Comptroller of the Currency
Administrator of National Banks

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The Value of the National Bank Charter

Office of the Comptroller of the Currency

June 2003

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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.

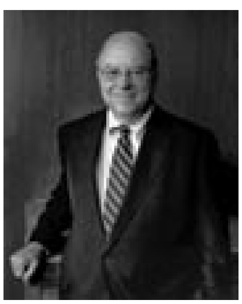
The OCC regulates national banks by its power to:

- Examine the banks;
- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure;
- Take supervisory 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 U.S. 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 $120 a year by writing to Publications—QJ, Comptroller of the Currency, Attn: Accounts Receivable, MS 4-8, 250 E St., SW, Washington, DC 20219.*** The *Quarterly Journal* is on the Web at http://www.occ.treas.gov/qj/qj.htm.

Quarterly Journal

OFFICE OF THE COMPTROLLER OF THE CURRENCY
ADMINISTRATOR OF NATIONAL BANKS

John D. Hawke, Jr.
Comptroller of the Currency

Volume 22, Number 2

June 2003
(First Quarter Data)

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Condition and Performance of Commercial Banks

Summary

Bank income rose again in the first quarter of 2003, as all major income categories—net income, net interest income, and noninterest income—remained near record levels. At national banks, return on assets and return on equity remained just below their all-time highs. In contrast to other recent quarters, however, when strong growth in interest income was the key factor, the biggest contributor this quarter was a decrease in provisions, reflecting improving credit quality at large banks.

Table 1—Lower provisioning boosts net income

National banks	Major income components (Change, $ millions)			
	2001Q1–2002Q1	Percent change	2002Q1–2003Q1	Percent change
Revenues:				
Net interest income	5,279	17.8%	75	0.2%
Realized gains and losses on securities	-136	-29.1	793	n.m.
Noninterest income	1,149	4.6%	1,098	4.2%
Expenses:				
Provisioning	2,900	54.5%	-1,728	-21.0%
Noninterest expense	601	1.9%	1,633	5.0%
Net income	2,077	18.2%	1,618	12.0%

Loan growth continued, particularly in the housing sector, which still benefits from record-low interest rates. The income benefit to banks from the expanding housing-related demand for credit was largely offset by a decline in net interest margins. Risks for banks include the following: in the consumer sector, unemployment and high debt burdens; and in the business sector, continued weakness in manufacturing, financial services, airlines, and some other services.

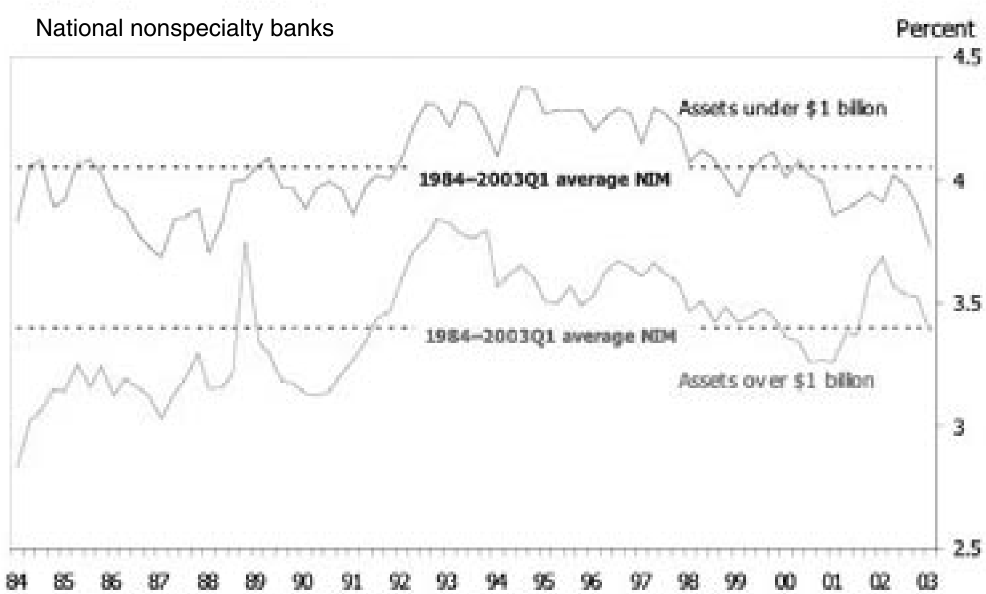
Key Trends

In the first quarter of 2003, all major income categories showed improvement compared to the same quarter of 2002. This time, however, the largest boost to net income came from a decrease in provisions, rather than from an increase in net interest income. Noninterest income continued to rise moderately. Noninterest expense rose, with large banks accounting for nearly all of the increase.

Improvements in credit quality, particularly at large banks, led banks to reduce provisioning expenses. Provisions dropped below charge-offs. Even so, the ratio of reserves against loan losses to noncurrent loans rose, as the nonperforming ratio declined.

Loan quality improved particularly for residential real estate. Business real estate loans showed a slight deterioration. For commercial and industrial (C&I) loans, the noncurrent ratio (noncurrents to total loans in a category) declined from the first quarter of 2002, although the volume of noncurrent loans actually fell. Moreover, the C&I noncurrent ratio improved for loans made to U.S. customers. In contrast, the noncurrent ratio for C&I loans to foreign customers rose again, having more than doubled over the last five quarters. Weakness in foreign economies suggests continuing problems with these loans.

Figure 1—Drop in margin hits net interest income (NIM)



Loan volume continued to rise, driven by the hot market in residential real estate. Over the last five quarters, residential real estate loans have increased at an annual rate of 27 percent at national nonspecialty banks, compared with 5.8 percent for business real estate loans, and minus 1.6 percent for all other loans. Home equity lending has shown particular strength, rising by 23 percent in 2001, 38 percent in 2002, and 37 percent (year-over-year) in the first quarter of 2003. At the same time, credit card lending has slowed to just 2 percent in the first quarter of 2003, suggesting that some homeowners are using home equity loans to pay down credit card debt. The consumer sector, which has kept the economy afloat for the last two years, is showing signs of strain. Persistent unemployment manifests as a rising bankruptcy rate, which now stands at double the level of 10 years ago. This in turn generally leads to an increase in noncurrents and charge-offs for credit cards and other consumer loans.

Net interest margins (NIMs) declined, offsetting the increase in loan volume. NIMs declined at both small and large banks. At large banks (over $1 billion in assets), NIMs had risen dramatically during 2001, coinciding with the sharp drop in short-term interest rates. As large net borrowers in the wholesale funds market, large banks were the big winners from the fall in short-term rates. By 2002, however, competitive pressures were squeezing NIMs, as some borrowers were able to negotiate more favorable terms with their lenders. For large banks, the substantial drop during the first quarter of 2003 returned NIMs to their average level over the last two decades.

In contrast, at small banks (under $1 billion in assets), where NIMs had not risen as far during 2001, the recent decline has pushed NIMs to a 15-year low. NIMs fell for small banks in all regions and in all lines of business. Those small banks with the lowest NIMs have relatively low ratios of core deposits to assets, and the asset side of their balance sheets is skewed toward securities rather than loans.

Deposits continued to flow into banks, as is normal when other investments are not performing well. Deposits grew 10.9 percent year-over-year at large banks, compared with 8.3 percent at small banks. The increase in deposits led to expanded holdings of securities and to healthy loan growth. At large banks, securities on the books grew 19 percent year-over-year, at the same time that loans were growing 6.8 percent.

Large banks continued to displace small banks in the market for residential real estate loans. Until the last two years, the residential real estate portfolios of large and small banks had grown at about the same rate. That changed over the last two years. Large banks expanded their portfolios by 26 percent in 2002 and 29 percent (year-over-year) in the first quarter of 2003; at the same time, small banks have expanded by only about 5 percent annually. Large banks have apparently been able to use their economies of scale, more efficient technologies for the management of smaller transactions, along with their advantages in securitization and hedging to increase their presence in this market.

As large banks have been moving into residential real estate, small banks have been expanding into business lending. At small banks, C&I lending is increasing by about 5 percent annually (it is shrinking at large banks), and business real estate lending by over 15 percent.

Figure 2—Some cities will lag behind the recovery. Metropolitan statistical areas not expecting recovery until 2005 or later.

Small banks face different challenges in different regions. In some cities, defense and other federal spending has propped up the local economy, pulling the area out of recession and improving prospects for local banks. But cities that rely on such industries as autos, machinery, furniture, telecoms, computers, aerospace, airlines, and financial services are still suffering from the effects of worldwide overcapacity and lack of demand. Among the 100 largest metropolitan statistical areas (MSAs), 18 are not expected to recover to their pre-recession employment peaks until 2005; another 23 are not expected to recover until 2006 or later; these 41 MSAs contain 324 small national banks.

Key indicators, FDIC-insured national banks
Annual 1999–2002, year-to-date through March 31, 2003, first quarter 2002, and first quarter 2003
(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q1	Preliminary 2003Q1
Number of institutions reporting	2,365	2,231	2,137	2,077	2,065	2,118	2,065
Total employees (FTEs)	983,212	948,665	966,538	993,469	991,873	972,505	991,873
Selected income data ($):							
Net income	$42,556	$38,901	$44,284	$56,662	$15,092	$13,475	$15,092
Net interest income	114,564	115,909	125,629	141,565	35,102	35,028	35,102
Provision for loan losses	15,554	20,565	28,970	32,643	6,495	8,223	6,495
Noninterest income	92,599	96,109	99,444	109,113	27,254	26,156	27,254
Noninterest expense	125,819	128,547	131,152	136,291	34,395	32,762	34,395
Net operating income	42,380	40,152	43,055	54,510	14,344	13,331	14,344
Cash dividends declared	30,016	32,327	27,743	41,747	10,085	13,266	10,085
Net charge-offs to loan and lease reserve	14,190	17,249	25,147	31,422	6,839	8,184	6,839
Selected condition data ($):							
Total assets	3,271,277	3,414,367	3,635,296	3,908,036	4,001,717	3,570,650	4,001,717
Total loans and leases	2,128,023	2,227,122	2,272,839	2,447,837	2,463,822	2,265,916	2,463,822
Reserve for losses	37,689	40,025	45,576	48,369	48,353	47,852	48,353
Securities	537,319	502,300	575,933	653,159	689,415	571,681	689,415
Other real estate owned	1,572	1,553	1,794	2,072	2,078	1,858	2,078
Noncurrent loans and leases	20,822	27,164	34,589	38,170	36,842	35,628	36,842
Total deposits	2,154,231	2,250,402	2,384,413	2,565,769	2,635,915	2,348,679	2,635,915
Domestic deposits	1,776,084	1,827,064	2,001,253	2,168,879	2,231,407	1,979,950	2,231,407
Equity capital	277,947	293,714	340,734	371,684	376,372	343,964	376,372
Off-balance-sheet derivatives	12,077,568	15,502,911	20,549,785	25,953,462	28,802,626	21,845,782	28,802,626
Performance ratios (annualized %):							
Return on equity	15.55	13.69	13.88	15.84	16.14	15.72	16.14
Return on assets	1.35	1.18	1.26	1.51	1.53	1.50	1.53
Net interest income to assets	3.63	3.50	3.56	3.76	3.55	3.89	3.55
Loss provision to assets	0.49	0.62	0.82	0.87	0.66	0.91	0.66
Net operating income to assets	1.34	1.21	1.22	1.45	1.45	1.48	1.45
Noninterest income to assets	2.94	2.90	2.82	2.90	2.76	2.90	2.76
Noninterest expense to assets	3.99	3.88	3.72	3.62	3.48	3.64	3.48
Loss provision to loans and leases	0.76	0.95	1.28	1.38	1.06	1.45	1.06
Net charge-offs to loans and leases	0.70	0.80	1.11	1.33	1.11	1.44	1.11
Loss provision to net charge-offs	109.61	119.23	115.20	103.89	94.98	100.48	94.98
Performance ratios (%):							
Percent of institutions unprofitable	7.10	6.95	7.44	6.93	5.81	7.74	5.81
Percent of institutions with earnings gains	62.11	66.61	56.81	71.16	57.58	62.09	57.19
Noninterest income to net operating revenue	44.70	45.33	44.18	43.53	43.71	42.75	43.71
Noninterrest expense to net operating revenue	60.73	60.63	58.27	54.37	55.16	53.55	55.16
Condition ratios (%):							
Nonperforming assets to assets	0.70	0.86	1.02	1.06	1.00	1.06	1.00
Noncurrent loans to loans	0.98	1.22	1.52	1.56	1.50	1.57	1.50
Loss reserve to noncurrent loans	181.00	147.34	131.76	126.72	131.25	134.31	131.25
Loss reserve to loans	1.77	1.80	2.01	1.98	1.96	2.11	1.96
Equity capital to assets	8.50	8.60	9.37	9.51	9.41	9.63	9.41
Leverage ratio	7.49	7.49	7.81	7.89	7.89	7.99	7.89
Risk-based capital ratio	11.70	11.84	12.61	12.68	12.85	12.88	12.85
Net loans and leases to assets	63.90	64.06	61.27	61.40	60.36	62.12	60.36
Securities to assets	16.43	14.71	15.84	16.71	17.23	16.01	17.23
Appreciation in securities (% of par)	-2.45	-0.01	0.48	2.12	1.97	0.15	1.97
Residential mortgage assets to assets	20.60	19.60	22.54	24.72	25.07	22.24	25.07
Total deposits to assets	65.85	65.91	65.59	65.65	65.87	65.78	65.87
Core deposits to assets	47.01	45.61	48.07	48.75	48.90	48.39	48.90
Volatile liabilities to assets	34.81	35.18	31.24	30.31	29.73	30.87	29.73

Loan performance, FDIC-insured national banks
Annual 1999–2002, year-to-date through March 31, 2003, first quarter 2002, and first quarter 2003
(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q1	Preliminary 2003Q1
Percent of loans past due 30-89 days:							
Total loans and leases	1.16	1.26	1.38	1.14	1.04	1.26	1.04
Loans secured by real estate (RE)	1.22	1.42	1.42	1.07	1.01	1.20	1.01
1-4 family residential mortgages	1.61	1.95	1.80	1.45	1.29	1.52	1.29
Home equity loans	0.77	1.07	0.98	0.62	0.52	0.64	0.52
Multifamily residential mortgages	0.69	0.59	0.75	0.40	0.56	0.64	0.56
Commercial RE loans	0.70	0.72	0.86	0.58	0.64	0.78	0.64
Construction RE loans	1.07	1.12	1.28	0.91	1.09	1.44	1.09
Commercial and industrial loans	0.71	0.71	0.95	0.76	0.75	1.03	0.75
Loans to individuals	2.36	2.40	2.39	2.16	1.82	1.99	1.82
Credit cards	2.53	2.50	2.51	2.57	2.14	2.36	2.14
Installment loans and other plans	2.24	2.31	2.65	2.08	1.82	1.94	1.82
All other loans and leases	0.50	0.58	0.84	0.56	0.55	0.90	0.55
Percent of loans noncurrent:							
Total loans and leases	0.98	1.22	1.52	1.56	1.50	1.57	1.50
Loans secured by real estate (RE)	0.87	0.93	1.05	0.97	0.98	1.09	0.98
1-4 family residential mortgages	0.91	1.06	1.05	1.02	0.99	1.20	0.99
Home equity loans	0.32	0.41	0.42	0.33	0.31	0.39	0.31
Multifamily residential mortgages	0.43	0.55	0.49	0.44	0.40	0.45	0.40
Commercial RE loans	0.84	0.77	1.03	1.05	1.17	1.05	1.17
Construction RE loans	0.63	0.82	1.15	1.03	0.98	1.13	0.98
Commercial and industrial loans	1.11	1.66	2.44	3.00	2.91	2.62	2.91
Loans to individuals	1.52	1.46	1.58	1.61	1.50	1.57	1.50
Credit cards	2.00	1.90	2.05	2.16	1.96	2.17	1.96
Installment loans and other plans	1.16	1.06	1.41	1.30	1.31	1.23	1.31
All other loans and leases	0.40	0.85	1.18	1.10	1.00	1.07	1.00
Percent of loans charged-off, net:							
Total loans and leases	0.70	0.80	1.11	1.33	1.11	1.44	1.11
Loans secured by real estate (RE)	0.10	0.12	0.26	0.19	0.15	0.20	0.15
1-4 family residential mortgages	0.14	0.14	0.32	0.17	0.16	0.18	0.16
Home equity loans	0.19	0.23	0.35	0.23	0.22	0.26	0.22
Multifamily residential mortgages	0.02	0.03	0.04	0.11	0.04	0.04	0.04
Commercial RE loans	0.03	0.07	0.18	0.17	0.09	0.22	0.09
Construction RE loans	0.03	0.05	0.15	0.19	0.13	0.18	0.13
Commercial and industrial loans	0.54	0.87	1.50	1.80	1.50	1.53	1.50
Loans to individuals	2.65	2.84	3.13	4.02	3.56	5.02	3.56
Credit cards	4.52	4.43	5.05	6.58	5.53	8.90	5.53
Installment loans and other plans	1.27	1.54	1.66	1.91	1.91	1.94	1.91
All other loans and leases	0.93	0.96	1.80	2.53	0.55	0.50	0.55
Loans outstanding ($):							
Total loans and leases	$2,128,023	$2,227,122	$2,272,839	$2,447,837	$2,463,822	$2,265,916	$2,463,822
Loans secured by real estate (RE)	853,141	892,140	976,138	1,139,550	1,160,866	966,516	1,160,866
1-4 family residential mortgages	433,807	443,002	472,719	573,974	578,256	452,662	578,256
Home equity loans	67,267	82,672	102,094	140,998	151,539	110,363	151,539
Multifamily residential mortgages	26,561	28,026	30,075	33,989	34,616	31,200	34,616
Commercial RE loans	214,145	221,267	236,484	253,402	257,864	239,854	257,864
Construction RE loans	71,578	76,899	91,484	95,407	96,515	90,523	96,515
Farmland loans	11,957	12,350	12,615	13,225	13,313	12,728	13,313
RE loans from foreign offices	27,825	27,923	30,668	28,556	28,763	29,186	28,763
Commercial and industrial loans	622,004	646,988	597,212	545,973	539,307	588,241	539,307
Loans to individuals	348,730	370,416	390,420	450,589	434,854	411,692	434,854
Credit cards*	147,275	176,425	167,079	209,936	191,950	187,551	191,950
Other revolving credit plans	na	na	29,259	33,243	32,682	29,690	32,682
Installment loans	201,455	193,991	194,082	207,410	210,222	194,452	210,222
All other loans and leases	306,041	319,144	311,001	314,174	331,333	302,294	331,333
Less: Unearned income	1,893	1,565	1,931	2,449	2,538	2,826	2,538

*Prior to March 2001, credit cards included “Other revolving credit plans.”

