan demand continues to be brisk. Capital has rarely been stronger.

But for the last several years, even as the industry was amassing these impressive numbers, it's had to look over its shoulder to see how developments in Washington would affect the banking franchise. As long as financial modernization was up in the air—as it was for what seemed like forever—so, to a considerable degree, was the industry's future. Clearly, if Congress had adopted some of the proposals that were aggressively advanced by those with their own territorial interests to serve, your ability to serve your customers and communities would have been greatly impaired. Now this uncertainty has been resolved. And for national bankers, the outcome is positive—more positive than many of us had dared hope.

As the legislation worked its way through Congress, the Office of the Comptroller of the Currency (OCC) pursued three basic goals. First, we insisted that nothing interfere with the ability of national banks to be fully competitive in serving the needs of their customers. Second, we insisted that financial modernization advance the safety and soundness of the banking system, by allowing national banks to diversify their sources of income and to diminish their dependence on net interest margins. Finally, we insisted that financial modernization legislation protect national banks against discrimination, to preserve all the inherent advantages that make the national charter such an attractive vehicle for delivering financial services.

I'm pleased to report that each of these goals was achieved.

Under the bill, national banks have gained significant opportunities to expand and diversify their revenue sources. National banks may now offer a broad array of products and services previously foreclosed to them, through financial subsidiaries, which may engage in virtually the full range of financial activities permitted for bank holding companies. The list includes underwriting and marketing securities, sponsoring mutual funds, and selling insurance from any place in America—powers that banks have wanted and worked for for years.

If properly used, these new powers offer new opportunities for growth. And we expect that with these powers, coupled with new delivery mechanisms like the Internet, national banks will become key players in the financial world of the future—just as they have been key players in the past.

As important as what the act did is what it didn't do. It left completely untouched our ability to define for national banks what constitutes the "business of banking," as well as what's "incidental" to that business. This authority has been the principal source of the innovations that the OCC has brought to national banks for the last four decades. You can be assured that as our concepts of the banking business change, we at the OCC will continue to have a

dynamic approach to change—and national banks will be able to keep pace with that change.

For much of the last 40 years, bankers had to conduct the defense of their markets with one hand tied behind their back. Now the major restraints are off. Coupled with the elimination of geographic barriers and the health of its balance sheet, the banking industry finally has the wherewithal—legal, financial, and managerial—to meet the multiple challenges of nonbank competition, future shifts in customer tastes and expectations, and the economic surprises that inevitably lie ahead.

But here I have to add a cautionary note. We can't afford to lose sight of the fact that the freedom to innovate is also the freedom to falter. The market can be a harsh and unforgiving place. And I'm convinced that those who are most likely to survive and thrive in this more open environment will be those that have as strong a commitment to the fundamentals of good banking as they do to being on the cutting edge of new financial products and services.

Time-honored practices like sound credit underwriting, effective internal controls, and responsive customer service have a demonstrable relationship to the bottom line. It may not be immediately apparent, but, as good bankers know, these things are the foundation of good banking—banking capable of withstanding all the bumps and bruises that the economy can dish out.

At the OCC, we're equally committed to the fundamentals of effective supervision—to providing the most expert, most professional, most responsive, and most efficient bank supervision obtainable from any source. And, judging by what I hear from national bankers around the country, there's a high level of satisfaction with the quality of the supervision we offer. Bankers praise the skill and professionalism of our examiners, and the important help they provide in identifying new markets and business opportunities, spotting existing and emerging risks, and in obtaining a better understanding of the industry. And they recognize our leadership representing the interests of the national charter in Congress and the courts.

But we expect no less of ourselves than we expect of you. We know something about competition, too. We know that when your customers have options, complacency won't do. And we know that a safe, sound, and competitive banking system is vital to our national well being. That's more than enough incentive to keep us on our toes, working to ensure that OCC supervision continues to be the standard against which other supervisory agencies—here and abroad—measure their own competence.

We understand that effective bank supervision requires clear lines of communication between bankers and supervisors. Our meeting here today—to be followed by others like it around the country—is an important part of our broader outreach effort. While we're committed to making regulation simpler and less burdensome, we know that considerable complexity—and the need for explanation—remains. So it's crucial that you hear from us—and that we hear from you about *your* needs and concerns. And that's what I hope to do—in our formal sessions and informal discussions—while I'm with you over these next two days.

But the listening doesn't stop when we part company, any more than the relationship between national banks and OCC examiners stops when all the concerned parties have signed off on the report of examination. OCC supervision—and your relationship with us—is designed to be continuous and ongoing. In this banking environment, it has to be. We know how rapidly risk can build, and how important it is that bankers stay on top of it every day. That's true for bank supervisors, too. So consider us your backstop—your resource—in the joint risk management effort. That's a message I'd like you to take away with you from this meeting.

It's been more than 20 years since the OCC led the way among bank supervisors by differentiating between the supervisory needs of large and smaller banks. As large banks have become even larger, the need for different approaches—and for examiners with specialized training—has never been greater.

I'm excited about our community bank initiative. I announced it last year, and it's already producing important results. We've turned out revised examination procedures geared to the special needs of community banks, new supervisory products designed with community banks in mind, and a new office in our Washington headquarters with a director whose job it is, among other things, to ensure that impact of our rules and regulations on community banks is properly understood before they're implemented. It's all part of an approach that recognizes that, in bank supervision, one size cannot fit all.

One of our goals in this connection is to increase the quantity and quality of the information we're able to provide to national bankers electronically. Most of our publications can already be accessed over the Internet or from our telephone-based information line.

But on its way is something bigger and better. We're calling it National Banknet—an integrated, Web-based communication system that we can use to communicate directly—and exclusively—with you. It will give national bankers the ability to file corporate applications on line and check on their status. It will enable national bankers to get up-to-the-minute information on events that affect their business. It will enable us to communicate instanta-

neously and simultaneously with all national banks, and for you to communicate back to us. And it will include a variety of new computer applications and tools to help national banks achieve their goals in the competitive financial marketplace. Already available is the Comparative Analysis Report, or CAR. It permits any national bank to have access to our database covering more than 8000 financial institutions in order to compare their performance with any other bank—or group of banks—it chooses.

National Banknet is just one more way that the OCC's local presence and national perspective add value to bank supervision. You'll hear about still other interesting developments over the next two days.

I said it at the outset, and I want to conclude these opening remarks by saying it again. I believe that commercial banks—and especially those that operate under the national charter—have before them today an unequaled opportunity to profit and to serve. Achieving your goals won't always be easy. But the best days—the days that leave you with a real feeling of accomplishment—rarely are.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the National Community Reinvestment Coalition, on banks and community development, Washington, D.C., March 21, 2000

In his 1962 State of the Union address, President Kennedy declared that "a strong America depends on its cities—America's glory. And sometimes," he added, "America's shame." They were words that stirred the nation's conscience—and then stirred it to action. And in the years since then, organizations like the National Community Reinvestment Coalition (NCRC), with leaders like John Taylor, have worked to harness the energies and the resources of our people, so that our cities—and our neglected rural areas—might shine once more.

Since then, we've turned many corners, and it's gratifying to see NCRC's approach to building partnerships starting to pay off in such a big way. As NCRC research shows, the trickle of community reinvestment dollars of the early years has turned into a veritable flood—nearly $900 billion committed by banks in the last two years alone.

Unfortunately, while these numbers are big, the need is bigger—and growing. Despite our progress in reversing the erosion of our housing stock, there's still not enough decent, affordable housing to go around. Despite the addition of thousands of small businesses in recent years, too many of our communities are still plagued by joblessness and despair. For too many of our nation's children, unsafe streets, dysfunctional schools, and inadequate recreational and medical facilities are still the norm.

History has shown us again and again that where conditions of financial stress exist, there will always be predators—those who charge exorbitant prices to the most vulnerable members of society for services that the more affluent receive for less.

The phenomenon of predatory lending is not new. Usurers have always been with us. But according to a recent report by the Woodstock Institute, predatory lending in secondary mortgages and home equity products—overwhelmingly by nonbank finance companies—threatens to erase progress we've made in redeveloping our communities. It's a growing problem with national implications.

Ironically, the progress we've made in community development is one reason predatory lending currently looms so large. The increased availability of housing finance since the early 1990s has enabled literally hundreds of thousands of low- and moderate-income Americans to start building wealth as homeowners. That makes them tempting targets for predators, who exploit the likelihood that new homeowners will occasionally be short of cash and financial sophistication, and ripe for a high-cost second mortgage. All too often, unfortunate homeowners wind up with a loan they can't afford. All too often, they find themselves on the road from "American Dream to Worst Nightmare," as the Woodstock Institute put it—a road that ends in foreclosure. And when that occurs, it's not just the ousted homeowner who's hurt: property values decline and investments—by individuals and financial institutions—suffer. The whole community feels the effects.

I share the concerns that have been raised about predatory lending. No one can condone such practices. That's why, where we have credible evidence that a national bank is engaged in predatory practices, we will focus on the remedies that are within our power to invoke to address the problem.

For example, in the course of our fair lending exams, we look for pricing differences based on race or other prohibited bases. Where possible violations are indicated, we will examine for marketing, targeting, or steering of consumers to high-cost products on a discriminatory basis. If we find discrimination, we will make a referral to the Department of Justice for enforcement under fair lending laws. To heighten our examiners' awareness of the fact that a predatory lending environment presents a high level of risk for discrimination, we will be issuing an advisory to examiners that instructs them to be on the alert for patterns of predatory lending so that we can follow up appropriately through the examination process.

At the same time, while we can insist on scrupulous observance of such laws as Truth in Lending, much of what we are seeing in this area is within the boundaries of existing law. For example, Congress enacted the Home Ownership and Equity Protection Act in 1994 to prevent predatory lending practices targeted at vulnerable consumers. But, despite this law and the Federal Reserve's regulatory implementation of it to date, we've seen predatory lending practices continue and even spread.

Furthermore, it's been noted that some national banks are "exporting" high lending rates authorized by their home jurisdictions into states whose laws are more restrictive, and we have been urged to put an end to this. But this is a well-established power granted to, and employed by, both national and state banks and thrifts.

Nonetheless, we continue to explore—both on our own and on an interagency basis—whether there are areas where we can take effective action. For example, while we don't have the power to promulgate regulations defining unfair and deceptive practices for banks—that authority resides solely in the Federal Reserve—we are exploring whether we can initiate cease-and-desist actions against banks on a case-by-case basis, challenging specific conduct that we might be able to characterize as unfair and deceptive. While formal rulemaking may be a more comprehensive way of dealing with widespread abuses, we may be able to make progress on an individual case basis. Further, while nondiscriminatory steering of customers to higher-priced loans may not be illegal per se, it can still raise warning signs and concerns. In view of this, we recently refused to approve a national bank's acquisition of a large subprime lender without a commitment to ensure that the price at which a loan would be offered to an applicant would not be affected by the delivery channel the applicant used to seek credit.

Quite apart from such remedies, it's important that, in attacking this problem, we get at the roots. We must target not just the predators themselves, but the conditions that allow them to flourish. That means encouraging responsible competition in the same markets in which the predators operate. It means helping low- and moderate-income Americans to gain a better understanding of their financial obligations and options. We need to focus on education and access. And that brings me to what brought you here for this conference—the question of how to increase wealth in our communities by improving access to financial services.

We have to be careful about how we define our terms. Strictly speaking, there's no shortage of financial services in many of our low- and moderate-income neighborhoods today. Check cashers, pawn shops, and payday lenders are often plentiful, and despite their high costs, they are likely to remain part of the financial services landscape in low- and moderate-income communities for a long time to come—unless they are displaced by mainstream providers.

It's clear that mainstream financial institutions—banks, thrifts, credit unions, and their offshoots—offer their customers important advantages, generally including the provision of transaction services at prices below those of fringe providers. Cost is obviously significant in this context, for the basic strategy for building personal wealth is to keep more of what you earn, and that's tough to do when you're handing over a substantial fraction of the face value of a paycheck just to cash it. Over a period of time, the difference of even a few dollars a week can make a big difference to people who are tired of living at the margins.

Even more important from a wealth-building standpoint are the financial services that fringe providers can't offer at all, such as safe repositories for funds and cheap and efficient payment services. For a small business loan, a loan for education or job training, or an affordable mortgage, only a bank or similar institution will suffice.

And the intangible benefits of dealing with a mainstream financial institution may be as important as the tangible ones. Banks give customers the opportunity to build the formal credit history and long-term financial relationships that are important to full participation in mainstream economic life.

The advantages of real banking should be obvious. Yet some 13 million American families do not have an account at an insured depository institution. There are a lot of reasons for this, but a primary one is cost. A conventional checking account is simply too expensive for the needs of a great many people.

A substantial number of unbanked Americans may find that there's simply no bank to do business *with*. For example, in New York City last year, only 2.5 percent of all bank branches were located in low-income areas that housed more than 6 percent of the city's total households. In those areas, check-cashing outlets outnumbered bank branches by more than two to one. Some of the city's poorest neighborhoods are without any banking facilities—despite the fact that local economic activity may be quite vibrant.

But even bringing back conventional financial institutions won't necessarily solve this problem. Indeed, a fair number of Americans without banking relationships *do* have one or more banks conveniently at hand, but choose to conduct their financial business elsewhere. Other things keep them away. There are concerns about confidentiality and, especially in communities where English is not the dominant language, the ability to communicate with bank personnel. The largest group of the unbanked, however, report that banks don't offer the services they need and that, when those services are available, banks charge too much for them—a perception that's hard to reconcile with the reality of the exorbitant fees fringe providers generally charge.

So it's clear that an effective response to the problem of the unbanked has to be multifaceted. First, we have to encourage banks to get back into low- and moderate-income neighborhoods. Over the years, there's been a significant turnover of banks in some of these neighborhoods. Some pulled out because locations were unprofitable. Others were concerned about security. And some ultimately decided that service to the unbanked was not

consistent with the upscale image they were seeking to cultivate.

What each of these banks found was that simply being in these communities was not enough. Success in low- and moderate-income markets takes patience and understanding, and it takes a well-conceived plan to tailor services to the specific needs of low- and moderate-income customers.

However, success *has* come to bankers who follow some basic guidelines.

First, as I've said, it's crucial that bankers provide a range of products and services tailored to the needs of the communities they serve. That usually includes a means of getting cash, payment services, passbook savings accounts, consumer credit, and mortgages.

Second, it requires banks to take full advantage of technology in delivering services. We all know that the old-style paper-based checking account, with all of the opportunities for overdrafts that it offers, is expensive for both banks and customers. Yet direct deposit coupled with debit card and point-of-sale access can be offered at a small fraction of the cost. Such electronic-based accounts can also be structured to provide extremely efficient payment services, and they can be offered with savings or investment features that will help build wealth.

Third, success requires commitment by senior management to the market and the community. It demands a high level of sensitivity in staffing and operating the facility, and a willingness to alter bank culture to conform to the values and habits of the community. Organized outreach, education, and financial literacy programs are often an important part of the successful bank marketing plan.

Finally, success in these markets requires resolute pursuit of the long-term goal of developing or migrating marginal customers to full service status. The customer with a regular source of income who opens a direct deposit, electronic transfer account, can be an excellent customer for a conventional small loan—at a far cheaper cost than the predatory payday loans offered by fringe providers.

Banks that have done these things right have been amply rewarded for it. They've attracted a larger and loyal customer base, increased opportunities to provide other banking products, and generated a reliable source of stable deposits. Some are making money now; all expect to do so in the future. And they're making a real difference in their communities.

Bank regulators obviously have a role to play in this process, and, as we look to the future, it's just as important that we, too, take an innovative approach to bringing the unbanked into the financial mainstream. We're exploring ways in which banks might be able to pool their resources to defray some of the associated start-up costs and ongoing marketing and operational expenses.

One possibility I find especially intriguing is the consortium bank, an institution chartered as a mainstream bank, owned and supported by large banks in the community. A consortium bank with a business plan tailored to the specific needs of an inner-city community may be able to bring services to areas that have otherwise been abandoned. We are giving detailed consideration to this idea.

It may be unrealistic to think that predatory lending can ever be fully eradicated. In all likelihood, there will always be some who fall victim to the unscrupulous. But while we cannot tolerate abuses, our focus must remain positive. Our goal is—and must always be—to provide practical alternatives that give rising Americans a better chance to gain control over their finances and to build wealth. Banks have always played an important part in that process, and they should play no less important a role in the future. I look forward to working with you to that end.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency, before the Fifth Annual Cyberbanking and Electronic Commerce Conference, on technological innovation in banking, Washington, D.C., February 24, 2000

There has been much discussion in financial industry forums these days about how the new financial modernization legislation—the Gramm-Leach-Bliley Act (GLBA)—will change the financial services business. While it is true that the GLBA will ultimately change the way that financial services companies are *structured*; in fact, more far-reaching changes are occurring in the financial services industry as a result of developments in technology. Ironically, the long-sought repeal of the Glass-Steagall Act may not be the main event of financial modernization.

The GLBA does not change the nature or range of available financial services. It does allow some types of companies directly to provide products that previously were provided only by other types of companies. The bigger story of financial modernization is how the Internet and new technologies are transforming how financial services are produced and delivered. More profoundly, as the potential of technology is being realized, the essence of what constitutes a banking and financial activity is transforming as well.

We shouldn't be surprised that the business of banking is changing. History reflects that banking is a business that has continuously—and constructively—evolved over time. We have come a long way since the "real bills" doctrine of the eighteenth, nineteenth, and early twentieth centuries, which held that a bank could maintain public confidence and liquidity only by balancing maturities on both sides of its ledger—limiting its loans to nonrenewable short-term working capital loans to business. Comptroller of the Currency John J. Knox endorsed this vision of banking in 1875 when he declared that "A bank is in good condition just in proportion as its business is conducted in short credits, with its assets so held as to be available on brief notice."

Today we would probably say that Comptroller Knox's ideal bank has an unacceptable credit concentration, possibly interest rate risk, needs to diversify its sources of revenue, and has failed to meet the credit needs of its community.

What is notable about the current phase of evolution of the business of banking is how technology is driving multi-dimensional change. Technology impacts not just how products and services are delivered, but also the substantive characteristics of products and services themselves.

In essence, the *medium* used to produce and deliver a product or service is merging with the product and service connected to it. As this occurs, the dimensions of the business of banking are expanding.

We already can see technology driving the evolution of banking in several ways:

- Technology provides new ways of applying the conventional roles and authorities of banks and, thereby, fundamentally transforms them.
- Technology provides banks with new applications for their existing core competencies and, thereby, expands their roles.
- Technology prompts banks to develop new core competencies that ultimately may migrate into the business of banking.
- Technology, and how bank customers use it, may compel banks to develop or acquire new capacities and competencies in order to remain competitive.
- Technology can combine financial and nonfinancial activities in such a way that a banking function based on nonbanking activities emerges.

Let me now review how we see these themes translating into realities. I'll use several recent OCC decisions to put them into context.

First, I'll cover some decisions that treat technology as "transparent" and look to the nature of the underlying service, function, or activity proposed to be conducted.

Good examples of this "transparency" approach are the OCC's decisions on electronic finder activities. As you know, the finder function is a long-recognized banking function. Banks bring together parties who then negotiate and complete a transaction between themselves. In the past, because of limitations on communications and information technology, the finder function was of limited utility. However, with the development of the Internet, the finder function empowers national banks to play a central role in electronic commerce.

Thus, in the *Fleet* decision, we found that national banks as finders can offer commercially enabled Web site hosting services to their merchant customers. The bank-hosted sites serve to bring together buyers and sellers—a

technologically advanced expression of the finder function—and the bank may also process payments for transactions derived from the site.

In the recent *AeroBank* decision, we explored the extent that a national bank, on its own behalf as finder, can negotiate with merchants and other providers the sales terms to be offered customers referred by the bank/finder via the bank's Web site. We concluded that national banks may, consistent with the finder doctrine, negotiate discounts to be offered to their Internet-referred customers.

Similarly, in the *Key/Econex* decision we concluded that the finder authority, as applied to Internet technology, permits national banks to host virtual mall sites. The sites are a bank-hosted set of Web pages with a collection of hyperlinks to third party Web sites organized by product type. As an electronic finder, the bank's virtual mall is introducing bank customers to vendors and merchants offering a range of financial and nonfinancial products and services via links to sites of a third party. As part of this function, the bank may handle payments processing for transactions between parties introduced via the bank's virtual mall.

In other areas, the principle of technological transparency has been applied to the conventional banking activity of facilitating payments and collection of funds to support the following "new" activities:

- Electronic bill presentment, an electronic expression of banks' traditional role in processing and collecting payments, which we approved in applications involving *Transpoint* [1] and *Spectrum*.[2]

- Issuance and processing of electronic stored value, which we approved in *Mondex*.[3] In that decision, we found the creation, sale, and redemption of electronic stored value in exchange for dollars to be the electronic equivalent of issuing circulating notes or other paper-based payment devices like travelers' checks.

- Electronic data interchange (EDI) services.[4] EDI services that allow businesses to send and receive payments, invoices, and orders are another expression of banks' traditional role in payments.

- Electronic payments and funds collection for public authorities,[5] an expression of banks' traditional role as fiscal agents for governments. A national bank thus could enter into a contract with a public authority to operate, on behalf of the public authority, an electronic toll collection system.

Reflecting the second theme, recent OCC decisions show how technology can present banks with new applications of their existing core competencies and may thereby expand their roles.

The authority of national banks to issue digital certificates is a prime example of technology expanding the application of existing core competencies. In the *Zions* and *Indentrus* decisions we concluded that a national bank may act as a certification authority to enable subscribers to generate digital signatures that verify the identity of a sender of an electronic message. This activity, although technologically advanced, is also the application of an existing core competency of banks—verification of identity and authenticity—in a high-tech form.

Third, technology causes (and may even compel) banks to develop new core competencies that, in time, can become part of an expanded business of banking. History is replete with examples of how this has occurred—the goldsmith bankers in seventeenth-century England evolved a money transfer function from their core competence of safekeeping.

Today's versions of an evolved core competency may arise from various activities. For example, as banks seek to save significant costs through electronic presentation of checks, a high degree of competence in imaging technology and storage will be essential to support this new approach to check processing. Imaging technology and storage may soon be understood to be part of, or incidental to, the business of banking.

Traditionally banks have focused predominantly on functions relating to processing, transfer, and storage of monetary value. However, technology offers the possibility that banks may come to serve a central role with respect to the processing, transfer, and storage of information generally. Internet banking is a primary current application of Netcentric or network computing where relatively little information is stored on consumer-controlled devices and the vast majority of information is stored on bank-controlled servers. TV banking is on the horizon; it will expand not only access, but also customer reliance upon bank-maintained databases. If this trend continues, consumers may conclude that banks are a logical repository

[1] Conditional Approval No. 304 (March 5, 1999).

[2] Conditional Approval No. 332 (October 18, 1999).

[3] Interpretive Letter No. 220 (December 2, 1996).

[4] Interpretive Letter No. 732 (May 10, 1996).

[5] Interpretive Letter No. 731 (July 1, 1996) (E-Z Pass System Letter).

of all their information, financial and nonfinancial, and banks will have the competency to meet that need.

Fourth, and similarly, the way consumers use technology will compel banks to develop or acquire the technological capacities needed in order to competitively provide their products and services. These capacities may relate both directly to how the bank's products and services are provided and, more broadly, to what types of products and services the customer has accessible through the bank.

Fifth, and finally, technology can combine financial and nonfinancial activities in ways such that a banking function based on nonbanking activities emerges. Data processing is an example. Processing of banking, financial, or economic data is part of the business of banking. However, this authority also enables a national bank to process information that is not necessarily banking, financial, or economic when the processing compiles or creates a derivative data product that is banking-, financial-, or economically-related. In other words, the processing by the bank seeks banking, financial, or economic correlations or relationships within the nonbanking data. This is part of the business of banking. Thus, the nature of the entry data being processed is not necessarily determinative of the permissibility of the data processing; the resultant product also must be considered.

These precedents illustrate how technology is creating new dimensions to the business of banking. The changes are dynamic. Traditional functions performed in new ways create new, technology-based banking products and services. Traditionally recognized areas of bank expertise—competencies—are manifested in new forms. New competencies that banks develop or need to acquire in order to be competitive may lead to availability of a broader mix of products and services. And the inherent capacities of technology to assemble, analyze, and transmit data enable banks to perform banking-related functions even if nonbanking functions or data also may be connected with the bank's activity.

All this promises an exciting future for the banking business in this new century and many new opportunities for bank customers. Realization of the potential of new technologies may even mark a unique evolutionary stage in the banking business where businesses and consumers, the technically well-equipped and adept and the economically underprivileged, may all benefit from innovations in products and services and delivery that new technologies make possible.

And of course, these developments also presents new challenges for bank regulators, as we strive to position ourselves to understand the new risks that may be presented by new dimensions of the banking business, and to develop expectations about the types of risk management systems we expect banks to employ to identify, monitor, and control those risks.

It is hard to predict what the next innovation will be and what issues it may present. But I do think it is fair to predict that, at the OCC, we will continue our tradition of supporting constructive and safe and sound evolution of the business of banking, in this dynamic, new dimension of the banking business.

Interpretations—January 1 to March 31, 2000

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Interpretive Letters

875—October 31, 1999

12 USC 24(7)

Richard A. Kopek
Vice President and Senior Counsel
KeyBank National Association
127 Public Square
Cleveland, Ohio 44114-1306

Dear Mr. Kopek:

This responds to your request for confirmation that Key Bank USA, National Association, Cleveland, Ohio ("bank") may lawfully acquire and hold a noncontrolling, minority interest in Econex LLC ("Econex"), a limited liability company that will provide certain Internet-related services to merchants, and that it is legally permissible for Key Merchant Services, LLC ("KMS"), a limited liability company in which the bank holds a noncontrolling, minority interest, to expand its activities to include the Internet-related services to merchants. Based upon the information and representations provided, we conclude that the bank's proposed investment in Econex and KMS's proposed expansion of activities are permissible.

I. BACKGROUND

A. Structure

The proposed owners of Econex, a Georgia limited liability company, will be the bank, NOVA Corporation ("NOVA"), FirstEnergy Corp. ("FirstEnergy"), and David Scantling ("Scantling"). NOVA is a provider of merchant debit/credit card processing services. FirstEnergy is a utility company headquartered in Akron, Ohio. Scantling is founder and first president of Econex. The proposed owners will acquire their interests in Econex in accordance with a four-phase investment plan. Phase I of the investment plan has been completed, resulting in NOVA, Scantling, and FirstEnergy owning 57.14 percent, 28.57 percent, and 14.29 percent of Econex, respectively. Under Phase II, the bank proposes to acquire new units of Econex that will result in a 28.57 percent interest in the company. As a consequence of the bank's investment (and a concurrent additional investment by FirstEnergy), the ownership interests of NOVA and Scantling will be diluted. The resulting ownership interests in Econex after Phase II will be 28.57 percent for the bank, 28.57 percent for NOVA, 28.57 percent for FirstEnergy, and 14.29 percent for Scantling. Under Phase III, NOVA has the right, but not the obligation, to acquire additional units of Econex such that its interest in the company will increase to 51 percent. If NOVA exercises its option under Phase III, the bank's and FirstEnergy's interests will be diluted to 19.6 percent each, and Scantling's interest will be diluted to 9.8 percent. Under Phase IV, Econex would convert to a Delaware corporation.[1]

An operating agreement currently governs Econex and its members. As part of Phase II this operating agreement will be amended to, among other things, include the bank as a party to the agreement. The bank represents the First Amended and Restated Operating Agreement ("amended agreement") will be adopted once it makes its investment in Econex. Section 2.79(b) of the amended agreement includes a provision that precludes Econex from engaging in any business that would constitute a new activity within the meaning of applicable banking law, rules, and regulations, and that would make the bank's investment in Econex impermissible, without first giving the bank notice of Econex's intent to engage in the new activity and allowing the bank an opportunity to obtain regulatory approval for such new activity (the "veto right"). In the event that the bank cannot obtain the appropriate regulatory approval, the amended agreement prohibits Econex from engaging in that new activity without the written consent of the bank.

Section 14.1 of the amended agreement requires the unanimous consent of all Econex investors for any amendment to the amended agreement that would adversely affect the rights and obligations of any of the members. Section 2.7(d) further provides that upon conversion to a corporation, the Econex investors will execute legal documents, including a certificate of incorporation, bylaws, and a shareholders' agreement, with terms, conditions, equity ownership, and governance rights, that are consistent with the operating agreement in effect at that time. Moreover, in Section 2.7(d) the members of Econex acknowledge and agree that the bank's veto right will be incorporated into the shareholders' agreement upon the conversion to a corporation.

The bank currently owns a 49 percent interest in KMS. The remaining 51 percent is owned by NOVA. KMS currently engages in the business of merchant credit and debit card processing and the leasing of point-of-sale terminals to merchants. KeyBank N.A., Cleveland, Ohio ("KBNA"), an affiliate of the bank, initially received OCC approval to acquire a 49 percent indirect interest in KMS through an operating subsidiary, Key Payments Services Inc ("KPSI").[2] The bank acquired its 49 percent interest in

[1] The conversion of Econex from a limited liability company to a corporation would occur at such time that Econex enters into an agreement with one or more underwriters for an initial public offering.

[2] See OCC Conditional Approval No. 269 (January 13, 1998).

KMS from KPSI as a result of an internal corporate reorganization that was effective April 1, 1999. Except for changes attendant to the transfer in ownership, the relevant facts about the structure and operating agreement of KMS as described in OCC Conditional Approval No. 269 remain the same.

B. Proposed Activities

Econex and KMS propose to provide services to merchants to facilitate the sales of goods and services over the Internet. Econex and KMS propose to offer merchants a package of electronic services ("Internet services") that bundle payment processing services with ancillary support necessary for merchants to have retail Web sites that will be linked to a "virtual mall" Web site. Additionally, Econex will provide these services to other financial institutions on a wholesale basis so that those institutions may offer similar Internet services to their merchant customers.

KMS will seek to sell these Internet services to merchants to which it currently provides debit and credit card processing services, as well as to other merchants.[3] KMS will provide merchants with software needed to create their own Web sites on the Internet, and the merchant may select a Web site template from a series of available templates, or opt to have KMS custom build the Web site.[4] KMS also will help merchants maintain their Web sites.[5] KMS will provide sales tax calculations on the products and services sold to merchants who request that information, will register merchants with a number of Internet search engines, and will obtain an Internet Web site address known as a Universal Resource Locator ("URL") for the merchant.

There will be links between KMS's Web sites and the Web sites of the merchants that sign up for KMS's Internet Services, thus forming a type of "virtual mall." There also will be links between the KMS Web site and the bank's Web site, so that a person visiting the bank's Web site will be able to access the KMS virtual mall Web site.[6]

Econex will provide to KMS the aforementioned software and Web site hosting services that KMS will then re-sell to the merchants, will contract directly with merchants to provide the Web site building, software, and hosting services, and will market to other financial institutions the same Web site software and hosting services that it provides to KMS so that these other financial institutions will be able to re-sell those services to merchants that they sign up.

Econex and KMS, via the Internet, will provide an electronic communications pathway between the merchant and its potential customers through which product orders and payment information flow.[7] Thus, customers who wish to purchase products or services from the merchants through their Web sites can also pay for those purchases through the Internet by debit or credit card, electronic checks, or other means of electronic payment. When a potential customer submits a purchase order at a mer-

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[3] KBNA is a party to the contracts KMS currently has with merchants to provide debit and credit card processing services. Under these three-party contracts between the merchant, KMS, and KBNA, KBNA is the sponsoring bank that provides access to the payments networks. These contracts will be assigned by KBNA to the bank. Furthermore, the bank will be a party to the contracts with merchants that KMS signs up for the Internet services. These contracts will likewise be three-party contracts between the merchant, KMS, and the bank under which the bank provides access to the payments networks as sponsoring bank. KMS currently has a services agreement with KBNA pursuant to which KBNA provides clearing, settlement, marketing, and other related services to KMS. This agreement will also be assigned by KBNA to the bank after which the bank will provide those services to KMS.

[4] The merchant purchasing the Internet services will make all decisions as to what information will be presented on its Web site and how that information will be presented.

[5] Such maintenance will include ongoing maintenance and support of the Web site's host servers, as well as providing merchants with reports on transaction volume and other data relating to the purchase of products and services from their Web sites. Each merchant, however, is responsible for maintaining and updating the store and product information contained on their Web site.

[6] The KMS home page will include a disclosure stating that the bank and its affiliates do not guarantee, endorse, or provide any of the goods or services available through the third-party Web sites linked through the KMS site. The user agreement of the bank's Web site will include a similar disclosure. The merchants' Web sites will not carry any indication that they are being hosted or supported by the bank, KMS, or Econex. The bank's logo or other references to the bank, KMS, or Econex will not appear on a merchant's Web site, except as may be necessary to effect the payments processing component. Bank, through KMS and Econex, will also limit its reputation risk by reserving the right to prohibit offensive or indecent material from hosted sites. Finally, the bank has committed to ensure that KMS complies with the FFIEC Interagency Statement on Retail Sales of Nondeposit Investment Products (FFIEC statement) if the OCC determines that the FFIEC statement is applicable. *See* OCC Banking Circular 274 (February 16, 1994).

[7] In connection with the services it provides, KMS may have access to personal information of its customers. In this regard, KMS has adopted a statement of policy concerning the treatment of personal customer information in the conduct of its business that recognizes customer expectations for privacy and provides standards for the use, collection, and retention of such information. KMS's policy states that if personally identifiable consumer information is provided to a third party, KMS insists that the third party adhere to strict privacy guidelines that provide for keeping such information confidential. KMS further represents that it maintains security standards and procedures intended to preclude unauthorized access to customer information. KMS's privacy statement will be accessible via link from each page of its Web site.

Econex initially will not be dealing directly with merchants' customers. However, since data will be stored on servers it owns or leases, Econex may have access to personal information of customers. Bank management involved in the Econex project has represented that Econex has no intention of selling customer data to which they might have access to third parties.

chant's Web site, the order, along with payment and shipping information, will be transmitted electronically to the merchant. The merchant will be able to electronically confirm payment authorization before shipping any goods. Econex will directly or indirectly provide the payment authorization and processing for these payment transactions. Econex and KMS also will provide merchants with electronic bill presentment services whereby the Econex and KMS will electronically present bills to customers who have previously ordered goods or services from these merchants.

Merchants who sign up for the Internet services will be charged various fees, including a licensing or start-up fee when they initially sign up for the services, monthly maintenance and hosting fees, and transaction fees in connection with processing credit and debit card transactions or other payment transactions. Neither KMS or Econex will receive any referral fee when a consumer links to a merchant's Web site from the KMS virtual mall Web site.

The proposed activities involve risks associated with the processing of debit and credit card transactions and other payment transactions. These risks are the same types of risk that banks already assume when providing merchant debit and credit card processing services for business customers. The risks associated with accepting and authorizing payments through a merchant's Web site are identical to those already assumed when banks enable an established Web site to receive debit and credit card orders or other forms of electronic payments. To the extent that Econex and KMS contract with other service providers, notably technology firms, to provide any of the necessary products and services to offer the Internet services to merchants, they will manage its indirect risk exposure to the activities of the service providers.

II. DISCUSSION

A. National Bank Express and Incidental Powers (12 USC 24(Seventh))

The Office of the Comptroller of the Currency ("OCC") has traditionally recognized the authority of national banks to organize and perform any of their lawful activities in a reasonable and convenient manner not prohibited by law. A national bank may engage in activities that are part of or incidental to the business of banking by means of an operating subsidiary.[8] Further, the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a noncontrolling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[9] In interpretive letters, the OCC has concluded that national banks are legally permitted to make a noncontrolling investment in a limited liability company or corporation provided four criteria or standards are met.[10] These standards, which have been distilled from our previous decisions in the area of permissible non-controlling investments for national banks and their subsidiaries, are:

(1) The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;

(2) The bank must be able to prevent the enterprise or entity from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment;

(3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and

(4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

Based upon the facts presented, the bank's proposal satisfies these four standards.[11]

1. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on noncontrolling ownership have recognized that the enterprise in which the bank holds an inter-

[8] *See* 12 CFR 5.34(d)(1).

[9] *See also* 12 CFR 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 USC 24(Seventh) and other statutes.

[10] *See* Corporate Decision No. 97-54 (June 26, 1997); OCC Interpretive Letter No. 711, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-026 (Feb. 23, 1996); OCC Interpretive Letter No. 692, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007 (November 1, 1995), and No. 694, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,009 (December 13, 1995); OCC Interpretive Letter No. 705, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,020 (October 25, 1995).

[11] In OCC Conditional Approval No. 269, the OCC determined that KBNA's indirect investment in KMS met all four of the noncontrolling minority investment standards. The proposed expansion of KMS's activities impact only the first and fourth standards. Except for changes attendant to KBNA's transfer of its indirect ownership of KMS to the bank, the relevant facts about the structure and operating agreement of KMS as described in OCC Conditional Approval No. 269 remain the same. Accordingly, we do not re-evaluate the bank's investment in KMS relative to the second and third standards herein.

est must confine its activities to those that are part of, or incidental to, the conduct of the banking business.[12]

In the present case, Econex and KMS will provide a package of Internet-related services linked with merchant debit and credit card processing and other electronic billing and payment services. Additionally, Econex will provide these services to other financial institutions on a wholesale basis so that those institutions may offer similar Internet services to their merchant customers. As discussed below, these proposed activities are part of, or incidental to, the business of banking.

The OCC has already addressed Internet services and related order and payment processing services, similar to those proposed by Econex and KMS, and has found that they are part of, or incidental to the business of banking and, therefore, authorized for national banks under 12 USC 24(Seventh).[13] We have previously determined that a national bank may provide a "package" of Internet-based services to retail merchants which included the following: hosting merchants' Web sites on its server; registering merchants with search engines and obtaining URLs; providing an electronic communications pathway for product ordering and payment; maintaining merchants' data associated with the Web sites on its server (e.g., price information, product descriptions, and images); providing merchants with software to create Web sites; providing reports on transactions, Web site "hits," and sales data; and processing credit card transactions. Econex and KMS propose to provide all of these previously approved activities.

In our previous decisions, we concluded that the hosting of commercial Web sites, registering merchants with search engines and obtaining URLs, providing an electronic communications pathway for product ordering and payment, and electronically storing and retrieving the data set for a merchant's on-line catalog are forms of finder activities authorized for national banks.[14] The finder function has long been recognized as a permissible banking activity that includes, "without limitation, identifying potential parties, making inquiries as to interest, introducing or arranging meetings of interested parties, and otherwise bringing parties together for transactions that the parties themselves negotiate and consummate."[15] Providing information to prospective buyers about the products or services of prospective sellers is also one of the fundamental activities of a finder.[16] By hosting merchants' Web sites, Econex and KMS will be bringing potential customers and merchants together for a transaction that the parties themselves negotiate and consummate, and providing potential customers with information about those merchants' goods and services. Accordingly, we conclude that the components of Econex's and KMS's proposed Internet services package that involve hosting of commercial Web sites, registering merchants with search engines and obtaining URLs, and electronic storage and retrieval of the data set for a merchant's on-line catalog are permissible finders activities authorized for national banks pursuant to 12 USC 24(Seventh).

We have also previously determined that a national bank engaged in permissible Web site hosting activity may provide merchants with software that will enable them to design their Web sites. The software is "necessary" to use or fully enjoy the permissible service and, thus, is either part of the service (if limited function) or incidental thereto (if

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[12] *See*, *e.g.*, OCC Interpretive Letter No. 380, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (December 29, 1986) (since a national bank can provide options clearing services to customers it can purchase stock in a corporation providing options clearing services); letter from Robert B. Serino, deputy chief counsel (November 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

[13] OCC Interpretive Letter No. 856 (March 6, 1999).

[14] *See also* OCC Corporate Decision No. 97-60 (July 1, 1997) (national bank operating subsidiary maintaining and operating an Internet Web site which provides information on pre-owned automobiles to potential buyers); OCC Conditional Approval No. 221 (Dec. 4, 1996) (national bank making a minority investment in a company that provides an electronic "gateway" through which customers of bank will be able to obtain home banking and other financial services from their respective financial institutions through various electronic access devices); OCC Interpretive Letter No. 611, *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449 (Nov. 23, 1992) (national bank linking nonbank service providers to its communications platform of smart phone banking services).

[15] 61 *Fed. Reg.* 4863 (Feb. 9, 1996) (codified at 12 CFR 7.1002(b)).

12 CFR 7.1002 provides in its entirety:

> (a) General. A national bank may act as a finder in bringing together a buyer and seller.
>
> (b) Qualification. Acting as a finder includes, without limitation, identifying potential parties, making inquiries as to interest, introducing or arranging meetings of interested parties, and otherwise bringing parties together for transactions that they themselves negotiate and consummate. Acting as a finder does not include activities that would characterize the bank as a broker under applicable federal law.
>
> (c) Advertisement and fee. Unless otherwise prohibited, a national bank may advertise the availability of, and accept a fee for, the services provided pursuant to this section.

Earlier OCC decisions regarding finder activities cite 12 CFR 7.7200. OCC interpretive rulings at 12 CFR Part 7 were revised and renumbered effective April 1, 1996. Interpretive ruling 7.1002 (1996) replaced former interpretive ruling 7.7200.

[16] *See* OCC Interpretive Letter No. 653, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (Dec. 22, 1994).

full function).[17] Thus, Econex's and KMS's provision to merchants of software to enable them to design their Web sites is permissible under 12 USC 24(Seventh).

The processing of payments resulting from orders received through a merchant's bank-hosted Web site is clearly part of the business of banking.[18] Econex and KMS will process payments resulting from orders received from a merchant's Web site in several ways. The two entities will process purchases made over the Internet with debit and credit cards. Merchant debit and credit card processing services generally involve verifying credit card authorizations at the time of purchase, processing card transactions, settlement of card transactions, and depositing funds in merchants' accounts. Econex and KMS will also process electronic checks and other means by which a purchaser electronically authorizes payment for the purchase of goods or services. This payment processing activity will include verifying authorizations, processing transactions, settlement of transactions, and depositing funds in merchants' accounts. The fact that the debit and credit card and other electronic payment transactions will involve purchases of goods or services over the Internet does not change the nature of the services that will be provided. Thus, the proposed payments processing activities of Econex and KMS are part of the business of banking.

Econex and KMS also propose to provide merchants with monthly reports on empirical data such as site "hits" and transaction volume arising from their Web sites, including number and types of products sold. Again, we have previously concluded that to the extent those reports involve the processing and transmittal of information relating to specific payment transactions the bank handles for the merchant, it is part of the payment processing function and not a separate service.[19] Additionally, we have determined that a bank's calculation of sales taxes owed by the merchants on their Internet sales is an activity incidental to the payments processing services and is thus permissible.[20]

Finally, we have concluded that the bank could, as part of its proposed Web site hosting services, provide the merchants with more general information and reports relative to their Web sites.[21] We have long held that as part of the business of banking, national banks may collect, transcribe, process, analyze, and store for themselves and others banking, financial, or related economic-related data.[22] Here, Econex and KMS propose to provide similar types of information and reports to the merchants as part

[17] OCC Interpretive Letter No. 856. *See also* Conditional Approval No. 221 (Dec. 4, 1996) (providing full-function Web browser software is a permissible incidental activity when a national bank is offering a home banking system based on Web server technology using "Internet compatible" browser software).

[18] OCC Interpretive Letter No. 856. *See also* OCC Conditional Approval No. 289 (October 2, 1998) (national banks may acquire a minority interest in a firm that, among other things, provides accounts receivable processing and accounts payable processing); Conditional Approval Letter No. 248 (national bank operating subsidiary may acquire a minority interest in an entity that provides merchant credit and debit card processing services); OCC Conditional Approval No. 282 (July 7, 1998) (national bank may acquire an interest in a firm that would, among other things, engage in payments processing for the health care firms); and OCC Interpretive Letter No. 731, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,048 (July 1, 1996) (national banks as part of the banking business may collect and process accounts in relating to an electronic toll collection system).

[19] OCC Interpretive Letter No. 856. *See also* OCC Interpretive Letter No. 731, *supra*; and OCC Interpretive Letter No. 732, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,049 (May 10, 1996) (design, development, marketing, and maintenance of a network for electronic funds transfer and electronic data interchange permissible for a national bank). *Cf.* Letter from Julie L. Williams, Chief Counsel, October 2, 1996 (unpublished) (national bank acting as finder could maintain a database of transactions resulting from its finder activities was "integral" to the finder function).

[20] OCC Interpretive Letter No. 856. *See also Clement Nat'l Bank v. Vermont*, 231 U.S. 120 (1913).

[21] OCC Interpretive Letter No. 856. *See also* OCC Interpretive Letter No. 653, *supra* (national bank acting as a finder for insurance could also keep financial and other records relating to the client agency sales, receipts and disbursements); OCC Interpretive Letter No. 741, *supra* (national bank acting as finder for automobile dealers may also maintain a comprehensive system that allows dealers to track information on customers referred and to generate market statistics such as buying trends and cycles).

[22] An earlier version of 12 CFR 7.1019 stated that "as part of its banking business and incidental thereto, a national bank may collect, transcribe, process, analyze, and store for itself and others, banking, financial, or related economic data." Interpretive Ruling 7.3500, 39 *Fed. Reg.* 14195 (Apr. 22, 1974). Although in its 1984 revision of the ruling, the OCC deleted this statement because it believed that "specific examples [of permissible electronic activities] are inappropriate given the imprecision of terms and rapid pace of change in the data processing industry, the "analytical framework" embodied in the ruling remained the same. 49 *Fed. Reg.* 11157 (Mar. 26, 1984). There was no intent to narrow or restrict the substantive effect of the rule. OCC Interpretive Letter No. 677, *reprinted in*, [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,625 (June 28, 1995). *See also*, OCC Interpretive Letter No. 737, *supra* (national bank may provide transaction and information processing services to support an electronic stored value system); OCC Interpretive Letter No. 653, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (Dec. 22, 1994) (national bank may act as an informational and payments interface between insurance underwriters and general insurance agents); and OCC Interpretive Letter No. 346, *reprinted in* (1985-1987 Transfer Binder) Fed. Banking L. Rep. (CCH) ¶ 85,516 (July 31, 1985) (national banks may maintain records on commodities transactions).

of their Internet services package. Accordingly, those proposed activities of Econex and KMS also are permissible.

Econex and KMS also propose to provide billing services, to provide links from their Web sites to the Web sites of merchants that have subscribed to the Internet services package, to provide the Internet merchant hosting services on a wholesale basis to other financial institutions to enable those institutions to resell the services to their merchant customers, and to build the merchants' Web sites at the merchant's option.

We have previously found that electronic bill presentment is part of the business of banking.[23] Thus, the proposed billing services of Econex and KMS are permissible activities pursuant to 12 USC. 24(Seventh).

We also have previously determined that providing links to third party vendors' Web sites, in the manner proposed by Econex and KMS, is a finder activity and, thus, part of the business of banking.[24] By providing links to the merchants' Web sites, KMS introduces two parties who may engage in a transaction. Any further negotiations will then occur between the customer and the merchant. At that point, KMS's role in the transaction is complete. Thus, the process of providing hypertext links in the manner proposed is acting as a finder and is a new way of conducting this aspect of the business of banking.

Providing the Internet merchant hosting services to other financial institutions for their resale to their merchant customers also qualifies as a modern correspondent banking function. The OCC has long permitted national banks to offer correspondent services as part of the business of banking.[25] More specifically, the OCC has allowed national banks as a permissible correspondent activity to provide data processing and other computer-related services to other financial institutions.[26]

Moreover, the OCC has permitted a national bank to market specially designed computerized "smart phones" to other financial institutions as a correspondent banking function.[27] Like the Internet merchant hosting services package here, the "smart phones" enabled customers to communicate with their banks and with other service providers through a supporting network of computers and software to conduct various financial transactions (e.g., bill paying, point-of-sale, and credit card transactions).

Econex's proposal to provide the Internet merchant hosting services package to financial institutions is functionally equivalent to providing them with the data processing services and the electronic gateways and communication devices referred to above. Hence, we conclude that providing Internet merchant hosting services packages that meet the banking needs of financial institution merchant customers is a valid correspondent banking service and, therefore, part of the business of banking.

Finally, Econex and KMS propose to build Web sites for merchants as part of the Internet merchant hosting services package. Both entities have presented convincing evidence that the ability to build the Web sites for the participating merchants as part of Internet services package is critical to the successful marketing of the package.[28] We therefore find that the proposed building of

[23] *See e.g.*, OCC Conditional Approval No. 304 (March 5, 1999) (electronic bill payment and presentment services over the Internet); OCC Interpretive Letter No. 731, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-048 (July 1, 1996) (operation of electronic toll collection system); OCC Interpretive Letter No. 836, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-290 (March 12, 1996) (data processing and electronic data interchange system to assist in the billing and collection for medical services).