Key indicators, FDIC-insured national banks by asset size
First quarter 2002 and first quarter 2003
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1
Number of institutions reporting	1,000	918	951	976	125	125	42	46
Total employees (FTEs)	23,355	21,442	94,490	93,728	107,415	94,139	747,245	782,564
Selected income data ($):								
Net income	$132	$129	$741	$834	$1,647	$1,183	$10,955	$12,946
Net interest income	516	467	2,445	2,462	4,017	3,228	28,049	28,945
Provision for loan losses	31	25	192	184	582	420	7,419	5,865
Noninterest income	196	185	1,282	1,308	2,868	2,312	21,810	23,449
Noninterest expense	507	465	2,505	2,480	3,839	3,384	25,911	28,065
Net operating income	129	122	734	801	1,635	1,155	10,833	12,265
Cash dividends declared	80	53	358	585	570	1,049	12,259	8,398
Net charge-offs to loan and lease reserve	20	17	130	129	562	331	7,472	6,362
Selected condition data ($):								
Total assets	52,563	49,496	250,748	264,451	403,612	377,890	2,863,728	3,309,881
Total loans and leases	31,210	28,901	155,780	163,116	257,676	229,740	1,821,251	2,042,065
Reserve for losses	441	411	2,237	2,386	4,547	3,450	40,628	42,106
Securities	13,103	12,223	61,931	66,472	85,216	81,836	411,431	528,884
Other real estate owned	74	83	256	293	225	229	1,303	1,473
Noncurrent loans and leases	366	376	1,585	1,672	2,599	2,281	31,077	32,513
Total deposits	44,278	41,682	203,499	214,165	260,324	245,626	1,840,578	2,134,441
Domestic deposits	44,278	41,682	202,976	214,057	258,005	242,822	1,474,691	1,732,846
Equity capital	5,929	5,728	25,376	26,798	41,608	40,637	271,050	303,209
Off-balance-sheet derivatives	17	48	1,252	4,601	35,875	19,116	21,939,705	29,062,853
Performance ratios (annualized %):								
Return on equity	8.92	9.09	11.81	12.54	16.32	11.85	16.14	17.16
Return on assets	1.01	1.05	1.19	1.28	1.65	1.27	1.51	1.58
Net interest income to assets	3.95	3.81	3.92	3.76	4.02	3.47	3.87	3.54
Loss provision to assets	0.24	0.21	0.31	0.28	0.58	0.45	1.02	0.72
Net operating income to assets	0.99	1.00	1.18	1.22	1.64	1.24	1.49	1.50
Noninterest income to assets	1.50	1.51	2.06	2.00	2.87	2.49	3.01	2.87
Noninterest expense to assets	3.87	3.79	4.02	3.79	3.84	3.64	3.57	3.43
Loss provision to loans and leases	0.40	0.35	0.49	0.45	0.93	0.75	1.62	1.15
Net charge-offs to loans and leases	0.26	0.24	0.33	0.32	0.90	0.59	1.63	1.25
Loss provision to net charge-offs	155.21	150.31	147.78	143.22	103.46	126.75	99.29	92.20
Performance ratios (%):								
Percent of institutions unprofitable	12.90	9.69	3.26	2.66	2.40	2.40	2.38	4.35
Percent of institutions with earnings gains	53.20	53.49	68.45	60.14	77.60	59.20	83.33	63.04
Nonint. income to net operating revenue	27.52	28.40	34.39	34.69	41.66	41.73	43.74	44.76
Nonint. expense to net operating revenue	71.14	71.32	67.21	65.79	55.76	61.08	51.97	53.57
Condition ratios (%):								
Nonperforming assets to assets	0.84	0.96	0.75	0.75	0.71	0.67	1.15	1.06
Noncurrent loans to loans	1.17	1.30	1.02	1.03	1.01	0.99	1.71	1.59
Loss reserve to noncurrent loans	120.31	109.38	141.09	142.67	174.93	151.25	130.73	129.51
Loss reserve to loans	1.41	1.42	1.44	1.46	1.76	1.50	2.23	2.06
Equity capital to assets	11.28	11.57	10.12	10.13	10.31	10.75	9.46	9.16
Leverage ratio	11.03	11.14	9.46	9.43	9.14	9.24	7.64	7.56
Risk-based capital ratio	18.19	18.44	15.02	15.00	14.92	15.63	12.43	12.38
Net loans and leases to assets	58.54	57.56	61.23	60.78	62.72	59.88	62.18	60.42
Securities to assets	24.93	24.70	24.70	25.14	21.11	21.66	14.37	15.98
Appreciation in securities (% of par)	0.54	2.15	0.51	2.22	0.37	2.43	0.04	1.86
Residential mortgage assets to assets	21.95	21.61	24.52	24.49	27.06	27.55	21.36	24.89
Total deposits to assets	84.24	84.21	81.16	80.98	64.50	65.00	64.27	64.49
Core deposits to assets	70.95	71.55	68.32	68.13	54.94	55.44	45.31	46.28
Volatile liabilities to assets	15.10	14.32	16.82	17.10	24.49	22.19	33.28	31.83

Loan performance, FDIC-insured national banks by asset size
First quarter 2002 and first quarter 2003
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1
Percent of loans past due 30-89 days:								
Total loans and leases	1.56	1.61	1.22	1.22	1.23	1.04	1.26	1.02
Loans secured by real estate (RE)	1.33	1.45	1.02	1.08	0.98	0.88	1.27	1.02
1-4 family residential mortgages	1.50	1.80	1.28	1.43	1.05	1.23	1.63	1.28
Home equity loans	0.55	0.51	0.49	0.48	0.60	0.36	0.65	0.54
Multifamily residential mortgages	0.44	0.62	0.37	0.51	0.51	0.33	0.72	0.61
Commercial RE loans	1.10	1.08	0.78	0.84	0.77	0.58	0.77	0.60
Construction RE loans	1.62	1.43	1.21	1.13	1.48	0.86	1.47	1.12
Commercial and industrial loans	1.82	1.62	1.44	1.32	1.50	1.09	0.95	0.68
Loans to individuals	2.19	2.39	1.93	1.87	1.88	1.82	2.01	1.82
Credit cards	2.20	2.24	3.89	2.98	1.85	2.52	2.41	2.11
Installment loans and other plans	2.23	2.43	1.69	1.70	2.05	1.68	1.94	1.84
All other loans and leases	1.60	1.55	1.35	1.28	0.71	0.64	0.89	0.51
Percent of loans noncurrent:								
Total loans and leases	1.17	1.30	1.02	1.03	1.01	0.99	1.71	1.59
Loans secured by real estate (RE)	1.02	1.17	0.85	0.87	0.79	0.87	1.18	1.00
1-4 family residential mortgages	0.90	0.99	0.75	0.76	0.67	0.87	1.36	1.03
Home equity loans	0.54	0.39	0.34	0.19	0.40	0.28	0.39	0.32
Multifamily residential mortgages	0.87	1.00	0.46	0.37	0.43	0.48	0.45	0.38
Commercial RE loans	1.11	1.23	1.00	1.04	0.99	1.01	1.07	1.24
Construction RE loans	0.92	1.31	0.85	0.77	1.02	0.93	1.21	1.02
Commercial and industrial loans	1.85	1.98	1.60	1.59	1.54	1.48	2.78	3.13
Loans to individuals	0.82	0.83	0.95	0.93	1.31	1.08	1.65	1.57
Credit cards	1.89	1.72	4.03	3.26	1.98	2.15	2.17	1.93
Installment loans and other plans	0.78	0.81	0.52	0.50	0.84	0.79	1.39	1.47
All other loans and leases	1.37	1.51	1.22	1.36	0.53	0.58	1.11	1.01
Percent of loans charged-off, net:								
Total loans and leases	0.26	0.24	0.33	0.32	0.90	0.59	1.63	1.25
Loans secured by real estate (RE)	0.08	0.04	0.09	0.06	0.17	0.08	0.23	0.17
1-4 family residential mortgages	0.05	0.06	0.09	0.07	0.11	0.13	0.21	0.17
Home equity loans	0.02	-0.07	0.06	0.03	0.23	0.08	0.27	0.24
Multifamily residential mortgages	-0.02	0.03	0.03	0.01	0.02	0.05	0.04	0.04
Commercial RE loans	0.17	0.05	0.12	0.05	0.19	0.03	0.25	0.12
Construction RE loans	0.02	0.07	0.03	0.10	0.39	0.01	0.16	0.16
Commercial and industrial loans	0.44	0.65	0.35	0.45	0.91	0.93	1.66	1.62
Loans to individuals	0.88	0.72	1.69	1.67	3.08	2.20	5.56	3.79
Credit cards	4.14	3.53	6.86	6.67	5.25	5.80	9.49	5.50
Installment loans and other plans	0.72	0.62	0.87	0.71	1.32	1.09	2.17	2.14
All other loans and leases	0.18	0.16	0.22	0.27	0.18	0.39	0.54	0.57
Loans outstanding ($):								
Total loans and leases	$31,210	$28,901	$155,780	$163,116	$257,676	$229,740	$1,821,251	$2,042,065
Loans secured by real estate (RE)	18,375	17,406	100,885	108,409	136,770	133,826	710,487	901,225
1-4 family residential mortgages	8,011	7,242	39,005	39,207	63,426	60,030	342,219	471,777
Home equity loans	474	484	4,550	5,633	8,946	10,322	96,392	135,101
Multifamily residential mortgages	446	441	3,779	4,058	5,095	4,905	21,880	25,211
Commercial RE loans	5,621	5,390	38,498	42,539	41,651	41,171	154,083	168,763
Construction RE loans	1,688	1,745	10,639	11,930	15,750	15,278	62,447	67,562
Farmland loans	2,135	2,104	4,411	5,041	1,773	1,671	4,409	4,497
RE loans from foreign offices	0	0	2	0	128	448	29,057	28,314
Commercial and industrial loans	5,270	4,768	27,693	27,347	48,007	42,779	507,270	464,413
Loans to individuals	4,050	3,496	18,092	17,964	50,521	33,988	339,029	379,407
Credit cards	178	122	2,289	2,869	22,298	7,636	162,786	181,323
Other revolving credit plans	67	50	367	345	2,079	1,023	27,177	31,264
Installment loans	3,805	3,323	15,435	14,750	26,144	25,329	149,067	166,820
All other loans and leases	3,562	3,268	9,301	9,584	22,456	19,242	266,974	299,239
Less: Unearned income	47	37	191	187	79	95	2,509	2,220

Key indicators, FDIC-insured national banks by region
First quarter 2003
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting:	230	241	408	426	589	171	2,065
Total employees (FTEs)	291,533	219,581	216,108	64,637	97,272	102,742	991,873
Selected income data ($):							
Net income	$4,278	$3,347	$3,432	$1,068	$1,023	$1,945	$15,092
Net interest income	10,139	7,524	7,794	2,723	2,638	4,284	35,102
Provision for loan losses	2,750	685	1,411	715	206	729	6,495
Noninterest income	9,547	5,024	5,304	2,357	1,808	3,214	27,254
Noninterest expense	10,728	7,229	6,976	2,829	2,891	3,741	34,395
Net operating income	4,136	3,124	3,137	1,043	972	1,933	14,344
Cash dividends declared	2,878	3,568	895	911	770	1,063	10,085
Net charge-offs to loan and lease reserve	3,220	791	1,297	660	176	695	6,839
Selected condition data ($):							
Total assets	1,081,308	995,287	992,302	228,274	295,366	409,180	4,001,717
Total loans and leases	629,227	567,119	633,918	161,812	178,848	292,897	2,463,822
Reserve for losses	17,003	9,039	11,734	3,302	2,549	4,726	48,353
Securities	207,123	164,873	188,129	30,031	65,466	33,793	689,415
Other real estate owned	186	507	770	132	321	162	2,078
Noncurrent loans and leases	13,522	7,561	9,588	1,758	1,898	2,514	36,842
Total deposits	730,874	683,161	603,709	136,305	224,937	256,929	2,635,915
Domestic deposits	467,553	617,712	554,501	131,577	223,437	236,628	2,231,407
Equity capital	104,220	91,166	83,181	25,508	28,632	43,666	376,372
Off-balance-sheet derivatives	10,826,955	15,277,216	1,830,433	7,584	72,135	788,303	28,802,626
Performance ratios (annualized %):							
Return on equity	16.54	14.62	16.71	16.80	14.35	18.17	16.14
Return on assets	1.61	1.36	1.40	1.84	1.39	1.94	1.53
Net interest income to assets	3.82	3.06	3.18	4.69	3.59	4.28	3.55
Loss provision to assets	1.04	0.28	0.58	1.23	0.28	0.73	0.66
Net operating income to assets	1.56	1.27	1.28	1.79	1.32	1.93	1.45
Noninterest income to assets	3.59	2.04	2.16	4.06	2.46	3.21	2.76
Noninterest expense to assets	4.04	2.94	2.85	4.87	3.94	3.74	3.48
Loss provision to loans and leases	1.74	0.49	0.89	1.74	0.46	1.03	1.06
Net charge-offs to loans and leases	2.04	0.56	0.81	1.61	0.40	0.98	1.11
Loss provision to net charge-offs	85.40	86.56	108.75	108.21	117.55	104.92	94.98
Performance ratios (%):							
Percent of institutions unprofitable	6.96	9.54	4.41	4.46	5.26	7.60	5.81
Percent of institutions with earnings gains	63.91	65.98	55.39	51.88	53.14	67.25	57.19
Noninterest income to net operating revenue	48.50	40.04	40.50	46.40	40.66	42.87	43.71
Noninterest expense to net operating revenue	54.49	57.61	53.26	55.70	65.02	49.90	55.16
Condition ratios (%):							
Nonperforming assets to assets	1.33	0.81	1.08	0.83	0.75	0.66	1.00
Noncurrent loans to loans	2.15	1.33	1.51	1.09	1.06	0.86	1.50
Loss reserve to noncurrent loans	125.74	119.56	122.39	187.79	134.26	187.97	131.25
Loss reserve to loans	2.70	1.59	1.85	2.04	1.43	1.61	1.96
Equity capital to assets	9.64	9.16	8.38	11.17	9.69	10.67	9.41
Leverage ratio	8.36	7.05	7.37	9.90	8.06	8.63	7.89
Risk-based capital ratio	13.25	11.86	12.45	14.93	13.32	13.76	12.85
Net loans and leases to assets	56.62	56.07	62.70	69.44	59.69	70.43	60.36
Securities to assets	19.15	16.57	18.96	13.16	22.16	8.26	17.23
Appreciation in securities (% of par)	1.49	1.99	2.01	2.46	2.36	3.33	1.97
Residential mortgage assets to assets	15.18	30.66	27.84	23.35	29.15	28.92	25.07
Total deposits to assets	67.59	68.64	60.84	59.71	76.16	62.79	65.87
Core deposits to assets	35.96	56.42	50.49	53.10	64.25	47.53	48.90
Volatile liabilities to assets	42.63	22.59	25.84	22.62	20.54	33.04	29.73

Loan performance, FDIC-insured national banks by region
First quarter 2003
(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	0.72	1.26	1.26	1.10	1.01	1.04
Loans secured by real estate (RE)	0.89	0.79	1.46	0.77	1.04	0.80	1.01
1-4 family residential mortgages	1.04	1.05	2.11	0.74	1.33	0.90	1.29
Home equity loans	0.44	0.55	0.62	0.30	0.59	0.35	0.52
Multifamily residential mortgages	0.46	0.28	0.68	0.68	1.27	0.10	0.56
Commercial RE loans	0.58	0.45	0.85	0.70	0.72	0.56	0.64
Construction RE loans	0.78	0.31	1.56	1.14	1.06	1.51	1.09
Commercial and industrial loans	0.65	0.46	0.94	1.30	1.03	0.87	0.75
Loans to individuals	1.95	1.49	1.62	1.94	1.76	2.00	1.82
Credit cards	2.15	1.62	1.88	2.01	2.34	2.37	2.14
Installment loans and other plans	2.35	1.58	1.68	1.84	1.79	1.64	1.82
All other loans and leases	0.48	0.24	0.76	0.99	0.80	0.68	0.55
Percent of loans noncurrent:							
Total loans and leases	2.15	1.33	1.51	1.09	1.06	0.86	1.50
Loans secured by real estate (RE)	1.30	0.72	1.43	0.53	0.98	0.44	0.98
1-4 family residential mortgages	1.42	0.60	1.90	0.31	1.09	0.29	0.99
Home equity loans	0.25	0.23	0.43	0.29	0.36	0.18	0.31
Multifamily residential mortgages	0.32	0.31	0.41	0.14	0.93	0.32	0.40
Commercial RE loans	0.85	1.26	1.51	1.03	1.04	0.82	1.17
Construction RE loans	1.05	0.88	1.18	0.67	0.88	0.91	0.98
Commercial and industrial loans	3.62	3.27	2.63	1.40	1.50	2.06	2.91
Loans to individuals	2.25	0.58	0.71	1.62	0.68	1.41	1.50
Credit cards	2.01	1.28	1.62	1.87	1.85	2.04	1.96
Installment loans and other plans	3.76	0.60	0.56	1.00	0.65	0.30	1.31
All other loans and leases	1.18	1.12	0.74	1.17	1.15	0.47	1.00
Percent of loans charged-off, net:							
Total loans and leases	2.04	0.56	0.81	1.61	0.40	0.98	1.11
Loans secured by real estate (RE)	0.14	0.07	0.30	0.04	0.18	0.04	0.15
1-4 family residential mortgages	0.10	0.07	0.36	0.05	0.25	0.05	0.16
Home equity loans	0.05	0.16	0.42	0.10	0.20	0.10	0.22
Multifamily residential mortgages	0.02	0.00	0.03	0.01	0.25	0.00	0.04
Commercial RE loans	0.12	0.03	0.23	0.01	0.03	-0.00	0.09
Construction RE loans	-0.02	0.16	0.13	0.01	0.28	0.02	0.13
Commercial and industrial loans	1.91	1.45	1.42	0.88	0.68	1.33	1.50
Loans to individuals	4.97	1.24	1.98	4.14	1.15	3.98	3.56
Credit cards	5.79	3.98	4.92	5.34	4.25	5.25	5.53
Installment loans and other plans	3.66	1.22	1.38	0.61	1.02	1.46	1.91
All other loans and leases	0.57	0.54	0.62	0.31	0.40	0.38	0.55
Loans outstanding ($):							
Total loans and leases	$629,227	$567,119	$633,918	$161,812	$178,848	$292,897	$2,463,822
Loans secured by real estate (RE)	171,067	313,211	320,108	68,029	113,905	174,545	1,160,866
1-4 family residential mortgages	69,481	178,917	145,586	39,786	45,372	99,115	578,256
Home equity loans	28,690	33,384	51,968	4,440	11,956	21,102	151,539
Multifamily residential mortgages	3,946	7,342	13,703	1,740	3,452	4,433	34,616
Commercial RE loans	35,912	65,363	72,664	14,198	33,764	35,963	257,864
Construction RE loans	7,441	23,074	32,071	4,623	16,420	12,884	96,515
Farmland loans	525	1,869	3,689	3,242	2,941	1,047	13,313
RE loans from foreign offices	25,074	3,262	426	0	0	1	28,763
Commercial and industrial loans	164,098	128,788	143,105	23,574	35,100	44,642	539,307
Loans to individuals	172,577	55,973	82,348	54,128	19,516	50,312	434,854
Credit cards	104,759	415	13,961	39,306	773	32,735	191,950
Other revolving credit plans	20,478	2,902	4,833	526	611	3,332	32,682
Installment loans	47,340	52,655	63,554	14,297	18,131	14,245	210,222
All other loans and leases	123,561	69,259	88,447	16,108	10,460	23,497	331,333
Less: Unearned income	2,076	113	90	25	133	100	2,538

Key indicators, FDIC-insured commercial banks
Annual 1999–2002, year-to-date through March 31, 2003, first quarter 2002, and first quarter 2003
(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q1	Preliminary 2003Q1
Number of institutions reporting	8,580	8,316	8,079	7,887	7,864	8,005	7,864
Total employees (FTEs)	1,657,628	1,670,874	1,701,717	1,745,343	1,750,682	1,719,166	1,750,682
Selected income data ($):							
Net income	$71,507	$70,945	$73,966	$89,926	$24,942	$21,711	$24,942
Net interest income	192,149	203,964	215,138	236,840	59,388	58,416	59,388
Provision for loan losses	21,821	30,019	43,396	48,212	9,519	11,489	9,519
Noninterest income	144,403	153,377	157,030	172,008	44,458	41,399	44,458
Noninterest expense	204,220	216,117	222,295	233,058	59,288	56,045	59,288
Net operating income	71,273	72,534	71,138	85,615	23,520	21,355	23,520
Cash dividends declared	52,082	53,854	54,164	67,512	15,614	19,598	15,614
Net charge-offs	20,378	24,794	36,519	44,564	9,637	11,043	9,637
Selected condition data ($):							
Total assets	5,735,175	6,244,536	6,551,692	7,076,562	7,196,354	6,486,733	7,196,354
Total loans and leases	3,491,755	3,819,569	3,889,482	4,158,343	4,192,058	3,886,420	4,192,058
Reserve for losses	58,772	64,149	72,311	77,033	77,445	74,985	77,445
Securities	1,046,534	1,078,986	1,171,921	1,334,224	1,381,537	1,178,409	1,381,537
Other real estate owned	2,796	2,912	3,565	4,162	4,311	3,808	4,311
Noncurrent loans and leases	33,006	42,945	54,908	60,563	58,895	57,074	58,895
Total deposits	3,831,062	4,179,572	4,377,573	4,689,522	4,778,446	4,338,126	4,778,446
Domestic deposits	3,175,473	3,472,905	3,748,067	4,031,489	4,125,638	3,734,604	4,125,638
Equity capital	479,668	530,601	593,868	647,670	659,184	601,334	659,184
Off-balance-sheet derivatives	34,819,179	40,571,148	45,326,156	56,078,916	61,423,425	46,667,359	61,423,425
Performance ratios (annualized %):							
Return on equity	15.30	14.01	13.12	14.50	15.27	14.53	15.27
Return on assets	1.31	1.19	1.15	1.33	1.40	1.33	1.40
Net interest income to assets	3.51	3.41	3.36	3.51	3.33	3.59	3.33
Loss provision to assets	0.40	0.50	0.68	0.71	0.53	0.71	0.53
Net operating income to assets	1.30	1.21	1.11	1.27	1.32	1.31	1.32
Noninterest income to assets	2.64	2.56	2.45	2.55	2.49	2.54	2.49
Noninterest expense to assets	3.73	3.61	3.47	3.45	3.32	3.44	3.32
Loss provision to loans and leases	0.66	0.82	1.13	1.21	0.91	1.18	0.91
Net charge-offs to loans and leases	0.61	0.67	0.95	1.12	0.92	1.14	0.92
Loss provision to net charge-offs	107.08	121.07	118.83	108.19	98.78	104.04	98.78
Performance ratios (%):							
Percent of institutions unprofitable	7.52	7.34	8.11	6.48	5.63	6.83	5.63
Percent of institutions with earnings gains	62.82	67.33	56.28	72.80	61.27	63.62	61.04
Noninterest income to net operating revenue	42.91	42.92	42.19	42.07	42.81	41.48	42.81
Noninterest expense to net operating revenue	60.68	60.48	59.73	57.00	57.09	56.15	57.09
Condition ratios (%):							
Nonperforming assets to assets	0.63	0.74	0.92	0.94	0.90	0.97	0.90
Noncurrent loans to loans	0.95	1.12	1.41	1.46	1.40	1.47	1.40
Loss reserve to noncurrent loans	178.06	149.37	131.70	127.19	131.50	131.38	131.50
Loss reserve to loans	1.68	1.68	1.86	1.85	1.85	1.93	1.85
Equity capital to assets	8.36	8.50	9.06	9.15	9.16	9.27	9.16
Leverage ratio	7.79	7.70	7.79	7.83	7.86	7.95	7.86
Risk-based capital ratio	12.15	12.12	12.71	12.78	12.98	12.98	12.98
Net loans and leases to assets	59.86	60.14	58.26	57.67	57.18	58.76	57.18
Securities to assets	18.25	17.28	17.89	18.85	19.20	18.17	19.20
Appreciation in securities (% of par)	-2.31	0.20	0.82	2.22	1.97	0.34	1.97
Residential mortgage assets to assets	20.78	20.20	21.64	23.29	23.80	21.60	23.80
Total deposits to assets	66.80	66.93	66.82	66.27	66.40	66.88	66.40
Core deposits to assets	46.96	46.39	48.73	48.68	48.96	49.04	48.96
Volatile liabilities to assets	34.94	34.98	31.46	31.41	30.67	31.48	30.67

Loan performance, FDIC-insured commercial banks
Annual 1999–2002, year-to-date through March 31, 2003, first quarter 2002, and first quarter 2003
(Dollar figures in millions)

	1999	2000	2001	2002	Preliminary 2003YTD	2002Q1	Preliminary 2003Q1
Percent of loans past due 30-89 days:							
Total loans and leases	1.14	1.26	1.37	1.17	1.11	1.26	1.11
Loans secured by real estate (RE)	1.09	1.26	1.31	1.08	1.06	1.16	1.06
1-4 family residential mortgages	1.43	1.72	1.67	1.48	1.33	1.44	1.33
Home equity loans	0.75	0.98	0.91	0.59	0.51	0.62	0.51
Multifamily residential mortgages	0.57	0.55	0.69	0.45	0.53	0.64	0.53
Commercial RE loans	0.69	0.74	0.90	0.68	0.79	0.85	0.79
Construction RE loans	0.98	1.06	1.21	0.89	1.10	1.23	1.10
Commercial and industrial loans	0.79	0.83	1.01	0.89	0.88	1.09	0.88
Loans to individuals	2.33	2.47	2.46	2.22	1.93	2.06	1.93
Credit cards	2.59	2.66	2.69	2.72	2.35	2.50	2.35
Installment loans and other plans	2.18	2.34	2.55	2.09	1.85	1.96	1.85
All other loans and leases	0.54	0.65	0.84	0.59	0.63	0.87	0.63
Percent of loans noncurrent:							
Total loans and leases	0.95	1.12	1.41	1.46	1.40	1.47	1.40
Loans secured by real estate (RE)	0.79	0.81	0.96	0.89	0.90	0.99	0.90
1-4 family residential mortgages	0.82	0.90	0.96	0.93	0.91	1.05	0.91
Home equity loans	0.33	0.37	0.39	0.31	0.29	0.36	0.29
Multifamily residential mortgages	0.41	0.44	0.43	0.37	0.36	0.43	0.36
Commercial RE loans	0.77	0.72	0.96	0.95	1.02	1.01	1.02
Construction RE loans	0.67	0.76	1.06	0.98	0.95	1.06	0.95
Commercial and industrial loans	1.18	1.66	2.41	2.92	2.80	2.62	2.80
Loans to individuals	1.42	1.41	1.48	1.51	1.42	1.48	1.42
Credit cards	2.06	2.01	2.12	2.24	2.10	2.25	2.10
Installment loans and other plans	1.04	0.98	1.21	1.14	1.12	1.10	1.12
All other loans and leases	0.39	0.69	0.96	1.01	0.98	0.90	0.98
Percent of loans charged-off, net:							
Total loans and leases	0.61	0.67	0.95	1.12	0.92	1.14	0.92
Loans secured by real estate (RE)	0.08	0.09	0.19	0.15	0.12	0.15	0.12
1-4 family residential mortgages	0.11	0.11	0.22	0.14	0.13	0.14	0.13
Home equity loans	0.15	0.18	0.27	0.19	0.19	0.20	0.19
Multifamily residential mortgages	0.02	0.03	0.04	0.08	0.03	0.04	0.03
Commercial RE loans	0.03	0.05	0.14	0.15	0.09	0.16	0.09
Construction RE loans	0.04	0.05	0.14	0.17	0.10	0.14	0.10
Commercial and industrial loans	0.58	0.81	1.43	1.76	1.39	1.47	1.39
Loans to individuals	2.32	2.43	2.73	3.34	3.04	3.92	3.04
Credit cards	4.46	4.39	5.12	6.38	5.68	8.00	5.68
Installment loans and other plans	1.04	1.18	1.29	1.46	1.44	1.48	1.44
All other loans and leases	1.02	0.92	1.64	2.32	0.46	0.45	0.46
Loans outstanding ($):							
Total loans and leases	$3,491,755	$3,819,569	$3,889,482	$4,158,343	$4,192,058	$3,886,420	$4,192,058
Loans secured by real estate (RE)	1,510,342	1,673,325	1,800,282	2,068,090	2,109,323	1,809,520	2,109,323
1-4 family residential mortgages	737,110	790,030	810,844	945,822	952,903	792,835	952,903
Home equity loans	102,339	127,694	154,157	214,650	228,675	166,311	228,675
Multifamily residential mortgages	53,168	60,406	64,129	71,939	73,917	65,816	73,917
Commercial RE loans	417,633	466,453	505,866	555,868	567,640	519,113	567,640
Construction RE loans	135,632	162,613	193,059	207,467	212,843	194,427	212,843
Farmland loans	31,902	34,096	35,532	38,064	38,747	36,021	38,747
RE loans from foreign offices	32,558	32,033	36,695	34,280	34,598	34,997	34,598
Commercial and industrial loans	969,257	1,051,992	981,059	911,841	906,515	963,317	906,515
Loans to individuals	558,520	606,716	629,885	703,739	684,477	646,719	684,477
Credit cards*	212,147	249,425	232,899	275,921	250,367	247,830	250,367
Other revolving credit plans	na	na	34,203	38,208	37,545	34,780	37,545
Installment loans	346,373	357,291	362,783	389,609	396,565	364,109	396,565
All other loans and leases	457,309	490,448	481,366	478,073	495,216	470,709	495,216
Less: Unearned income	3,673	2,912	3,110	3,399	3,474	3,845	3,474

*Prior to March 2001, credit cards included "Other revolving credit plans."

Key indicators, FDIC-insured commercial banks by asset size
First quarter 2002 and first quarter 2003
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1
Number of institutions reporting	4,437	4,114	3,178	3,337	310	330	80	83
Total employees (FTEs)	89,372	82,009	297,354	299,397	243,759	243,167	1,088,681	1,126,109
Selected income data ($):								
Net income	$548	$535	$2,478	$2,784	$3,294	$3,100	$15,390	$18,524
Net interest income	2,140	1,977	8,165	8,373	8,627	8,222	39,484	40,815
Provision for loan losses	133	115	681	606	1,223	1,014	9,452	7,784
Noninterest income	526	578	3,124	3,146	5,435	5,075	32,314	35,659
Noninterest expense	1,837	1,783	7,092	7,202	7,958	7,785	39,159	42,517
Net operating income	537	510	2,503	2,682	3,238	2,995	15,077	17,332
Cash dividends declared	353	328	1,346	1,432	2,311	2,888	15,589	10,966
Net charge-offs	78	63	440	423	1,205	872	9,320	8,280
Selected condition data ($):								
Total assets	221,194	209,910	821,197	882,036	896,294	940,913	4,548,047	5,163,495
Total loans and leases	134,816	126,759	533,362	568,749	559,411	566,159	2,658,831	2,930,391
Reserve for losses	1,958	1,877	7,837	8,513	10,228	9,509	54,962	57,545
Securities	53,918	50,094	188,108	203,405	213,961	233,218	722,422	894,819
Other real estate owned	327	336	976	1,221	633	640	1,872	2,114
Noncurrent loans and leases	1,561	1,589	5,282	5,722	6,144	6,146	44,086	45,438
Total deposits	187,753	177,464	671,130	720,808	610,273	638,446	2,868,969	3,241,727
Domestic deposits	187,753	177,464	669,480	719,516	600,183	628,358	2,277,188	2,600,300
Equity capital	23,998	23,460	79,816	86,939	90,171	97,299	407,349	451,486
Off-balance-sheet derivatives	48	126	4,788	8,767	72,031	69,213	46,762,527	61,810,527
Performance ratios (annualized %):								
Return on equity	9.16	9.17	12.54	12.97	14.92	12.95	15.15	16.52
Return on assets	1.00	1.03	1.22	1.28	1.48	1.33	1.34	1.45
Net interest income to assets	3.90	3.80	4.01	3.84	3.87	3.54	3.44	3.18
Loss provision to assets	0.24	0.22	0.33	0.28	0.55	0.44	0.82	0.61
Net operating income to assets	0.98	0.98	1.23	1.23	1.45	1.29	1.31	1.35
Noninterest income to assets	0.96	1.11	1.53	1.44	2.44	2.19	2.82	2.78
Noninterest expense to assets	3.34	3.43	3.48	3.30	3.57	3.35	3.41	3.32
Loss provision to loans and leases	0.40	0.37	0.51	0.43	0.88	0.73	1.42	1.06
Net charge-offs to loans and leases	0.23	0.20	0.33	0.30	0.87	0.62	1.40	1.13
Loss provision to net charge-offs	170.99	184.36	154.63	143.41	101.50	116.23	101.42	94.02
Performance ratios (%):								
Percent of institutions unprofitable	10.30	8.85	2.55	2.13	2.58	1.52	1.25	3.61
Percent of institutions with earnings gains	57.52	55.74	70.74	66.80	75.48	67.58	73.75	66.27
Noninterest income to net operating revenue	19.74	22.63	27.67	27.31	38.65	38.16	45.01	46.63
Noninterest expense to net operating revenue	68.88	69.78	62.82	62.52	56.59	58.55	54.54	55.60
Condition ratios (%):								
Nonperforming assets to assets	0.86	0.93	0.77	0.79	0.76	0.73	1.05	0.95
Noncurrent loans to loans	1.16	1.25	0.99	1.01	1.10	1.09	1.66	1.55
Loss reserve to noncurrent loans	125.43	118.12	148.37	148.78	166.47	154.73	124.67	126.64
Loss reserve to loans	1.45	1.48	1.47	1.50	1.83	1.68	2.07	1.96
Equity capital to assets	10.85	11.18	9.72	9.86	10.06	10.34	8.96	8.74
Leverage ratio	10.62	10.78	9.23	9.26	8.94	9.02	7.40	7.28
Risk-based capital ratio	17.05	17.32	14.20	14.23	14.14	14.52	12.42	12.38
Net loans and leases to assets	60.06	59.49	63.99	63.52	61.27	59.16	57.25	55.64
Securities to assets	24.38	23.86	22.91	23.06	23.87	24.79	15.88	17.33
Appreciation in securities (% of par)	0.48	2.16	0.52	2.18	0.30	2.04	0.29	1.89
Residential mortgage assets to assets	21.55	21.48	23.74	23.34	26.40	27.21	20.28	23.35
Total deposits to assets	84.88	84.54	81.73	81.72	68.09	67.85	63.08	62.78
Core deposits to assets	71.72	71.66	68.27	68.17	55.47	55.25	43.20	43.61
Volatile liabilities to assets	14.66	14.33	17.27	17.24	25.53	24.47	36.04	34.76

Loan performance, FDIC-insured commercial banks by asset size
First quarter 2002 and first quarter 2003
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1	2002Q1	2003Q1
Percent of loans past due 30-89 days:								
Total loans and leases	1.73	1.82	1.29	1.28	1.26	1.17	1.23	1.04
Loans secured by real estate (RE)	1.50	1.60	1.09	1.13	0.99	0.97	1.21	1.02
1-4 family residential mortgages	1.73	1.95	1.39	1.55	1.09	1.11	1.52	1.30
Home equity loans	0.70	0.62	0.55	0.56	0.64	0.45	0.63	0.51
Multifamily residential mortgages	0.61	0.73	0.53	0.50	0.49	0.56	0.73	0.52
Commercial RE loans	1.20	1.30	0.85	0.87	0.88	0.89	0.80	0.65
Construction RE loans	1.61	1.33	1.17	1.11	1.26	1.14	1.23	1.07
Commercial and industrial loans	1.98	1.95	1.52	1.44	1.47	1.33	0.95	0.69
Loans to individuals	2.41	2.54	2.07	2.05	2.08	1.92	2.05	1.90
Credit cards	2.19	2.24	4.65	4.31	2.47	2.80	2.44	2.26
Installment loans and other plans	2.46	2.59	1.81	1.82	1.97	1.70	1.95	1.85
All other loans and leases	1.85	2.07	1.47	1.36	0.86	0.80	0.79	0.52
Percent of loans noncurrent:								
Total loans and leases	1.16	1.25	0.99	1.01	1.10	1.09	1.66	1.55
Loans secured by real estate (RE)	1.01	1.08	0.86	0.86	0.86	0.89	1.08	0.90
1-4 family residential mortgages	0.88	0.98	0.76	0.80	0.83	0.85	1.18	0.94
Home equity loans	0.33	0.29	0.33	0.24	0.38	0.30	0.36	0.30
Multifamily residential mortgages	0.70	0.90	0.52	0.46	0.39	0.34	0.40	0.31
Commercial RE loans	1.13	1.15	0.94	0.94	0.94	1.00	1.07	1.07
Construction RE loans	1.01	1.18	0.99	0.95	1.04	1.06	1.10	0.89
Commercial and industrial loans	1.74	1.86	1.47	1.51	1.79	1.84	2.93	3.16
Loans to individuals	0.95	0.99	0.88	0.99	1.18	0.99	1.63	1.54
Credit cards	1.64	1.36	3.29	3.83	2.11	2.21	2.24	2.05
Installment loans and other plans	0.94	1.00	0.61	0.64	0.71	0.61	1.30	1.31
All other loans and leases	1.26	1.52	1.24	1.30	0.76	0.90	0.88	0.94
Percent of loans charged-off, net:								
Total loans and leases	0.23	0.20	0.33	0.30	0.87	0.62	1.40	1.13
Loans secured by real estate (RE)	0.07	0.04	0.09	0.06	0.14	0.10	0.18	0.15
1-4 family residential mortgages	0.05	0.05	0.07	0.08	0.10	0.11	0.17	0.15
Home equity loans	0.02	0.03	0.04	0.03	0.16	0.14	0.23	0.21
Multifamily residential mortgages	0.04	0.04	0.06	0.03	0.06	0.03	0.03	0.03
Commercial RE loans	0.10	0.04	0.11	0.06	0.15	0.09	0.20	0.11
Construction RE loans	0.09	0.07	0.09	0.06	0.25	0.11	0.11	0.11
Commercial and industrial loans	0.46	0.42	0.50	0.52	1.41	0.94	1.64	1.62
Loans to individuals	0.75	0.69	1.59	1.61	2.84	2.44	4.54	3.34
Credit cards	3.78	3.32	7.54	8.18	5.67	6.30	8.43	5.56
Installment loans and other plans	0.66	0.62	0.83	0.75	1.22	1.12	1.70	1.64
All other loans and leases	0.19	0.22	0.26	0.31	0.40	0.42	0.47	0.48
Loans outstanding ($):								
Total loans and leases	$134,816	$126,759	$533,362	$568,749	$559,411	$566,159	$2,658,831	$2,930,391
Loans secured by real estate (RE)	80,195	76,970	356,598	392,042	315,441	341,114	1,057,286	1,299,197
1-4 family residential mortgages	34,528	31,978	127,699	130,001	123,848	129,537	506,761	661,387
Home equity loans	2,271	2,317	16,100	20,063	19,233	24,448	128,707	181,847
Multifamily residential mortgages	1,840	1,761	12,538	14,494	13,891	14,952	37,547	42,711
Commercial RE loans	24,039	23,469	140,708	158,865	113,175	122,149	241,191	263,157
Construction RE loans	7,307	7,347	44,612	51,459	40,926	44,678	101,581	109,360
Farmland loans	10,210	10,099	14,905	17,130	4,034	4,287	6,873	7,231
RE loans from foreign offices	0	0	36	32	334	1,063	34,627	33,504
Commercial and industrial loans	23,101	21,426	93,834	96,139	113,843	108,544	732,539	680,406
Loans to individuals	16,437	14,265	56,477	53,197	92,853	80,659	480,951	536,356
Credit cards	434	344	6,130	6,007	33,278	20,194	207,989	223,822
Other revolving credit plans	280	233	1,553	1,540	3,653	2,439	29,294	33,333
Installment loans	15,722	13,688	48,794	45,650	55,923	58,027	243,669	279,201
All other loans and leases	15,228	14,203	27,036	27,940	37,734	36,315	390,711	416,759
Less: Unearned income	144	105	584	570	461	473	2,655	2,326

Key indicators, FDIC-insured commercial banks by region
First quarter 2003
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	626	1,081	1,676	2,046	1,752	683	7,864
Total employees (FTEs)	530,484	411,856	340,039	118,188	176,012	174,103	1,750,682
Selected income data ($):							
Net income	$7,705	$5,538	$5,070	$1,591	$1,670	$3,368	$24,942
Net interest income	17,798	12,987	11,700	4,297	4,615	7,990	59,388
Provision for loan losses	4,026	1,188	1,768	864	338	1,334	9,519
Noninterest income	18,173	8,609	7,531	2,738	2,464	4,944	44,458
Noninterest expense	21,197	12,655	10,501	3,968	4,568	6,399	59,288
Net operating income	7,108	5,242	4,717	1,551	1,583	3,318	23,520
Cash dividends declared	4,123	6,167	1,602	1,246	1,056	1,419	15,614
Net charge-offs	4,428	1,357	1,585	773	268	1,226	9,637
Selected condition data ($):							
Total assets	2,440,206	1,627,165	1,473,977	391,522	500,276	763,208	7,196,354
Total loans and leases	1,173,920	991,433	941,015	270,829	301,292	513,568	4,192,058
Reserve for losses	27,296	15,225	16,184	5,238	4,305	9,197	77,445
Securities	488,754	294,136	293,742	65,438	120,526	118,941	1,381,537
Other real estate owned	538	1,119	1,150	372	720	412	4,311
Noncurrent loans and leases	23,397	11,326	13,068	2,922	3,252	4,931	58,895
Total deposits	1,516,422	1,120,154	948,090	268,922	394,865	529,992	4,778,446
Domestic deposits	1,038,882	1,040,997	882,516	264,193	393,332	505,717	4,125,638
Equity capital	211,169	149,818	125,738	42,242	48,818	81,399	659,184
Off-balance-sheet derivatives	43,130,905	15,427,000	1,937,120	10,997	73,967	843,436	61,423,425
Performance ratios (annualized %):							
Return on equity	14.74	14.81	16.32	15.15	13.80	16.84	15.27
Return on assets	1.27	1.38	1.39	1.61	1.35	1.78	1.40
Net interest income to assets	2.94	3.23	3.21	4.35	3.72	4.23	3.33
Loss provision to assets	0.66	0.30	0.49	0.88	0.27	0.71	0.53
Net operating income to assets	1.17	1.30	1.29	1.57	1.28	1.76	1.32
Noninterest income to assets	3.00	2.14	2.07	2.77	1.99	2.62	2.49
Noninterest expense to assets	3.50	3.15	2.88	4.02	3.68	3.39	3.32
Loss provision to loans and leases	1.37	0.48	0.75	1.27	0.45	1.06	0.91
Net charge-offs to loans and leases	1.51	0.55	0.67	1.13	0.36	0.97	0.92
Loss provision to net charge-offs	90.93	87.58	111.52	111.75	126.38	108.83	98.78
Performance ratios (%):							
Percent of institutions unprofitable	7.67	8.23	3.94	3.67	5.94	8.93	5.63
Percent of institutions with earnings gains	66.61	66.70	63.19	55.33	55.71	72.47	61.04
Noninterest income to net operating revenue	50.52	39.86	39.16	38.92	34.81	38.22	42.81
Noninterest expense to net operating revenue	58.93	58.59	54.61	56.41	64.53	49.47	57.09
Condition ratios (%):							
Nonperforming assets to assets	1.03	0.77	0.99	0.84	0.80	0.71	0.90
Noncurrent loans to loans	1.99	1.14	1.39	1.08	1.08	0.96	1.40
Loss reserve to noncurrent loans	116.66	134.43	123.84	179.26	132.39	186.54	131.50
Loss reserve to loans	2.33	1.54	1.72	1.93	1.43	1.79	1.85
Equity capital to assets	8.65	9.21	8.53	10.79	9.76	10.67	9.16
Leverage ratio	7.39	7.50	7.73	9.69	8.52	8.96	7.86
Risk-based capital ratio	13.17	12.08	12.53	14.54	13.93	13.91	12.98
Net loans and leases to assets	46.99	59.99	62.74	67.84	59.36	66.09	57.18
Securities to assets	20.03	18.08	19.93	16.71	24.09	15.58	19.20
Appreciation in securities (% of par)	1.47	2.42	2.04	2.27	2.34	2.23	1.97
Residential mortgage assets to assets	18.09	28.73	26.63	21.77	27.86	24.46	23.80
Total deposits to assets	62.14	68.84	64.32	68.69	78.93	69.44	66.40
Core deposits to assets	34.47	56.51	52.54	60.49	65.67	55.38	48.96
Volatile liabilities to assets	44.31	22.33	26.02	18.91	19.80	26.98	30.67