[24] *See* OCC Conditional Approval No. 221 (December 4, 1996).

[25] *See* e.g., OCC Interpretive Letter No. 811, *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) [0014] 81-259 (Dec. 18, 1997) (permitting national bank to offer printing services to other financial institutions as correspondent service); Corporate Decision No. 97-79 (July 11, 1997) (federal flood hazard determinations).

[26] *See* OCC Interpretive Letter No. 516, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,220 (July 12, 1990) (authorizing national bank to provide other financial institutions with electronic "gateways" to communicate and receive financial information and to conduct transactions); OCC Interpretive Letter No. 346, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,516 (July 31, 1985) (bank operating subsidiary may provide electronic information and transaction services and linkage for financial settlement services).

[27] OCC Interpretive Letter No. 611, *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449 (Nov. 23, 1992).

[28] In designing the Internet services package to be offered by Econex and KMS, Econex conducted a survey of 1,000 randomly selected small merchants. The results of this survey suggest that those merchants overwhelmingly demand that the proposed Internet services include the building of the Web site. Of the 455 merchants that responded to the survey question about whether they would develop their Web site in-house or outsource it, approximately 83 percent said they desire total outsourcing. *See also* Jennifer Kingson Bloom, "Vendor Groups Woo Banks into Net Services," *Am. Bankr.*, May 27, 1999, at 14 (reporting that vice president of the National Retail Federation says merchants of all sizes prefer to outsource the building of virtual stores). In light of this indicia of consumer demand, Econex and the LLC assert that they need to include the building of Web sites as part of their package of Internet services in order to successfully market that package.

The marketplace apparently agrees. To enhance marketability and reduce costs to merchants, the firms that will compete with Econex and KMS in providing Internet commerce products and services are now offering complete packages to merchants which include the building of the Web sites. *See e.g.*, Bloom, *supra*; Steven Marjanovic, "First Data to Buy Stake in iMall, a Software Firm," *Am. Bankr.*, Nov. 9, 1998, at 17; Tami Luhby, "Wells Fargo

Web sites by Econex and KMS for those merchants desiring that service is incidental to the business of banking.

Recently, the OCC determined that a national bank subsidiary may provide home banking services via an Internet connection to the bank's home banking system and, incidental to that service, may also provide Internet access to customers and nonbank customers in the bank's service area.[29] We based this conclusion in part upon a finding that, under the facts of that case, providing full Internet access created a package of related services needed to satisfy consumer demand and enable the bank to successfully market its home banking services:

> OCC precedent has established that the provision of such ancillary non-banking services is permissible as incidental to the business of banking when needed to successfully package and promote other permissible banking services. [Citations omitted.]

Here, the service of building the merchants' Web sites is needed to successfully market Econex's and KMS's Internet services package. Without the Web site building component, Econex's and KMS's Internet services package will not fully satisfy customer demand, thus putting them at a competitive disadvantage relative to other providers of Internet commerce and Web site hosting services.

Econex and KMS have demonstrated that there is strong merchant demand for a Web site building component in the package of Internet services supported by the LLC. There is also clear evidence that competitors of Econex and KMS are and will be offering such a feature. Finally, the Internet access feature will be only a minor part of the entire package offered by Econex and KMS (on average over the next five years, projected gross profits from Web site building will be less than 30 percent of the projected gross profits of the entire Internet services package).[30] Under these circumstances, we find the Web site building services to be incidental to the other Internet services, and therefore authorized.

Thus, we conclude that all the proposed activities to be conducted by Econex and KMS are part of, or incidental to, the business of banking. Therefore, the first standard is met.

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest. This standard may be met if the bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest.[31]

The amended agreement precludes Econex from engaging in any business that would constitute a new activity within the meaning of applicable banking law, rules, and regulations, and that would make the bank's investment in Econex impermissible, without first giving the bank notice of Econex's intent to engage in the new activity and allowing the bank an opportunity to obtain regulatory approval for such new activity. In the event that the bank cannot obtain the appropriate regulatory approval, the amended agreement prohibits Econex from engaging in that new activity without the written consent of the bank (the veto right). Moreover, the amended agreement requires the unanimous consent of all Econex investors for any changes to the amended agreement that would adversely affect the rights and obligations of any of the members. Thus, the bank would have the right to block any changes to its veto right.

The amended agreement further provides that upon conversion to a corporation, the Econex investors will execute legal documents, including a certificate of incorporation,

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Opens Door to Web for Small Business," *Am. Bankr.*, Sept. 15, 1998. Experts say that without these packages, most smaller companies lack the budget and manpower to do a thorough job of creating and maintaining a commerce-enabled Web site. Bloom, *supra*.

[29] OCC Interpretive Letter No. 742, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking. L. Rep (CCH) ¶ 81-106 (Aug. 19, 1996) (the "Apollo letter").

[30] Full-function products provided as an incidental part of a package of banking services cannot dominate the banking services being provided. *See* OCC Interpretive Letter No. 737, *supra*; OCC Interpretive Letter No. 516, *supra*; Letter from Michael J. O'Keefe, district counsel, midwestern district (July 13, 1987) (unpublished); OCC Interpretive Letter No. 345, *reprinted in* [1986-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 77,799 (July 9, 1986). The OCC has two alternative tests for determining when sale of full-function products as part of a package of banking services is "incidental" to those services. The older OCC test is whether the cost of the full-function product is less than 30 percent of the cost of the entire package. OCC Interpretive Letter No. 742, *supra*. As an alternative to the cost test, a recent letter adopted a test based on the percentage of "gross profits" (sales less cost of goods sold) that is derived from the sale of the hardware. OCC Interpretive Letter No. 754, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-120 (Nov. 6, 1996). Specifically, this letter held that where the gross profits generated by a full-function product provided in connection with a banking service do not exceed 30 percent of the total gross profits from that service, the sale of the full-function product is incidental to the permitted banking service.

[31] *See*, *e.g.*, Interpretive Letter No. 711, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-026 (February 3, 1996); Interpretive Letter No. 625, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993).

bylaws, and a shareholders agreement, with terms, conditions, equity ownership, and governance rights, that are consistent with the operating agreement in effect at that time. In Section 2.7(d) the members of Econex acknowledge and agree that the bank's veto right will be incorporated into the shareholders agreement upon the conversion to a corporation. In the event that a decision is subsequently made not to incorporate the bank's veto right in the incorporation documents, and Econex undertakes to engage in a new activity that is not permissible for national banks, the bank represents it will sell its interest in Econex.[32] Therefore, the second standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

a. Loss exposure from a legal standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that the national bank's investment not expose it to unlimited liability.

Initially, Econex will be a Georgia limited liability company. As a legal matter, investors in a Georgia limited liability company do not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the company.[33] Furthermore, the amended agreement includes a provision which states that no member, manager, agent, or employee of Econex shall be liable for any debt, obligation, or liability of the Econex solely by reason of being a member, manager, agent, or employee.

Econex may, in the future, convert to a Delaware corporation. A corporation is an entity distinct from its shareholders.[34] It is generally accepted that shareholders are protected by the "corporate veil" from liability for the debts and obligations of the corporation provided proper corporate separateness is maintained.[35]

Thus, the bank's loss exposure for the liabilities of Econex, as limited liability company or as a corporation, will be limited.

b. Loss exposure from an accounting standpoint

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's 20-50 percent ownership share of investment in a limited liability company is to report it on an unconsolidated basis. Under the equity method of accounting, unless the bank has extended a loan to the entity, guaranteed any of its liabilities or has other financial obligations to the entity, losses are generally limited to the amount of the investment shown on the investor's books.[36]

The bank will account for its investment in Econex under the equity method of accounting. Thus, the bank's loss from an accounting perspective will be limited to the amount invested in Econex, and the bank will not have any open-ended exposure to the liabilities of Econex.

Therefore, for both legal and accounting purposes, the bank's potential loss exposure relative to Econex should be limited to the amount of its investment. Thus, the third standard is satisfied.

4. The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank must also satisfy the requirement that the investment have a beneficial connection to the bank's business, i.e., be convenient or useful to the investing bank's business activities, and not constitute a mere passive investment unrelated to that bank's banking business. 12 USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful."[37] Our precedents on bank noncontrolling investments have indicated that the investment must be convenient or useful to the bank in conducting *that bank's* business. The invest-

[32] Section 10.1 of the amended agreement provides that during the 18-month period following the bank's investment in Econex, any member of the Econex may sell its interest in the company only with the consent of all other members. The bank represents that if the conversion to a corporation occurs during that 18-month period, it will not agree to leave its veto right out of the incorporation documents unless this restriction on transfer is also left out of the incorporation documents. Thus, the bank would be in a position to sell its interest in Econex without having to obtain the consent of the other investors.

[33] *See* Ga. Code Ann. § 14-11-303.

[34] 1 Fletcher, *Cyclopedia of the Law of Private Corporations* § 25 (rev. perm. ed. 1990).

[35] *Id.*

[36] *See generally*, Accounting Principles Board, Op. 18 § 19 (1971) (equity method of accounting for investments in common stock). Interpretive Letter No. 692, *supra*.

[37] *See Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

ment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[38]

The bank's proposed investment in Econex, and its continued investment in KMS after it expands its activities as proposed, will meet this standard. KMS and Econex will market the Internet services to customers for which the bank is providing merchant processing services. The bank anticipates that providing these Internet services through KMS and Econex will help retain existing and attract new merchant customers. Furthermore, by undertaking these proposed activities through joint ventures involving NOVA and FirstEnergy, the bank believes the investment in technology needed to make the venture successful will be ensured. Thus, the investments are convenient and useful to the bank in carrying out its business and are not a mere passive investment. Thus, the fourth standard is satisfied.

III. CONCLUSION

Based upon the information and representations you have provided, and for the reasons discussed above, we conclude that the bank may acquire and hold a noncontrolling minority interest in Econex in the manner and as described herein, and continue to hold a noncontrolling minority interest in KMS, subject to the following conditions:

1. Econex and KMS will engage only in activities that are part of, or incidental to, the business of banking;
2. The bank will have veto power over any activities and major decisions of Econex and KMS that are inconsistent with condition number one, or will withdraw from Econex or KMS in the event the entity engages in an activity that is inconsistent with condition number one;
3. The bank will account for its investment in Econex and KMS under the equity method of accounting; and
4. Econex and KMS will be subject to OCC supervision, regulation, and examination.

Please be advised that the conditions of this approval are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 USC 1818 and, as such, may be enforced in proceedings under applicable law.

This approval is granted based on a thorough review of all information available, including the representations and commitments made in the bank letters and by bank representatives.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[38] *See*, *e.g.*, Interpretive Letter No. 697, *supra*; Interpretive Letter No. 543, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); Interpretive Letter No. 427, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); Interpretive Letter No. 421, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) [0014] 85,645 (March 14, 1988); Interpretive Letter No. 380, *supra*.

876—December 8, 1999

12 USC 24(7)

Dear [ ]:

This letter responds to your request on behalf of [ ], a federally licensed branch (" ") of [ ] Corporation ("bank"), an [ ] Bank. [ ] proposes to act as agent in brokering certain securities that are held by the bank as principal. Based on the representations made by [ ] and the undertakings described below, we have no objection to the proposed activities.

[ ] is a federally licensed institution located in [*State*] that is supervised by the Office of the Comptroller of the Currency ("OCC"). The bank, through [ ], currently markets, and sells, derivative, foreign exchange, and fixed income products to banks, nonbank financial institutions, U.S. corporations, and money managers. [ ] also provides financing to U.S. corporations with some connection to Australia, New Zealand, or Asia. [ ] believes the ability to act as agent to provide U.S.-based institutional clients with the full range of Australian and New Zealand corporate and government debt securities is necessary to compete, and will also serve to provide U.S. institutional investors with better pricing and greater depth of investment choices.

Under the proposal, the bank (through its offshore offices and affiliates) will act as an initial purchaser of Australian and New Zealand corporate and government debt securities, which will be resold pursuant to Rule 144A under the Securities Act of 1933.[1] [ ] will sell these securities

[1] In a Rule 144A offering, the issuer sells to one or more initial purchasers. Rule 144A permits the initial purchasers to sell securities to qualified institutional buyers ("QIBs"). The definition of QIB includes: (1) certain institutions (e.g. an insurance company, a registered investment company, an employee benefit plan, a registered investment advisor) that own or have under management on a discretionary basis at least $100 million in securities of unaffiliated issuers, (2) a registered dealer that owns and invests at least $10 million of securities not affiliated with the issuer, or a registered dealer acting in a riskless principal transaction on behalf of a QIB,

as agent within the requirements of Rule 144A ("the proposed securities activities"). [ ] intends to engage in a full range of permissible brokerage activities in the promotion of Rule 144A transactions in the United States, including road shows to QIBs. The QIBs will pay an amount that includes a commission to [ ]. The bank will receive these payments and remit the commission amount to [ ]. [ ] represents that it will comply with all applicable laws and regulations.[2]

[ ] will engage in permissible brokerage activities under this proposal. Brokerage activity is permissible for national banks pursuant to 12 USC 24(Seventh), and it is therefore a permissible activity for [ ] under the International Banking Act pursuant to 12 USC 3101 *et seq.*[3] [ ] will conduct the proposed securities activities in conformance with the following undertakings:

- [ ]'s activities will be limited to brokerage as agent in the sale of 144A securities.
- The securities operations of the bank's offshore offices and affiliates will be limited to transactions that do not constitute impermissible dealing in securities in the United States.
- [ ] will disclose in writing to each purchaser of a security placed in reliance on Rule 144A the fact that the Bank, through its offshore offices or affiliates, is acting as "initial purchaser." Such disclosure will be made before any order from a QIB is accepted.
- [ ] represents that it will comply with 12 CFR Part 12 by providing customer confirmations, maintaining the required records, and following all applicable Part 12 requirements.
- All notices, tickets, advice, confirmations, correspondence and similar documentation generated in connection with the proposed securities activities will be clearly imprinted so as to avoid confusion between [ ]'s business and any other entity.

and (3) a bank or savings association that owns and invests on a discretionary basis at least $100 million in securities not affiliated with the issuer and has a net worth of at least $25 million. If resales by the initial purchasers are in compliance with Rule 144A, the initial purchasers are deemed not to be engaged in a distribution of securities and not to be underwriters under the Securities Act of 1933. 17 CFR 230.144A.

[2] This letter does not express any opinion on the applicability of the federal securities laws to any part of the proposed activity. [ ] has represented that the proposed activities will be structured to comply with all applicable securities laws.

[3] The fact that the securities brokered by [ ] will be held by the bank as principal does not affect the characterization of [ ]'s role as a permissible brokerage activity. This is the case because, under the International Banking Act, [ ] may be deemed as distinct from the bank for purposes of the proposed activity.

- [ ] will limit its sales activities in connection with the proposed securities activities to contacts with QIBs, a class of investors considerably more sophisticated than the "accredited investors" to whom private placements generally may be marketed.
- The proposed securities activities will in no case involve marketing activities aimed at retail investors or the public at large.
- [ ] will not purchase for its own account any security with respect to which any of the bank's offshore offices or affiliates have acted as initial purchaser in a Rule 144A placement.

Based on the representations made by [ ] and subject to the undertakings described above, we do not object to [ ] engaging in the proposed activities.

If you have any questions, please do not hesitate to contact Lee Walzer, senior attorney, International Activities, at (202) 874-4487, or Nancy Worth, senior attorney, Securities and Corporate Practices Division, at (202) 874-5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

877—December 13, 1999

12 USC 92
12 USC 92a

Re: [ ] ("trust co.")

Dear [ ]:

This responds to your request for confirmation that [ ] ("trust co.") may sell insurance pursuant to 12 USC 92 from a trust office located in a place with a population of 5,000 or fewer inhabitants. As we describe below, *if* the trust office performs "core fiduciary functions" at its office in that "place," then the trust co. may sell insurance pursuant to 12 USC 92 from that trust office.

I. Background

Trust co. is an uninsured, limited purpose national bank. Trust co. specializes in preneed funeral trusts. Trust co. is also engaged in (1) estate planning, including making recommendations on the use of trusts and the availability of tax minimization strategies, and (2) establishing trusts

in connection with court settlements, generally for minors or incapacitated individuals.[1]

Trust co.'s main office is in *[City]*. It proposes establishing an office in *[City2]*, which it describes as a place with a population of 5,000 or fewer inhabitants. Trust co. views *[City2]* as a strong potential market for its trust products. Trust co. plans to actively market its products and services at this proposed office and to offer the local community a full range of the bank's trust services. At the *[City2]* office, Trust co. proposes to sell life insurance as agent and to sell other forms of insurance.[2] Trust co. will obtain a *[State]* insurance license. Trust co. represents that it will comply with OCC guidance on sales of insurance and annuity products and conform to all applicable *[State]* and OCC requirements on sales of insurance. Trust co. has inquired whether it may engage in the proposed insurance sales from the *[City2]* office under 12 USC 92.

II. Legal Analysis

A. OCC May Charter Limited Purpose Trust Banks That Conduct Annuity Sales and Insurance Agency Activities

The OCC may charter national banks that offer a full or limited range of banking products and services. The OCC may grant a national bank charter to special purpose banks, such as trust banks, that engage in a limited range of banking activities.[3] With respect to trust banks, this authority is expressly acknowledged in the National Bank Act, which provides that a bank "is not illegally constituted solely because its operations are or have been required by the Comptroller of the Currency to be limited to those of a trust company and activities related thereto." 12 USC 27(a).[4]

The OCC may establish limits on the authorities of trust banks in the chartering process by imposing conditions in the approval or requiring limiting language in the articles of association. The OCC has not limited the operations of trust banks to the exercise of fiduciary powers, but has permitted a range of incidental and nonfiduciary activities.[5] The OCC, when it chartered trust co., did not restrict or address its insurance agency activities. Hence, trust co.'s charter is sufficiently broad to encompass its proposed insurance and annuity sales.[6]

B. A Limited Purpose Trust Bank May Act as an Insurance Agent under 12 USC 92 through a Trust Office in a Place of 5,000 or Fewer Inhabitants

In order to sell insurance under the authority of 12 USC 92, trust co. must be "located and doing business" in a place of 5,000 or fewer inhabitants. In the past, the OCC has found that a bank is "located and doing business" in a place under section 92 if the bank has a branch office or its main office at that place. Trust co. does not take deposits, offer checking accounts, or make loans; that is, it does not engage in branching activities as defined in 12 USC 36(j). Therefore, trust co. cannot establish a "branch," and its main office is not located in a place of 5,000. Trust co. has proposed that it would establish a trust office in a place with a population of 5,000 or fewer inhabitants where it would conduct its insurance sales.

Trust co.'s proposal raises the issue of whether its proposed trust office is a sufficient presence to satisfy the "located and doing business" requirement of section 92. While there is no precedent on this precise point, the OCC recently considered where a bank is "located" for purposes of providing trust services under another statute, 12 USC 92a.[7] As discussed below, we believe it is reason-

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[1] For example, funds received in connection with a settlement in a car accident case for a minor (who might be unable to hold assets in his/her own name) might be placed partly in a trust (with funds available for immediate medical needs) and partly in a structured annuity (with funds, for example, available for college). The trust and/or annuity may be held by the guardian *ad litem*, and/or family member of the minor.

[2] Trust co. suggests that it might seek to sell, as agent, insurance for property held by trusts and any other insurance as appropriate for existing trust customers. In any purchase for a trust customer, Trust co. would comply with all applicable conflict of interest provisions. *See* 12 CFR 9.12. Trust co. also plans to sell variable annuities as agent, generally in connection with its court settlement business. This activity is clearly permissible under Section 24(Seventh), without regard to Section 92. It is well established that national banks may sell annuities, and that there are no geographic restrictions on these activities. 12 USC 24(Seventh); *NationsBank of North Carolina, N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995).

[3] 12 CFR 5.20(*l*).

[4] This last sentence in section 27(a) was added following a challenge to the OCC's authority to charter trust banks. *See National State Bank of Elizabeth, N.J. v. Smith*, 591 F.2d 223 (3d Cir. 1979).

[5] For example, the OCC has indicated that safekeeping and safe deposit services, while not fiduciary activities under section 92a, are related to the business of a trust company and therefore permissible under section 27. Letter from James M. Kane, District Counsel, dated June 20, 1985.

[6] Trust co.'s articles of association currently provide that "[t]he business of the association will be limited to the operations of a trust department, and to support activities incidental thereto." Trust co. has represented that it plans to revise its articles of association to clarify that it may engage in activities of a "trust company and activities related or convenient thereto."

[7] OCC Interpretive Letter No. 866 (October 8, 1999).

able to conclude that a bank that is located in a place for purposes of providing trust services under section 92a should also be "located and doing business" in the place for purposes of section 92.

1. A Trust Bank Is Located Where It Performs Core Fiduciary Functions For Purposes of Section 92a

The OCC has determined that a bank with multistate offices is located for purposes of section 92a in the states where it acts in a fiduciary capacity and that a bank "acts in a fiduciary capacity" for section 92a purposes at the places at which the bank performs the core functions of a fiduciary. These core functions include accepting the appointment as fiduciary, executing the documents that create the fiduciary relationship, and making decisions regarding the investment or distribution of fiduciary assets.[8] If the *[City2]* office performs these functions, Trust co. would be located at the *[City2]* office for purposes of section 92a.

2. A Section 92a Location Can Also Be a Section 92 Location For a Trust Bank

The OCC has not previously addressed whether a national trust bank may sell insurance under section 92 from a location where it maintains an office engaged in core fiduciary activities. The plain language of section 92, which considers where a bank is "located and doing business," supports a finding that trust banks are located and doing business where they perform core fiduciary functions. Banks are "located and doing business" where they have a main office or branch, locations where they perform core banking activities.[9] National trust banks similarly are "located and doing business" through offices that perform their core fiduciary functions since those functions represent their primary lines of business.[10]

This conclusion is further supported by OCC precedent finding that trust banks are located at offices where they perform core fiduciary functions under section 92a, which provides statutory authority for national banks to engage in fiduciary activities. We believe a trust bank similarly is located and doing business at such offices for purposes of section 92, and may sell insurance from those locations. Hence, trust co. may sell insurance from its *[City2]* office if that office performs core fiduciary functions.

III. Conclusion

The OCC may charter limited purpose trust banks that engage in activities of a trust company and activities related or convenient thereto, including sales of insurance under the authority of section 92. For purposes of section 92, trust banks are located at offices where they perform core fiduciary functions for purposes of section 92a. Accordingly, *if* a trust office located in a "place of 5,000" performs core fiduciary functions at that office, then the trust company may sell insurance pursuant to 12 USC 92 from that office. We recommend that you contact your examiner-in-charge to discuss whether, in fact, the trust co.'s *[City2]* office would satisfy this standard.

Please contact Nancy Worth, senior attorney, at 202-874-5210 if you have any questions.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[8] *Id.*

[9] *See e.g.*, Interpretive Letter No. 824, *reprinted in* [1997-1998 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-273 (Feb. 27, 1998); Interpretive Letter No. 823, *reprinted in* [1997-1998 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-272 (Feb. 27, 1998).

[10] Section 92 states that, in addition to other powers vested in banks, any bank "located and doing business in any place the population of which does not exceed five thousand . . . may act as [insurance] agent. . . ." The statute does not define the type of presence required to be "located and doing business." Nor does the legislative history of section 92 provide guidance on the type of presence required to be "located" in a place of less than 5,000 inhabitants. *See National Ass'n. of Life Underwriters v. Clarke*, 736 F. Supp. 1162, 1169 (D.D.C. 1990) ("*NALU*"), *rev'd on other grounds sub nom. Independent Ins. Agents v. Clarke*, 955 F.2d 731 (D.C. Cir.), *reh'g en banc denied*, 965 F.2d 1077 (D.C. Cir. 1992), *rev'd and remanded sub nom. United States Nat'l Bank v.Independent Ins. Agents*, 124 L. Ed.2d 402 (U.S. 1993), *aff'd on remand, Independent Ins. Agents v. Ludwig*, 997 F.2d 958 (D.C. Cir. 1993) (Comptroller Williams' letter is the only substantive legislative history on section 92's insurance provision).