Loan performance, FDIC-insured commercial banks by region
First quarter 2003
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30-89 days:							
Total loans and leases	1.10	0.89	1.23	1.43	1.30	1.06	1.11
Loans secured by real estate (RE)	1.04	0.87	1.35	1.06	1.21	0.85	1.06
1-4 family residential mortgages	1.23	1.13	1.89	1.00	1.58	1.03	1.33
Home equity loans	0.47	0.50	0.57	0.54	0.59	0.38	0.51
Multifamily residential mortgages	0.27	0.43	0.76	0.62	1.09	0.30	0.53
Commercial RE loans	0.82	0.67	0.96	1.01	0.88	0.56	0.79
Construction RE loans	1.17	0.69	1.43	1.14	1.17	1.37	1.10
Commercial and industrial loans	0.72	0.65	0.99	1.51	1.22	1.09	0.88
Loans to individuals	2.03	1.92	1.61	2.10	1.99	1.87	1.93
Credit cards	2.30	3.81	1.90	2.27	2.18	2.23	2.35
Installment loans and other plans	2.10	1.70	1.66	1.85	2.04	1.56	1.85
All other loans and leases	0.50	0.29	0.82	1.55	1.20	0.67	0.63
Percent of loans noncurrent:							
Total loans and leases	1.99	1.14	1.39	1.08	1.08	0.96	1.40
Loans secured by real estate (RE)	1.00	0.72	1.28	0.66	0.98	0.55	0.90
1-4 family residential mortgages	0.97	0.67	1.61	0.48	1.02	0.32	0.91
Home equity loans	0.23	0.24	0.40	0.31	0.36	0.19	0.29
Multifamily residential mortgages	0.21	0.30	0.45	0.43	0.84	0.23	0.36
Commercial RE loans	0.92	0.97	1.35	0.85	1.05	0.78	1.02
Construction RE loans	0.99	0.77	1.26	0.68	0.86	1.02	0.95
Commercial and industrial loans	4.00	2.57	2.34	1.47	1.51	2.06	2.80
Loans to individuals	1.99	0.93	0.66	1.61	0.75	1.28	1.42
Credit cards	2.19	2.62	1.63	2.02	1.63	1.95	2.10
Installment loans and other plans	2.12	0.69	0.54	0.90	0.73	0.33	1.12
All other loans and leases	1.09	0.95	0.75	1.25	1.45	0.69	0.98
Percent of loans charged-off, net:							
Total loans and leases	1.51	0.55	0.67	1.13	0.36	0.97	0.92
Loans secured by real estate (RE)	0.08	0.08	0.24	0.05	0.15	0.06	0.12
1-4 family residential mortgages	0.06	0.08	0.30	0.06	0.19	0.04	0.13
Home equity loans	0.05	0.16	0.35	0.15	0.18	0.07	0.19
Multifamily residential mortgages	0.01	0.01	0.02	0.03	0.23	-0.01	0.03
Commercial RE loans	0.08	0.06	0.19	0.01	0.06	0.08	0.09
Construction RE loans	0.02	0.08	0.10	0.12	0.20	0.08	0.10
Commercial and industrial loans	1.91	1.16	1.20	0.67	0.62	1.54	1.39
Loans to individuals	3.84	1.90	1.71	3.95	1.08	3.66	3.04
Credit cards	5.93	6.55	4.87	5.64	4.14	5.12	5.68
Installment loans and other plans	2.01	1.16	1.20	0.56	0.94	1.40	1.44
All other loans and leases	0.44	0.45	0.59	0.25	0.43	0.32	0.46
Loans outstanding ($):							
Total loans and leases	$1,173,920	$991,433	$941,015	$270,829	$301,292	$513,568	$4,192,058
Loans secured by real estate (RE)	402,714	580,703	499,470	133,881	194,406	298,148	2,109,323
1-4 family residential mortgages	196,264	273,388	212,207	61,368	74,847	134,829	952,903
Home equity loans	46,626	61,175	72,214	6,826	13,832	28,003	228,675
Multifamily residential mortgages	16,122	15,653	21,262	3,795	5,413	11,672	73,917
Commercial RE loans	91,341	152,928	132,510	37,211	64,358	89,292	567,640
Construction RE loans	20,622	69,060	51,382	12,565	28,899	30,316	212,843
Farmland loans	1,462	5,238	9,415	12,116	7,058	3,458	38,747
RE loans from foreign offices	30,277	3,262	479	0	0	580	34,598
Commercial and industrial loans	290,504	203,582	217,598	43,266	56,705	94,860	906,515
Loans to individuals	279,476	112,930	107,842	64,460	33,651	86,119	684,477
Credit cards	125,971	15,358	14,799	41,730	1,371	51,138	250,367
Other revolving credit plans	21,805	4,334	5,295	664	818	4,628	37,545
Installment loans	131,699	93,238	87,748	22,066	31,462	30,352	396,565
All other loans and leases	203,482	94,564	116,271	29,277	16,796	34,826	495,216
Less: Unearned income	2,255	346	167	55	266	386	3,474

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- to 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.

Recent Licensing Decisions

Change in Bank Control Notices

On March 27, 2003, the OCC posed no objection to a Notice of Change in Bank Control (notice) filed by HSBC Holdings plc (HSBC), London, England, to acquire Household Bank (SB) National Association, Las Vegas, Nevada. The OCC noted in its decision that while it received several public comments on the notice, performance under the Community Reinvestment Act is not one of the statutory factors upon which the OCC may disapprove a notice. [Corporate Decision No. 2003–2; April 2003]

On January 31, 2003, the OCC conveyed its intent not to disapprove the Notice of Change in Bank Control file by LPL Holdings, Inc. to acquire 100 percent of PTC Holdings, Inc., which in turn, owns 100 percent of The Private Trust Company, subject to the condition that LPL comply with its commitments to the OCC. The commitments generally related to maintaining certain capital levels and entering into a formal agreement with the OCC to not deviate from the proposed business plan. [Conditional Approval No. 576, February 2003]

Charters

On January 27, 2003, the OCC conditionally approved Morgan Stanley's application to charter a national CEBA trust bank with the title of "Morgan Stanley Trust, National Association," Wilmington, Delaware. Besides the routine charter conditions, the conditions required the bank to maintain certain capital levels and to seek the OCC's no objection to changes in the bank's business plans or operations. [Conditional Approval No. 575, February 2003]

On February 4, 2003, the OCC conditionally approved The Charles Schwab Corporation's application to charter a national bank with the title of "Charles Schwab Bank, National Association," Reno, Nevada. Besides the conditions normally imposed on charters, the conditions also related to an independent audit function, a risk management function, and lending and investment activity outside the Reno assessment area. [Conditional Approval No. 577, February 2003]

CRA Decisions

On February 11, 2003, the OCC approved an application filed by First National Bank & Trust Company, Beloit, Wisconsin, to purchase certain assets and assume certain liabilities of three Clinton and Darien, Wisconsin, branch offices of Amcore Bank, National Association, Rockford, Illinois. The OCC received one comment after the end of the comment period in connection with the transaction. However, the OCC investigated the concerns and found the proposed transaction was not anti-competitive and was consistent with the Community Reinvestment Act. [CRA Decision No. 115, March 2003]

Operating Subsidiaries

On February 27, 2003, the OCC conditionally approved an application filed by Bank of America, N.A., North Carolina, for its wholly owned operating subsidiary, Banc of America Capital Management, LLC, to hold for limited periods of time limited interests in certain private investment funds for which it serves as investment manager. The conditions related to ensuring proper controls by the bank and supervision by the OCC. [Approval No. 578, March 2003]

On March 17, 2003, the OCC approved an application filed by Bank One, N.A., Chicago, Illinois, to establish an operating subsidiary that will purchase and then sell or license data-processing software that performs functions regarding the charges and payments on a corporate credit card. Specifically, the software enables corporate credit card customers to automatically collect information on corporate card use and then merge the data to generate invoices, and to approve and make payments. [Corporate Decision No. 2003–6, April 2003]

Speeches and Congressional Testimony—January 1 to March 31, 2003

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Of the Comptroller of the Currency

Of the First Senior Deputy Comptroller and Chief Counsel

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on reforming federal deposit insurance, Washington, D.C., February 26, 2003

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

Chairman Shelby, Senator Sarbanes, and members of the committee, I am pleased to have this opportunity to present the views of the Office of the Comptroller of the Currency (OCC) on deposit insurance reform. For almost 70 years, federal deposit insurance has been one of the cornerstones of our nation's economic and financial stability. It has relegated bank runs to the history books and helped our country weather the worst banking crisis since the great depression without significant adverse macroeconomic effects.

Despite this admirable history, there are flaws in our current deposit insurance structure. In fact, efforts to address weaknesses in the system uncovered during the banking and thrift crises of the 1980s and early 1990s have not been entirely adequate to the task. Indeed, the legislation adopted in response to those crises has actually constrained the Federal Deposit Insurance Corporation (FDIC) from taking sensible and necessary actions. This is particularly the case with respect to the FDIC's ability to price deposit insurance in a way that reflects the risks posed by different depository institutions, and to the funds' ability to absorb material losses over the business cycle without causing sharp increases in premiums. Failure to address these issues in the current financial environment poses the danger that the next major domestic financial crisis will be exacerbated rather than ameliorated by the federal deposit insurance system.

In summary, the OCC recommends that

- The FDIC be provided with the authority to implement a risk-based deposit insurance premium system for all banks;
- The current fixed designated reserve ratio (DRR) be replaced with a range to allow the FDIC more flexibility in administering the deposit insurance premium structure over the business cycle;
- Any program of rebates or credits issued when the fund exceeds the upper end of the DRR range take into account the fact that the FDIC and the Federal Reserve already deliver a substantial subsidy to state-chartered banks by absorbing their costs of federal supervision, and that deposit insurance premiums paid by national banks pay, in part, for the supervision of state chartered banks;

- The Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) be merged; and
- Coverage limits on deposits not be increased.

Eliminating Constraints on Risk-Based Pricing

The ability of the FDIC to set premiums for deposit insurance that reflect the risks posed by individual institutions to the insurance funds is one of the most important parts of deposit insurance reform. While current law mandates that the FDIC charge risk-based insurance premiums, it also prohibits the FDIC from charging premiums to any institution in the 1A category—in general, well-capitalized institutions with composite CAMELS ratings of 1 or 2—whenever the reserves of the deposit insurance funds are at or above the designated reserve ratio (DRR) of 1.25 percent of insured deposits. As a result, 91 percent of all insured depository institutions pay nothing for their deposit insurance even though all institutions pose some risk of loss to the FDIC. Moreover, quite apart from the risk that a specific bank might present, banks are not required to pay even a minimum "user" fee for the governmentally provided benefit represented by the deposit insurance system—a benefit without which, as a practical matter, no bank could engage in the business of taking deposits from the public.

A system in which the vast majority of institutions pay no insurance premium forgoes one of the major benefits of a risk-based pricing system—creating an incentive for good management by rewarding institutions that pose a low risk to the insurance funds. A mandated zero premium precludes the FDIC from charging different premiums to banks with different risks within the 1A category, despite the fact that within the 1A category there are banks that pose very different risks to the funds. The FDIC should be free to set risk-based premiums for all insured institutions.

Dampening Procyclicality and Fund Management

Under current law, whenever the reserve ratio of the BIF or SAIF falls below 1.25 percent, the FDIC is required either to charge an assessment rate to all banks high enough to bring the fund back to the DRR within one year, or if that is not feasible, an assessment rate of at least 23 basis points. This sharp rise in premiums, or "cliff effect," is likely to hit banks the hardest when they are most vulnerable to earnings pressure. To avoid creating this procyclical volatility in deposit insurance premiums, it would be preferable to let the funds build in good times and to draw down slightly in bad times.

The OCC supports giving the FDIC the authority to establish a range for the DRR to replace the present arbitrary fixed DRR of 1.25 percent. The FDIC should have the authority to set the range based on its assessment of the overall level of risk in the banking system. We also believe that in establishing the range, the FDIC should provide notice and an opportunity for the public to comment on the proposed range. If a fund falls below the bottom of the range, we believe it would be preferable to allow the FDIC to rebuild the fund gradually to eliminate the 23 basis points "cliff effect." Adoption of a range and elimination of the "cliff effect" would allow the FDIC more flexibility in administering the premium structure and would minimize the likelihood of sharp increases in premiums during economic downturns when banks can least afford them.

If a fund exceeds the upper boundary of the DRR range, the FDIC should be authorized to pay rebates or grant credits against future premiums. While such credits or rebates seem reasonable, there are two principles that should be observed in determining their allocation and use. First, a system of rebates or credits should not undermine the risk-based premium system. Thus, rebates or credits should not be based on an institution's current assessment base. If they were, rebates or credits would lower the marginal cost of insurance. For example, if an institution with a risk-based premium of 3 basis points received a rebate or credit of 2 basis points for each dollar of assessable deposits, its true premium would only be 1 basis point. Another implication of rebates or credits not undermining risk-based premiums is that institutions that paid high insurance premiums in the past because they posed a higher risk to the funds should not receive larger rebates than less risky institutions of the same size. The fact that these high-risk institutions did not fail during that period does not alter the fact that they subjected the funds to greater than average risks. Finally, an institution that is faced with a high premium because of high risk should not be allowed to completely offset that premium with credits.

The second principle is that the payment of rebates and credits should take into account the fact that not all insured institutions receive the same services for their deposit insurance dollars. The FDIC uses proceeds from the deposit insurance funds to cover its own costs of supervising state-chartered banks, and it does not pass these costs on to the banks. In 2001, this amounted to an in-kind transfer from the FDIC to state nonmember banks of over $500 million. During this same time, by contrast, national banks paid over $400 million in assessments to the OCC to cover their own costs of supervision.[1] In a regime under which all institutions were paying premiums, national banks should not be required to pay both for their own supervision and also for a portion of the supervisory costs of their state-chartered competitors. It would be unconscionable for the FDIC to issue credits or rebates to state-chartered banks without first taking into account the subsidy it provides to these banks by absorbing their costs of supervision—a subsidy that is funded in good part by deposit insurance premiums paid by national banks.

Merger of the BIF and the SAIF

One of the most straightforward issues of deposit insurance reform is the merger of the BIF and the SAIF. The financial conditions of thrifts and banks have converged in recent years, as have the reserve ratios of the two funds, removing one of the primary objections to a merger of the funds.

[1] The Federal Reserve pays for its supervision of state member banks out of funds that would otherwise be remitted to the Treasury. Thus, the taxpayer pays for the supervision of state member banks.

As of the third quarter of 2002, the reserve ratio of the BIF was 1.25 percent, while that of the SAIF was 1.39 percent. The reserve ratio of a combined fund would have been 1.28 percent as of the same date. As is described in greater detail below, many institutions now hold some deposits insured by each fund. But under the current structure, BIF and SAIF deposit insurance premiums could differ significantly depending on the relative performance of the two funds, raising the possibility that institutions with similar risks could pay very different insurance premiums. This would unfairly penalize low-risk institutions insured by the fund charging the higher premiums.

In addition, a combined fund would insure a larger number of institutions with broader asset diversification than either fund individually. It would also decrease the exposure of the funds—especially the SAIF—to a few large institutions. Industry consolidation has led to increased concentration of insured deposits in a handful of institutions. As of September 30, 2002, the three largest holders of BIF-insured deposits held 15 percent of BIF-insured deposits. The corresponding share for the three largest holders of SAIF-insured deposits was 18 percent. For a combined fund the figure would have been 14 percent. For all these reasons, merger of the two funds would result in a diversification of risks.

Further, there is significant overlap in the types of institutions insured by the two funds. As of September 30, 920 banks and thrifts, or roughly 10 percent of all insured depository institutions, were members of one fund but also held deposits insured by the other fund, and BIF member institutions held 43 percent of SAIF-insured deposits. Finally, merger of the BIF and the SAIF would undoubtedly result in operational savings as the two funds were combined into one.

Increasing Coverage Limits

The question of deposit insurance coverage limits is a challenging one, in part because it is easy for depositors to obtain full insurance of deposits in virtually unlimited amounts through multiple accounts. Proponents of an increase in coverage assert that it would ease liquidity pressures on small community banks and better enable small banks to compete with large institutions for deposits. However, there is little evidence to support this contention. Over the twelve months ending September 30, 2002, deposits at commercial banks with under $1 billion in assets grew at a healthy 3.8 percent annual rate, while loan volume actually declined. As a result, loan-to-deposit ratios at such institutions fell from 88 percent to 79 percent.

In addition, it is not at all clear that increasing deposit insurance coverage would result in an increase in the deposits of the banking system. One effect could be to cause a shift in deposits among banks. It is far from clear, however, that any such redistribution of existing deposits would favor community banks. Depositors who multiply insurance coverage today by using multiple banks might consolidate their deposits in a single institution if coverage were raised, but there is no way of determining which institutions would be the ultimate beneficiaries when the switching process ended. Moreover, it is quite possible that larger, more aggressive institutions might use the expanded coverage to offer even more extensive governmentally protected investment vehicles to wealthy customers. That could cause an even greater shift of deposits away from community banks and increase liquidity pressures.

For many of the same reasons that we object to an increase in the general insurance limit, we are also concerned about proposals to use the federal deposit insurance system to favor particular classes of depositors such as municipal depositors. Increasing the limit on municipal deposits would not provide municipalities with greater protection—they can already secure their deposits—and it is by no means clear that increasing the deposit insurance limit would result in funds flowing into community banks. In addition, an increase in insured coverage could spur riskier lending because banks would no longer be required to collateralize municipal deposits with low-risk securities.

Conclusion

The OCC supports a merger of the BIF and the SAIF and proposals to eliminate the current constraints on deposit insurance premiums. We also favor elimination of the current fixed DRR and its replacement with a range that would allow the FDIC more flexibility in administering the deposit insurance premium structure. We believe that any credits or rebates issued when the fund exceeds the upper range of the DRR must first take account of the subsidy that state-chartered banks receive as a result of having the costs of their federal supervision absorbed by their federal regulators and the fact that deposit insurance premiums paid by national banks in effect pay for a large portion of this subsidy.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. House Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the Committee on Financial Services, on the proposed revisions to the Basel Capital Accord, Washington, D.C., February 27, 2003

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

Chairman King, Congresswoman Maloney, and members of the subcommittee, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on proposed revisions to the 1988 Capital Accord developed by the Basel Committee on Banking Supervision ("Basel Committee"), and the policy implications and effects these revisions will have on domestic and international banking systems. I welcome the efforts of the subcommittee to focus attention on these critical issues. Given the importance of the U.S. commercial banking system to our domestic economy, it is essential that any regulatory changes that might affect our banking system's financial condition and competitiveness be fully understood and considered by the banking industry, the U.S. Congress, and the American public.

The 1988 accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards for commercial banks in all of the G–10 countries, and has been adopted by most other banking authorities around the world. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions.

Over the past several years, the Basel Committee has been developing a more detailed and risk-sensitive capital adequacy framework to replace Basel I. The OCC and the other U.S. banking agencies expect to revise U.S. risk-based capital regulations to reflect the primary components of the Basel Committee's new capital adequacy framework (Basel II), but before doing so, the agencies will publish proposed revisions for public comment. Let me be absolutely clear about the integrity of this rulemaking process: the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not sign off on a final Basel II framework until we have fully considered all comments received during our notice and comment process, as we would with any domestic rulemaking. If we determine through this process that changes to the proposal are necessary, we will not implement proposed revisions until appropriate changes are made.

The OCC fully supports overhauling the existing capital adequacy framework. The original Capital Accord, groundbreaking when adopted in 1988, has become increasingly obsolete. Moreover, the OCC fully endorses the goals and objectives of Basel II. The Basel Committee's efforts in this regard are to be commended. They have advanced the cause of international cooperation, supervisory competence, effective risk management practices in financial institutions, and the safety and soundness of the global financial system.

Having said that, I should add that significant work remains before the current draft of Basel II can be considered final. Supervisors and bankers, as well as legislators and other interested parties, need to gain a level of comfort that the revised Capital Accord has truly achieved the objectives first enunciated by the committee in 1999. This minimum level of comfort is conditional on achievement of the revised Capital Accord's objectives from both a theoretical as well as a practical perspective.

In working towards finalizing Basel II, we must also be mindful of the risks of excessive complexity. Achieving a level playing field among large international banks has been a principal objective of the Basel Committee since its formation and is a major goal of Basel II. However, the more complex Basel II is, the more difficult it will be to implement it consistently across countries, especially in light of widely varying supervisory structures and approaches. We also need to think carefully about the competitive effects of Basel II on the domestic banking scene. Maintaining an appropriate competitive balance in the United States between our large, internationally active banks, on the one hand, and the thousands of smaller banks and thrift institutions, on the other, is a crucial consideration. Finally, we need to avoid issuing a rule that is so prescriptive in its approach that it would discourage innovation in market practices and advances in risk management. I will address each of these challenges below.

Background

The Basel Committee was established in 1974 by the governors of the central banks of the G–10 countries in the aftermath of disturbances in international currency and banking markets, notably the failure of Bankhaus Herstatt in West Germany. Originally, the Basel Committee focused primarily on cooperation and information sharing among its members. Increasingly, the committee has come to see its role as promoting international harmonization through the issuance of "best practices" papers and the development of supervisory standards to which its members voluntarily agree to adhere. The committee does not have any formal authority, and its standards are not legally binding on its members. The committee's current members are the senior officials of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

One of the most significant efforts of the Basel Committee was the development and issuance of the 1988 Capital Accord (Basel I). Basel I established the framework for the risk-based capital adequacy standards for counter-party credit risk used by all G–10 countries and by most other banking authorities around the world. The first Capital Accord represented an important convergence in the measurement of capital adequacy, a strengthening in the stability of the international banking system, and a removal of a source of competitive inequality arising from differences in national capital requirements.

However, by the late 1990s, the committee realized that Basel I had become outdated. The increased scope and complexity of the banking activities of our largest banking institutions over the last decade, and the unintended consequences of various provisions of the regulations, severely undercut the utility of the Capital Accord. Basel I simply does not provide large, internationally active banks with a meaningful measure of the risks they face or the capital they should hold against those risks.

In commencing the effort to revise its Capital Accord, the Basel Committee adopted five key objectives to guide its efforts:

- The accord should continue to promote safety and soundness in the financial system, and should at least maintain the current overall level of capital in the system.
- The accord should continue to enhance competitive equality.
- The accord should constitute a more comprehensive approach to addressing risks.
- The accord should contain approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's position and activities.
- The accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

The development of Basel II has been a prolonged and often difficult process. The first public document, Consultative Paper No. 1 ("CP–1"), was issued in June 1999. That document provided the framework of Basel II but provided few details. The committee provided additional detail on the specifics of Basel II in its January 2001 issuance of Consultative Paper No. 2 ("CP–2"). Although it was more than 500 pages long, CP–2 still left a number of key issues unaddressed and unresolved. Industry reaction was mixed, with concerns expressed regarding the incompleteness of the proposal, regulatory burden, the treatment of operational risk, and a potential spike in regulatory capital requirements.

Current Basel Proposal

Since the issuance of CP–2, the Basel Committee and its numerous task forces and working groups have been laboring to complete a series of revisions to Basel I. In addition to assessing the comments received on the first two consultative papers, committee staff and principals have made numerous contacts with third parties to understand the nature of the comments and to assess more completely the likely effect of Basel II on measured levels of required regulatory capital, risk management systems, data requirements, supervisory programs, and credit availability.

An important component of the impact assessment has been the Basel Committee's quantitative impact surveys. The committee concluded its third Quantitative Impact Study, known as QIS–3, on December 20, 2002. The objective of the three impact studies has been to assess the impact of Basel II on required capital levels across all Basel-member countries. The individual bank regulatory capital amounts submitted under the impact studies provide indications of whether the committee has met the first key objective for the new Basel Accord—ensuring that the new framework maintains the current overall level of capital in the system. At this point, Basel Committee staff is still analyzing the results of the QIS–3 exercise.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As described by the committee in a July 2002 press release, and subsequently reaffirmed, the remaining timeline for adoption of Basel II is as follows:

- May 2003: Issuance of Consultative Paper No. 3. A three-month comment period is expected for this document.
- December 2003: Finalization of Basel II by the Basel Committee.
- December 2006: Implementation of Basel II.

Forthcoming Consultative Paper No. 3

While work on Consultative Paper No. 3 ("CP–3") continues, we are in a position to describe much of its expected content. The attachment to this written statement provides a summary of the substantive provisions likely to be contained in CP–3. As before, this iteration of the proposed new accord will have three mutually reinforcing "pillars" that comprise the framework for assessing bank capital adequacy. The first pillar of the new accord is the minimum regulatory capital requirement. The Pillar 1 capital requirement includes a credit risk charge, measured by either a standardized approach or one of the new internal ratings–based ("IRB") approaches (foundation or advanced), an operational risk charge, and a market risk charge. Again, the attached document provides a more detailed description of the various components of the Pillar 1 charge.

Pillar 2 addresses supervisory review. It is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 should also be seen as a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the committee is proposing a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the advanced IRB approach, the new accord will require a significant increase in the level of disclosure. In essence, the trade-off for greater reliance on a bank's own assessment of the building blocks of capital adequacy is greater transparency.

U.S. Implementation Actions

It is important to recognize that the Basel Accord is not self-executing in the United States. Even when adopted by the Basel Committee, the revised Basel Accord will not apply to U.S. institutions unless and until the U.S. banking agencies adopt regulations to implement it. In accordance with the Administrative Procedure Act, 5 USC 551, et seq., the U.S. banking agencies must publish notice and seek comment from all interested persons on any such proposal, and must fully consider those comments, before adopting a new capital regulation in final form. Obviously, the OCC and the other federal banking agencies intend to fully comply with these requirements. We believe that the solicitation and assessment of comments is a critical step in determining the workability and effectiveness of Basel II and related domestic capital regulations.

This summer, the U.S. banking agencies expect to issue an advance notice of proposed rulemaking ("ANPR") soliciting comment on proposed revisions to the existing domestic capital adequacy regulations that would implement Basel II. The ANPR, which would be largely based on CP–3, would provide a description of proposed revisions to current capital regulations, seeking comment on outstanding or contentious issues, a draft of qualifying criteria for those banks seeking to make use of the advanced methodologies set forth in Basel II (i.e., the Advanced IRB approach for credit risk and the Advanced Measurement approaches ("AMA") for operational risk), and supervisory guidance articulating general supervisory expectations. Recognizing that CP–3 will likely be as lengthy and complex as its predecessors, we understand the importance of U.S. banks being able to review and comment on U.S. implementing documents as soon as practicable. By describing these concepts within the context of our existing regulatory and supervisory regime, this ANPR will provide a meaningful forum for a dialogue on Basel II.

After fully assessing comments generated during the ANPR process, the U.S. banking agencies will develop specific regulatory language for a full notice of proposed rulemaking ("NPR"). In order to meet the aggressive timeline for the adoption of Basel II, the agencies anticipate issuing the NPR in the fourth quarter of 2003. Again, the banking industry and other interested parties will have a full opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

I want to focus on two important unique features of the U.S. regulatory capital regime that will be highlighted in the ANPR and NPR—the scope of application of Basel II and the content and structure of the proposed revisions to the capital adequacy regulations. First, the U.S. expects to set forth in the ANPR definitive criteria for identifying which banks in the United States will be subject to the new accord. In 1988, despite language in the Capital Accord that permitted a more limited application, U.S. banking and thrift agencies applied the Basel framework to *all* U.S. insured depository institutions. As we will highlight in the forthcoming ANPR, the U.S. agencies have determined to apply Basel II concepts more narrowly. Specifically, proposed regulatory text incorporating Basel II concepts will apply on a mandatory basis only to large, internationally active institutions that compete on a significant global basis with other financial service providers. Other institutions will have the opportunity to voluntarily opt into the Basel framework upon application to, and approval by, their primary federal supervisor.

Preliminary analysis by the U.S. agencies suggests that under the narrow approach we are proposing, there are currently fewer than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. Of course, the approach of requiring only a small population of banks to comply with Basel II will be subject to notice and comment in the ANPR and will be definitively resolved only after the U.S. rulemaking process has been completed.

Second, in developing revisions to existing capital adequacy regulations, U.S. banking agencies recognize that the revised regulation, and interagency implementation policy, need not follow the literal structure and language of Basel II. While consistent with the objectives, general principles, and core elements of the revised Basel Accord, the language, structure, and degree of detail of U.S. implementing documents could be very different from Basel II. These implementation differences are reflective of the particular statutory, regulatory, and accounting structures and practices in place in the United States, including, for example, regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As is described more fully in the attachment, the U.S. agencies will likely propose for notice and comment a Basel II-based regime incorporating the Advanced IRB approach for credit risk, the AMA for operational risk, and the internal ratings approach for market risk.

As noted above, we believe that the solicitation and careful consideration of comments is a critical step in the overall assessment of Basel II and related domestic capital regulations. U.S. banking agencies will work within the Basel Committee to ensure that comments by U.S. banks or other interested persons are appropriately taken into account prior to the finalization of Basel II.

Status of Basel Proposal—Outstanding Issues

Despite the protracted nature of Basel II deliberations, significant issues remain, and the aggressive timeline for implementation of Basel II noted earlier will almost certainly be under pressure.

In commencing an objective assessment of the status of Basel II, it is important to reiterate and reaffirm the commendable work of the Basel Committee, and in particular, the strong and intelligent leadership of its chairman, William McDonough, president of the Federal Reserve Bank of New York. The OCC strongly supports the objectives of Basel II. These objectives, restated above, constitute a sound conceptual basis for the development of a new regulatory capital regime and should continue to serve as a useful benchmark to gauge our progress in this effort.

While theoretically sound, the concepts underlying Basel II present significant implementation challenges. Those concepts have their foundation in modern financial theory. However, some of the concepts, such as the advanced IRB approach for credit risk and the AMA for operational risk, are untested, with only limited industry practice to substantiate their practicality. Agency staffs have worked diligently but have not yet achieved a necessary level of comfort with the effectiveness of many of these Basel concepts in application. Moreover, the agencies have not fully assessed the effect of Basel II on bank regulatory capital, risk management systems, data requirements, supervisory programs, and credit availability. For example, there is an obvious tension between the objectives of maintaining the current overall level of capital in the banking system, on the one hand, and, on the other, providing an inducement to banks to lower their capital by investing in more refined risk measurement systems. A discussion of some of the specific unresolved implementation issues is provided below.

Complexity

Perhaps the most important objective for Basel II enumerated by the Basel Committee is that the accord should promote approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's balance sheet and activities. This desire for risk sensitivity has led to a proposal that focuses on a bank's own determination of risk. Reliance on internal determinations of risk for capital adequacy, however, is a radical departure from Basel I and mandates changes in the way we structure the capital framework. In order for external stakeholders—shareholders, creditors, and supervisors—to have confidence in the capital numbers produced by the proposed system, bank internal risk determinations will have to be verifiable. Much of the material developed as part of the Basel II process seeks to specify expectations for rating systems, control mechanisms, audit processes, data systems and other internal bank processes in an attempt to gain comfort with the reliability of internal determinations of risk by individual banks. The challenge for supervisors, however, is to create a verifiably accurate system that does not at the same time stifle innovation in risk management and that takes into account practical cost/benefit considerations.

I have consistently expressed profound concern about the level of detail and specificity of the Basel proposal. In my view, the complexity generated in Basel II goes well beyond what is reasonably needed to implement sensible capital regulation. CP–2 reflected a desire to develop encyclopedic standards for banking systems that minimizes the role of judgment or discretion by those applying or overseeing the new rules. While the intent of such prescriptiveness is to promote consistency and uniformity in the application of Basel II, this approach is highly problematic, especially in the rapidly changing financial landscape that confronts both financial institutions and supervisors. It must be recognized that credit risk management is continuing to evolve in the financial services industry. Banks currently use a variety of different approaches to estimating appropriate capital levels and no "best practice" has yet emerged.

A highly detailed capital rule may make it easier to compare banks' capital numbers. But it may not be possible, or even desirable, for the Basel Committee to craft a capital rule that prescribes to the same level of detail a uniform set of risk management systems and processes that each individual bank would be expected to put into place. Our large banks are not homogeneous entities—their operations and business strategies vary significantly. A highly detailed and prescriptive rule that would apply to every large bank may have unintended consequences. And while we do not know the magnitude of the cost of attempting to implement such a prescriptive rule, we do know that there will be costs. One cost will be the burden on banks of conforming their current systems and processes to what is required under the new rule. A related cost is that we may lock banks into a particular way of measuring risk that may, ultimately, prove to be inferior to, as yet, undiscovered techniques.

We should remember that Pillar 2 and Pillar 3 were introduced precisely because of recognition by the committee of the limitations of Pillar 1's formulaic approach to determining capital requirements. Pillars 2 and 3 offer complementary sources of discipline over bank risk taking. In short, with more modest expectations concerning the need for precision under Pillar 1 come more modest demands for prescriptiveness.

While much is still unclear about the issues that will determine the correct balance between prescriptiveness and flexibility in the proposed capital reform, I offer three guiding principles. First, the capital rule that we implement must respect the evolutionary nature of risk management. As regulators we must acknowledge that we are still in the relative early days of credit risk measurement and we must recognize the inevitability of further innovation. We are about to propose a capital rule that will require banks to devote significant resources to developing and implementing complex measurement systems, data systems, and control structures. While we believe that some amount of additional expenditure for those purposes is justifiable on the basis of a new approach to regulatory capital requirements, we recognize that there will be a limit to that justification. And one factor that contributes to that limit is the possibility that banks will want to change those systems and structures in response to improvements in risk measurement technology.

Second, Basel reform should, in our view, be more principles-based than is suggested by the level of detail in the Basel documents. Attempting to regulate a bank's internal capital assessments, a complex and evolving field, by issuing detailed and prescriptive rules will most likely create an environment in which banks are constantly developing new instruments and practices not anticipated by the rules. The concern about the complexity of Basel II is similar to the current debate on possible improvements to the U.S. financial reporting system, especially as it relates to the

[1] See section 108(d), Sarbanes–Oxley Act, Public Law No. 107–204 (January 23, 2002)

[2] See Written Statement, Robert K. Herdman, chief accountant, U.S. Securities and Exchange Commission, before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives (February 14, 2002).

U.S. accounting standards process. As you know, in the Sarbanes–Oxley Act, Congress required the Securities and Exchange Commission (SEC) to study the adoption of a system of principles-based accounting standards.[1] In recent testimony,[2] the chief accountant of the SEC described the rules-based versus principles-based accounting standards debate in the following way: "Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting." A principles-based accounting standard "requires financial reporting to reflect the economic substance, not the form, of the transaction. . . . Principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues."

Third, regardless of the degree of specificity of the proposal, the document must be written in a manner that is understandable to the institutions that are expected to implement it, and to third parties, without regard to the complexity of the subject matter. It is imperative that the industry and other interested parties understand the proposed regulatory requirements and appreciate the supervisory expectations, if they are to provide a meaningful assessment of the consequences of the proposal. It is also imperative that any final capital rule be understandable by banks and supervisors in order to minimize unnecessary regulatory burden due to misunderstandings and confusion. And finally, given the importance of disclosure under Pillar 3 in reinforcing the efficacy of capital regulation and supervision, it is imperative that outside stakeholders in banks understand the operation of capital requirements.

Competitive Equality

The second stated goal of the Basel Committee in developing Basel II was that "the accord should continue to enhance competitive equality." Despite QIS–3 and other similar efforts, however, we are not in a position to definitively assess the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. We are particularly concerned that Basel II may create or exacerbate relative advantages between domestic banks and foreign banks, between banks and nonbanks, and between large domestic banks and mid-size/small domestic banks. It is imperative that the U.S. banking agencies remain sensitive to these concerns and assess, to the extent possible, any unintended consequences resulting from the implementation of Basel II.

One of the primary objectives of the Basel Committee itself is the reduction of gaps and differences in international supervisory coverage by national supervisory agencies, especially as it relates to large internationally active banks that compete on a significant global basis with other financial service providers. This principle of competitive equality and a level playing field for international banks is an admirable one and an appropriate goal of the committee's efforts. Yet one must question whether the exceedingly complex and highly prescriptive approach to capital reflected in Basel II will truly foster competitive equality.

Global rules, no matter how carefully weighed and measured, are not a satisfactory substitute for judgment, especially in a field like financial risk management, where the state of the art is constantly in flux. In the United States, we have a highly developed—some say intrusive—system of bank supervision. For example, the OCC has full-time teams of resident examiners on site at our largest bank—as many as 20 to 30 examiners at the very largest. In addition, most U.S. institutions are also subject to holding company supervision by the Federal Reserve, and in some cases by the FDIC and state supervisors. In other countries, by contrast, supervision may rely less on bank examiners, as we know them, and more on outside auditors to perform certain oversight functions. Given such disparities in the methods of supervision, I submit that U.S. banks are more likely to be subjected to more vigorous enforcement of a set of complex and prescriptive rules and less likely to be the beneficiaries of permissive exceptions, than banks in countries whose supervisory practices fall at the other end of the spectrum.

Second, for many banks, the principle source of competition is not other insured depository institutions, but nonbanks. This situation is especially pronounced in businesses such as asset management and payments processing. As you are aware, however, regulations implementing Basel II–based concepts in the United States will apply only to insured depository institutions and their holding companies. While differences in regulatory requirements for banks and nonbanks exist today, many institutions have voiced concern that implementation of Basel II may unduly exacerbate the current differences. These concerns have been focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Third, there is concern about the potential effect of Basel II on the competitive balance between large and small banks. As implemented in the United States, Basel II would result in a bifurcated regulatory capital regime, with large banks subject to Basel II–based requirements and small and mid-sized banks subject to the current capital regime. This structure is premised on the belief that, to the extent possible, regulations should reflect the size, structure, complexity, and risk profile of banking institutions. The Basel II framework was developed to address the unique risks of large internationally active institutions. Mandatory application of such a framework to small banks, with its associated costs, was deemed inappropriate. In fact, the banking agencies sought comment from the banking industry, especially smaller institutions, on the development of a simplified capital framework specifically for non-complex institutions.[3] Industry comments were overwhelming negative on the proposal—most institutions felt that the cost of adopting a new regulatory capital regime outweighed any potential benefits. Accordingly, the banking agencies tabled the proposal.

With that said, the banking agencies need to continue to assess the competitive effects of a bifurcated regulatory capital regime. There are two primary concerns in this regard. First, banks using

[3] See Advance Notice of Proposed Rulemaking, Simplified Capital Framework for Non-Complex Institutions, 65 *Federal Register* 66193 (November 3, 2000).

a Basel II–based regime will likely have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with small banks for both assets and liabilities. That concern is discussed in more detail in the "Calibration"section below. Second, banks using a Basel II–based regime will have a lower marginal regulatory capital charge for some types of loan products. As stated by the FDIC in a recent paper,[4] under the current capital regime, the regime applicable to most small banks after Basel II, a bank making a $100.00 commercial loan is required to hold $8.00 in capital. For banks using advanced methodologies in a Basel II–based regime, the required capital for that same loan would range from $0.37 to $41.65, depending on the riskiness of the credit exposure.[5] The banking agencies must continue to assess this situation and, if warranted, take steps to mitigate adverse effects on the competitive balance between large and small banks. We would be concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the United States.

Operational Risk

Perhaps the most contentious aspect of the proposed revisions to the Basel Capital Accord has been the introduction of operational risk as a separate and distinct component of minimum regulatory capital. I should say at the outset that the OCC supports the view that there should be an appropriate charge for operational risk. Indeed, our banks already take account of operational risk in their own internal economical capital allocations. Since the issuance of CP–1 in June 1999, there have two competing views on the regulatory treatment of operational risk. Some have argued that operational risk is sufficiently similar to credit risk and market risk to be included in the Pillar 1 charge, while others have maintained that operational risk inheres in the quality of an institution's internal control systems, supporting a Pillar 2 approach in which supervisors focus on a qualitative evaluation of such systems. I have consistently advanced the position before the Basel Committee that any charge for operational risk should be committed to the discretion of bank supervisors, under Pillar 2 of the proposal, rather than being calculated through a formulaic approach under Pillar 1. I regret to say that I have not been able to persuade the committee as a whole to adopt this approach.

Nonetheless, it should be recognized that Basel's operational risk proposal has changed considerably since CP–1, reflecting some convergence from the ongoing debate about whether the subject should be addressed under Pillar 1 or Pillar 2. The current operational risk proposal, especially the option of the AMA, which the OCC helped develop, is a significant improvement over earlier proposals. Recognizing the early stage of development of operational risk as a separate discipline,

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[4] See "Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back," FDIC Emerging Issues Paper (January 14, 2003).

[5] Calculations reflect representative lower and upper bounds for capital to be held in support of the $100.00 loan. Lower bound reflects an LGD of 10 percent (high recovery) with a one-year maturity loan. Upper bound reflects an LGD of 90 percent and a five-year maturity loan.

the AMA is a flexible approach that allows an individual institution to develop a risk management process best suited for its business, control environment and risk culture. The AMA tries to balance this need for flexibility with the establishment of broad standards for the identification, measurement, management, control, and mitigation of operational risk to ensure a measure of consistency of application.

Despite recent improvements in the operational risk proposal, the OCC remains receptive to comment on this aspect of Basel II. While credit, market, and operational risks can all cause significant financial losses to financial institutions, those risks are not identical in character, and the differences need to be reflected in any regulatory capital regime incorporating an operational risk charge. Unlike credit risk and market risk, which a bank consciously assumes in the expectation of financial return, operational risk is an unwanted byproduct of day-to-day business activities. At the same time, banks can take significant steps to mitigate exposure to operational risk *ex ante*, rather than relying on capital to absorb losses *ex post*. As was described in a recent paper,[6] the trade-off a bank faces in managing operational risk is not risk versus return, but risk versus the cost of avoidance.

As events in recent times have confirmed, internal control deficiencies, external and internal fraud, system breakdowns and other similar "operational" risks can result in significant financial losses, undesirable earnings volatility, and reputation damage for individual institutions. The challenge for banks and bank supervisors is to identify the appropriate response to those risks. Banks have used an assortment of risk management tools in addressing operational risk, including enhanced controls, audit, improved risk measurement, pricing, insurance, and capital. As the U.S. banking agencies develop the domestic capital rules, qualifying criteria and supervisory guidance for operational risk, supervisors must ensure that implementing regulations and policies appropriately reflect the full range of management choices in addressing this risk.

Calibration

As discussed earlier, the first objective of the Basel Committee in embarking on the Basel II effort was to calibrate minimum capital requirements to bring about a level of capital in the industry that, on average, is approximately equal to the global requirements of the present Basel Accord. That calibration was to be designed to provide an incentive to banks to develop and maintain sophisticated and risk-sensitive internal ratings-based systems. The recent QIS–3 exercise was designed, in part, to determine whether this calibration exercise was successful. While, as noted earlier, the Basel Committee has not yet officially received a report on the results of the QIS–3 exercise, issues concerning the overall calibration of regulatory capital amounts can be identified and discussed.

[6] See "Operational Risk Capital: A Problem of Definition," Andrew Kuritzkes, *The Journal of Risk Finance* (Fall 2002).

To ensure that it meets its goal of avoiding significant decreases in the aggregate level of required capital in the banking system, the committee has proposed the use of a minimum floor capital requirement in the revised accord. Under this approach, there will be a single overall capital floor for the first two years following implementation of the new accord. This floor will be based on calculations using the rules of the existing accord. Beginning in the first year following implementation, minimum regulatory capital at an individual bank cannot fall below 90 percent of the minimum level required under the capital rules, and in the second year, the minimum will be 80 percent of this level.