878—December 22, 1999

12 USC 24(7)

Re: [ ] Bank, National Association/[ ], Inc.
Nonqualified Employee Deferred Compensation Plan

Dear [ ]:

This responds to your letter of December 20, 1999, on behalf of your client, [ ] (the "bank") requesting that the Office of the Comptroller of the Currency ("OCC") not object to the bank's subsidiary [ ], Inc.,[1] holding various insurance company products and investment funds in order to hedge, on a dollar-for-dollar basis, [ ]'s obligations to make payments to employees under nonqualified deferred compensation plans. Based on the representa-

[1] In this letter, "[ ]" refers to [ ], Inc. and its subsidiaries.

tions made by the bank, the OCC does not object to [ ] conducting the proposed activities.

I. BACKGROUND

[ ] proposes to hold various insurance company products and investment funds in order to hedge, on a dollar-for-dollar basis, its obligations to make payments to employees under a non-qualified deferred compensation plan. Under the terms of the plan, a participating employee will defer a portion of his or her income from a bonus for a period of time and select a benchmark fund from among a list of options. At the distribution date selected by the employee, he or she will receive the sum of the changes in values of deferred amounts indexed to the various benchmarks over the period that the employee selected each benchmark. The performance of an employee's deferred compensation account is indexed to the performance of selected benchmark investments. Employees will not own an interest in the benchmark funds. Instead, employees will own an unsecured contractual obligation of [ ] to pay the deferred amount at the distribution date.[2]

[ ] proposes to offer its employees a variety of registered investment companies and private investment funds managed by [ ], as well as investment funds managed by third parties, as benchmark funds under the plan. These benchmark funds will include funds that invest exclusively in bank-eligible assets, as well as funds that invest in assets traditionally impermissible for investment by a national bank.

[ ] proposes to hedge its obligations under this plan. [ ] will acquire the number of units of each benchmark fund selected by each participating employee that equals the value of deferred compensation divided by the net asset value of a unit, and hold those units for the period of time that the employee elects to use that benchmark fund as an index. In this way, all of the increase in value and all of the decrease in value of the units (including reinvested dividends) held by [ ] as a hedge exactly equals [ ]'s obligations under the plan.

[ ] seeks to make its hedging investments in a way that is most neutral to [ ] from a tax and financial accounting standpoint. To this end, [ ] may invest in insurance company products such as variable life or variable annuities that are funded by the insurance companies through an investment in an insurance company separate account. This separate account will invest in an underlying registered investment company or private investment company that is managed by [ ] or a third party, or in a separate account that is managed in a way and invested in assets substantially identical to the benchmark fund selected by the employee. In the alternative, [ ] may instead invest directly in the benchmark funds, or invest through a "rabbi trust" in the benchmark funds.

[2] [ ]'s obligation is unsecured in order to avoid current inclusion of the deferred compensation in the employee's taxable income. *See* Internal Revenue Code § 83.

I. DISCUSSION

[ ] is an operating subsidiary of the bank. As a general matter, a national bank may engage in activities that are part of or incidental to the business of banking by means of an operating subsidiary.[3] An operating subsidiary is subject to the same banking laws, regulations, and OCC examinations and supervision as the national bank, unless otherwise provided by statute or regulation.[4]

A. National Banks May Compensate Employees and Provide Employee Benefit Plans As Part of the Business of Banking

The National Bank Act, in relevant part, provides that national banks shall have the power:

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

The Supreme Court has held that the powers clause of 12 USC 24(Seventh) is a broad grant of power to engage in the business of banking, including but not limited to the enumerated powers and the business of banking as a whole.[6]

National banks and their operating subsidiaries have explicit authority to hire various officers. A national bank is expressly permitted "[t]o elect or appoint directors, and by its board of directors to appoint a president, vice president, cashier, and other officers, define their duties, require bonds of them and fix the penalty thereof, dismiss such officers or any of them at pleasure, and appoint others to fill their places."[7] In order to exercise this express authority, a national bank must have the power to

[3] *See* 12 USC 24(Seventh).

[4] *See* 12 CFR 5.34(d)(1).

[5] 12 USC 24(Seventh).

[6] *See NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("VALIC").

[7] 12 USC 24(Fifth).

compensate reasonably those employees it hires.[8] The power to compensate is a logical and necessary outgrowth of the power to employ officers and other employees, provides banks and their customers with substantial benefits, and involves risks banks have managed since their inception.[9]

While federal banking law does not expressly limit the form of compensation that a national bank may provide its employees, that compensation must be consistent with safety and soundness considerations.[10] National banks and their operating subsidiaries may establish and operate benefit plans for their employees.[11] Consistent with safety and soundness standards, a national bank also may provide its officers and employees deferred compensation through reasonable means.[12]

B. National Banks May Hedge Risks Arising From Employee Benefit Obligations Under Incidental Authorities

Section 24(Seventh) authorizes national banks to engage in activities that are incidental to enumerated bank powers as well as the broader "business of banking."[13] Prior to VALIC, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours, Inc. v. Camp.*[14] The *Arnold Tours* standard defined an incidental power as one that is "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act."[15] Even prior to *VALIC*, the *Arnold Tours* formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act.[16] The *VALIC* decision, however, has established that the Arnold Toursformula provides that an incidental power includes one that is convenient and useful to the "business of banking," as well as a power incidental to the express powers specifically enumerated in 12 USC 24(Seventh).

Incident to the permissible activity of compensating employees, [ ] proposes to hedge its deferred compensation obligations, on a dollar-for-dollar basis, by holding insurance company products and investment funds. Hedging risks arising from banking activities is "convenient and useful," and incidental to the business of banking.[17] The proposed hedge is particularly effective since it virtually eliminates all risks to the bank and [ ] from the employee compensation program.

(1) Proposed Holdings Do Not Conflict with Section 24(Seventh) Restrictions

Section 24(Seventh) limits the authority of a national bank to underwrite and deal in corporate debt and equity securities. A national bank dealing in securities and stock is "limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock."[18] [ ], however, will not be acting as a "dealer" or "underwriter" with respect to the shares that it owns in the investment funds. Therefore, [ ]'s proposed investments would not implicate the prohibitions on underwriting and dealing in securities in Section 24(Seventh). Moreover, [ ] will not rely on the authorization in Section 24(Seventh) to purchase "investment securities" to make the proposed fund investments.

The 1933 Act also added the following new sentence, "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association of any shares of stock of any corpora-

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[8] *See* 12 USC 24(Seventh) ([a national bank shall have the power] [t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking).

[9] There are three general principles used to determine whether an activity is within the scope of the "business of banking": (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking function; (2) would the activity benefit bank customers and/or strengthen the bank; (3) does the activity present risks of a type similar to those already assumed by banks. *See*, *e.g.*, Interpretive Letter No. 845 (October 20, 1998), *reprinted in* [1998-99 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-300; Interpretive Letter No. 812 (December 29, 1997), *reprinted in* [1997-98 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-260; Interpretive Letter No. 742 (August 19, 1996), *reprinted in* [1996-97 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-106. The power to compensate also is "convenient or useful" in performing an expressly stated power. *See Arnold Tours, Inc. v. Camp*, 400 U.S. 45 (1970) (per curiam), 472 F.2d 427 (1st Cir. 1972); Letter from Ellen Broadman, director, Securities and Corporate Practices Division (January 19, 1995)(Unpublished).

[10] *See* 12 USC 1818(b); 12 CFR part 30.

[11] *See* 12 CFR 7.2011(a) (A national bank may adopt a bonus or profit-sharing plan designed to ensure adequate remuneration of bank officers and employees).

[12] *See* Letter from Christopher C. Manthey, senior attorney, Bank Activities and Structure Division (June 21, 1996)(Unpublished).

[13] *See VALIC*, 513 U.S. at 258 n.2.

[14] 472 F.2d 427 (1st Cir. 1972).

[15] *Id*. at 432.

[16] *See* Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

[17] *See generally Arnold Tours, Inc.* v. *Camp*, 472 F.2d 427 (1st Cir. 1972).

[18] 12 USC 24(Seventh).

tion."[19] In a 1996 memorandum in support of a revised operating subsidiary regulation, OCC staff argued that it is important to recognize what this sentence is, and what it is not.[20] The staff argued that it is not a bar on national bank ownership of corporate stock. Rather, it is a disclaimer which clarifies that "nothing herein contained", *i.e.*, nothing in the amendments to Section 24(Seventh) made by Section 16 of the 1933 Act, should be construed to increase the authority of national banks to own stock. The staff also stated that the sentence recognizes that if a national bank's stock-ownership is "otherwise permitted by law", it remains permissible. Such "law" includes the powers sentence at the beginning of Section 24(Seventh), which dates back to 1864 and was not altered by the Section 16 changes. Thus, the proposed fund investments to hedge employee benefit obligations, which are authorized by the powers clause, rather than the provisions added in Section 16 of the 1933 Act, would not be restricted by the disclaimer provision.

OCC precedent has recognized that national banks may acquire equity investments and make noncontrolling investments that are necessary to conduct a banking business, and not motivated by speculative purposes. [ ]'s proposal lacks the speculative characteristics for the bank and its operating subsidiaries with which Congress was concerned in passing the prohibitions of Section 24(Seventh). The bank and [ ] will own the assets only as a necessary incident to engaging in the permissible banking activity of employee compensation. In addition, all gains and losses attributed to these investments will ultimately be passed through to the participating employees. Section 24(Seventh) thus does not restrict [ ]'s proposed investments.

(2) National Banks May Fund or Hedge Exposures From Banking Activities Through Acquisition of Bank Eligible and Ineligible Assets

In the past, the OCC approved various plans by national banks for hedging risks, while not permitting speculative activities as prohibited by the National Bank Act.[21] Previous OCC opinions recognize the importance of hedging liabilities under employee benefit plans as a legitimate banking activity.[22] For example, national banks may purchase and hold life insurance under 12 USC 24(Seventh) in connection with employee compensation and benefit plans.[23] National banks may use permanent insurance to finance or recover the cost of pre- and post-retirement employee benefit plans.[24] A national bank may purchase whole life insurance and use the death benefits eventually received under the policies to recover the cost of payments made to officers and directors, or fund remaining payments owed to beneficiaries.[25] Payments to beneficiaries may be made on an installment basis.[26]

A national bank may establish a "rabbi trust" to provide reasonable, deferred compensation for its officers and employees consistent with safety and soundness considerations.[27] The trust may hold investments beyond those allowed for national banks, without violating Section 24(Seventh) and 12 CFR Part 1, if the bank does not receive any income or profit from the trust's assets, and the trust meets all other applicable requirements under state and federal law, the Internal Revenue Code, and ERISA.[28]

National banks and their operating subsidiaries may offer equity derivative swaps, where consistent with safe and sound banking principles.[29] At times, banks may hedge swaps exposure by acquiring or selling non-swap financial derivative instruments, such as exchange-traded equity futures or options. This hedging transaction serves the same purpose as offsetting contracts between shorts and longs, to counteract the risk associated with the initial swap.[30]

[19] *Id.*

[20] *See* Memorandum from Julie L. Williams, Chief Counsel, to Eugene A. Ludwig, Comptroller of the Currency (November 18, 1996) (Legal Authority for Revised Operating Subsidiary Regulation), *reprinted in* [1996-97 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 90-464.

[21] For example, a national bank may purchase an interest in an insurance company separate account that in turn invests in bank-eligible securities. *See* Interpretive Letter No. 826 (March 17, 1998), *reprinted in* [1997-98 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-275. As part of this investment strategy, the separate account, for purposes of hedging price and interest rate exposure, may enter into exchange traded and over-the-counter futures and options transactions; interest rate swaps, caps and floors; short sales of U.S. Treasury and agency securities; and covered dollar rolls, with the proceeds reinvested in short-term investments maturing within five days of the maturity date of the corresponding dollar roll. *See id.*

[22] *See generally* OCC Bulletin 96-51 (September 20, 1996), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 35-491; Interpretive Letter No. 848 (November 23, 1998), *reprinted in* [1998-99 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-303.

[23] *See* OCC Bulletin 96-51, *supra*; Interpretive Letter No. 848, *supra*.

[24] *See* OCC Bulletin 96-51, *supra*.

[25] *See* Interpretive Letter No. 848, *supra*.

[26] *See id.*

[27] See Letter from Ellen Broadman, *supra*; see also 12 USC 24(Fifth).

[28] *See generally* Letter from Ellen Broadman, *supra*.

[29] *See* Interpretive Letter No. 652 (September 13, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600.

[30] *See id.*

A national bank also may offer a non-transferable time deposit account paying interest based in part on movements in the S&P 500 Index, and hedge its interest obligations by purchasing or selling futures contracts on the same index.[31] The hedging activity is an important complement to the bank's expressly authorized deposit-taking authority, and provides a prudent means of managing the bank's interest rate exposure risk. This strategy also provides national banks with the flexibility to establish the amount of the payments to be made and received under their deposit and loan contracts based on market conditions and the needs of their customers.[32]

A national bank may act as principal in unmatched commodity price index swaps with their customers.[33] As part of such a strategy, the bank may hedge any unmatched commodity price risk exposure by purchasing and selling exchange-traded commodity futures with the intention of entering into offsetting commodity price swaps if they become available. The bank may not use the unmatched contracts or futures to speculate in commodity price movements.[34]

In addition, a national bank may, subject to limitations, hedge the financial exposure arising from otherwise permissible banking activities in markets that involve physical delivery of commodities.[35] In some cases, exchange-traded and over-the-counter transactions do not provide the most accurate hedges possible, thereby exposing the bank to basis risk.[36] Access to the physical markets provides a more precise hedge in these cases. Such hedging activity is limited in scope, used only to supplement a bank's existing hedging activities, and is customer driven and not for speculative purposes.[37]

In each case cited above, the hedging investment was viewed as an asset held incidental to a permissible banking activity in order to hedge the bank's obligations, rather than as a security held by the bank for investment. The transactions were used to manage risks arising from otherwise permissible banking activities and not entered into for speculative purposes. In much the same manner, incidental to the permissible banking activity of providing deferred compensation to employees, [ ] may hold otherwise ineligible assets for the sole purpose of hedging on a dollar-for-dollar basis its obligations to employees under nonqualified deferred compensation plans. This conclusion is consistent with the foregoing OCC precedents permitting bank-impermissible investments for hedging purposes to manage risks arising from permissible banking activities. The hedges proposed by [ ] offer a particularly well matched and effective risk management mechanism. As the cases above illustrate, offsetting banking risks in this manner is a prudent and desirable goal for national banks.

For these reasons, we now conclude that [ ] may hold interests in investment funds, "rabbi trusts," and variable life insurance and annuities[38] products through separate accounts for the sole described purpose of hedging employee deferred compensation plans.

III. CONCLUSION

For the reasons discussed above, the OCC will not object to the bank or [ ] holding interests in insurance company products, investment funds, and "rabbi trusts" in order to hedge, on a dollar-for-dollar basis, their deferred compensation obligations to employees. This position is based on the facts and representations made in your letter and any material changes in the facts or conditions may result in a different conclusion. Please note that we take no position regarding [ ]'s possible future plans that differ from the described voluntary deferral of compensation by participating employees.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[31] *See* Decision of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A., to Offer the Chase Market Index Investment Deposit Account (August 8, 1988).

[32] *See id.*

[33] *See* No Objection Letter No. 90-1 (February 16, 1990), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095.

[34] *See id.*

[35] *See* Interpretive Letter No. 632 (June 30, 1993), *reprinted in* [1993-94 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,516.

[36] Basis risk is the risk that the price fluctuations of the hedging instrument will not exactly match the price fluctuations of the underlying transaction.

[37] *See* Interpretive Letter No. 632, *supra*.

[38] Moreover, we note that there are strong arguments for the assertion that variable annuities are not "securities" for purposes of Section 24(Seventh).

879—November 10, 1999

12 USC 214

Re: [ ] (“bank”)
Share Exchanges Pursuant to Virginia State Corporate Law

Dear [ ]:

This is in response to your request for confirmation that the bank may elect the corporate governance provisions of Virginia law and complete a share exchange in accordance with those provisions. Based on the representations that you have made, we conclude that the bank may effect a proposed share exchange by following the provisions of Virginia law.

Background

The bank proposes to elect the corporate governance provisions of Virginia law through amendment to its articles of association and bylaws, and engage in a share exchange as provided by Virginia law. The bank wishes to form a parent holding company and proposes the share exchange to ensure that the holding company will own 100 percent of the shares of the bank.

The bank would use several steps to accomplish the share exchange. The bank would form a company to act as the holding company of the bank.[1] The shareholders of the bank would vote on the plan of share exchange. If the holders of two-thirds of the shares of the bank approve the share exchange, the holding company would then exchange its shares for shares of the bank using the procedures described in Virginia law.[2] As a result, each shareholder of the bank would own shares of the holding company, and the holding company would own 100 percent of the shares of the bank. Each shareholder of the bank would have the opportunity to own the same number and percentage of shares in the holding company as that shareholder previously held in the bank. In the alternative, shareholders could exercise dissenters' rights and receive cash for their shares.[3]

Applicable Law

National banks may adopt corporate governance procedures that comply with applicable federal banking law and safe and sound banking practices. An OCC regulation provides that:

> To the extent not inconsistent with applicable Federal banking statutes or regulations, or bank safety and soundness, a national bank may elect to follow the corporate governance procedures of the law of the state in which the main office of the bank is located, the law of the state in which the holding company of the bank is incorporated, the Delaware General Corporation Law, Del. Code Ann. Tit. 8 (1991, as amended 1994, and as amended thereafter), or the Model Business Corporation Act (1984, as amended 1994, and as amended thereafter). A national bank shall designate in its bylaws the body of law selected for its corporate governance procedures.[4]

Virginia statutory law expressly permits corporations to conduct share exchanges.[5] The holders of at least two-thirds of each class of shares entitled to vote must approve the plan of share exchange.[6] The corporation's board of directors also must approve the transaction.[7] After the shareholders approve the share exchange, the acquiring corporation must deliver articles of share exchange to the secretary of state.[8]

Virginia statutory law requires corporations conducting share exchanges to provide dissenters' rights to shareholders.[9] Corporations must include notice of dissenters' rights with the notice for the meeting at which the shareholders will vote on the transaction.[10] Any shareholder who wishes to dissent must give notice to the corporation of intent to dissent and may not vote in favor of the transaction at the shareholders' meeting.[11] If the shareholders approve the transaction, the corporation must send written notice to all dissenters after the meeting concerning the procedure for demanding payment.[12] Dissenting shareholders must then demand payment, and the corporation must make payment to the shareholders.[13] Any shareholder who is dissatisfied with the payment offered must provide the corporation with an estimate of fair

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[1] The bank would file an application with the appropriate Federal Reserve Bank to form the holding company.

[2] *See* Va. Code Ann. § 13.1-717 *et seq.*

[3] *See id.* at § 13.1-729 *et seq.*

[4] 12 CFR 7.2000(b).

[5] Va. Code Ann. § 13.1-717(a).

[6] *Id.* at § 13.1-718(e).

[7] *Id.* at § 13.1-717(a).

[8] *Id.* at § 13.1-720(a).

[9] *Id.* at § 13.1-730(a)(2).

[10] *Id* at § 13.1-732(a).

[11] *Id.* at § 13.1-733(a).

[12] *Id.* at § 13.1-734.

[13] *Id.* at §§ 13.1-735(a) and 13.1-737(a).

value.[14] The corporation must then either pay the amount requested by the shareholder, or seek an appraisal from the court.[15] In an appraisal proceeding, the corporation is presumed to pay costs, but the court may assess the costs to the shareholders if the court finds that the shareholders' actions were arbitrary, vexatious, or not in good faith.[16]

Federal banking law does not expressly address the authority of national banks to engage in share exchanges. There are several mechanisms, however, by which a national bank may form a parent holding company and, as a result, own 100 percent of the shares of a bank. For example, a national bank can effect a holding company reorganization by forming a holding company and chartering an interim bank, which is a subsidiary of that company. The existing bank then merges into the interim bank.[17] The National Bank Act provides protection for shareholders in an interim merger by providing dissenters' rights.[18]

A national bank may become a holding company subsidiary through other methods, e.g., by forming a holding company which then conducts a tender offer for the shares of the bank. Those methods can be time consuming, relatively expensive, and present a risk that the holding company will acquire less than 100 percent of the bank's shares.

Discussion

A national bank may adopt Virginia state corporate governance procedures and conduct a share exchange, to the extent that those procedures are not inconsistent with applicable federal banking statutes and regulations. OCC regulation expressly permits a national bank to elect the corporate governance procedures of the law of the state in which the main office of the bank is located.[19] Because the main office of the bank is located in Virginia, the bank may elect Virginia corporate governance procedures.

Virginia state law allowing share exchanges is not inconsistent with applicable federal banking statutes or regulations. The transaction would not directly or indirectly violate federal banking law, which is silent concerning share exchanges. Virginia law permitting share exchanges is consistent with those provisions in federal banking law that permit national banks to accomplish the same result through different steps where the bank provides adequate dissenters' rights, as described below. To ensure consistency with federal banking law addressing interim mergers,[20] national banks that effect a share exchange must provide reasonable appraisal rights to those shareholders who choose not to receive shares by dissenting from the transaction. A national bank conducting a share exchange should provide dissenters' rights that are substantially similar, although not necessarily identical to those in section 215a.[21]

Virginia law governing share exchanges provides shareholders with dissenters' rights that are substantially similar to those in section 215a for interim mergers.[22] Both Virginia law and section 215a provide shareholders the right to dissent and receive fair value for the shares. In both cases, if the parties are unable to settle on the fair value of the shares, an independent third party (a state court under Virginia law or the Comptroller under the National Bank Act) ultimately determines the fair value of the shares.[23] Under each system of dissenters' rights, a dissatisfied shareholder may dissent from the transaction and receive the fair value of the shares, as determined by the independent third party.

Virginia law in two respects is not consistent with the merger provisions of federal banking law. With regard to dissenters' rights, Virginia law provides that the corporation must pay the cost of any judicial appraisal, unless the court finds that the dissenting shareholders acted arbi-

[14] *Id.* at § 13.1-739(a).

[15] *Id.* at § 13.1-740(a).

[16] *Id.* at § 13.1-741(a).

[17] *See* 12 USC 215a and 12 CFR 5.33(e)(4). Some circuit courts have permitted interim mergers. *See*, *e.g.*, *NoDak Bancorporation* v. *Clarke*, 998 F.2d 1416 (8th Cir. 1993) (permitting interim merger of national bank that froze out minority shareholders).

[18] *See* 12 USC 215a(b)-(d). A dissenting shareholder must either vote against the merger, or give written notice of dissent prior to or at the shareholder meeting at which the shareholders vote on the merger. The value of the dissenting shareholder's shares is determined by an appraisal made by a committee of three persons: one chosen by the dissenting shareholders, one chosen by the directors of the bank (as it exists after the merger), and one chosen by the other two members of the committee. If the committee fails to determine a value of the shares, or a dissenting shareholder is not satisfied with the value determined, the OCC must make an appraisal of the shares. The resulting bank must pay the costs of any appraisal conducted by the OCC.

[19] 12 CFR 7.2000(b).

[20] 12 USC 215a.

[21] *See* Footnote 18, *supra*.

[22] Va. Code Ann. § 13.1-729 *et seq.*

[23] The scheme of dissenters' rights in Virginia law is also substantially similar to that found in Iowa law. *Compare* Va. Code Ann. at § 13.1-729 *et seq.* with Iowa Code § 490.1301, *et seq.* The OCC has found that the dissenters' rights available under Iowa law afford comparable protections to corresponding provisions in the National Bank Act. *See* Interpretive Letter No. 786, *reprinted in* [1997 Transfer Binder] Fed. Banking Law Rep. (CCH) ¶ 81-213 (June 9, 1997) and Conditional Approval No. 99-10 (Apr. 1, 1999) at 5.

trarily, vexatiously, or not in good faith in demanding payment.[24] Federal banking law, in contrast, requires the resulting bank to pay for any Comptroller appraisal, without exception.[25] Section 7.2000(b) limits the ability of national banks to adopt alternative corporate governance to only those statutes that are not inconsistent with federal banking law so that national bank shareholders will not suffer a disadvantage resulting from the bank's selection of that alternative law. To meet that limitation in section 7.2000(b), a national bank proposing to adopt Virginia law and conduct a share exchange must agree to pay the cost of any judicial appraisal that may result. The bank must also agree to pay for arbitration of the matter if the appropriate court refuses jurisdiction of an appraisal action.