Based on preliminary analysis, the minimum floor capital requirements may prove binding on a number of U.S. institutions. The OCC does not believe that a reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an adverse feature of Basel II. Such a result is only acceptable, however, if the reduction is based on a regulatory capital regime that appropriately reflects the degree of risk in that bank's positions and activities. The OCC is not yet in a position to make that determination as it relates to Basel II. Given our current understanding of the data provided by banks that participated in QIS–3, and the uncertainty surrounding those submissions, the OCC is not yet comfortable allowing national banks to materially lower their current capital levels simply on the basis of the output of the currently proposed Basel II framework.

Conclusion

As I have indicated, the OCC strongly supports the objectives of Basel II—a more risk-sensitive and accurate capital regime. However, I believe that significant work remains before the current draft of Basel II can be considered final. This summer, the OCC and the other banking agencies expect to seek notice and comment on an ANPR that translates the current version of Basel II into a regulatory proposal and accompanying supervisory guidance for U.S. banks. Once this process is complete, we will be in a position to have a full and complete consideration of the proposal from all interested parties. As I said in the beginning of my statement, the OCC, the agency to which Congress has committed the authority to define capital requirements for national banks, will not sign off on a final Basel II framework until we have fully considered all comments received during our notice and comment process. If we determine through this process that changes to the Basel proposal are necessary, we will press the Basel Committee to make changes, and we preserve our ability to assure that any final U.S. regulation applicable to national banks reflects those views. Given the importance of this proposal, the significant issues that remain unresolved, and the prospect that whatever emerges from this process is likely to govern the financial landscape for years to come, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee in both theory as well as practice.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

Attachment

Summary of Basel II: The Proposed New Accord
Office of the Comptroller of the Currency

The Basel Committee has been developing the new accord over the past five years. During that time, two full-scale consultative papers (June 1999 and January 2001) and numerous working papers supporting various elements of the new accord have been released to the industry for comment. This summary is intended to convey a general idea of the structure and substance of the proposed new accord, and does not attempt to provide a complete analysis. It is based on the most recent publications from the Basel Committee, notably the "Technical Guidance" of the Quantitative Impact Study and the recent consultative paper of Pillar 3 on transparency and disclosure; the underlying documents can be found on the Basel Committee's Web site at http://www.bis.org/bcbs/index.htm.

The new accord will include menus of approaches for measuring the capital required for credit risk, market risk, and operational risk. For credit risk and operational risk, each of the proposed approaches is described briefly below; capital charges for market risk are unchanged in the new accord and are not discussed here. Some of the approaches described are unlikely to be implemented in the United States and have been noted as such. Moreover, based on preliminary analysis by the U.S. agencies, currently there are less than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. While other banks would be permitted to opt into the Basel rules (subject to meeting prudential qualification requirements), the U.S. capital rules will remain in place for the vast majority of U.S. banks that either are not required to, or do not opt to, apply the Basel II framework. Of course, any issues regarding U.S. implementation of the new accord will be definitively resolved only after the U.S. rulemaking process has been completed.

General Structure of the Proposed New Accord

The new accord has three mutually reinforcing "pillars" that make up the framework for assessing capital adequacy in a bank. The first pillar of the new accord is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market and operational risk. The new accord offers a series of options for calculating credit and operational risk. Market risk will remain unchanged from a 1996 amendment to the accord. The new options for credit and operational risk were designed to be available to a wide range of banks, from relatively simple to very complex. For credit risk, the Pillar 1 capital requirement includes both the standardized approach, updated since the 1988 accord, and the new internal ratings–based ("IRB") approaches (foundation and advanced). Pillar 1 has been the focal point of much of the discussion and comment from the industry on the new accord.

Pillar 2 covers supervisory review and banks' obligation to hold sufficient capital vis-à-vis their risk profile. The pillar is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy. It provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 is also a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the new accord proposes a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies for market and operational risk, the new accord will require a significant increase in the level of disclosure. In essence, the trade-off for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar was subject to a recent redraft and consultation process (ended February 14, 2003); the new draft was in response to significant concerns raised about the January 2001 proposal.

Capital for Credit Risk

Under Basel II, banks must select one of three approaches to determine their capital for credit risk. The three approaches, from simplest to most complex, are: the standardized approach, the foundation IRB, and the advanced IRB.

Standardized Approach

The 1988 accord introduced the standardized risk-bucketing approach for setting the minimum regulatory capital requirement, which is still used in the United States today. The approach has been subject to criticism that it lacks sufficient risk sensitivity. The revised standardized approach under Basel II enhances the 1988 accord by providing greater, though still limited, risk sensitivity.

Key changes to create a more risk-sensitive framework include the refinement and addition of risk buckets, the introduction of external credit ratings, and a wider recognition of credit risk mitigation techniques. Risk weights are still determined by category of the borrower—sovereign, bank or corporate—but within each of these categories changes have been made to make the capital more reflective of the riskiness of the asset category. For example, the risk weight on mortgage loans has decreased from 50 percent to 40 percent and the risk weight on certain retail credits has moved from 100 percent to 75 percent. Risk weights for externally rated corporate credits, currently 100 percent, will range from 20 percent to 150 percent. Sovereign risk weights are no longer dependent upon whether a country is a member of the Organization for Economic Cooperation and Development ("OECD"), but rather on the external rating identified for the country.

The standardized approach is not likely to be implemented in the United States. U.S. supervisors believe that credit risk measured under the standardized approach of Basel II would generally not be appreciably different than that measured under current rules for most U.S. banks, and the marginal changes in capital requirements would not justify the cost of implementation.

Internal Ratings–Based Approach (Foundation and Advanced)

The IRB approach represents a fundamental shift in the committee's thinking on regulatory capital. It builds on internal credit risk rating practices used by some institutions to estimate the amount of capital they believe necessary to support their economic risks. In recent years, as a result of technological and financial innovations and the growth of the securities markets, leading banking institutions throughout the world have improved their measurement and management of credit risks. These developments have encouraged the supervisory authorities to devote greater attention to developing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of stringent eligibility standards or "qualifying criteria" in order to use the IRB approach. Because the requirements include both qualitative and quantitative measures, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by both the type of exposure and whether the bank intends to use the simpler foundation IRB framework or the more advanced IRB framework. The requirements are extensive and cover a number of different areas, including rating system design, risk rating system operations, corporate governance, and validation of internal estimates. A brief sample of actual criteria include:

- The board of directors and senior management have a responsibility to oversee all material aspects of the IRB framework, including rating and probability of default ("PD") estimation processes, frequency and content of risk rating management reports, documentation of risk rating determinations, and evaluation of control functions.
- A one-year PD estimate for each grade must be provided as a minimum input.
- Banks must collect and store historical data on borrower defaults, rating decisions, rating histories, rating migration, information used to assign ratings, PD estimate histories, key borrower characteristics, and facility information.

As mentioned above, the requirements that a bank must meet are partially dependent upon which of the two IRB approaches a bank will use. The first methodology, called the foundation approach, requires fewer direct inputs by banks and provides several supervisory parameters that, in many cases, carry over from those proposed for the standardized approach. For a variety of reasons, the United States does not plan to introduce the foundation approach in its regulations. The second approach, the advanced IRB approach, allows banks much greater use of their internal assessments in calculating the regulatory capital requirements. This flexibility is subject to the constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equality among banks worldwide.

There are four key inputs that are needed under IRB, for both the foundation and advanced approaches. The first element is the probability of default ("PD") of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second piece is the estimate of loss severity, known as the loss given default ("LGD"). The final two elements are the amount at risk in the event of default or exposure at default ("EAD") and the facility's remaining maturity ("M"). LGD, EAD, and M are provided by supervisors in the foundation approach, but must be provided by banks operating under the advanced approach (subject to supervisory review and validation). For each exposure, the risk weight is a function of PD, LGD, and EAD.

The IRB approach envisions internal rating systems that are two-dimensional. One dimension focuses on the borrower's financial capacity and PD estimates that quantify the likelihood of default by the borrower, independent of the structure of the facility. The other dimension takes into account transaction-specific factors such as terms, structure, and collateral. These characteristics would determine the second dimension, i.e., the LGD. Implicit in this treatment is the assumption that when a borrower defaults on one obligation, it will generally default on all its obligations. (This assumption is relaxed with the IRB treatment of retail portfolios.)

Calculating the capital charge under the IRB approach involves several steps. The first of these steps is the breakdown of the bank's portfolio into five categories: corporate, retail, bank, sovereign, and equity. The IRB rules differ to varying degrees across these portfolios. As a result, the IRB capital charge is calculated by category, with the PD, LGD, and EAD inputs potentially differing across these categories. Supervisory approval is needed before banks can use the IRB approach for any of the five categories. The minimum requirements described above were written to apply across these five types of exposure. The IRB approaches are most developed for portfolios of exposures to corporates, banks, and sovereigns.

Another important step is the determination by the bank of the PDs for its loan-grading categories. The PD of an exposure is the one-year PD associated with the borrower grade, subject to a floor of 0.03 percent (excluding sovereigns). The determination of PDs for borrowers supported by guarantees or credit derivatives is more complex. Banks under the advanced approach would use their internal assessments of the degree of risk transfer within supervisory defined parameters, while those under the foundation approach would use the framework set forth in the new credit risk mitigation provisions. Overall, the PD must be "grounded in historical experience and empirical evidence," while being "forward looking" and "conservative." A reference definition of default has been developed for use in PD estimation and internal data collection of realized defaults.

Once the PD has been established, banks must then establish the dimensions of LGD ("loss severity") based on collateral and M. Under the foundation approach, M is assumed to be 2.5 years. There are several options that may be selected for the advanced approach, but in general, M is defined as the greater of one year or the remaining effective maturity in years.

After the bank determines the PDs and LGDs for all applicable exposures, these combinations can be mapped into regulatory risk weights. The risk weights, which are calibrated to include coverage for both expected and unexpected losses, are expressed as a continuous function, which provides maximum risk sensitivity and flexibility in accommodating diverse bank risk rating systems. The minimum capital charge is then determined by multiplying the risk weight by the amount expected to be outstanding at the time of default (EAD), and by 8 percent.

A final step in this process involves the ongoing review by the supervisors of the systems used to develop the IRB capital charge. Periodically, supervisors will need to validate these systems and review the internal controls that provide the foundation for the IRB approach. In addition, supervisors will also have to consider, under Pillar 2, whether the amount of capital generated by the IRB approach is commensurate with the bank's risk profile.

Implementation of the IRB Approach

In addition to the requirement that a bank meet the qualifying or eligibility criteria, the new accord requires that banks using the IRB approach run parallel systems for one year before implementation. This means that a bank planning to implement the IRB approach in December 2006 will actually have to begin calculating results as of December 2005 while continuing to run its current systems.

Adjustments to the Capital Charge for Credit Risk

There are additional considerations that banks may have to factor in when determining the capital charge for credit risk. These additional considerations will further adjust required capital, outside of the requirements of the different approaches to credit risk. The two primary adjustments that might be made to the credit risk charge are for credit risk mitigation and asset securitization.

Credit Risk Mitigation

The new accord provides a measure of capital relief for certain qualifying risk-mitigating techniques used by banks. However, it is important to note that the credit risk mitigation proposals in the new accord are generally only directly relevant to the standardized or foundation IRB approaches, which are not likely to be used in the United States. In the advanced IRB approach, credit risk mitigation must meet certain qualitative requirements, such as legal certainty, but there are no specific proposals for adjusting the capital requirement for transactions that include credit risk mitigation techniques. It is assumed that any credit risk mitigation efforts will be factored into the PDs and LGDs assigned by the bank.

With that caveat in mind, the section on credit risk mitigation in the new accord attempts to provide rough approximations of the risk reduction attributable to various forms of collateralized credit exposures, guarantees, credit derivatives, and on-balance-sheet netting arrangements. The committee has proposed a conceptual approach to these risk mitigation techniques that, while recognizing their risk reduction benefits, attempts to capture the additional risks posed by such transactions.

The credit risk mitigation proposal provides both a simple and a comprehensive approach to dealing with collateral. The proposal expands the range of eligible collateral from that recognized in Basel I. It also discusses the appropriate treatment for maturity mismatches between the credit risk mitigant and the underlying credit exposure. The proposal introduces haircuts, which the bank may estimate, to cover the market price and foreign exchange volatility that may be inherent in the mitigant. The proposal allows banks to greatly reduce the capital requirements for exposures with large amounts of high quality collateral. There are strict quantitative and qualitative factors that must be met in order for a bank to be permitted to use its own haircut estimates. The proposal encourages the use of credit risk mitigation by expanding the type of collateral, guarantors, and transaction structures that are recognized for capital reduction. Different types of credit risk mitigation techniques pose different levels of additional risk; the proposal incorporates flexibility that recognizes these differences and adjusts the capital treatment accordingly.

Asset Securitization

Asset securitization is clearly an important issue in the United States, as the securitization market is significantly greater than the securitization market of any other Basel member country. The Basel Committee believes that it is important to construct a more comprehensive framework to better reflect the risks inherent in the many forms of asset securitizations, including traditional and synthetic forms.

The securitization framework in the new Basel Accord applies generally when there is a transaction that involves the stratification or tranching of credit risk. The committee has developed securitization approaches for both standardized and IRB banks. The level of complexity is significantly higher for IRB banks. The framework tries to focus on the economic substance of the transaction, rather than its legal form.

Under the proposal for the treatment of securitizations by standardized banks, the capital charge is generally determined by multiplying the amount of the securitization exposure by the risk weight mapped to the long- and short-term rating categories. Off-balance-sheet exposures are subject to a conversion factor before the appropriate risk weight is applied. The proposal does allow for some recognition of credit risk mitigants provided on securitization exposures, but that recognition is permitted only when the bank meets a series of stringent criteria.

Banks that have adopted the IRB approach for credit risk are required to use one of two methods for determining capital requirements for securitization exposures. One method is the supervisory formula approach ("SFA"), under which capital is calculated through the use of five bank-supplied inputs: the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); the tranche's credit enhancement level and thickness; the pool's effective number of loans; and the pool's exposure-weighted average loss given default. The second method is known as the ratings-based approach ("RBA"). Under this approach, capital is determined by multiplying the amount of the exposure by the appropriate asset-backed security risk weights, which depend on external rating grades, short- or long-term. Granularity of the pool and the level of seniority of the position are also considered.

The securitization proposal is one of the newest pieces of the accord and its impact on the industry is not yet fully known. In the latest QIS exercise, banks were asked for the first time to provide data on the relative impact of the proposals. Due to a number of questions about the proposal, the QIS results did not provide entirely reliable results, and it appears that more work is needed to make the proposal more understandable for banks.

Operational Risk

One of the most significant changes in the new accord is the proposal for an operational risk charge. It is expected to represent, on average, 10–15 percent of the total minimum regulatory capital charge. The framework is based upon the following operational risk definition: the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.

The committee has proposed three approaches to calculate the operational risk charge, which represent a continuum of increasing sophistication and risk sensitivity. The basic indicator approach ("BIA") is the simplest of the three approaches; the capital charge is determined by taking an alpha factor decided by the committee and multiplying it by an indicator, gross income. The next approach is known as the standardized approach and is similar to the BIA, but breaks out gross income into business lines. Because there is no compelling link between these measures and the level of operational risk, the United States does not plan to utilize the BIA or the standardized approach to determine the capital charge for operational risk.

The committee has made the most significant changes to the advanced approach since it was originally introduced in January 2001. At that time, the committee envisaged a single, very prescriptive advanced approach for operational risk, similar to credit risk. However, after numerous comments from the industry, the committee made substantive changes in the proposal to reflect the evolutionary nature of the operational risk framework. The committee recognized that, unlike credit risk, there are very little data and no internal systems specifically designed to target operational risk; instead, banks and supervisors rely primarily on internal controls to deal with a myriad of banking risks that cannot be as readily quantified as credit and market risks.

The committee considered the comments and analyzed the state of the art of operational risk and developed what is known as the advanced measurement approaches ("AMA"). Rather than prescribing one methodology, the AMA will allow banks the option of designing the operational risk measurement framework that best suits their institution, subject to some broad criteria. The criteria will be the key to achieving a certain level of consistency and comparability among institutions, as well as providing a margin of comfort to supervisors who must assess these differing systems. The criteria currently identified in the new accord include the need for internal and external data, scenario analysis, consideration of business environment and internal control factors, and an adjustment for qualitative factors. Banks may also, under the AMA, consider the impact of risk mitigation (such as insurance), again subject to certain criteria set to ensure that the risk mitigants are effective.

Temporary Capital Floors

Two floors that have been established for the Basel II framework. In the first year of implementation, the total capital requirement cannot fall below 90 percent of the result the bank would have had under the current (1988) accord; in the second year, that floor drops to 80 percent.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Institute of International Bankers, on the proposed revisions to the Basel Capital Accord, Washington, D.C., March 3, 2003

Last week, I testified before a House of Representatives subcommittee on the proposed revisions to the Basel Capital Accord—Basel II, as we call it—and Basel II is what I'll be speaking to you about this morning. Over the past several months, there has been a great surge of interest in the news from the picturesque Swiss city that not too long ago was better known for its museums and medieval cathedral than for the pronouncements of the central bankers and bank supervisors who have been gathering there for decades. The financial press is full of the latest Basel news and rumors—the cottage industry of Basel-watchers could now fill a large office building—and financial institutions are hastening to get their views on the record in the hope that there may still be time to influence the Basel process. Let me assure you that there is still time—but the clock is ticking away.

The growing interest in Basel II comes as the Basel Committee on Bank Supervision and its various task forces and working groups gear up for a last push to achieve a new Capital Accord. Indeed, the year since I last visited with the Institute of International Bankers was an unusually eventful and productive one for the Basel Committee, and so I should like to begin with a summary of just what has occurred during this period.

At its July 2002 meeting, members of the committee reached agreement in principle on a number of important issues relating to Pillar I—the provisions prescribing a minimum regulatory capital charge. As you know, Pillar I offers financial institutions three major options for calculating capital:

- The standardized approach—essentially, a set of refinements to the old risk buckets—which provides for the use of external ratings in certain circumstances and gives some weight to risk mitigation devices;
- The foundation internal ratings–based ("IRB") approach, which sets forth a methodology for using a bank's own internal risk rating system, including its calculated "probabilities of default" ("PD") as a base for calculating capital, using a factor for "loss given default" ("LGD") provided by supervisors; and
- The "advanced IRB" approach, which bases capital calculations on the bank's own supervisory-validated models, including bank-calculated PDs and LGDs.
- In each of the three approaches there would be a calculation for determining an assignment of capital to cover operational risk.

These Pillar I options—and the manner in which they would be applied and implemented—had long been among the most problematic elements of the Basel II proposals. That's why the agreements that came out of the committee's July meeting were so important. We agreed on:

- Creation of a new IRB risk-weight curve that should provide a more risk-sensitive treatment of certain revolving retail exposures, including many credit card exposures.
- The need for banks using the "advanced IRB" approach to take account of a loan's remaining maturity when determining regulatory capital, while allowing national supervisors to exempt smaller domestic borrowers from this requirement.
- New elements of the corporate and retail IRB frameworks and a standardized approach designed to provide reduced capital requirements for loans to small- and medium-sized enterprises (SMEs) under the new accord.
- The need for flexibility in the capital treatment of operational risk, which I'll return to in a moment.
- A plan to narrow the gap between the amounts of capital required in the foundation and advanced IRB approaches.

Another key milestone achieved during 2002 was the launch of the committee's third Quantitative Impact Study, known as QIS–3. When the results of QIS–3 are reported to the committee later this year, we should have some idea of how the latest version of the Basel II proposal may impact bank capital—although I should hasten to say that there are some shortcomings in QIS–3 and I have some serious reservations about the reliability of QIS–3 as a basis for calibrating the new accord.

The committee agreed to an aggressive timetable for the remaining actions leading to the adoption of Basel II. The plan calls for issuance of the third consultative paper (CP–3) in May of this year, with a three-month comment period to follow; adoption of Basel II by the committee in December 2003; and full implementation of the new accord by December 2006.

All of this represents good progress—far greater than many critics of the process thought possible. The committee and its various working groups, under the strong and intelligent leadership of Bill McDonough, have achieved impressive results under difficult circumstances. But we're not there yet. Problems—intractable and consequential problems—remain. Much as we would all like to declare victory and move on to other things, it is imperative that we forthrightly come to terms with these problems rather than trying to minimize their importance in the rush to an accord—an accord that will undoubtedly govern the financial landscape for many years to come.

I'd like to spend my remaining time with you this morning discussing a few of what I believe are the major unresolved issues that confront the Basel Committee.

Calibration

As I said a moment ago, one of the key concerns for the committee in Basel II is to assure that the new framework does not result in a significant decrease in the aggregate level of capital in the banking system. This is, in my view, more a political rather than an economic concern. After all, the very purpose of Basel II is to have capital rules that better reflect actual risk, and a more sophisticated and accurate measurement of risk might well result in a lowering of capital. To be sure, bank supervisors are inclined to believe that more capital is always better, and we would be concerned if Basel II resulted in a lowering of capital that was not clearly related to risk. But we are also aware that there can be adverse consequences for governmental requirements for too much capital—an impairment of the competitiveness of our banks and a misallocation of resources. From a political point of view, of course, there is a strong likelihood that Basel II might be viewed with a jaundiced eye by legislators if it resulted in an appreciable lowering of capital—particularly since the new process will be based on the banks' own assessments of risk. On the other hand, the committee wants to induce banks to make the sizeable investments in new risk management systems that will be required to make an internal ratings-based approach feasible and acceptable, and it has held out the prospect of reduced capital as such an inducement. It remains to be seen whether we are up to this kind of prestidigitation—simultaneously allowing large banks to reduce their capital while keeping the level of capital in the system undiminished. As F. Scott Fitzgerald once observed, "the test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function." There is no question but that the Basel Committee is comprised of first-rate intelligences.

To accomplish these apparently inconsistent goals, the committee has proposed the use of a capital floor requirement in the revised accord. Under this approach, there will be a single overall capital floor for the first two years following implementation of the new accord. This floor will be based on calculations using the rules of the existing accord. Beginning the first year following implementation, minimum regulatory capital at individual banks would not be permitted to fall below 90 percent of the current minimum required level, and in the second year, the minimum would be 80 percent of this level. Preliminary analysis suggests that these minimum capital requirements may prove binding on a number of U.S. institutions.

The OCC's position on the proper calibration of the Basel capital rules has been consistent. We do not believe that a reduction in minimum regulatory capital requirements for certain institutions is necessarily an adverse feature of Basel II. Such an outcome is only acceptable, however, if the reduction is based on a regulatory capital regime that has validity and integrity and appropriately reflects the degree of risk in that bank's positions and activities. Until we have better evidence that Basel II meets that standard, the OCC will be reluctant to allow national banks to materially lower their current capital levels.

Operational Risk

No Pillar I issue has generated more controversy than the proposed provision for operational risk as a separate and distinct component of minimum regulatory capital. We define "op" risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

Since the issuance of CP–1 in June 1999, there have been two competing views on the regulatory treatment of operational risk. Some have argued that op risk is sufficiently quantifiable to be treated similarly to credit risk and market risk and to be included in the Pillar 1 charge. Others maintain that an evaluation of op risk is inherently judgmental, inhering as it does in the quality of an institution's internal control systems, thus supporting a Pillar II approach under which supervisors would focus on a qualitative evaluation of such systems. The OCC has consistently advocated a Pillar II approach for op risk, rather than the more formulaic approach of Pillar I. Unfortunately, I have not been successful in persuading my committee colleagues to adopt that position.

Nonetheless, the committee's approach to op risk has changed significantly—and for the better, in my judgment—since CP–1. The current op risk proposal offers three options, reflecting a continuum of increased sophistication and risk sensitivity. The most sophisticated of these options, the so-called Advanced Measurement Approach ("AMA"), affords considerable flexibility to financial institutions in developing an op risk management process best suited to its business, control environment, and risk culture. The AMA tries to balance this need for flexibility with the establishment of broad standards for the identification, measurement, management, control, and mitigation of operational risk to ensure consistent application.

Whether these improvements are sufficient to bridge what we see as the fundamental differences between credit and market risk, on the one hand, and operational risk on the other, is another question. Banks assume credit and market risk in the expectation of financial return; op risk, by contrast, is an unwanted by-product of normal business activity.

Banks make provision for operational risk through a variety of risk management tools. They build internal controls of varying degrees of robustness, develop audit capabilities, purchase insurance—and allocate capital. As the U.S. banking agencies develop the domestic capital rules, qualifying criteria, and supervisory guidance for op risk, supervisors must ensure that implementing regulations and policies appropriately reflect the full range of management choices in addressing this risk.

Complexity

The Basel committee sought to realize an ambitious set of goals in the new accord. We hoped to integrate all we have learned over the years about capital regulation and risk in a single, logically consistent package. We hoped to recognize the technological and conceptual advances in the science of risk management since the adoption of Basel I and to provide incentives for bankers to make use of these advances. We wanted to supplement the risk judgments of supervisors with those of the marketplace and of bankers themselves and ensure that the guidelines supervisors produce are relevant to the changes—structural changes, portfolio changes, and management changes—that have occurred in the international banking environment.

In one respect, the result of such an ambitious undertaking was probably predictable. The process has generated a product of vast complexity—putting to shame the U.S. Internal Revenue Code, long the world's record holder for complexity. Thousands of pages of task force and working group papers, years in the making, have given rise to hundreds of pages of rules, guidelines, and standards saturated with arcane mathematical formulae. They're not written by or for bankers—or for that matter, by or for conventional bank examiners. They're written for mathematicians and economists—"quants."

When I have complained in the Basel committee about the complexity problem, my colleagues have roundly admonished me. "We live in a complex world," they say. "Don't quibble if we try to fashion capital rules that reflect that complexity." But with great respect for my colleagues, the complexity we have generated goes far beyond what is reasonably needed to deal with the intricacies of sensible capital regulation. It reflects, rather, a compulsion to close every possible loophole, to dictate every detail, and to exclude to the maximum extent possible any opportunity for the exercise of judgment or discretion by those applying and overseeing the application of the new rules. In short, it reflects much more a commitment to prescriptiveness than a mere recognition of the complexity of today's banking business.

This complexity has a price. Most obviously, it will impose a heavy cost burden on bankers, who have to design systems and educate staff to deal with the complex new rules. It may also have a cost in terms of credibility and public acceptance, for if legislators, customers, and market participants cannot penetrate the new rules, can we expect them nonetheless to love and respect them?

Finally, it may have a cost in terms of competitive equality, and this is what concerns me most. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an evenhanded way across a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 or 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in watching the banks' operations and judging the banks' compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to comparably sized institutions, or may put heavy reliance on the oversight of outside auditors. It's fair to ask, I think, in which regime 800 pages of detailed, prescriptive capital rules are more likely to be robustly enforced? The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedrock principle of Basel II. Can we really achieve competitive equality without addressing disparities in supervision—particularly when we are operating on the assumption that the complex new rules we're writing will be applied in an evenhanded way throughout the world?

I cannot resist recalling words that seem peculiarly relevant to this effort. In the 1780s, as Americans engaged in a great debate on the principles that should underlie their new government, one of the most original of our thinkers on that subject (and later president), James Madison, contributed an important insight. Popularly elected governments do not automatically command popular confidence, Madison observed. “It will be of little avail to the people if laws are made by men of their choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood.”

Certainly what has come out of Basel has been voluminous; whether it is incoherent I shall leave for others to decide—although I frankly confess that much of it boggles my mind. But in light of some of the criticisms I’ve heard, I think it would be well to consider whether we’re not approaching that point of perfect impenetrability—as with our tax code—that makes honest compliance difficult, if not impossible.

Each of the problems I have outlined deserves serious consideration by the Basel committee—and by everyone who will be affected by what comes out of its deliberations. Until the final accord is inked, the Basel committee must remain open to new ideas and new solutions, even if that involves some further slippage in the timetable for bringing the accord to a conclusion. Congress is playing a key role—as it should—in ensuring that the interests of U.S.-based institutions—and U.S. citizens—with respect to Basel II are properly understood and safeguarded.

Most of all, we’re counting on continued input from the banks that will have to live under the new Basel regime—and pay most of the costs associated with it. I assure you that we will take your comments with the utmost seriousness—now and during the formal notice and comment process. The OCC, which has been invested by Congress with the statutory duty and authority to fix capital requirements for national banks will not give its final agreement to Basel II until we have fully and objectively considered all the comments we receive. And we will not sacrifice good public policy to the dictates of an arbitrary time schedule. If, after reviewing the views of commenters, we determine that changes to the Basel proposal are necessary, we will insist upon such changes. The integrity of the process is crucial if Basel II is to achieve the goals we set out to achieve—for now and for years to come.

Since we began the process of revising Basel I, the OCC’s position has been firm and unequivocal. This is a tremendously important endeavor, and we strongly support its objectives. But Basel II must work in practice as well as theory; it must provide supervisors with sufficient flexibility to accommodate differences among financial institutions; and it must work in a way that avoids placing banks at a competitive advantage compared to other financial services providers. In advocating these broad policy goals, the OCC has looked at the issues independently as on operational risk. And while we have not always prevailed when we have had differences, I believe our efforts make it more likely that we’ll eventually get a workable new Basel agreement —one that all concerned parties can live with and prosper under.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Independent Community Bankers of America, on plain English financial disclosures, Orlando, Florida, March 4, 2003

I've long believed that bank supervisors have a special responsibility when community banks are concerned—not just because of your importance to your customers and the local economies you serve but also because community banks tend to be especially susceptible to the burdens of supervisory policies and actions. That's why the Office of the Comptroller of the Currency ("OCC") takes so seriously the need to develop supervisory policies that are sensible, constructive, and supportive of community banks. The Independent Community Bankers of America ("ICBA") is one of our principal sounding boards on issues of community bank supervision, and I'm delighted to be with you once again to discuss some important issues of mutual concern.

At the outset, let me repeat some points I have shared with you before. While the OCC is sometimes thought of as the "large bank" regulator, the fact is that community banks make up an enormously important part of our jurisdiction. Of the 2,100 banks we supervise, close to 2,000, or 92 percent, are under $1 billion in assets. Almost 1,000 of these—or 46 percent of all the banks we supervise—are under $100 million in size. Thirteen hundred of our examiners—about 80 percent of our total workforce—are community bank specialists, and most live in or near the communities whose banks they work with. Our assistant deputy comptrollers, who make 90 percent of the supervisory decisions affecting their banks, average more than 20 years of supervisory experience. Each year this highly talented group of people conducts literally hundreds of outreach events for community banks around the country, and we in Washington regularly meet with dozens of delegations of community bankers. In short, the OCC has a huge commitment to community banking. Beyond these institutional concerns, I personally believe that the nation's community banks are an essential foundation of our financial system, and I want to see community banks flourish and prosper.

Of course, my old friend Ken Guenther and the ICBA leadership have long provided community bankers with effective and forthright representation in Washington, and they are always there, looking over our shoulders, highlighting issues of particular importance to community banks and reminding us of the importance of weighing the costs against the benefits of new regulations as we write them and implement them.

That the laws and regulations that govern banking are burdensome and costly is a proposition I suspect will get no argument from this audience. Scholars, industry groups, and government agencies have studied the question from almost every angle, and their studies invariably come to the same conclusion: regulation—particularly what we refer to as "compliance" regulation—constitutes a significant and growing burden for banks of all sizes, a burden that falls with disproportionate weight on the smallest banks. Where large banks may have dozens of lawyers and other specialists working in their compliance shops—parsing regulations and advisories, drafting forms, following a myriad of court and agency rulings and interpretations, and dealing with examiners—those tasks may be a part-time responsibility for one person in many of your banks. Yet you have to understand and comply with the very same laws and rules as the largest banks.

The sharpest increase in regulatory burden has occurred in the area of consumer-oriented legislation. Since 1968, more than two dozen such laws have gone on the books, with the Truth-in-Lending Act ("TILA") leading the way. Others followed in rapid succession: the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act ("RESPA"), the Community Reinvestment Act ("CRA"), the Home Owners Protection Act, the Home Mortgage Disclosure Act, the Consumer Leasing Act, the Electronic Fund Transfer Act, the Truth in Savings Act, the Fair Debt Collection Act, to name only a few—and, most recently, the privacy provisions of the Gramm–Leach–Bliley Act ("GLBA").

The costs of complying with these laws, and the regulations promulgated to implement them, are substantial. In 1991, according to one study, those costs may have exceeded 12 percent of bank noninterest expenses. And this figure doesn't take into account the hundreds of millions of dollars that are spent annually by the supervisory agencies monitoring and measuring bank compliance with consumer regulations, or the hundreds of millions more spent examining for safety and soundness—costs that are directly or indirectly passed on to banks and taxpayers generally.

Statistical analyses lend credence to the point I made at the start—that compliance regulation is particularly onerous for community banks, which don't enjoy the economies of scale that are available to larger banks. A 1977 study, for example, showed that, for banks in the under-$10 million category, the cost of regulation per million dollars of assets was nearly twice what it was for banks with between $10 and $25 million in assets. Every subsequent study—and there have been many, of varying sophistication—has come to the same conclusion. But we didn't need teams of economists to tell us that.

What may be less immediately apparent is that the costs of bank regulation are spread over the broad economy. We have credible studies showing that regulation constitutes a significant barrier to the entry of new banking firms, that it reduces competition among financial providers, and that it discourages innovation and creativity in the development of new financial services. All of this imposes burdens whose impact is felt well beyond the financial sector.

Yet it must be emphasized that bank regulation is an unavoidable necessity. Banking is not like other businesses. It was the first regulated business in America, and for a long time it was the only one. Banks are critical to the health of our economy, they operate our payments system, and they provide crucial financial services to the communities they serve. In recognition of their enormously important role, banks are the beneficiaries of a federal safety net and a system of deposit insurance. Avoidance of bank failure is a major objective of government policy. The rationale for bank regulation was inarguable 200 years ago, and it's inarguable today.

Of course, the vast majority of compliance laws are of more recent vintage. It's important to remember, however, that these laws—and the burdens they've created—were not enacted in a vacuum. Almost without exception they were responsive to abuses in the financial marketplace that the banking industry had proved unable or unwilling to correct on its own. In many cases, these abuses were engaged in by a relatively small number of banks, but they were abuses nevertheless. It is a simple fact of political life that legislators will respond to the conduct of the worst actors and will generally do so with laws that affect the business of all, including the best.

One need only recall—to cite just a few examples—the impossible welter of incompatible approaches to interest rate calculation that had been used by financial institutions or the frustration that customers sometimes faced in getting billing errors corrected, or the discrimination on grounds of race or gender that some borrowers faced, or the abusive practices used by some unscrupulous collection agents, or the epidemic of "redlining" that contributed to the decline of so many inner-city neighborhoods, to understand why legislators found appeal in these laws. No doubt, TILA and CRA impose burdens on financial institutions, but it cannot be denied that they were responsive to real abuses.

To be sure, much good has come from these compliance laws. There is little doubt, for example, that the financial marketplace is fairer and more rational than it was a generation ago, especially for women and minorities and other previously neglected groups. Since the advent of standardized annual percentage rate ("APR") disclosures, consumers have been able to understand the true cost of credit and to do the kind of comparison-shopping that was always difficult before Truth in Lending and Truth in Savings went into effect. Shopping for a credit card became simpler when consumers could turn for information on interest rates, grace periods, and the like to the so-called Schumer Box on the issuer's solicitation. And while obtaining a mortgage loan and seeing it through to closing can still be something of an ordeal, there's far greater transparency about the process—and the costs associated with it—since TILA, RESPA, and their cohorts became the law of the land.

Certainly we've come a long way since the wild and wooly days when caveat emptor was the only real protection available to the financial consumer. Yet there's also plenty of evidence that we could be doing better—and getting a better return on the large investment in time and money that goes toward maintaining a fair and open marketplace for financial services through compliance regulation.

Many people take it for granted—indeed, take it as an article of faith—that simply because a particular set of disclosures is required by law, it must be valuable and important. It's significant that most of the evidence we have to the contrary is anecdotal. Many of us who don't read the pages of disclosures that accompany loan or new account applications or credit card statements assume that others aren't reading them either. We know about the frustration of trying to wade through paragraph upon dense paragraph of legalese. We hear stories—stories that seem quite plausible—about settlement agents impatiently suggesting that a real estate closing might have to be rescheduled for a later date if the borrower insisted on reading all the disclosures. Legend has it that a large national bank conducted its own nonscientific survey by inserting a line of fine print somewhere in the middle of a lengthy disclosure document offering $100 to any customer that brought the item into a branch—and that not a single customer did.

The question of efficacy in our system of financial disclosures has a more troubling dimension as well. Despite the prevalence of disclosure as a cure for abuse, there is still much of what many people would see as shortsighted decision-making by financial consumers. Those who believe that many consumers don't always act in their own self-interest watch people paying payday lenders fully disclosed APRs that may reach 500 percent or more, and they conclude that mere disclosure is not enough and that more stringent substantive regulation is needed.

Of course, one needs to be careful here. After all, a free society gives people the freedom to make bad choices as well as wise ones. There is sometimes a troubling tendency to believe that just because someone is not wealthy, he or she may not be smart enough to be trusted to act in their own best interest.

I happen to believe, on the contrary, that people with limited means are more likely to make choices that are economically sensible for them. To be sure, people with limited means may not have the same access to financial products as more prosperous customers, and they may in some cases present greater risks that translate into higher costs. Assuring fair and nondiscriminatory access to credit and other financial services is of course a critically important objective of government policy.

Nonetheless, there is an important question whether our consumer protection and disclosure laws effectively provide individuals with the information they need to make informed personal choices. I believe that they often don't. Unreadable, unfathomable, and costly disclosures may be no better—and they're possibly worse—than no disclosures at all. Unfortunately many of the disclosures that fill our mailboxes and settlement packages fall into the "unreadable and unfathomable" category. Yet the costs to financial institutions to provide these disclosures may nonetheless be enormous.

The truth is, it would be remarkable if our consumer disclosures were effective, considering how little attention we've paid to making them effective. In contrast to the multitude of industry and academic studies that have appeared over the years on the cost of our regulations and disclosures, very little has been done to assess their *efficacy*, let alone to weigh the benefits against the cost burdens of compliance.

I'm aware of just a handful of exceptions to this general rule. In the mid-1970s, when Ken Guenther and I were very young colleagues at the Federal Reserve, a study was performed that focused on "information overload"—the concern that TILA disclosures were so extensive that they actually interfered with the ability of consumers to get the information they really needed. These concerns gave rise to the Truth in Lending Simplification Act of 1980. Significantly, the Simplification Act took up more pages in the statute books than Congress needed when it enacted TILA in the first place. Suffice it to say, this well-intentioned effort did not result in a more effective, less costly disclosure regime.

In 1996, the Federal Reserve and the U.S. Department of Housing and Urban Development were directed by Congress to prepare recommendations for reform of TILA and RESPA disclosures. A year later, the two agencies submitted their report—a report that, with appendices, ran well over 100 pages.

The study found many technical problems with the existing disclosure regime, and it issued more than a dozen specific recommendations for improvement. It noted that consumers in mortgage loan transactions are often required to pay various fees to their lender *before* the lender is required to provide the required disclosures, giving the borrower an incentive to go through with the transaction regardless. The agencies pointed out that RESPA "good faith estimates" often turn out to be incomplete and inaccurate—almost invariably to the disadvantage of the borrower. And they recommended an expansion in the definition of the finance charge to assure that all costs the consumer is required to pay to close the loan were reflected in the APR.

Some of these recommendations await action by Congress; others have already been adopted under the two agencies' rulemaking authority.

Yet only in passing did this comprehensive study even touch upon what may be a more fundamental flaw in the existing TILA and RESPA disclosures—their sheer oppressive weight, their inscrutability, the confusion or cynicism they engender among the consumers to whom they are given. Nor did the study come to grips with a critical basic question—a question that could be raised about almost all compliance regulation. Are the benefits being delivered to consumers worth the costs being imposed on the industry? Or, to put it in more positive terms, can we improve the effectiveness and value of these laws and at the same time relieve financial institutions of some of the deadweight costs of compliance?

These are critically important questions, because the costs of compliance are not a free good. It must be assumed that most, if not all, of these costs are passed on to consumers. They become, in effect, part of the cost of credit and other financial products and services—costs that the intended beneficiaries must themselves bear.

I believe that legislators and policymakers need the answers to these questions, and the inquiry should not be approached on an ideological basis. It should be very pragmatic. Are we getting our money's worth? More specifically,

- Do the laws in question maximize the ability of consumers to understand the relative costs, benefits, and limitations of financial transactions by providing key information in a clear, easily understandable way?

- Do they maximize the ability of consumers to make informed and appropriate decisions based on the information they've received?
- What in fact are the costs of compliance? What magnitude of resources are devoted to compliance by banks, and what are the costs incurred by supervisors in implementing and overseeing compliance?

To answer these questions, I believe we need an independent, professional, well-funded research effort that would not only survey and document the costs of compliance regulation, both for banks and for regulators, but would analyze whether consumers are getting the most user-friendly and effective protections we can offer. I am convinced we can do better in serving the interests of consumers, and do it more simply and at less of a cost burden.

I know there's a better way, because we've seen it in action.

The U.S. Food and Drug Administration ("FDA") had a voluntary nutritional labeling program for packaged foods as early as the 1970s. But in the face of evidence that this framework wasn't meeting the growing public interest in the nutritional content of packaged foods—or rising health concerns about the American diet—the FDA decided to switch to a new arrangement. It's significant that the FDA decision to adopt a mandatory system of uniform labeling predated the passage of federal legislation; for the most part, the Nutritional Labeling and Education Act of 1990 called for changes that the FDA had already initiated under its rulemaking authority.

Four years later, the now familiar "nutrition facts" panels began to appear on food packages throughout the country. Finally consumers had—in simple, readable form—the right kind of reliable, relevant, and consistent information about what they were buying and consuming. And they had it at a critical time—before they made a purchase. If they choose to make unwise dietary decisions nonetheless—and certainly the new information has proved to be no panacea from a public health standpoint—it's not because the information they need to make sound decisions at the supermarket isn't available to them.

Four years from conception to rollout may seem like a long time. But this was time well spent. The FDA took pains to bring all interested parties—industry, public health experts, consumer groups, and regulators—into the process. Consumers were intimately involved from the start. Extensive task-based testing was performed to establish what consumers were looking for and how they intended to use the information; different disclosure formats were developed, refined, and tested, focusing on ease of use and accuracy. Consumers were then surveyed on their views of the label design. Was it legible? Easy to use? Did consumers understand what was being presented? And did it serve its intended purpose?

Enough said "yes" to give us the "nutrition facts" format we have today. The acceptance and the accolades it's won—including the coveted Presidential Design Achievement Award—speak for themselves.

I believe that every regulator in America can learn from the FDA experience. It should certainly encourage us to reconsider the way we've gone about developing our disclosure regime for financial institutions. We have to start by talking to the people for whom the disclosures are designed to learn more about their needs and how those needs are best met. We have to do more research, more testing, more consulting with end users, and more validating to ensure that our disclosures produce positive results and not simply more waste and frustration.