With regard to the share exchange generally, Virginia law permits the board of directors of the corporations to amend the plan of share exchange without seeking shareholder approval for the amendment.[26] Federal banking law, in contrast, does not permit amendment of a merger agreement without shareholder approval.[27] To ensure that national bank shareholders will not suffer any disadvantage from any amendment to a plan of share exchange, a national bank proposing to adopt Virginia law and conduct a share exchange must also agree not to amend the plan of share exchange without shareholder approval.

Conclusion

For the above reasons, and subject to the above conditions, we conclude that the Bank may effect a share exchange pursuant to Virginia law. If you have any questions concerning this letter, please contact Frederick G. Petrick, Jr., senior attorney, Securities and Corporate Practices Division, at 202-874-5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[24] Va. Code Ann. § 13.1-741(a).

[25] 12 USC 215a(d).

[26] Va. Code Ann. § 13.1-718(i). The statute prohibits amendments that would change the consideration to be received for shares, adversely affect the shares of any class or series of a corporation, or amend the articles of any corporation whose shares must approve the share exchange. *Id*.

[27] *See* 12 U.S.C. § 215a.

880—December 16, 1999

12 USC 24(7)

Re: Investment Advice Related to Real Estate

Dear [ ]:

This letter responds to your request for an opinion regarding the permissibility of certain investment advisory and related intermediary services ("services") provided in connection with investment in real estate by a bank's clients. The services include activities in connection with the exchange of existing investment real estate in a client's portfolio (the "original property") for "like kind" investment real estate (the "exchange property") in a tax-free exchange under Internal Revenue Code Section 1031 ("1031 exchange transaction"). In connection with the real estate investment advisory services the banks would take part in negotiating the 1031 exchange transactions. Based on the representations made in your letter and in subsequent conversations with this office, and for the reasons discussed below, we believe the bank's negotiating services, in the manner described, are permissible.

I. Background

A. Real Estate Investment Advisory and Related Intermediary Services

As described in your letter, a national bank would provide services to individuals and institutional investors whose investment portfolios include investment real estate held for the purpose of realizing capital appreciation or income. These real estate investments would typically include apartments and other multi-family housing, office buildings, medical offices, industrial facilities, warehouses, and other commercial buildings. They could also include raw land on which the client-investor may intend to construct a "built-to-suit" facility for an end-user or which the client-investor would develop, at least partly on a speculative basis, and hold for lease rather than immediate disposition.

A bank providing services would consult with a client to determine the composition of the client's existing portfolio, his objectives and his tax exposure. The basic analytical tools employed in evaluating this information are comparable to those employed in general investment management, and include the consideration of diversification, cash flows, potential for appreciation, the estate planning objectives of the client, and liquidity needs. In its analysis of the client's existing real estate portfolio, a bank would undertake a review of the concept, design, layout, suitability for purpose, and prospects of any real estate, in-

cluding an identification of possible original properties and any characteristics of exchange properties in consideration of a potential 1031 exchange transaction.

Based on its review of its client's objectives, needs and portfolio, a bank providing services would prepare a written analysis of the client's portfolio and would formulate a proposal to hold or dispose of specified original properties and, in the case of a recommended disposition, consider possible exchanges and proposed characteristics of possible exchange properties.

B. 1031 Exchange Transactions

Section 1031 of the Internal Revenue Code (IRC) provides for tax deferred treatment for exchanged property of like-kind.[1] IRC Section 1031 also generally requires that the acquisition be completed within 6 months of the disposition of the original property.

Your letter states that a bank's involvement in the sale of original property could entail: (1) advising its client on sale strategies; (2) placing the property by contacting a limited number of qualified investors; (3) identifying and engaging a real estate broker; (4) advising the investor concerning valuation issues and the terms of sale, with particular emphasis on the consistency of such terms with the investor's overall investment strategy; (5) participating in the structuring of the transaction (including negotiations with the buyer)[2]; and (6) administering the closing. The bank's involvement in the purchase of an exchange property would entail similar services.

A bank would also provide general administrative services in connection with 1031 exchange transactions. These services include: (1) disbursement services; (2) helping a client identify and comply with contractual conditions; (3) assisting a client in coordinating actions associated with the real estate transactions (including the review of title information and the sufficiency of title insurance coverage); (4) identification of and the engagement of persons to provide any required real estate management services; (5) preparation of tax returns; and (6) in consultation with appropriate third-party tax experts, documenting and assisting the client in reviewing compliance with the technical requirements of IRC Section 1031. Once the 1031 exchange transaction was finalized, a bank would ordinarily continue to provide general real estate investment portfolio advice and services with respect to the exchange property and other investment property held by the client.

C. Limitations and Conditions

Your letter also represents that a bank involved in a 1031 exchange (1) will not arrange transactions resulting in the acquisition of real estate to be "held for productive use in a trade or business"; (2) will not directly market or advertise real estate to the general public, or be involved "on a day-to-day basis" in showing the property to prospective acquirers; (3) will not base its fees for the services on the profits ultimately realized by clients on 1031 exchange transactions; and (4) will not acquire any of the subject real estate. A bank could, however, lend in connection with a 1031 exchange transaction. If the bank desires to lend in connection with a 1031 exchange transaction, the bank will base its loan decision on an independent credit evaluation, and the loan will be on terms and under circumstances substantially the same as those prevailing at the time for comparable transactions with or involving non-1031 exchange transaction clients.

II. Discussion

A. The National Bank Act

The National Bank Act provides, in relevant part, that national banks have the power:

> [t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes.[3]

The powers clause of 12 USC 24(Seventh) is a broad grant of power to engage in the business of banking, including, but not limited to, the five enumerated powers and the business of banking as a whole.[4]

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[1] "Like-kind" is defined as real property for real property, this means exchanging not only an apartment building for an apartment building, but also an apartment building for raw land, as long as the new property will be held for productive use or investment.

[2] Although negotiating 1031 exchange transactions represents only a very small portion of the proposed services, such negotiation services are an element of the competitive range of real estate investment advisory services that your letter states that a bank must offer to meet its clients' portfolio objectives. Competitors in the real estate advisory and management business offer such negotiation services. Your letter states that unless banks can offer the same range of services requested by clients, clients will search for an alternative provider of such services. See discussion at pages 6 - 9 *infra*.

[3] 12 USC 24(Seventh).

[4] *NationsBank v. Variable Life Annuity Co.*, 513 U.S. 251 (1995) ("*VALIC*"). The Comptroller of the Currency is the administrator of the National Bank Act and is the primary supervisor of national banks and accorded deference in determining the scope of "the business of banking." *See* 12 USC 1, 24, 26-27, and 481.

Many activities that are not included in the enumerated powers are also part of the business of banking. Judicial cases reflect three general principles used to determine whether an activity is within the scope of the "business of banking" under 12 USC 24(Seventh): (1) is the activity functionally equivalent to, or a logical outgrowth of, a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks.[5]

National banks are also authorized to engage in an activity if that activity is incidental to the performance of the five powers enumerated in 12 USC 24(Seventh) *or* incidental to the performance of an activity that is part of the business of banking.[6] Incidental activities are activities that are permissible for national banks, not because they are part of the "business of banking," but rather because they are "convenient" or "useful" to an activity that is part of the "business of banking."[7]

B. Real Estate Investment Advisory and Related Intermediary Services are Part of the Business of Banking

The OCC has long recognized that the provision of investment advisory services relating to real estate is part of the business of banking and thus permissible for national banks.[8] In particular, the OCC has specifically determined that a national bank may serve as an advisor to a real estate investment trust and provide investment advice and management of a portfolio of real estate equity investments.[9] The scope of the real estate investment advisory component of the services is well within the range of those permitted in Interpretive Letter No. 508. The evaluation process, the proposal and implementation of an investment strategy, the ancillary services and fee terms are the same as those approved in Interpretive Letter No. 508.[10]

Real estate investment advisory services respond to the needs of customers and benefit the bank. These services meet the convenience and needs of customers by enabling them to take advantage of a broad range of products and services in a single interaction. Customers benefit from the ability to utilize fully a bank's expertise in real estate investment advice to enhance their assets and meet their financial objectives. The ability of a national bank to offer customers a complete package of real estate investment advisory services enables the bank to better serve its customers by offering a full range of products to meet their needs, compete more effectively with other companies providing similar services, expand its customer base, and generate additional fee income.

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[5] *See*, *e.g.*, *Merchants' Bank v. State Bank*, 77 U.S. 604, 648 (1871) (certification of checks has grown out of the business needs of the country and involves no greater risk than a bank issuing a certificate of deposit); *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377, 1382-83 (9th Cir. 1977), *cert. denied*, 436 U.S. 987 (1978) (personal property lease financing is "functionally interchangeable" with the express power to loan money on personal property); *American Ins. Assoc. v. Clarke*, 865 F.2d 278, 282 (D.C. Cir. 1988) (standby credits to insure municipal bonds is "functionally equivalent" to the issuance of standby letters of credit).

[6] *VALIC*, *supra*; Interpretive Letter No. 742 (August 19, 1996), *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,106 (bank may provide full Internet access to customers and non-customers in order to create a package of related services needed to satisfy consumer demand and enable the bank to successfully market its home banking services); Interpretive Letter No. 737 (August 19, 1996), *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,101 (where a national bank was providing a closed stored value system, the provision of multi-function smart cards and card readers is incidental to the business of banking because it enables the bank to create a package of related services required to satisfy customer needs and to market successfully its stored value system).

[7] *VALIC*, *supra*; *Norwest Bank Minn., N.A. v. Sween Corp.*, 916 F. Supp. 1494 (D.Minn. 1996), *aff'd* 118 F.3d 1255 (8thCir. 1997).

[8] Interpretive Letter No. 508 (April 6, 1990), *reprinted in* [Transfer Binder 1990-1991] Fed. Banking L. Rep. (CCH) ¶ 83,206 (operating subsidiary may engage in real estate investment advisory services, including identifying and evaluating proposed real estate investments; making specific investment recommendations to a client with respect to investment in, or disposal of, individual real estate investments; providing analysis to client as to performance of portfolio; acting as finder to bring together parties for real estate transaction); Interpretive Letter No. 389 (July 7, 1987), *reprinted in* [Transfer Binder 1988-1989] Fed. Banking L. Rep. (CCH) ¶ 85,613 (allowing operating subsidiary to engage in similar real estate investment advisory activities). *See also* Conditional Approval No. 241 (May 1, 1997) (approving operating subsidiary's investment in partnership advising clients relative to their real estate, including purchase and sale of real estate and acting as finder to bring together parties wishing to finance the purchase, construction, development, and operation of real estate).

[9] Interpretive Letter No. 508, *supra*; Interpretive Letter No. 389, *supra*.

[10] *See also* Conditional Approval No. 276 (May 8, 1998) (approving, in connection with the origination of extensions of credit by third parties, appraisal management; title review activities; closing management; property inspections; property preservation services; and real estate tax services). Furthermore, as part of the permissible real estate investment advisory services, the bank may act as finder to bring together the parties for the 1031 exchange transaction. The OCC has determined that a national bank, as part of comprehensive real estate investment advisory services, may assist a client by acting as a finder to bring together parties for a recommended real estate transaction. Interpretive Letter No. 508, *supra*. *See also* Conditional Approval No. 241, *supra*.

C. The Negotiation of 1031 Exchange Transaction in the Present Case is Incidental to the Business of Banking

Under the proposal outlined in your letter, a national bank also would participate in negotiating 1031 exchange transactions in connection with the provision of comprehensive real estate investment advisory services. Those negotiations would constitute a *de minimus* portion of the bank's total revenue from its real estate investment advisory services, but the ability to offer this service as part of a full range of real estate investment advisory services is integral to the bank's ability to successfully compete with other types of firms that offer a full range of financial products and services in connection with their real estate investment advisory services. Were a bank unable to offer its services in the negotiations of 1031 exchange transactions, it would be unable, in some cases, to help obtain the property that it had recommended as most appropriate for a particular customer. Moreover, the bank would be unable to provide the full range of services offered by competitors in the real estate investment management business. Accordingly, for the reasons discussed below, we conclude that a national bank may offer its services as negotiator in a 1031 exchange transaction, in the manner described herein, as an activity incidental to the bank's authority to provide real estate investment advisory services.

1. The Negotiating Services are Necessary to Successfully Provide Competitive Financial Planning Services

The services proposed in your letter are supported by ample precedent which holds that national banks may provide a variety of ancillary products and services incidental to the business of banking when necessary to successfully package or promote permissible banking related products or services. Products and services are incidental to a banking activity, as is the case here, when they make the use of a banking authorized product or service more convenient and thereby increase customer demand for banking products. For example, in *Clement Nat'l Bank* v. *Vermont*,[11] the Supreme Court held that a national bank could, incidental to its deposit services, perform the additional services of computing, reporting, and paying the tax levied on the interest earned by bank customers on their deposits, thereby promoting the convenient consumer use of its business and enhancing the demand for a banking service. Similarly, in *Miller* v. *King*[12] the Supreme Court held that a national bank could institute a lawsuit on behalf of a customer to collect funds as an activity incidental to the bank's power to accept deposits; the bank's service to facilitate collection of the funds enabled the customer to use the bank's deposit services.[13]

Numerous OCC precedents have also confirmed that banks may provide a variety of ancillary incidental products and services to promote consumer use or demand for banking products. In OCC Interpretive Letter No. 754, the OCC permitted a national bank to sell general purpose computer hardware to other financial institutions as part of its larger computer network services in response to consumer demand for a single-source provider of network services.[14] The OCC has also authorized a national bank to provide full Internet access to customers and noncustomers in order to create a package of related services needed to satisfy consumer demand and enable the bank to successfully market its home banking services.[15] Similarly, the OCC has permitted a national bank to provide a smart phone to offer a variety of banking and nonbanking services "to increase the customer base and the usage of the program."[16]

Likewise, courts have relied on incidental powers to permit bank affiliates to provide nonbanking services where necessary for the successful promotion of other permissible services. This concept was applied to bank holding companies in *National Courier Ass'n v. Board of Governors.*[17] The *National Courier* court, in analogizing to the powers of national banks under 12 USC 24(Seventh), stated that "[i]n enumerating the activities that could be carried on, [Congress] certainly could not have meant to forbid engagement in other 'incidental' activities as were reasonably necessary to carrying out those that were enu-

[11] 231 U.S. 120 (1913).

[12] 223 U.S. 505 (1912).

[13] *See also Corbett v. Devon Bank*, 299 N.E.2d 521, 12 Ill. App. 3d 559 (1973) (as a means of promoting its banking business, a national bank may sell state motor vehicle licenses).

[14] Interpretive Letter No. 754 (November 6, 1996), *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,118 (national bank operating subsidiary may sell general purpose computer hardware to other financial institutions as part of larger product or service when necessary, convenient, and useful to bank permissible activities).

[15] Interpretive Letter No. 742, *supra* note 6.

[16] Interpretive Letter No. 611 (November 23, 1992), *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449. *See also* Interpretive Letter No. 737); Interpretive Letter No. 737 (August 19, 1996), *reprinted in* [1996-1997] Fed. Banking L. Rep. (CCH) ¶ 81,101 (national banks may offer nonbanking products as part of larger product or service to create a package of related services required to satisfy customer need and promote other permissible banking services); Conditional Approval Letter No. 221 (December 4, 1996) (Internet access incidental to the business of banking because Internet access is necessary for the successful marketing of home financial services and constitutes only a minor part of the total package of services offered).

[17] 516 F.2d 1229, 1240 (D.C. Cir. 1975) ("*National Courier*").

merated."[18] The promotional powers concept was further developed in *Alabama Ass'n of Insurance Agents* v. *Board of Governors*,[19] where the court reviewed orders of the Board of Governors of the Federal Reserve System ("Board") granting holding companies permission to act as agent with respect to certain types of insurance. The orders were issued under provisions of the Board's then Regulation Y that permitted holding companies to sell insurance, including insurance sold as a matter of convenience to the purchaser, so long as the premium income did not constitute a significant portion of the aggregate insurance premium income of the holding company. The court, troubled that the regulation did not require the insurance to be related at all to banking, nevertheless concluded that "[t]o the extent that [the Board asserts] that [the insurance] is an incidental activity reasonably necessary to the carrying on of clearly permissible [activities] we would find that it is [an activity] that, if supported, would be legally sufficient."[20]

As described above, the negotiation of 1031 exchange transactions presents a comparable situation. Your letter argues that a bank should be able to negotiate the transaction in order to benefit its customers by providing comprehensive services.

Clients may obtain real estate investment advisory services from a bank, including recommendations for one or more 1031 exchange transactions. A client obtaining these services may wish to pursue a recommended 1031 exchange transaction with the bank participating in the negotiations. This would allow a customer to obtain nearly seamless real estate investment advisory services and minimize the necessity of engaging separate service providers. Your letter states that the ability to provide a full range of real estate investment advisory services, including negotiating 1031 exchange transactions, would be integral to a bank's ability to compete successfully with other types of firms that offer a full range of financial products and services in connection with their real estate investment advisory services.

2. The Negotiating Services Enable the Bank to Optimize the Use and Value of Its Facilities, Competencies and Personnel

The negotiating services described in your letter are also supported by numerous precedents holding that, within reasonable limits, certain activities can be incidental to banking when those activities enable a bank to optimize the use and value of its facilities and other resources.

The ability to include negotiating services as part of the services offered in connection with 1031 exchange transactions allows a bank to operate in an economically rational manner by optimizing the use and value of its facilities, competencies, and personnel and by avoiding waste. In developing real estate investment advisory plans, the bank collects information; identifies client investment goals and objectives; assesses a client's need to adjust his real estate portfolio; and prepares a comprehensive real estate investment advisory plan that may include one or more 1031 exchange transactions. Through the planning process and advising a client in a 1031 exchange transaction, a bank also does much of the analysis and work involved negotiating a 1031 exchange transaction. Permitting a bank to participate in the 1031 exchange transaction negotiations optimizes the use of the bank's time, expertise, and personnel in developing and implementing real estate investment advice.

OCC precedents establish that national banks may offer incidental nonbanking products and services to customers where the nonbanking product or service offered is part of a larger banking product or service. In Interpretive Letter No. 742,[21] the OCC permitted a national bank to provide customers with full Internet access in order to deliver banking services over the Internet, even though customers might use that access for nonbanking purposes because full access did not dominate the bank's

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[18] *Id.*

[19] 553 F.2d 224 (5th Cir. 1976), *vacated in other part*, 558 F.2d 729 (1977), *cert. denied*, 435 U.S. 904 (1978).

[20] *Id.* at 242 (citing 12 USC 24(Seventh)). Recently the Board approved a holding company's application to acquire an employee benefits consulting company that provides insurance-related services. Order of the Federal Reserve Board Approving Notice by Mellon Bank Corporation to Acquire an Employee Benefits Consulting Company (June 16, 1997) ("*Mellon*"). The insurance agency activities, had they been viewed in isolation, would have been *prohibited* under the Bank Holding Company Act. Nevertheless, the Board ruled that acting as a licensed insurance agent for an employee benefits consulting business was *permissible* because it was necessary and "incidental" to the permissible activity of providing employee benefit consulting services. In determining whether an activity is an incidental activity, the Board noted it "generally has considered whether the activity is reasonably necessary to the conduct of a permissible activity and whether the activity constitutes a relatively minor part of the overall business of the company conducting the activities." *Id.* The Board must also determine that "proposed activities are a proper incident to banking, that is, that the proposal 'can reasonably be expected to produce benefits to the public.' " *Id.* The Board found that this test was met in the *Mellon* case, because the employee benefits consulting company would otherwise operate at a competitive disadvantage; customers would derive increased convenience from being able to purchase a wider range of services from one entity; the combination of these services increased operational efficiency for the company; and the insurance activities represented only a small fraction of the consulting work performed.

[21] Interpretive Letter No. 742, *supra* note 6.

services. In Interpretive Letter No. 653,[22] the OCC permitted a national bank that maintained a database of insurance agent activities for purposes of calculating and paying commissions as a service to its customers, to also maintain incidental information on the agents' licensing status as a minor part of the overall operation. In Interpretive Letter No. 611,[23] the OCC permitted a national bank to sell a variety of banking services to customers and a smaller amount of incidental nonbanking services through a specially developed smart phone. In Interpretive Letter No. 345,[24] the OCC permitted a national bank to provide a package of bank permissible data processing services to customers with incidental full function hardware where the hardware was not the dominant part of the total package offered.[25] In the case of 1031 exchange transaction negotiating services, the negotiations are necessary to implement a portion of the bank's real estate investment advisory services and constitute an extremely small part of the overall service.

III. Conclusion

Accordingly, based on the representations made in your letter and in subsequent conversations with this office, we concur that the bank's real estate investment advisory and related services, including participation in 1031 exchange transaction negotiations, as described herein, are permissible.

If you have any questions concerning this letter, please contact Steven V. Key, attorney, Bank Activities and Structure Division, at (202) 874-5300.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[22] Interpretive Letter No. 653 (December 22, 1994), *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601.

[23] Interpretive Letter No. 611 (November 23, 1992), *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449.

[24] Interpretive Letter No. 345 (July 9, 1985), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,515.

[25] *See also* Unpublished Letter from Michael J. O'Keefe, district counsel, midwestern district (July 13, 1987) (distribution of software and incidental full function hardware to banks permissible so long as full function hardware does not "dominate" permissible data processing services involved); Interpretive Letter No. 516, *supra* (sale of incidental hardware permissible when incidental hardware does not exceed 30 percent of total cost of package).

881—December 16, 1999

Mr. Perry LaCaria
President and CEO
Landmark Bank, N.A.
2600 East Commercial Boulevard
Fort Lauderdale, Florida 33308

Re: giantbank.com: Internet Trade Name

Dear Mr. LaCaria:

The Office of the Comptroller of the Currency (OCC) received your letter describing the future plans of Landmark Bank, N.A. (Landmark) to conduct business on the Internet under the name of "giantbank.com." Your intent is to use the "giantbank.com" trade name exclusively on the Internet channel for those customers who wish to establish a relationship with an on-line bank.

Your letter requested our opinion and guidance regarding your proposed consumer disclosures and intended procedures. The use of multiple trade names raises a number of issues that Landmark management should address as it begins the operations under the name of "giantbank.com."[1] Your consumer disclosures and procedures should incorporate the following guidance.

The use of multiple trade names gives rise to customer confusion, as customers may be unaware that "giantbank.com" is a part of Landmark. This confusion could result in bank customers inadvertently exceeding the $100,000 deposit insurance limit. However, this risk can be controlled by taking reasonable steps to ensure that customers receive adequate disclosures about either the identity of the bank or the extent of FDIC insurance coverage. The banking agencies have addressed this issue with the Interagency Statement on Branch Names, published as OCC Bulletin 98-22 (branch names statement). This issuance provided guidance to banks that use a different name for a branch or other facility. Although the statement refers to Internet facilities, it is not immediately

[1] The OCC has concluded nothing in the National Bank Act prohibits banks from using multiple trade names. *See* OCC Bulletin 98-22 and OCC Interpretive Letter No. 698, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-013 (February 1, 1996). However, we have said that the official title of the bank should be used on all critical documents, including documents establishing trusts, powers of attorney, loans, and deposit account relationships, as well as regulatory filings. Moreover, national banks should review relevant state statutory and common law and federal trade name and trademark law.

apparent how to adapt the guidance to such a facility.[2] The branch names statement suggests four measures.

First, the branch names statement suggests that banks using multiple trade names should be " . . . disclosing, clearly and conspicuously, in signs, advertising, and similar materials that the facility is a branch, division, or other unit of the insured institution." The branch names statement further suggests that "institutions should exercise care that the signs and advertising do not create a deceptive and/or misleading impression."

As applied to its "giantbank.com" operations, Landmark management should make clear on its homepage and on any pages that allow a customer to initiate deposit account transactions, that the customer is dealing with Landmark. Disclosures must be clear, prominent, and easy to understand. Examples of how Internet disclosures may be made conspicuous include: large print easily viewable when a page is first opened; a dialog box that pops up whenever a customer accesses a Webpage; or a simple graphic near the top of the page or in close proximity to the bank's logo. These examples are only some of the possibilities for conspicuous disclosures given the available technology.

Second, the branch names statement suggests: ". . . using the legal name of the insured institution for legal documents, certificates of deposit, signature cards, loan agreements, account statements, checks, drafts, and other similar documents."

Thus, Landmark management should make clear to account holders and other individuals and businesses in bank contracts and other such documents that Landmark is the legal entity with which they are contracting.

Third, the branch names statement suggests: ". . . educating the staff of the insured depository institution regarding the possibility of customer confusion with respect to deposit insurance. The agencies recommend that the insured depository institution instruct staff at the branch and any other facilities operating under trade names to inquire of customers, prior to opening new accounts, whether they have deposits at the depository institution's other facilities or branches. In addition, during the time period after one institution acquires or combines with another, staff should be reminded to call customers' attention to disclosures that identify a particular branch or facility as part of an institution."

In the present situation, this guidance means that it will be important for the staff that responds to questions from potential and current account holders of both Landmark and Landmark d.b.a. "giantbank.com" to clarify the status of "giantbank.com" in a way that is readily understood by customers. Thus call center employees, whether employees of the bank or employees contracted through a third party service provider, will need instruction about the possible customer confusion associated with the multiple trade names.

Fourth, the branch names statement suggests that banks using multiple trade names: " . . . obtain from depositors opening new accounts at the branch a signed statement acknowledging that they are aware that the branch and other facilities are in fact parts of the same insured institution and that the deposits held at each facility are not separately insured."

Thus, to address possible customer confusion with respect to FDIC insurance, the new deposit account customers of both "giantbank.com" and Landmark should sign a document indicating awareness of FDIC aggregation of deposits for the multiple identities. For example, Landmark could place the following disclosure in its "giantbank.com" deposit application forms and deposit disclosure documents on the giantbank.com Website:

> giantbank.com (Division of Landmark Bank N.A.) and Landmark Bank N.A. are the same FDIC-insured institution. Deposits held under each trade name are not separately insured, but are combined to determine whether a depositor has exceeded the $100,000 federal deposit insurance limit.

We understand that management intends to establish and rely on appropriate internal control practices to ensure that all new and existing customers of Landmark and "giantbank.com" acknowledge that the two entities are not separate for deposit insurance purposes. We also understand that Landmark d.b.a. "giantbank.com" does not intend to solicit deposit accounts with existing Landmark account holders. If that marketing strategy should change in the future, management should consider taking additional steps to detect and mitigate potential customer confusion.

Please contact national bank examiner Christopher Waltz at (305) 262-8203 should you have any questions regarding the bank's compliance with the branch names state-

[2] The branch names statement provides that banks using "different trade names over a computer network should take reasonable steps to ensure that customers are not confused about either the identity of the insured depository institution or the extent of FDIC insurance coverage."

ment on its Website. If you have questions about compliance with the branch names statement or Internet disclosures generally, please contact Clifford Wilke, Bank Technology Division, at (202) 874-4157.

Emory W. Rushton
Senior Deputy Comptroller
Bank Supervision Policy

Leann G. Britton
Senior Deputy Comptroller
Bank Supervision Operations

Mergers—January 1 to March 31, 2000

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Mergers—January 1 to March 31, 2000

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 January 1 to March 31, 2000

Title and location (charter number)	Total assets
California	
San Jose National Bank, San Jose (017315)	402,158,000
and Saratoga National Bank, Saratoga (017520)	148,533,000
merged on January 5, 2000 under the title of **San Jose National Bank, San Jose** (017315)	550,691,000
City National Bank, Beverly Hills (014695)	6,924,060,000
and The Pacific Bank, National Association, San Francisco (017917)	732,454,000
merged on February 29, 2000 under the title of **City National Bank, Beverly Hills** (014695)	7,655,431,000
Maryland	
Farmers & Mechanics National Bank, Frederick (001267)	1,246,166,000
and Commercial and Farmers Bank, Ellicott City	172,957,000
merged on December 30, 1999 under the title of **Farmers & Mechanics National Bank, Frederick** (001267)	1,419,123,000
Nebraska	
Cornerstone Bank, National Association, York (002683)	268,276,000
and Bank of Monroe, Monroe	18,940,000
merged on February 15, 2000 under the title of **Cornerstone Bank, National Association, York** (002683)	284,950,000
New York	
Safra National Bank of New York, New York (020948)	3,406,000,000
and Skylake National Bank, North Miami Beach (023499)	5,000,000
merged on January 1, 2000 under the title of **Safra National Bank of New York, New York** (020948)	3,408,000,000
Oklahoma	
The First National Bank and Trust Company of Ada, Ada (012591)	188,557,000
and The Prague National Bank, Prague (008159)	75,813,000
merged on January 01, 2000 under the title of **The First National Bank and Trust Company of Ada, Ada** (012591)	264,370,000
Texas	
American National Bank, Wichita Falls (016617)	185,960,000
and Bank of America of Texas, National Association, Dallas (023978)	200,000
merged on March 17, 2000 under the title of **American National Bank, Wichita Falls** (016617)	185,960,000
Bank of Texas, National Association, Dallas (018307)	586,755,000
and Canyon Creek National Bank, Richardson (016555)	126,681,000
merged on March 17, 2000 under the title of **Bank of Texas, National Association, Dallas** (018307)	713,436,000

Affiliated mergers (mergers consummated involving affiliated operating banks), from January 1 to March 31, 2000

Title and location (charter number)	Total assets
Alabama	
SouthTrust Bank, National Association, Birmingham (014569)	39,964,148,000
and Heritage Bank, Waxahachie	170,902,000
merged on January 14, 2000 under the title of SouthTrust Bank, National Association, Birmingham (014569)	40,146,920,000
California	
Wells Fargo Bank, National Association, San Francisco (001741)	89,993,576,000
and Wells Fargo Bank (Arizona), National Association, Phoenix (022863)	27,237,000
merged on February 18, 2000 under the title of Wells Fargo Bank, National Association, San Francisco (001741)	90,020,903,000
Nara Bank, National Association, Los Angeles (021669)	334,693,000
and Korea First Bank of New York, New York City (324918)	117,280,000
and NB Interim Bank, National Association, Los Angeles (024030)	200,000
merged on February 25, 2000 under the title of Nara Bank, National Association, Los Angeles (021669)	451,973,000
Florida	
First National Bank Northwest Florida, Panama City (018214)	95,600,000
and First Northwest Florida Bank, Fort Walton Beach	34,500,000
merged on February 29, 2000 under the title of First National Bank Northwest Florida, Panama City (018214)	130,100,000
Illinois	
First Midwest Bank, National Association, Buffalo Grove (013660)	5,059,230,000
and Heritage Bank, National Association, Monee (008933)	483,000
merged on December 31, 1999 under the title of First Midwest Bank, National Association, Buffalo Grove (013660)	5,060,196,000
The Old Second National Bank of Aurora, Aurora (004596)	646,218,000
and Bank of Sugar Grove, Sugar Grove	44,150,000
merged on February 25, 2000 under the title of The Old Second National Bank of Aurora, Aurora (004596)	691,858,000
Kansas	
Central National Bank, Junction City (004284)	370,861,000
and Farmers State Bank, Mankato	59,114,000
and Farmers State Bank and Trust Company of Superior, Superior	64,651,000
merged on February 7, 2000 under the title of Central National Bank, Junction City (004284)	494,626,000
Minnesota	
U.S. Bank National Association, Minneapolis (013405)	70,841,000,000
and Peninsula Bank of San Diego, San Diego	456,000,000
merged on January 14, 2000 under the title of U.S. Bank National Association, Minneapolis (013405)	71,382,000,000
The First National Bank of Bertha-Verndale, Bertha (007373)	36,152,000
and West Central Bank, Barrett	39,214,000
merged on March 1, 2000 under the title of Star Bank, National Association, Bertha (007373)	74,366,000
Missouri	
Mercantile Bank of Trenton National Association, Trenton (023973)	74,262,000
and Mercantile Bank National Association (023783)	22,459,744,000
merged on October 22, 1999 under the title of St. Louis Mercantile Bank National Association, St. Louis (023973)	22,534,006,000
UMB Bank, National Association, Kansas City (023920)	6,719,500,000
and Charter National Bank, Oklahoma City (017745)	59,930,000
and UMB Oklahoma Bank, Oklahoma City	146,234,000
merged on March 04, 2000 under the title of UMB Bank, National Association, Kansas City (023920)	6,912,721,000
Nebraska	
Western Nebraska National Bank, North Platte (020195)	235,541,000
and Western Nebraska National Bank, Valentine (023639)	18,062,000
merged on January 18, 2000 under the title of Western Nebraska National Bank, North Platte (020195)	253,603,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
New Mexico	
Wells Fargo Bank New Mexico, National Association, Albuquerque (006187)	3,454,130,000
and The First National Bank of Farmington, Farmington (006183)	631,960,000
and Capital Bank, Albuquerque	24,849,000
merged on March 18, 2000 under the title of **Wells Fargo Bank New Mexico, National Association, Albuquerque** (006187)	4,191,909,000
New York	
Delta National Bank and Trust Company of New York, New York (020547)	323,727,000
and Delta National Bank and Trust Company of Florida, Miami (020612)	154,787,000
merged on January 03, 2000 under the title of **Delta National Bank and Trust Company, New York** (020547)	478,514,000
Ohio	
Firstar Bank, National Association, Cincinnati (000024)	16,750,000,000
and Firstar Bank Milwaukee, National Association, Milwaukee (000064)	8,375,000,000
and Firstar Bank Wausau, National Association, Wausau (001998)	2,940,000
merged on October 15, 1999 under the title of **Firstar Bank, National Association, Cincinnati** (000024)	36,683,000,000
Bank One Trust Company, National Association, Columbus (016235)	914,275,000
and Boaz Interim Bank, Phoenix	504,000
merged on February 14, 2000 under the title of **Bank One Trust Company, National Association, Columbus** (016235)	914,779,000
The First National Bank of Southeastern Ohio, Caldwell (005552)	86,101,000
and The Peoples Banking and Trust Company, Marietta	874,358,000
and Peoples Bank, National Association, Ashland (024037)	91,736,000
merged on March 10, 2000 under the title of **Peoples Bank, National Association, Marietta** (005552)	1,050,595,000
Oklahoma	
First National Bank, Sallisaw (015429)	76,447,000
and First National Bank of Roland, Roland (017596)	54,273,000
merged on March 13, 2000 under the title of **First National Bank, Sallisaw** (015429)	130,720,000
Rhode Island	
BankBoston, National Association, Boston (000200)	71,541,323,000
and Fleet National Bank, Providence (001338)	80,475,000,000
merged on March 1, 2000 under the title of **Fleet National Bank, Providence** (000200)	158,577,745,000
Tennessee	
Union Planters Bank, National Association, Memphis (013349)	32,513,550,000
and First State Bank of Covington, Tennessee, Covington	122,522,000
merged on February 12, 2000 under the title of **Union Planters Bank, National Association, Memphis** (013349)	32,636,072,000
Texas	
Norwest Bank Texas, National Association, San Antonio (014208)	11,443,404,000
and First National Bank of South Texas, San Antonio (016618)	265,904,000
and The Bank of South Texas, Floresville	122,644,000
merged on February 12, 2000 under the title of **Norwest Bank Texas, National Association, San Antonio** (014208)	11,869,268,000
Wisconsin	
First National Bank in Manitowoc, Manitowoc (004975)	364,427,000
and Dairy State Bank, Plymouth	66,722,000
merged on January 1, 2000 under the title of **First National Bank in Manitowoc, Manitowoc** (004975)	421,390,000

Affiliated mergers—thrift (mergers consummated involving affiliated national banks and savings and loan associations), from January 1 to March 31, 2000

Title and location (charter number)	Total assets
Illinois	
LaSalle Bank National Association, Chicago (014362)	28,873,999,000
and LaSalle Bank, F.S.B., Chicago	14,138,843,000
merged on March 31, 2000 under the title of LaSalle Bank National Association, Chicago (014362)	42,975,532,000

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Tables are provided by the Economic Analysis Division and include data for nationally chartered, FDIC-insured commercial banks that file a quarter-end call report. Data for the current period are preliminary and subject to revision. Figures in the tables may not sum to totals because of rounding.

Assets, liabilities, and capital accounts of national banks
March 31, 1999 and March 31, 2000

(Dollar figures in millions)

	March 31, 1999	March 31, 2000	Change March 31, 1999–March 31, 2000 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,433	2,326	(107)	(4.40)
Total assets	$3,141,386	$3,301,883	$160,497	5.11
Cash and balances due from depositories	190,738	180,878	(9,860)	(5.17)
Noninterest-bearing balances, currency and coin	135,318	136,012	694	0.51
Interest bearing balances	55,420	44,866	(10,554)	(19.04)
Securities	527,431	533,818	6,387	1.21
Held-to-maturity securities, amortized cost	56,040	47,992	(8,048)	(14.36)
Available-for-sale securities, fair value	471,391	485,826	14,435	3.06
Federal funds sold and securities purchased	108,198	109,442	1,244	1.15
Net loans and leases	1,979,546	2,103,182	123,636	6.25
Total loans and leases	2,016,817	2,141,170	124,353	6.17
Loans and leases, gross	2,018,739	2,142,869	124,130	6.15
Less: Unearned income	1,922	1,699	(223)	(11.59)
Less: Reserve for losses	37,271	37,988	717	1.92
Assets held in trading account	88,555	102,612	14,057	15.87
Other real estate owned	1,824	1,533	(291)	(15.97)
Intangible assets	68,164	77,986	9,822	14.41
All other assets	176,930	192,432	15,502	8.76
Total liabilities and equity capital	3,141,386	3,301,883	160,497	5.11
Deposits in domestic offices	1,747,101	1,785,411	38,310	2.19
Deposits in foreign offices	354,293	381,183	26,890	7.59
Total deposits	2,101,394	2,166,594	65,200	3.10
Noninterest-bearing deposits	405,507	417,022	11,515	2.84
Interest-bearing deposits	1,695,887	1,749,572	53,685	3.17
Federal funds purchased and securities sold	260,745	266,521	5,775	2.21
Demand notes issued to U.S. Treasury	9,817	21,989	12,172	123.99
Other borrowed money	273,539	331,321	57,782	21.12
With remaining maturity of one year or less	168,429	216,369	47,939	28.46
With remaining maturity of more than one year	105,110	114,953	9,843	9.36
Trading liabilities less revaluation losses	13,855	16,690	2,835	20.47
Subordinated notes and debentures	53,966	57,034	3,068	5.68
All other liabilities	149,348	160,519	11,171	7.48
Trading liabilities revaluation losses	51,719	59,167	7,447	14.40
Other	97,628	101,352	3,724	3.81
Total equity capital	278,722	281,215	2,493	0.89
Perpetual preferred stock	471	924	453	96.27
Common stock	16,625	14,689	(1,936)	(11.64)
Surplus	142,938	150,960	8,022	5.61
Net undivided profits and capital reserves	119,743	115,609	(4,134)	(3.45)
Cumulative foreign currency translation adjustment	(1,055)	(968)	88	NM

NM indicates calculated percent change is not meaningful.

Quarterly income and expenses of national banks
First quarter 1999 and first quarter 2000
(Dollar figures in millions)

	First quarter 1999	First quarter 2000	Change First quarter, 1999–first quarter, 2000 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,433	2,326	(107)	(4.40)
Net income	$10,534	$11,545	$1,012	9.60
Net interest income	28,666	29,110	443	1.55
Total interest income	53,803	57,713	3,909	7.27
On loans	40,762	44,442	3,680	9.03
From lease financing receivables	1,864	1,681	(183)	(9.81)
On balances due from depositories	846	729	(117)	(13.84)
On securities	8,285	8,811	527	6.36
From assets held in trading account	668	677	9	1.30
On federal funds sold and securities repurchased	1,378	1,372	(6)	(0.45)
Less: Interest expense	25,137	28,603	3,466	13.79
On deposits	16,946	18,444	1,498	8.84
Of federal funds purchased and securities sold	3,040	3,547	507	16.67
On demand notes and other borrowed money*	4,303	5,665	1,362	31.64
On subordinated notes and debentures	848	947	100	11.75
Less: Provision for losses	4,081	4,110	29	0.72
Noninterest income	22,549	24,721	2,173	9.64
From fiduciary activities	2,295	2,579	284	12.36
Service charges on deposits	3,493	3,749	256	7.32
Trading revenue	1,541	1,809	268	17.41
From interest rate exposures	667	780	114	17.05
From foreign exchange exposures	718	733	15	2.04
From equity security and index exposures	129	282	153	NM
From commodity and other exposures	27	13	(13)	NM
Total other noninterest income	15,220	16,585	1,365	8.97
Gains/losses on securities	368	(701)	(1,068)	NM
Less: Noninterest expense	31,167	31,088	(79)	(0.25)
Salaries and employee benefits	12,239	12,523	285	2.33
Of premises and fixed assets	3,924	3,952	28	0.71
Other noninterest expense	15,005	14,613	(392)	(2.61)
Less: Taxes on income before extraordinary items	5,770	6,404	634	10.99
Income/loss from extraordinary items, net of income taxes	(32)	16	48	(150.31)
Memoranda:				
Net operating income	10,314	11,988	1,673	16.23
Income before taxes and extraordinary items	16,335	17,933	1,598	9.78
Income net of taxes before extraordinary items	10,566	11,529	964	9.12
Cash dividends declared	5,181	6,732	1,551	29.94
Net charge-offs to loan and lease reserve	3,684	3,636	(48)	(1.31)
Charge-offs to loan and lease reserve	4,642	4,585	(57)	(1.22)
Less: Recoveries credited to loan and lease reserve	958	949	(9)	(0.90)

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

Year-to-date income and expenses of national banks
Through March 31, 1999 and through March 31, 2000

(Dollar figures in millions)

	March 31, 1999	March 31, 2000	Change March 31, 1999–March 31, 2000 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,433	2,326	(107)	(4.40)
Net income	$10,534	$11,545	$1,012	9.60
Net interest income	28,666	29,110	443	1.55
Total interest income	53,803	57,713	3,909	7.27
On loans	40,762	44,442	3,680	9.03
From lease financing receivables	1,864	1,681	(183)	(9.81)
On balances due from depositories	846	729	(117)	(13.84)
On securities	8,285	8,811	527	6.36
From assets held in trading account	668	677	9	1.30
On federal funds sold and securities repurchased	1,378	1,372	(6)	(0.45)
Less: Interest expense	25,137	28,603	3,466	13.79
On deposits	16,946	18,444	1,498	8.84
Of federal funds purchased and securities sold	3,040	3,547	507	16.67
On demand notes and other borrowed money*	4,303	5,665	1,362	31.64
On subordinated notes and debentures	848	947	100	11.75
Less: Provision for losses	4,081	4,110	29	0.72
Noninterest income	22,549	24,721	2,173	9.64
From fiduciary activities	2,295	2,579	284	12.36
Service charges on deposits	3,493	3,749	256	7.32
Trading revenue	1,541	1,809	268	17.41
From interest rate exposures	667	780	114	17.05
From foreign exchange exposures	718	733	15	2.04
From equity security and index exposures	129	282	153	119.00
From commodity and other exposures	27	13	(13)	(50.57)
Total other noninterest income	15,220	16,585	1,365	8.97
Gains/losses on securities	368	(701)	(1,068)	(290.49)
Less: Noninterest expense	31,167	31,088	(79)	(0.25)
Salaries and employee benefits	12,239	12,523	285	2.33
Of premises and fixed assets	3,924	3,952	28	0.71
Other noninterest expense	15,005	14,613	(392)	(2.61)
Less: Taxes on income before extraordinary items	5,770	6,404	634	10.99
Income/loss from extraordinary items, net of income taxes	(32)	16	48	NM
Memoranda:				
Net operating income	10,314	11,988	1,673	16.23
Income before taxes and extraordinary items	16,335	17,933	1,598	9.78
Income net of taxes before extraordinary items	10,566	11,529	964	9.12
Cash dividends declared	5,181	6,732	1,551	29.94
Net charge-offs to loan and lease reserve	3,684	3,636	(48)	(1.31)
Charge-offs to loan and lease reserve	4,642	4,585	(57)	(1.22)
Less: Recoveries credited to loan and lease reserve	958	949	(9)	(0.90)

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

Assets of national banks by asset size
March 31, 2000
(Dollar figures in millions)

	All national banks	National banks				Memoranda: All commercial banks
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	
Number of institutions reporting	2,326	1,180	975	126	45	8,518
Total assets	$3,301,883	$59,514	$258,075	$381,661	$2,602,633	$5,847,134
Cash and balances due from	180,878	3,044	11,134	17,394	149,305	319,091
Securities	533,818	16,341	67,281	87,624	362,572	1,057,255
Federal funds sold and securities purchased	109,442	2,963	7,838	10,731	87,911	248,730
Net loans and leases	2,103,182	34,417	158,679	237,219	1,672,868	3,508,482
Total loans and leases	2,141,170	34,888	160,990	242,236	1,703,057	3,568,368
Loans and leases, gross	2,142,869	34,973	161,269	242,322	1,704,306	3,571,621
Less: Unearned income	1,699	85	280	85	1,249	3,253
Less: Reserve for losses	37,988	470	2,311	5,018	30,189	59,885
Assets held in trading account	102,612	7	188	758	101,658	281,647
Other real estate owned	1,533	61	206	143	1,122	2,763
Intangible assets	77,986	253	1,780	8,040	67,913	101,317
All other assets	192,432	2,427	10,969	19,752	159,285	327,849
Gross loans and leases by type:						
Loans secured by real estate	868,524	20,077	98,107	121,297	629,043	1,561,354
1–4 family residential mortgages	438,015	9,422	44,000	60,310	324,283	754,989
Home equity loans	70,299	434	4,013	7,172	58,680	108,079
Multifamily residential mortgages	28,363	464	3,396	4,479	20,024	57,274
Commercial RE loans	218,807	5,814	34,004	35,689	143,301	433,502
Construction RE loans	73,296	1,597	8,532	11,893	51,274	142,414
Farmland loans	12,112	2,346	4,153	1,565	4,047	32,731
RE loans from foreign offices	27,632	0	9	189	27,433	32,366
Commercial and industrial loans	633,126	5,998	28,887	47,482	550,759	1,001,637
Loans to individuals	342,377	4,913	24,398	58,364	254,702	556,487
Credit cards	144,540	254	4,886	30,885	108,516	207,463
Installment loans	197,836	4,659	19,512	27,479	146,186	349,024
All other loans and leases	192,432	2,427	10,969	19,752	159,285	327,849
Securities by type:						
U.S. Treasury securities	53,852	1,635	5,586	5,589	41,041	109,407
Mortgage-backed securities	240,432	3,361	20,348	44,107	172,615	461,879
Pass-through securities	162,922	2,368	12,791	28,750	119,013	287,213
Collateralized mortgage obligations	77,510	994	7,558	15,356	53,602	174,666
Other securities	239,534	11,344	41,347	37,929	148,915	485,969
Other U.S. government securities	81,801	8,008	25,201	18,907	29,686	218,509
State and local government securities	39,529	2,569	11,339	7,787	17,835	89,380
Other debt securities	94,962	380	3,037	7,661	83,883	138,905
Equity securities	23,243	388	1,770	3,574	17,511	39,175
Memoranda:						
Agricultural production loans	19,519	3,426	4,776	2,718	8,598	43,380
Pledged securities	258,668	5,852	31,325	43,250	178,241	524,476
Book value of securities	546,950	16,683	68,799	89,372	372,096	1,080,478
Available-for-sale securities	498,958	13,323	55,597	71,758	358,279	936,096
Held-to-maturity securities	47,992	3,360	13,202	17,614	13,817	144,382
Market value of securities	532,865	16,282	67,001	87,261	362,321	1,053,804
Available-for-sale securities	485,826	12,981	54,079	70,010	348,755	912,873
Held-to-maturity securities	47,039	3,301	12,922	17,250	13,566	140,931

Past-due and nonaccrual loans and leases of national banks by asset size
March 31, 2000
(Dollar figures in millions)

	All national banks	National banks				Memoranda: All commercial banks
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	
Number of institutions reporting	2,326	1,180	975	126	45	8,518
Loans and leases past due 30–89 days	$24,046	$518	$1,843	$3,050	$18,635	$39,798
Loans secured by real estate	10,272	241	900	1,101	8,031	16,909
1–4 family residential mortgages	6,161	136	494	530	5,000	9,620
Home equity loans	599	2	24	53	521	836
Multifamily residential mortgages	191	4	19	19	149	333
Commercial RE loans	1,750	53	243	277	1,177	3,424
Construction RE loans	1,035	19	79	194	743	1,815
Farmland loans	167	27	41	24	76	429
RE loans from foreign offices	369	0	0	4	365	452
Commercial and industrial loans	4,926	182	443	625	3,677	8,885
Loans to individuals	7,178	93	451	1,189	5,445	11,459
Credit cards	3,409	8	163	675	2,562	4,901
Installment loans	3,769	85	287	514	2,882	6,558
All other loans and leases	1,669	1	50	135	1,483	2,545
Loans and leases past due 90+ days	6,185	107	429	986	4,662	9,861
Loans secured by real estate	1,672	53	171	245	1,203	2,939
1–4 family residential mortgages	1,091	25	98	133	835	1,790
Home equity loans	136	1	4	13	119	182
Multifamily residential mortgages	20	1	3	6	11	40
Commercial RE loans	237	10	46	50	130	554
Construction RE loans	130	5	9	36	80	218
Farmland loans	41	12	11	6	11	131
RE loans from foreign offices	18	0	0	0	18	24
Commercial and industrial loans	611	39	104	75	393	1,230
Loans to individuals	3,489	15	134	626	2,714	5,164
Credit cards	2,401	3	88	467	1,843	3,198
Installment loans	1,088	12	45	160	871	1,965
All other loans and leases	413	0	21	40	352	528
Nonaccrual loans and leases	15,506	229	911	1,031	13,335	24,732
Loans secured by real estate	5,995	106	444	533	4,912	9,419
1–4 family residential mortgages	2,920	36	162	188	2,534	4,387
Home equity loans	109	1	8	9	91	184
Multifamily residential mortgages	101	1	8	11	80	184
Commercial RE loans	1,574	34	201	236	1,103	2,792
Construction RE loans	452	7	28	67	350	827
Farmland loans	160	27	37	21	74	326
RE loans from foreign offices	681	0	0	1	680	720
Commercial and industrial loans	7,139	106	333	381	6,319	11,591
Loans to individuals	1,416	15	106	65	1,230	2,337
Credit cards	391	1	65	39	287	911
Installment loans	1,024	14	41	26	943	1,426
All other loans and leases	957	2	28	53	874	1,386

Liabilities of national banks by asset size
March 31, 2000
(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	2,326	1,180	975	126	45	8,518
Total liabilities and equity capital	$3,301,883	$59,514	$258,075	$381,661	$2,602,633	$5,847,134
Deposits in domestic offices	$1,785,411	$50,400	$208,445	$240,937	$1,285,629	$3,238,803
Deposits in foreign offices	381,183	0	452	2,600	378,131	639,489
Total deposits	2,166,594	50,400	208,897	243,537	1,663,760	3,878,291
Noninterest to earnings	417,022	8,100	33,303	42,478	333,140	708,243
Interest bearing	1,749,572	42,300	175,594	201,059	1,330,620	3,170,048
Other borrowed funds	636,521	2,063	21,430	91,067	521,961	1,089,155
Subordinated notes and debentures	57,034	3	154	2,656	54,221	78,934
All other liabilities	160,519	553	3,194	7,895	148,877	308,970
Equity capital	281,215	6,494	24,400	36,506	213,815	491,784
Total deposits by depositor:						
Individuals and corporations	1,939,458	45,649	190,454	227,247	1,476,108	3,471,236
U.S., state, and local governments	73,407	3,978	14,675	11,148	43,606	154,474
Depositories in the U.S.	68,892	414	2,242	2,896	63,340	93,363
Foreign banks and governments	72,198	1	262	855	71,080	129,147
Certified and official checks	10,078	359	1,263	1,381	7,074	18,380
All other foreign office deposits	2,561	0	0	9	2,552	11,691
Domestic deposits by depositor:						
Individuals and corporations	1,671,459	45,649	190,210	225,236	1,210,365	3,015,713
U.S., state, and local governments	73,407	3,978	14,675	11,148	43,606	154,474
Depositories in the U.S.	27,641	414	2,222	2,866	22,139	42,914
Foreign banks and governments	3,964	1	74	306	3,584	8,573
Certified and official checks	8,939	359	1,263	1,381	5,935	17,128
Foreign deposits by depositor:						
Individuals and corporations	267,999	0	244	2,012	265,743	455,523
Depositories in the U.S.	41,250	0	20	30	41,201	50,449
Foreign banks and governments	68,234	0	188	550	67,496	120,574
Certified and official checks	1,139	0	0	0	1,139	1,252
All other deposits	2,561	0	0	9	2,552	11,691
Deposits in domestic offices by type:						
Transaction deposits	367,129	15,481	53,612	43,083	254,953	669,957
Demand deposits	301,767	8,090	31,718	34,252	227,707	516,428
NOW accounts	64,526	7,237	21,527	8,702	27,060	151,197
Savings deposits	785,755	10,525	60,163	106,265	608,802	1,308,555
Money market deposit accounts	535,124	5,712	35,983	68,884	424,545	869,410
Other savings deposits	250,632	4,813	24,180	37,382	184,257	439,144
Time deposits	632,527	24,394	94,670	91,588	421,875	1,260,291
Small time deposits	388,240	17,305	63,841	58,632	248,462	760,232
Large time deposits	244,287	7,089	30,829	32,957	173,413	500,060

Off-balance-sheet items of national banks by asset size
March 31, 2000
(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	2,326	1,180	975	126	45	8,518
Unused commitments	$2,887,700	$90,508	$179,127	$313,743	$2,304,322	$4,064,588
Home equity lines	110,724	358	4,703	8,473	97,190	152,406
Credit card lines	1,673,302	85,839	148,672	257,561	1,181,230	2,207,454
Commercial RE, construction and land	74,596	1,039	6,925	10,471	56,162	139,520
All other unused commitments	1,029,078	3,273	18,827	37,239	969,740	1,565,208
Letters of credit:						
Standby letters of credit	143,093	143	1,483	5,164	136,304	231,877
Financial letters of credit	114,266	90	950	3,766	109,459	191,145
Performance letters of credit	28,827	52	533	1,397	26,844	40,732
Commercial letters of credit	16,554	30	587	730	15,208	26,107
Securities borrowed and lent:						
Securities borrowed	21,046	47	752	4,479	15,768	32,514
Securities lent	76,300	20	1,561	7,221	67,497	471,722
Financial assets transferred with recourse:						
Mortgages—outstanding principal balance	37,175	43	97	5,251	31,784	61,573
Mortgages—amount of recourse exposure	8,380	33	85	531	7,732	14,907
All other—outstanding principal balance	266,917	476	1,396	55,543	209,501	303,665
All other—amount of recourse exposure	15,954	6	128	2,849	12,971	20,033
Spot foreign exchange contracts	308,128	0	13	39	308,077	489,503
Credit derivatives (notional value)						
Reporting bank is the guarantor	44,648	0	15	0	44,634	133,843
Reporting bank is the beneficiary	53,298	0	0	0	53,298	168,149
Derivative contracts (notional value)	13,836,359	31	1,942	43,555	13,790,832	37,631,929
Futures and forward contracts	4,664,453	16	172	5,180	4,659,085	9,992,679
Interest rate contracts	2,257,429	16	133	4,793	2,252,487	5,494,651
Foreign exchange contracts	2,373,955	0	39	388	2,373,529	4,379,710
All other futures and forwards	33,069	0	0	0	33,069	118,319
Option contracts	2,927,799	15	584	9,733	2,917,467	7,671,672
Interest rate contracts	2,322,338	15	584	9,634	2,312,106	5,991,704
Foreign exchange contracts	382,562	0	0	1	382,562	938,881
All other options	222,898	0	1	98	222,799	741,087
Swaps	6,146,162	0	1,171	28,642	6,116,348	19,665,585
Interest rate contracts	5,831,231	0	1,171	27,964	5,802,095	18,674,337
Foreign exchange contracts	253,892	0	0	656	253,236	822,238
All other swaps	61,039	0	0	22	61,017	169,010
Memoranda: Derivatives by purpose						
Contracts held for trading	12,649,927	10	44	6,042	12,643,830	35,695,638
Contracts not held for trading	1,088,486	21	1,883	37,513	1,049,070	1,634,299
Memoranda: Derivatives by position						
Held for trading—positive fair value	150,258	0	5	141	150,112	428,496
Held for trading—negative fair value	148,706	0	0	36	148,671	421,936
Not for trading—positive fair value	4,892	0	16	115	4,761	8,545
Not for trading—negative fair value	8,244	0	7	463	7,773	12,245

Quarterly income and expenses of national banks by asset size
First quarter, 2000
(Dollar figures in millions)

	All national banks	National banks				Memoranda: All commercial banks
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	
Number of institutions reporting	2,326	1,180	975	126	45	8,518
Net income	$11,545	$205	$890	$1,621	$8,829	$19,549
Net interest income	29,110	618	2,617	3,725	22,149	50,079
Total interest income	57,713	1,092	4,750	6,986	44,884	100,347
On loans	44,442	792	3,560	5,274	34,817	74,387
From lease financing receivables	1,681	4	29	78	1,570	2,373
On balances due from depositories	729	10	26	29	665	1,473
On securities	8,811	244	1,031	1,434	6,103	16,939
From assets held in trading account	677	0	1	18	657	2,015
On fed. funds sold & securities repurchased	1,372	43	104	153	1,073	3,159
Less: Interest expense	28,603	474	2,133	3,261	22,735	50,268
On deposits	18,444	444	1,823	1,975	14,202	33,784
Of federal funds purchased & securities sold	3,547	10	119	536	2,883	6,264
On demand notes & other borrowed money*	5,665	21	188	705	4,752	8,894
On subordinated notes and debentures	947	0	3	45	899	1,327
Less: Provision for losses	4,110	31	194	468	3,416	5,781
Noninterest income	24,721	341	1,482	3,102	19,797	38,416
From fiduciary activities	2,579	4	364	223	1,988	5,489
Service charges on deposits	3,749	68	260	390	3,031	5,556
Trading revenue	1,809	3	17	36	1,753	3,855
From interest rate exposures	780	3	16	26	735	1,722
From foreign exchange exposures	733	0	0	1	732	1,340
From equity security and index exposures	282	0	0	7	275	624
From commodity and other exposures	13	0	0	2	11	169
Total other noninterest income	16,585	266	842	2,453	13,024	23,516
Gains/losses on securities	(701)	(2)	(7)	(103)	(588)	(730)
Less: Noninterest expense	31,088	673	2,593	3,764	24,057	51,945
Salaries and employee benefits	12,523	291	1,147	1,283	9,802	22,406
Of premises and fixed assets	3,952	74	303	407	3,169	6,634
Other noninterest expense	14,613	308	1,143	2,075	11,086	22,905
Less: Taxes on income before extraord. items	6,404	69	415	863	5,057	10,506
Income/loss from extraord. items, net of taxes	16	22	(0)	(6)	0	17
Memoranda:						
Net operating income	11,988	185	895	1,698	9,209	20,013
Income before taxes and extraordinary items	17,933	252	1,305	2,490	13,885	30,038
Income net of taxes before extraordinary items	11,529	183	891	1,627	8,829	19,532
Cash dividends declared	6,732	139	505	1,881	4,208	11,568
Net loan and lease losses	3,636	17	192	487	2,940	5,043
Charge-offs to loan and lease reserve	4,585	27	250	608	3,700	6,497
Less: Recoveries credited to loan & lease resv.	949	11	58	121	760	1,454

* Includes mortgage indebtedness

Year-to-date income and expenses of national banks by asset size
Through March 31, 2000
(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	2,326	1,180	975	126	45	8,518
Net income	$11,545	$205	$890	$1,621	$8,829	$19,549
Net interest income	29,110	618	2,617	3,725	22,149	50,079
Total interest income	57,713	1,092	4,750	6,986	44,884	100,347
On loans	44,442	792	3,560	5,274	34,817	74,387
From lease financing receivables	1,681	4	29	78	1,570	2,373
On balances due from depositories	729	10	26	29	665	1,473
On securities	8,811	244	1,031	1,434	6,103	16,939
From assets held in trading account	677	0	1	18	657	2,015
On fed. funds sold & securities repurchased	1,372	43	104	153	1,073	3,159
Less: Interest expense	28,603	474	2,133	3,261	22,735	50,268
On deposits	18,444	444	1,823	1,975	14,202	33,784
Of federal funds purchased & securities sold	3,547	10	119	536	2,883	6,264
On demand notes & other borrowed money*	5,665	21	188	705	4,752	8,894
On subordinated notes and debentures	947	0	3	45	899	1,327
Less: Provision for losses	4,110	31	194	468	3,416	5,781
Noninterest income	24,721	341	1,482	3,102	19,797	38,416
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From foreign exchange exposures	733	0	0	1	732	1,340
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From commodity and other exposures	13	0	0	2	11	169
Total other noninterest income	16,585	266	842	2,453	13,024	23,516
Gains/losses on securities	(701)	(2)	(7)	(103)	(588)	(730)
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Salaries and employee benefits	12,523	291	1,147	1,283	9,802	22,406
Of premises and fixed assets	3,952	74	303	407	3,169	6,634
Other noninterest expense	14,613	308	1,143	2,075	11,086	22,905
Less: Taxes on income before extraord. items	6,404	69	415	863	5,057	10,506
Income/loss from extraord. items, net of taxes	16	22	(0)	(6)	0	17
Memoranda:						
Net operating income	11,988	185	895	1,698	9,209	20,013
Income before taxes and extraordinary items	17,933	252	1,305	2,490	13,885	30,038
Income net of taxes before extraordinary items	11,529	183	891	1,627	8,829	19,532
Cash dividends declared	6,732	139	505	1,881	4,208	11,568
Net loan and lease losses	3,636	17	192	487	2,940	5,043
Charge-offs to loan and lease reserve	4,585	27	250	608	3,700	6,497
Less: Recoveries credited to loan & lease resv.	949	11	58	121	760	1,454

* Includes mortgage indebtedness

Quarterly net loan and lease losses of national banks by asset size
First quarter, 2000
(Dollar figures in millions)

	All national banks	National banks				Memoranda: All commercial banks
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	
Number of institutions reporting	2,326	1,180	975	126	45	8,518
Net charge-offs to loan and lease reserve	$3,636	$17	$192	$487	$2,940	$5,043
Loans secured by real estate	216	1	5	29	181	277
1–4 family residential mortgages	143	0	3	17	122	183
Home equity loans	36	(0)	0	4	32	42
Multifamily residential mortgages	(6)	0	0	(0)	(6)	(5)
Commercial RE loans	31	0	1	7	23	40
Construction RE loans	1	0	0	1	(0)	7
Farmland loans	(12)	(0)	0	0	(12)	(12)
RE loans from foreign offices	23	0	0	(0)	23	23
Commercial and industrial loans	914	6	19	46	844	1,287
Loans to individuals	2,365	10	165	406	1,784	3,283
Credit cards	1,711	4	139	338	1,230	2,389
Installment loans	654	6	26	68	554	894
All other loans and leases	141	0	3	6	131	195
Charge-offs to loan and lease reserve	4,585	27	250	608	3,700	6,497
Loans secured by real estate	311	2	9	38	261	411
1–4 family residential mortgages	175	1	5	21	148	230
Home equity loans	43	0	0	5	38	54
Multifamily residential mortgages	1	0	0	0	0	3
Commercial RE loans	59	0	3	10	46	83
Construction RE loans	7	0	1	2	3	14
Farmland loans	1	0	0	0	0	2
RE loans from foreign offices	25	0	0	(0)	25	25
Commercial and industrial loans	1,100	11	36	60	994	1,638
Loans to individuals	2,967	14	200	496	2,257	4,152
Credit cards	1,995	5	159	393	1,438	2,824
Installment loans	972	9	41	103	819	1,327
All other loans and leases	207	0	5	13	189	296
Recoveries credited to loan and lease reserve	949	11	58	121	760	1,454
Loans secured by real estate	95	2	5	9	79	134
1–4 family residential mortgages	32	1	2	4	26	47
Home equity loans	7	0	0	1	6	12
Multifamily residential mortgages	7	0	0	0	6	8
Commercial RE loans	28	0	2	3	23	43
Construction RE loans	5	0	1	1	4	7
Farmland loans	12	0	0	0	12	14
RE loans from foreign offices	2	0	0	0	2	2
Commercial and industrial loans	186	5	17	14	150	351
Loans to individuals	602	4	35	90	473	868
Credit cards	284	1	20	55	208	435
Installment loans	318	3	15	35	265	433
All other loans and leases	67	0	2	7	58	101

Year-to-date net loan and lease losses of national banks by asset size
Through March 31, 2000
(Dollar figures in millions)

	All national banks	National banks				Memoranda: All commercial banks
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	
Number of institutions reporting	2,326	1,180	975	126	45	8,518
Net charge-offs to loan and lease reserve	3,636	17	192	487	2,940	5,043
Loans secured by real estate	216	1	5	29	181	277
1–4 family residential mortgages	143	0	3	17	122	183
Home equity loans	36	(0)	0	4	32	42
Multifamily residential mortgages	(6)	0	0	(0)	(6)	(5)
Commercial RE loans	31	0	1	7	23	40
Construction RE loans	1	0	0	1	(0)	7
Farmland loans	(12)	(0)	0	0	(12)	(12)
RE loans from foreign offices	23	0	0	(0)	23	23
Commercial and industrial loans	914	6	19	46	844	1,287
Loans to individuals	2,365	10	165	406	1,784	3,283
Credit cards	1,711	4	139	338	1,230	2,389
Installment loans	654	6	26	68	554	894
All other loans and leases	141	0	3	6	131	195
Charge-offs to loan and lease reserve	4,585	27	250	608	3,700	6,497
Loans secured by real estate	311	2	9	38	261	411
1–4 family residential mortgages	175	1	5	21	148	230
Home equity loans	43	0	0	5	38	54
Multifamily residential mortgages	1	0	0	0	0	3
Commercial RE loans	59	0	3	10	46	83
Construction RE loans	7	0	1	2	3	14
Farmland loans	1	0	0	0	0	2
RE loans from foreign offices	25	0	0	(0)	25	25
Commercial and industrial loans	1,100	11	36	60	994	1,638
Loans to individuals	2,967	14	200	496	2,257	4,152
Credit cards	1,995	5	159	393	1,438	2,824
Installment loans	972	9	41	103	819	1,327
All other loans and leases	207	0	5	13	189	296
Recoveries credited to loan and lease reserve	949	11	58	121	760	1,454
Loans secured by real estate	95	2	5	9	79	134
1–4 family residential mortgages	32	1	2	4	26	47
Home equity loans	7	0	0	1	6	12
Multifamily residential mortgages	7	0	0	0	6	8
Commercial RE loans	28	0	2	3	23	43
Construction RE loans	5	0	1	1	4	7
Farmland loans	12	0	0	0	12	14
RE loans from foreign offices	2	0	0	0	2	2
Commercial and industrial loans	186	5	17	14	150	351
Loans to individuals	602	4	35	90	473	868
Credit cards	284	1	20	55	208	435
Installment loans	318	3	15	35	265	433
All other loans and leases	67	0	2	7	58	101

Number of national banks by state and asset size
March 31, 2000

	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	2,326	1,180	975	126	45	8,518
Alabama	24	11	12	0	1	157
Alaska	3	1	0	2	0	6
Arizona	16	7	4	2	3	43
Arkansas	47	16	31	0	0	194
California	85	34	43	6	2	320
Colorado	59	39	17	2	1	188
Connecticut	7	3	4	0	0	24
Delaware	15	4	7	1	3	33
District of Columbia	5	2	3	0	0	6
Florida	83	35	41	7	0	259
Georgia	63	32	29	2	0	339
Hawaii	1	0	1	0	0	10
Idaho	1	0	1	0	0	17
Illinois	203	90	100	9	4	728
Indiana	33	10	17	4	2	157
Iowa	47	25	20	2	0	443
Kansas	106	80	25	1	0	378
Kentucky	58	28	27	3	0	250
Louisiana	19	10	6	1	2	154
Maine	5	1	4	0	0	15
Maryland	17	5	10	2	0	75
Massachusetts	13	5	6	2	0	43
Michigan	36	16	18	1	1	174
Minnesota	135	81	48	4	2	498
Mississippi	20	7	12	1	0	100
Missouri	49	26	19	3	1	365
Montana	18	14	2	2	0	85
Nebraska	89	64	22	3	0	296
Nevada	8	2	2	4	0	29
New Hampshire	6	2	3	0	1	19
New Jersey	24	2	14	7	1	77
New Mexico	17	6	8	3	0	51
New York	63	15	39	8	1	150
North Carolina	10	2	4	1	3	71
North Dakota	18	8	8	2	0	113
Ohio	95	44	37	8	6	220
Oklahoma	112	73	35	4	0	297
Oregon	5	1	3	1	0	45
Pennsylvania	94	25	61	5	3	194
Rhode Island	2	0	0	1	1	6
South Carolina	23	16	6	1	0	79
South Dakota	23	12	9	1	1	102
Tennessee	28	8	17	1	2	197
Texas	374	240	125	6	3	747
Utah	8	2	3	2	1	51
Vermont	9	3	6	0	0	19
Virginia	34	13	18	3	0	147
Washington	15	12	3	0	0	81
West Virginia	26	11	11	4	0	80
Wisconsin	54	26	26	2	0	318
Wyoming	21	11	8	2	0	50
U.S. territories	0	0	0	0	0	18

Total assets of national banks by state and asset size
March 31, 2000
(Dollar figures in millions)

	All national banks	National banks				Memoranda: All commercial banks
		Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	
All institutions	$3,301,883	$59,514	$258,075	$381,661	$2,602,633	$5,847,134
Alabama	47,444	676	2,910	0	43,859	179,228
Alaska	4,417	49	0	4,368	0	5,325
Arizona	49,600	233	1,824	2,919	44,624	53,227
Arkansas	9,133	955	8,178	0	0	25,620
California	167,555	1,757	14,193	19,382	132,224	293,985
Colorado	23,956	1,853	4,218	5,634	12,251	43,091
Connecticut	881	198	682	0	0	3,515
Delaware	85,927	176	2,242	2,518	80,990	132,996
District of Columbia	560	59	500	0	0	671
Florida	23,935	1,951	10,187	11,797	0	54,664
Georgia	19,449	1,568	6,132	11,749	0	152,354
Hawaii	296	0	296	0	0	23,516
Idaho	206	0	206	0	0	2,145
Illinois	237,952	4,666	24,627	32,030	176,629	357,413
Indiana	38,566	519	6,217	5,538	26,293	61,653
Iowa	13,163	1,325	4,616	7,222	0	45,727
Kansas	13,514	3,729	7,537	2,248	0	35,186
Kentucky	24,276	1,822	5,113	17,341	0	51,264
Louisiana	35,166	613	1,241	5,464	27,848	50,704
Maine	1,397	50	1,346	0	0	4,855
Maryland	6,034	314	2,598	3,121	0	44,984
Massachusetts	3,837	253	1,224	2,360	0	91,849
Michigan	18,870	872	4,409	2,445	11,144	129,058
Minnesota	140,855	3,785	11,981	8,953	116,136	161,965
Mississippi	10,047	316	2,998	6,734	0	30,144
Missouri	45,084	1,310	5,836	17,767	20,171	80,695
Montana	3,376	559	344	2,473	0	10,128
Nebraska	16,018	2,966	5,168	7,885	0	28,261
Nevada	20,999	77	330	20,592	0	32,762
New Hampshire	15,080	55	640	0	14,385	24,012
New Jersey	57,179	131	4,678	22,224	30,146	116,454
New Mexico	11,909	303	2,594	9,012	0	15,787
New York	364,961	931	11,442	14,630	337,958	1,178,833
North Carolina	885,193	65	1,819	1,945	881,364	957,602
North Dakota	6,447	314	2,473	3,660	0	11,750
Ohio	256,776	2,109	12,045	17,624	224,999	322,081
Oklahoma	24,363	3,703	6,824	13,836	0	39,945
Oregon	8,335	4	626	7,705	0	15,078
Pennsylvania	153,427	1,412	18,471	12,898	120,646	195,667
Rhode Island	155,203	0	0	6,362	148,841	164,514
South Carolina	4,343	713	1,851	1,779	0	21,690
South Dakota	25,804	436	3,230	6,825	15,313	33,289
Tennessee	63,644	561	4,725	6,310	52,048	84,523
Texas	130,211	11,941	29,809	21,690	66,772	183,178
Utah	27,862	109	624	9,136	17,993	66,598
Vermont	1,910	182	1,728	0	0	7,509
Virginia	12,901	650	4,628	7,624	0	52,798
Washington	1,482	588	893	0	0	14,013
West Virginia	14,068	643	3,039	10,385	0	23,085
Wisconsin	13,242	1,577	7,543	4,122	0	75,853
Wyoming	5,028	436	1,239	3,353	0	8,077
U.S. territories	0	0	0	0	0	47,813

1999 Audited Financial Statements

Chief Financial Officer's Message

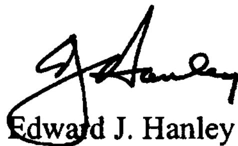
In the next few pages, we are presenting to you OCC's financial statements as of December 31, 1999 and the related independent auditors' reports.

As you can see from reading the statements, and the related footnotes and auditors' reports, OCC has made significant improvements in managing its finances and strengthening its internal controls in 1999:

- our financial statements earned an unqualified "clean" opinion;
- several internal controls initiatives were successful in completely or partially eliminating the material weaknesses that were identified last year by our independent auditors; and
- the auditors did not identify any reportable instances of non-compliance with laws and regulations other than those that we reported ourselves to the Department of the Treasury.

However, much remains to be accomplished in 2000. Plans are under way to procure and install an integrated financial management system to replace our existing legacy systems. We have launched a major effort to improve management accountability across OCC. We have reengineered our funds control process by introducing a more rigorous budget formulation and execution process. Several other efforts will continue to evolve as we progress into 2000.

We are proud of our accomplishments to date and will continue our efforts to strengthen our controls and modernize our processes to better serve our customers and provide accurate and reliable information to our stakeholders.



Edward J. Hanley
Senior Deputy Comptroller and
Chief Financial Officer

OFFICE OF THE COMPTROLLER OF THE CURRENCY
Statement of financial position
As of December 31, 1999

Assets	
Fund balance with Treasury, cash and cash equivalents:	
Fund balance with Treasury	$ 2,454,193
Cash and cash equivalents	6,958,092
Subtotal, fund balance with Treasury, cash and cash equivalents	9,412,285
Receivables:	
Interest receivable	1,459,998
Accounts receivable, net	424,379
Subtotal, receivables	1,884,377
Prepayments	3,169,590
Investments (Note 3)	202,506,847
Property, plant, and equipment, net (Notes 4 and 7)	26,858,621
Total assets	$ 243,831,720
Liabilities and net position	
Accrued expenses	$ 7,490,990
Accounts payable	2,890,561
Accrued payroll and benefits	18,013,767
Accrued annual leave	19,079,836
Post-retirement benefit liability (Note 6)	6,394,746
Total liabilities	53,869,900
Net position (Note 7)	189,961,820
Total liabilities and net position	$ 243,831,720

The accompanying notes are an integral part of these statements

OFFICE OF THE COMPTROLLER OF THE CURRENCY
Statement of operations and changes in net position
For the year ended December 31, 1999

Revenue and Financing Sources	
Assessments	$ 378,562,988
Corporate fees	2,025,886
Investment income	13,040,584
Other	1,685,494
Total revenue and financing sources	395,314,952
Operating expenses	
Personnel compensation and benefits (Note 6)	264,551,179
Travel	27,498,744
Employee relocation expenses	4,680,131
Education and conferences	5,778,463
Rent and communications (Note 5)	31,680,987
Office equipment and software	5,958,112
Contractual services	28,514,987
Depreciation and amortization	3,521,796
Repairs and maintenance	5,284,172
Office supplies	4,235,426
Postage and freight	1,501,762
Printing, reproduction, and other	824,557
Total operating expenses	384,030,316
Excess of revenue and financing sources over operating expenses	11,284,636
Net Position, Beginning of year	
As previously reported	153,805,663
Prior period adjustments (Note 7)	24,871,521
As adjusted	178,677,184
Net Position, End of year	$ 189,961,820

The accompanying notes are an integral part of these statements

OFFICE OF THE COMPTROLLER OF THE CURRENCY
Statement of cash flows
For the year ended December 31, 1999

Cash flows from operating activities	
Excess of revenue over operating expenses	$ 11,284,636
Adjustments affecting cash flow	
Increase in receivables	(1,110,016)
Increase in prepayments	(212,644)
Decrease in accrued expenses	(6,962,150)
Decrease in accounts payable	(4,657,585)
Increase in accrued payroll and benefits	1,708,135
Increase in accrued annual leave	935,646
Increase in post-retirement benefit liability	597,888
Depreciation and amortization	3,521,796
Net cash provided by operating activities	5,105,706
Cash flows from investing activities	
Proceeds from sales of investment securities	541,553,499
Purchases of investment securities	(532,144,772)
Purchases of property, plant, and equipment	(12,667,261)
Net cash used in investing activities	(3,258,534)
Increase in Fund Balance with Treasury, cash and cash equivalents	1,847,172
Fund Balance with Treasury, cash and cash equivalents beginning of the year	7,565,113
Fund Balance with Treasury, cash and cash equivalents end of the year	$ 9,412,285

The accompanying notes are an integral part of these statements

OFFICE OF THE COMPTROLLER OF THE CURRENCY NOTES TO FINANCIAL STATEMENTS

Note 1—Organization

The Office of the Comptroller of the Currency (OCC) was created as a bureau within the Department of the Treasury (the Department) by act of Congress in 1863. The OCC was created for the purpose of establishing and regulating a system of federally chartered national banks. The National Currency Act of 1863, rewritten and reenacted as the National Bank Act of 1864, authorized the OCC to supervise national banks and to regulate the lending and investment activities of these federally chartered institutions.

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 does not receive Congressional appropriations to fund any of its operations.

By federal statute at 12 USC § 481, the OCC's funds are maintained in a U.S. government trust revolving fund. The funds remain available to cover the annual costs of OCC operations in accordance with policies established by the Comptroller of the Currency.

The OCC is a bureau within the Department of the Treasury (the Department). Departmental Offices (DO), another entity of the Department, provides certain administrative services to the OCC. The OCC pays the Department for services rendered pursuant to established interagency agreements. Periodically, payments are made in advance for anticipated services in accordance with instructions from the DO. Administrative services provided by the Department totaled $2,979,362 for the year ended December 31, 1999.

Note 2—Significant Accounting Policies

Basis of Accounting

The accounting policies of the OCC conform to generally accepted accounting principles (GAAP). 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, Cash and Cash Equivalents

Cash receipts and disbursements are processed primarily by the U.S. Treasury. The funds with the U.S. Treasury are available to pay current liabilities. The OCC considers overnight investments to be cash equivalents.

Receivables

Receivables represent monies owed to the OCC for services or goods provided and interest on investments in U.S. Government obligations. Accounts receivables are shown net of an allowance for doubtful accounts of $115,944 as of December 31, 1999. The OCC wrote off receivables totaling $50,959 as uncollectible during 1999.

Liabilities

Liabilities represent the amount of monies 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 in a timely manner in accordance with the Prompt Payment Act. Interest penalties are paid when payments are late. Discounts are taken when cost effective and the invoice is paid by the discount date.

Annual, Sick, and Other Leave

Annual leave is accrued as earned, and the accrual is reduced as leave is taken or paid. 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.

Note 3—Investments

Investments are U.S. Government obligations stated at amortized cost, which is an approximation of the fair value and reflect maturities through May 15, 2006. The OCC plans to hold these investments to maturity.

Premiums and discounts 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, 1999 are as follows:

Investments, at amortized cost	$ 202,506,847
Gross unrealized holding loss	(577,728)
Market value	$ 201,929,119

Investments, at par value, mature as follows:

During 2000	$ 67,800,000
During 2001	30,000,000
During 2002	80,000,000
During 2006	25,000,000

Note 4—Property and Equipment

Property and equipment purchased with a cost greater than or equal to the thresholds below and useful lives of two years or more are capitalized at cost and depreciated or amortized, as applicable:

Type	Threshold
• Furniture, fixtures, machines, equipment, portable computers, motor vehicles, and leasehold improvements	$ 50,000
• Bulk and aggregate purchases	250,000
• Internal use software	500,000

Leasehold improvements are amortized on a straight-line basis over the lesser of the terms of the related leases or their estimated useful lives. All other property and equipment are depreciated or amortized, as applicable, on a straight-line basis over their estimated useful lives.

The following table summarizes property and equipment balances as of December 31, 1999. (See Note 7 regarding prior period adjustments):

Class of assets	Service life (years')	Acquisition value	Accumulated depreciation/ amortization	Net book value
Leasehold improvements	5–20	$ 29,568,324	$ 16,700,608	$ 12,867,716
ADP software	5–10	2,021,763	2,011,038	10,725
Equipment	3–10	11,610,353	6,598,813	5,011,540
Furniture and fixtures	5–10	1,464,212	1,024,147	440,065
Internal Use Software	5	8,528,575	—0—	8,528,575
Totals		$ 53,193,227	$ 26,334,606	$ 26,858,621

Note 5—Leases

The OCC leases office space for headquarters operations in Washington, D.C., and for the district and field operations throughout the United States. The lease agreements expire at various dates through 2008. These leases are treated as operating leases.

Future lease payments are shown in the following table:

2000	$ 22,921,631
2001	22,039,792
2002	20,491,678
2003	18,239,006
2004	14,693,966
Thereafter	18,910,956
Total minimum lease payments	$ 117,297,029

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 $25,086,081 for 1999.

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 prior to 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 election period. Employees hired after December 31, 1983 are automatically 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 $19,330,281 in 1999.

The OCC does not report on its financial statements information pertaining to the retirement plans covering its employees. Reporting amounts such as plan assets, accumulated plan benefits, or unfunded liabilities, if any, are the responsibility of the Office of Personnel Management (OPM).

Other Benefit Plans

The OCC employees are eligible to participate in the Federal Thrift Savings Plan (TSP). For those employees under FERS, a TSP account is automatically established, and the OCC contributes a mandatory 1 percent of basic pay to this account. In addition, the OCC 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 $4,817,021 in 1999. 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 OPM. The OCC contributions for active employees who participate in the FEHB plans were $8,898,397 for 1999. The OCC contributions for active employees who participate in the FEGLI plan were $160,428 for 1999.

The OCC sponsors a life insurance benefit plan for current and former employees. Premium payments made during 1999 totaled $120,370. The following table shows the accrued post-retirement benefit cost for this plan at December 31, 1999 and the post-retirement benefit expenses for 1999:

Accumulated post-retirement benefits obligation	$ (7,736,547)
Fair value of assets	—
Funded status	(7,736,547)
Unrecognized transition obligations	2,246,892
Unrecognized net gain	(905,091)
Accrued post retirement benefit cost	$ (6,394,746)

Net periodic post-retirement benefit cost for 1999

Service cost	$ 285,019
Interest cost	498,487
Amortization of gain	(22,054)
Amortization of transition obligation over 20 years	172,837
Net periodic post-retirement benefit cost	$ 934,289

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.

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 $3,757,436 of workers' compensation costs as of December 31, 1999. 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, 1999:

1. Correction of accounting for lease agreement of the office space in Washington D.C.	$ 22,729,837
2. Correction of accrual for payroll benefits	689,652
3. Correction of accrual for Relocation costs	1,452,032
Total Prior Period Adjustments	$ 24,871,521

1. The correction of accounting for lease agreement of the office space in Washington, D.C. was made to recognize that the lease should have been treated as an operating lease to conform with GAAP. During 1999, OCC performed an analysis of the accounting treatment for the lease agreement and identified that it had been inappropriately treated as a capital lease since inception. The resulting effect of this correction on the Balance Sheet as of December 31, 1998 is a reduction to Property, Plant and Equipment of $76,933,048 and the elimination of the Capital Lease Liabilities of $99,662,885. Furthermore, the effect of not correcting the treatment of this lease agreement would have been an increase in operating expenses for the year ended December 31, 1999 of $2,559,999.
2. The correction of accrual for payroll benefits was made to reverse an excessive accrual made in 1998 for amounts due to OPM regarding employee and retiree benefits.
3. The correction of accrual for relocation costs was made to reverse excessive accruals from 1996 and 1998 for relocation costs that were not incurred.

2001 M Street, N.W.
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, 1999, and the related statements of operations and changes in net position and cash flows 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.

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 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, 1999, 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 April 14, 2000 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. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

KPMG LLP

April 14, 2000

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internal control testing to those controls necessary to achieve the objectives described above. We did not test all internal controls relevant to operating objectives broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion on internal control over financial reporting.

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.

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 I, involving the internal control over financial reporting and its operation that we consider to be reportable conditions. We do not consider these matters to be material weaknesses as defined above. A summary of the status of material weaknesses and other reportable conditions included in our prior year *Independent Auditors' Report on Internal Control Over Financial Reporting* is included as Exhibit II. Management's response to our findings and recommendations is presented following Exhibit II.

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 April 14, 2000.

This report is intended solely for the information and use of the OCC management, 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

April 14, 2000

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, 1999, and have issued our report thereon dated April 14, 2000. 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;
- 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 control, misstatements, losses, or noncompliance 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. We limited our

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Exhibit I

OFFICE OF THE COMPTROLLER OF THE CURRENCY
Reportable Conditions
For the Fiscal Year Ended December 31, 1999

1. Timely reconciliation of the 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) account 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 has not regularly performed reconciliation of its records with Treasury records for fund balance in a timely manner. Reconciliation procedures for the month of May 1999 were not completed until October 1999. We note that OCC improved its performance at year-end, as reconciliation procedures were completed concurrent with the initial closing of the December 1999 general ledger in February 2000.

Not reconciling and documenting the reconciliation of Fund Balance with Treasury on a timely basis could result in errors in the accounting records going undetected. In addition, the absence of such procedures could hinder effective cash management and increase the risk that a misappropriation of funds could go undetected.

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 individuals with appropriate training, skills, and resources. Correction and resolution of reconciling items should be reviewed by appropriate supervisory personnel. Such review should be documented.

2. Policies and procedures are not adequately documented

Finding
The Comptroller's Office lacks adequate written procedures for many of its accounting and financial processes. Although OCC documented procedures in several areas during 1999, we note that as of December 31,1999 many key policies were still in draft versions and in

several areas OCC lacked standard operating procedures that employees could follow in performing their duties. The unwritten institutional knowledge of employees is often relied upon to ensure that transactions are accounted for and reported properly in the financial statements. 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.* Adequate written procedures have not been documented for processing receipts and reconciling OCC records to bank and other third party data for bank assessments ($378 million in 1999), as well as recording of accounts receivable for other goods and services, including receivables from employees.

2. *Payroll and benefits accounting process.* Undocumented payroll and benefits functions include accounting for OCC 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.

   Although OCC documented procedures performed by accounting staff in some payroll areas, we note that OCC has not documented procedures for supervisory review of key payroll accounting processes. Examples of areas for which OCC has not documented procedures for supervisory review include:

   - Reconciliation of general ledger postings of payroll and benefits expenses to NFC payroll data.
   - Calculation of payroll and benefits accruals.

3. *Accounting for property and equipment.* OCC lacks adequate written procedures for many procedures performed in the accounting for property and equipment. For example, although OCC has documented draft policies for bulk purchases of property and equipment, operational procedures are not documented for the identification, processing, and recording of quantity purchases of items that, in aggregate, represent items that must be capitalized under the policy. Without such procedures, assets may be expensed rather than capitalized because individual items with costs above the capitalization threshold can be difficult to recognize as part of a bulk purchase.

4. *Investments Process*. OCC had not documented its policy for and method of designating personnel with authority to approve investment (purchases and redemptions) transactions.

5. *Reconciliation of Fund Balance with Treasury*. OCC had not documented its procedures for reconciliation of its records with Treasury's records for Fund Balance with Treasury.

Recommendation
OCC should develop a comprehensive policies and procedures manual that includes thoroughly written and easily understood desk procedures for all accounting processes. The manual should be updated on a regular basis and include current policies, references to applicable laws and regulations, and step-by-step instructions for processing transactions, obtaining proper approvals, and maintaining supporting documentation.

3. Internal controls over timekeeping were not adequate

OCC did not consistently follow its procedures for timekeeping functions. The following are examples of areas in which procedures for internal controls over timekeeping were not followed:

1. OCC certifying officials did not timely review, approve, and submit timekeeping certifying rosters to timekeeping coordinators. Of the 45 certifying rosters we tested, there were 12 instances in which the certifying rosters were not signed and submitted to timekeeping coordinators in a timely manner. OCC policy states that certifying rosters should be reviewed and returned by the second Friday following the end of the pay period. Untimely review of certifying rosters increases the risk that errors, fraud, or omissions in annual leave, sick leave, comp time, etc. will go undetected.

2. Leave slips were not provided to timekeepers on a timely basis. In our sample of 45 items we noted five instances in which the leave slip for the period was not processed timely, as required by OCC policy. In one of these instances, the employee had a negative leave balance at year-end (contrary to OCC policy) which was not reflected in the NFC system until the following year because of the delay in processing the leave slip. We also noted one instance in which leave was processed in the Time Entry system although the leave slip had not been approved by a supervisor.

OCC's procedures do not describe the method by which leave slips are to be provided to timekeepers or whether leave slips should be reviewed by certifying officers. In the absence of timely recording of leave slips, the risk of employees taking leave without their leave balances being charged is increased. Additionally, leave slips may be processed with errors if not reviewed by a supervisor.

3. OCC has only been performing internal audits of leave for employees separating from OCC. These leave audits are performed by the timekeeper that originally entered the leave data, and only include pay periods since the beginning of the current calendar year in which the employees separated from OCC.

   By performing leave audits only on separated employees, the risk of leave being misstated and not detected is greatly increased. Given the limited scope of the internal audits, errors in prior years would not be detected. Additionally, the practice of having time keepers audit their own work represents a lack of proper segregation of duties and increases the risk that errors or fraud will go unreported.

Recommendation 1

OCC should implement procedures to enforce timely and accurate review of certifying rosters by certifying officials. Examples of internal controls that could be implemented are:

- As part of a periodic payroll quality review process, review a sample of certifying rosters and determine that the rosters reflect the correct type of leave and number of hours as supported by approved leave slips.
- Implement supervisory review of the timeliness of filing of certifying rosters with Time Entry (TE) coordinators. A supervisor should review and document whether TE coordinators are maintaining correct records of submitted certifying rosters and performing timely follow-up of delinquent rosters.
- Require timekeeping coordinators to inform the CFO (or other applicable management position) of delinquent submission of certifying rosters so that timely management follow up action can be taken.

Recommendation 2

OCC should strengthen procedures and internal controls over accounting for personal leave and develop procedures to ensure compliance with policies as follows:

- Supervisors should submit leave slips to timekeepers by noon Monday following the end of a pay period.
- Timekeepers should provide the certifying roster and leave slips to the certifying officers by the end of the second Monday after the pay period.

- Timekeepers should ensure that leave slips submitted without approval are routed to the applicable supervisor for approval.
- OCC should periodically review bi-weekly annual leave slips to determine the leave was properly recorded and approved.

OCC should also enact a policy of requiring leave audits be performed by a person(s) who is not responsible for entering the personal leave data into the system. OCC should consider implementing a policy to periodically perform leave audits for a sample of current employees and timekeepers.

4. Adequate controls over disbursements were not in place

We noted numerous examples of OCC employees failing to follow OCC procedures related to processing of disbursements.

1. OCC does not always properly retain and maintain original Time and Travel Reporting System (TTRS) vouchers. OCC could not locate 7 of 45 original vouchers we requested for review. OCC provided unofficial copies of 4 of the 7 TTRS vouchers by obtaining copies that employees had made for their personal records. OCC needed several weeks to locate many of the remaining TTRS vouchers. Additionally, OCC could not locate one of 45 vendor vouchers we requested for review.

2. In addition to missing documentation, we noted numerous other compliance and accuracy exceptions in our review of disbursement documentation as follows:

   - Certain TTRS vouchers contained an authorized official's signature dated after the expense reimbursement check was issued.
   - Although certain TTRS vouchers included an employee request for a Government Card direct payment to the issuing bank, the payment was made directly to the employee.
   - Certain TTRS vouchers were submitted later than 10 days after expenses were incurred (Violation of page 43 of the OCC Handbook for Travel).
   - Certain TTRS vouchers did not include proper supporting documentation.
   - Certain travel vouchers contained expense calculation errors that were not identified by the approving official (however, the errors were detected and corrected by OCC financial services personnel prior to disbursement).
   - Purchase orders were not included in the voucher package for certain vendor vouchers for district office purchases.
   - Certain vendor vouchers were not stamped with a receipt date.

- Certain vendor vouchers (from the Central District Office) revealed items which were purchased prior to receiving approval.
- Certain vendor voucher packages did not include proper supporting evidence to indicate that goods/services were received.
- Certain vendor vouchers were processed for payment although an approval signature on the Invoice Control Sheet, which is required for a payment to be processed, was missing.
- In testing accounts payable detail one item, out of a sample of 15 items, was erroneously approved and paid for an amount $5,034 greater than the amount of the invoice. OCC recovered these funds after being notified of the error.

Failure to perform key internal control functions puts OCC at risk of failing to prevent and detect errors, fraud, or omissions in travel and vendor disbursements, accounting records, and compliance with laws and regulations.

Recommendations

In order to improve internal control over accounts payable and disbursements, we recommend OCC:

- Develop written desk policies and procedures addressing proper methods for filing and storing documentation at all OCC locations, including the length of time that support should be stored on-site and which employees are responsible for managing storage files; and
- Strengthen its quality control review procedures over TTRS and vendor disbursement processing and accounting functions.

Exhibit II

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Status of Prior Year Findings

1998 Finding	Type	1999 Status
Timely reconciliation of Fund balance with Treasury account with U.S. Treasury records was not performed	1998 – Material Weakness 1999 – Reportable Condition	Although improvements have been made subsequent to fiscal year end, reconciliations during 1999 were not performed timely. This finding has been revised to reflect current operations and included as a non-material reportable condition for 1999.
Account analyses and other significant accounting tasks were not performed and/or were not subject to adequate supervisory review	1998 – Material Weakness 1999 – Other Comments	OCC has made significant improvements in its performance of account analyses and accounting tasks. However, continuing minor weaknesses noted during 1999 indicate continued attention to improvements and timeliness of performance in this area is necessary. This finding has been addressed with specific comments in a separate letter to OCC management.
An adequate process was not in place for review and evaluation of the accounting treatment for unusual or nonroutine financial events	1998 – Material Weakness 1999 – Closed	OCC financial management implemented processes whereby experienced senior management addresses and resolves unusual accounting issues as they arise. As a result, this finding is considered closed.
The OCC lacks adequate written procedures for many of its accounting and financial processes	1998 – Reportable Condition 1999 – Reportable Condition	Although some improvement has been made, this area deserves continued attention. This finding has been revised to reflect current operations and included as a continuing non-material reportable condition for 1999.
Adequate controls and procedures for payment of Prompt Payment Act penalties are not in place	1998 – Reportable Condition 1999 – Other Comment	OCC has made significant improvements in its ability to identify and calculate appropriate Prompt Payment Act penalties, when required. However, continuing minor errors noted during 1999 indicate continued attention to improvements in this area is necessary. This finding has been revised and included as a comment in a separate letter to OCC management.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 3, 2000

KPMG L.L.P.
2001 M Street
Washington, DC 20036

Ladies and Gentlemen:

We have reviewed your draft audit report on OCC's 1999 financial statements. We concur with your findings and appreciate your recommendations for improvements.

Your report recognizes that OCC's internal controls were noticeably strengthened since last year and that the material weaknesses identified during the audit of our 1998 financial statements were completely or partially eliminated. I am pleased to note that these accomplishments resulted from improvement efforts initiated in the fall of 1999. These improvements include adopting a more rigorous funds control process, updating existing accounting policies, reengineering some processes used, and strengthening documentation.

Additional improvements are still underway and more remains to be done to remedy the conditions that still exist in our internal controls. We will soon proceed to develop a corrective action plan that addresses the conditions you have identified.

We are confident that our continuing efforts will result in stronger internal controls for 2000 and thereafter, and we intend to consult with you, during the year, on some of the more significant initiatives that we are undertaking.

Sincerely,

Edward J. Hanley
Senior Deputy Comptroller and
Chief Financial Officer

2001 M Street, N.W.
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, 1999, and have issued our report thereon dated April 14, 2000. 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 no instances of noncompliance with laws and regulations which are required to be reported under *Government Auditing Standards*. However, we noted immaterial instances of noncompliance with laws and regulations that we have reported to management in a separate letter dated April 14, 2000.

Additionally, as a bureau within the U.S. Department of the Treasury, OCC reported three material instances of nonconformance for fiscal year 1999 under the Federal Managers' Financial Integrity Act (FMFIA) and the Federal Financial Management Improvement Act (FFMIA), in its annual assurance statement submitted to Treasury, as follows:

- No formal management accountability program
- No formal system for administrative control of funds
- Non-compliance with the United States Standard General Ledger at the transaction level

This report is intended solely for the information and use of the OCC management, 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

April 14, 2000

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