Fortunately, we may have an opportunity at hand for a new beginning in the design and implementation of financial disclosures to consumers.

As you well know, Title V of the Gramm–Leach–Bliley Act created privacy standards that financial institutions must meet to protect their customers' personal information—and, at the same time, required financial institutions to inform consumers about how those standards were being met. These requirements have led to disclosures that, at their worst, embody all that's wrong with our current approach. Today's privacy disclosures are long, dense, complex—and, if the anecdotal evidence is to be believed, likely to wind up in the trash without having been read. While a major objective of the new law was to give consumers the ability to "opt out" with regard to the sharing of their personal information with third parties, it takes enormous fortitude—and, seemingly, a graduate-level education—to unravel the language that instructs consumers on how to accomplish this.

We can't place the blame on financial institutions for the unwieldiness of our privacy disclosures. After all, Congress left them with little discretion in determining what belongs in privacy disclosures—and left the regulators with very little time to develop appropriate standards. The FDA took four years. In our case, seven financial regulatory agencies were expected to compose their differences and produce privacy standards in six months.

Congress was quite explicit in requiring that the disclosures include discussion of the kinds of information that the financial institution collects, the categories of persons to whom the information is or may be disclosed, and the policies and practices of the institution with respect to disclosing the nonpublic personal information of those who are no longer customers of the institution. Additionally, the disclosure must explain the policies that the institution has to protect the confidentiality and security of the nonpublic personal information.

I defy anyone to convert that mass of information into a form that would fit on the side of a cereal box.

But there may be a better approach—a "layered" approach under which consumers would receive a "short-form" privacy disclosure with a few basic facts presented in large, boldface type. This disclosure would provide only the basic information—such as the fact that the institution shares the consumer's information with third parties for marketing purposes, and that the consumer has the right to block such sharing arrangements. But it would also advise consumers about where to turn—with a phone number or a Web site address, for example—to obtain a more detailed disclosure with all of the information required by GLBA.

We believe that this approach would meet both the letter and the spirit of the law. For surely it was not the intent of Congress in enacting privacy legislation to leave consumers more baffled and frustrated than before. Nor were the GLBA privacy provisions intended to embroil financial institutions in a costly paper exercise that adds burden without benefit.

As I said, this is only a concept—and only a start. Clearly, there is much work to be done in moving toward the more consumer-centric approach to disclosure pioneered by FDA. We still know too little about the kinds of financial information that consumers need and want. The basic research in this area remains to be done. But I believe that our concept could take us an important step toward a more efficacious regime of financial disclosure.

* * *

Financial institutions tend to see consumer regulation as an unavoidable fact of life—as a burden to be endured. Yet it can be much more than that, as the food industry's experience with the FDA proves. Food manufacturers entered the new disclosure era not quite kicking and screaming but with a healthy skepticism. They soon discovered, however, that better nutritional labeling could work to their competitive advantage. By learning what consumers wanted—products with less fat or cholesterol, for example—they were able to reformulate existing products and develop new products that met the evolving demands of the marketplace.

The message for bankers should be clear: figure out what consumers want and give it to them. That basic rule of commerce applies to financial services as much as it does to the food industry. Compete on the basis of openness. If banks provide clearer and more relevant information—and brag about it—they'll be better able to tailor financial products that meet consumer tastes and preferences, build customer loyalty, and draw new customers into the fold.

In that sense, we should start viewing disclosure not as a burden, but as a competitive opportunity. It's a view I would encourage all bankers to embrace.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Centre for the Study of Financial Innovation, on the proposed revisions to the Basel Capital Accord, London, England, March 13, 2003

It is an honor and a pleasure to be with the Centre for the Study of Financial Innovation ("CSFI") as it celebrates 10 years of distinguished service to the financial community. The roster of your officers, sponsors, and trustees—as well as the impressive list of CSFI publications—makes it self-evident why the organization enjoys the reputation it does. I particularly want to express my appreciation to Sir Brian, Minos Sombanakis, and Andrew Hilton, for the invitation to speak as well as for this evening's fine hospitality.

When I alluded to your "distinguished service to the financial community," I was obviously not referring to "service" in the same sense one might use the term in a gathering of back-office consultants or software developers. What CSFI provides is quite different—and extraordinarily important in an age when polemics and self-interest masquerade as solemn truth. What CSFI gives us is judgment we can trust, perspective we can apply, and forthright analysis that is indispensable to our understanding of the pressing policy issues of the day.

For internationally active banks, their supervisors, and those who try to make sense of it all, no public policy issues matter more than those currently on the table at Basel. In the United States, Basel II has recently attracted a great deal of attention from banks and policy makers following a Congressional hearing in mid-February at which I expressed concerns with the proposal.

It has certainly been a difficult journey for the members of the Basel Committee and the various working groups and task forces from the central banks and supervisory agencies that are so heavily involved in the Basel process. We have been at it for nearly four years now, and will be at it for some time longer—at least until the end of 2003.

With respect for the kind of perspective that informs so much of CSFI's work, I thought that I would step back and look at Basel II in the context of the history of capital regulation. In what ways does Basel II draw on the experiences of the past—and to the extent that it is leaving experience behind and breaking new ground, what kinds of issues may it be raising?

One needn't go back too far—the late 1970s would do—to find a time when many bank supervisors believed they could easily get along with no formal rules on capital. Experience had taught them that such simple ratios as capital to assets and capital to total deposits were not very useful and that supervisory judgment was a far better tool than mathematical ratios. I recall asking the head of supervision at the Federal Reserve years ago how much capital was enough, and he answered, "I can't tell you, but I know it when I see it"—a response that sounded eerily like that of a late U.S. Supreme Court Justice who was asked to define obscenity.

In any case, bank supervisors of a generation ago were reluctant to place too much faith in fixed capital ratios, partly because they feared giving rise to a false sense of security—or insecurity—about the safety and soundness of the banking system, and partly because the idea that formulaic ratios should carry any decisive weight in an assessment of a bank's condition offended their sense of professionalism. It had taken many decades to overcome the view of the bank examiner as an accounting clerk with enforcement powers—people who might be depended upon to find shortages in the till or moribund loans still being treated as viable, but not much else. In place of that image, a shiny new one was evolving of bank supervisors, whose expertise in banking and finance was matched only by their intuition, discretion, and ability to look beyond the raw numbers to discern the true condition of the institutions under their responsibility.

Not surprisingly, therefore, in the United States the initiative for a return to capital ratios as a supervisory mainstay came not from bank supervisors themselves but rather from lawmakers reacting to the rather abrupt deterioration of the U.S. banking system during the late 1970s. Postmortems on several high-profile failures revealed that the industry's capital-to-assets ratio had been eroding for some time, although it was never definitively established that more capital would have averted or significantly ameliorated the crisis. Regardless, in response to congressional pressure, the regulatory agencies, including the Office of the Comptroller of the Currency ("OCC"), adopted blunt regulatory capital requirements.

As the regulators had predicted, problems quickly cropped up. First, by each adopting its own requirements for regulatory capital, the agencies inevitably found themselves in conflict with one another. That generated restrained dispute among the regulators and the advocates for their respective points of view. But more importantly, it led regulated institutions to engage in a new form of regulatory arbitrage, since it was a simple matter to move to the charter that offered the most permissive approach to capital. In the international arena, it also created invidious distinctions among institutions competing across borders, affording a competitive advantage to those whose home country supervisors took a more lenient approach to capital.

Congress took steps to deal with the domestic ramifications of the problem in several legislative enactments. In 1978 it created the Federal Financial Institutions Examination Council, with a mandate to achieve greater uniformity among the supervisory agencies. In the International Lending Supervision Act of 1983, it required the U.S. banking agencies to do what they had already done voluntarily, if reluctantly, in regard to capital policy, and in 1984, the Federal Reserve ("Fed"), the Federal Deposit Insurance Corporation ("FDIC"), and the OCC agreed to revise their new capital-adequacy guidelines to establish common capital standards for all banking organizations.

The goal of creating a more level playing field for financial institutions—and promoting more consistent supervisory treatment of those institutions—was one of the central objectives of the

Basel Committee from the time of its inception in 1974, and it remains one of its overriding objectives today. By the mid-1980s, the committee had turned its attention to the development of common capital standards for all internationally active banks.

But the Basel process took off in a different direction from where the United States had started under congressional mandate—and it produced very different results. France, the United Kingdom, and Germany had adopted risk-based capital standards starting in the late 1970s, reflecting the industry shift toward higher risk assets and off-balance-sheet activities. This approach involved less prescription and more discretion on the supervisors' part than the more rigid, formulaic approach that U.S. supervisors had objected to but adopted nonetheless under pressure. The European approach became the starting point for work on an international capital accord—and, with minor exceptions, its end result.

The Basel Accord set forth capital standards that U.S. supervisors were well satisfied with—capital standards that not only went a long way toward harmonizing international practice, but that also carved out an important role for supervisory judgment and expertise in determining how much capital a particular institution required, given its risk profile.

If the Basel principals thought that the publication of their work marked the final word on the subject, however, they were mistaken. First, at least in the United States, the adoption of the Basel Accord represented no definitive ratification of the philosophy it embodied. Indeed, the Basel approach scarcely survived the U.S. banking crisis that was already under way when the accord was adopted. In the light of mounting losses and near insolvency of the federal deposit insurance fund, supervisory discretion—the underlying approach of Basel—was increasingly viewed as a euphemism for forbearance, which even some U.S. bank supervisors, under the spotlights, conceded had helped to create and prolong the crisis. In the FDIC Improvement Act of 1991, Congress acted to strip away some of that discretion. Putting strong new emphasis on "prompt corrective action"—that is, a mandate to supervisors to force remedial steps, including recapitalization, when capital levels fall—Congress hard-wired a set of capital trigger points in an effort to limit discretion and to prevent forbearance by the banking agencies—not recognizing that since the supervisors retained the power to assay what the level of capital actually is, any effort to force action based on specific capital levels was not likely to eliminate discretion from the process.

It's unclear which strain in the current philosophical duality is responsible for the industry's impressive current capital strength. However, some bankers have since spoken of their experiences during the crisis of a decade ago as a personal turning point that convinced them never again to split hairs over the risk weight of a given asset and to build capital well beyond regulatory minimums to enable them to weather any foreseeable contingency.

Looking back from today's perspective, the original Basel Accord—Basel I—may be viewed as charmingly unsophisticated, comprised, as it was, of a handful of prefabricated "risk buckets." Two things became clear before long: first, that these rather coarsely structured "buckets" had little to do with real risk, and, second, that it was a simple matter to arbitrage from one bucket to another. These realizations helped to give birth to Basel II.

The authors of Basel II established a noble and ambitious set of goals for themselves: to integrate all that we have learned about capital regulation and risk over the years in a single, logically consistent package; to accommodate, if not resolve, the chronic tension between prescription and supervisory discretion; to recognize the technological and conceptual advances in the science of risk management, and to provide incentives for bankers to make use of those advances; to fine-tune our current risk ratings in a way that makes them more sensitive, more discriminating, and more forward-looking; to supplement the risk judgments of supervisors with those of the marketplace and of bankers themselves; and to ensure that the regulations we produce are relevant to the massive changes that have occurred in international banking—structural changes, portfolio changes, and management changes—since Basel I.

I assume that this audience is reasonably familiar with the key features of Basel II, but at the risk of being tedious, let me briefly outline the structure. The new approach would be built on three "pillars"—the first, a set of formulas for determining regulatory capital; the second, a set of principles for the exercise of supervisory oversight; and the third, a set of disclosure requirements intended to enhance market discipline.

Pillar I basically sets out three means for calculating capital:

- The "standardized" approach—essentially, a set of refinements to the old risk buckets, which provides for the use of external ratings in certain circumstances, and gives some weight to risk mitigation devices.
- The "foundation internal ratings-based (IRB)" approach, which sets forth a methodology for using a bank's own internal risk rating system, including its calculated probabilities of default (PD), as a base for calculating capital, using a factor for loss given default (LGD) provided by supervisors.
- The "advanced IRB" approach, which bases capital calculations on the bank's own supervisory-validated models, including bank-calculated PDs and LGDs.

In each of the three approaches there would be a separate calculation for determining an assignment of capital to cover operational risk. In measuring their operational risk, banks can choose between a basic approach, a standardized approach that looks at individual business lines, and an advanced measurement approach ("AMA").

I suppose in one respect the result of such an ambitious undertaking might have been predictable. The process has generated a lengthy and complex product, as the Committee has sought to develop a risk-based rule that could be applied to banks around the world with varying degrees of sophistication. Part of the complexity of the most recent consultative paper (CP–2), which will be reflected in the soon to be released CP–3, is simply the consequence of there being so many different components of the rule, and thus a variety of possible permutations.

When I have complained in the Basel Committee about the complexity of the paper, I am roundly admonished by my colleagues. “We live in a complex world,” they say. “Don’t quibble if we try to fashion capital rules that reflect that complexity.” But with great respect for my colleagues, the complexity we have generated goes far beyond what is reasonably needed to deal with the intricacies of sensible capital regulation. It reflects, rather, a desire to close every possible loophole, to dictate every detail, and to exclude to the maximum extent possible any opportunity for the exercise of judgment or discretion by those applying and overseeing the application of the new rules. In short, it reflects much more a commitment to prescriptiveness than a mere recognition of the complexity of today’s banking business. To be sure, much of the complexity also reflects the myriad compromises negotiated in the drafting process. And therein lies the greatest obstacle to simplification, for almost any effort to simplify runs the danger of being viewed as having the potential to upset compromises that have been hammered out.

This complexity has a price. Most obviously, it will impose a heavy cost burden on bankers, who have to design systems and educate staff to deal with the complex new rules. It may also have a cost in terms of credibility and public acceptance, for if legislators, customers, and market participants cannot penetrate the new rules, can we expect them nonetheless to love and respect them?

Finally, it may have a cost in terms of competitive equality, and this is what concerns me most. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an evenhanded way across a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 to 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in watching the banks’ operations and judging the banks’ compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to a comparably sized institution, or may examine such an institution thoroughly only every five or six years, or may put heavy reliance on the oversight of outside auditors.

It’s fair to ask, I think, in which regime hundreds of pages of detailed, prescriptive capital rules are more likely to be robustly enforced. The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedstone principle of Basel II. Can we really achieve competitive equality without addressing disparities in supervision—particularly when we are operating on the assumption that the complex new rules we’re writing will be applied in an evenhanded way throughout the world?

As a practical matter, particularly given the rigorous schedule set by the committee, I think it is unrealistic to think that we will see significant simplification in the next iteration of the proposal. I would count it a major achievement, nonetheless if we were able to do no more than simplify the *articulation* of the proposal.

I cannot resist recalling words that seem peculiarly relevant to this effort. In the 1780s, as Americans engaged in a great debate on the principles that should underlie their new government, one of the most original of our thinkers on that subject (and later president), James Madison, contributed an important insight. Popularly elected governments do not automatically command popular confidence, Madison observed. "It will be of little avail to the people if laws are made by men of their choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood." Certainly what has come out of Basel has been voluminous; whether it is incoherent I shall leave for you to decide—as you try to make your way through it.

So where do we go from here? The committee has reaffirmed its intention to release a third consultative paper for comment in early May, with a view toward issuing a final document by year-end. While some have argued that we should scrap the whole Basel II process and go back to the drawing board, or even adopt an entirely new approach, that is not going to happen. There is enormous momentum being generated by Basel Committee members, and by the central bank governors who comprise the Bank for International Settlements, to move ahead with the current approach on the current timetable.

In the United States, the three bank regulatory agencies (Federal Reserve, FDIC, and OCC) have jointly agreed to three steps to simplify our implementation of Basel II.

First, we will make available to U.S. banks only the advanced IRB and the advanced measurement approach to operational risk. The U.S. agencies will likely propose for notice and comment a Basel II-based regime incorporating the advanced IRB approach for credit risk, the AMA for operational risk, and the internal ratings approach for market risk. The underlying strategy is that banks would realize lower capital charges as they moved up the scale of sophistication and would thus have an incentive to make the investment in systems required to make such a movement.

Second, we will apply Basel II only to our large internationally active banks. We do not intend to apply it to the thousands of smaller community banks we have in the United States. While other banks in the United States can apply to come under Basel II, we anticipate that at the outset only a very few will do so—although we also anticipate that market forces will drive some of them in this direction. We expect these two actions will make it easier for us to develop a draft U.S. regulation, which will in effect be a subset of Basel II, and by limiting the number of banks coming under Basel, it will help focus these key banks on the proposal during the comment period, which we expect to undertake this summer.

Third, in drafting the proposed U.S. capital framework, we will use a combination of regulatory language and supervisory guidance to "translate" the objectives and principles of Basel II into terminology and a framework consistent with the U.S. approach to capital regulation. We expect the U.S. rule will require at least as much capital as a literal interpretation of Basel II; at the same time, we will seek to write regulations and guidance that can be understood by both our large banks and by the line bank supervisors enforcing the new capital rule—mindful that we are required to articulate all our regulations in "plain English."

In the United States, our Congress is just beginning to focus on this subject, and is considering what its role should be in the process. While to date the heavy lobbying has been related to the handling of operational risk, there is still a possibility, in my view, that Congress could be energized by some of the large internationally active banks, if they are discontented with the terms of Basel II in its final iteration, or with its impact on their required capital; or by smaller banks claiming that they will suffer a competitive inequity because they don't have access to the potential capital reductions offered the large banks. Members have been particularly insistent that when U.S. regulators translate Basel II into specific regulatory language, which will then be published for public comment, that process must have real integrity—that is, the banking agencies must give serious consideration to the comments they receive, and, if they find some problems, must resolve those issues or bring them back to Basel for further consideration. Let me reaffirm that the OCC and the other U.S. banking agencies cannot sign off on a final Basel II framework until we have weighed the final product in the light of all the comments we receive and have determined that we can implement the new rules in a way that does not compromise safety and soundness or the competitive strength of our banking system. We expect that other countries will go through a similar process with their banks and may also identify substantive issues.

One "safety valve" in the process is the Accord Implementation Group ("AIG") the committee has formed. The AIG will be a continuing subset of the committee that will address problems encountered during the implementation phase, with the potential for mitigating unforeseen difficulties.

The Office of the Comptroller of the Currency has from the outset argued strongly and consistently that Basel II must work in practice as well as in theory; that it must provide supervisors with sufficient flexibility to accommodate differences among financial institutions; and that it must work in a way that avoids placing banks at a competitive disadvantage compared to other financial services providers. In advocating these broad policy goals, the OCC has staked out its own independent positions, as on operational risk. And while we have not always prevailed, I believe that our efforts make it more likely that we'll eventually get a workable new Basel agreement—an agreement that all concerned parties can live with and prosper under.

One final word on timing. The Basel Committee, under the strong and intelligent leadership of Bill McDonough, has wisely set time frames as a means of disciplining itself, and we will work earnestly within the committee in an effort to achieve that schedule. We need to be sure, however, that we get it right. We have taken on a huge task for ourselves as supervisors, and we are confronting our banks with imposing new challenges and cost burdens. The new rules will govern banking for many years to come, and we need to keep the long view in mind, even as we press ahead.

In that endeavor, we have counted on the support and assistance of CSFI and look forward to continued collaboration with you on Basel II—and beyond.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the Financial Services Regulatory Conference, on the OCC, the national bank charter, and current issues facing the national banking system, Washington, D.C., March 17, 2003

Early in *The Tempest,* one of Shakespeare's characters advises that "What's past is prologue,"[1] meaning, in that context, that events of the past provide guidance for a present-day course of action. Much the same could be said for many of the most significant issues facing the Office of the Comptroller of the Currency (OCC) and national banks today. The mission of the agency and the essence of the powers and the character of the national bank charter are deeply rooted in the circumstances that gave rise to the creation of both the agency and national banks in 1863. As the OCC celebrates its 140th anniversary this year, that past provides the principles that define the OCC's contemporary role and the characteristics and legal status of the national bank charter.

Prologue[2]

Banks have never been particularly popular American institutions, and in the early days of this country, banks that operated under a broad grant of national authority may have been most unpopular of all. Thomas Jefferson spoke for many of his time when he said that "banking institutions are more dangerous than standing armies." American history buffs will recall that even George Washington was opposed to an American standing army, so Jefferson's comment was saying quite a lot.

Yet even Jefferson did not believe that the country could afford to dispense with banks altogether. In fact, America needed banks even more than Britain did, for the United States was a young, undeveloped, and far-flung country noticeably lacking in the great private accumulations of liquid wealth with which England was blessed. In order to mobilize capital in such a place, banks were essential to create and facilitate the flow of money.

In 1791, at the urging of Alexander Hamilton, the first Secretary of the Treasury, Congress created the First Bank of the United States—America's first venture into the area of central banking. When the bank's 20-year charter expired, the bank expired with it. But a crumbling economy led lawmakers five years later to create the Second Bank of the United States, which proved no more popular than the first. And state-chartered banks, of which there were well over a hundred by 1816, took advantage of that unpopularity by encouraging state legislatures to pass a variety of discriminatory laws, hoping to rein in, if not destroy, the sometimes overbearing Second Bank.

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[1] *The Tempest,* II, I, 257.

[2] Special thanks to Jesse Stiller, OCC special advisor for Executive Communications, for much of the content of this section.

Maryland's contribution to this state effort was an annual tax of $15,000 levied against the Baltimore branch of the Second Bank of the U.S. When the bank refused to pay, it was successfully sued in state court. In the name of its cashier, J.W. McCulloch, the Second Bank appealed that verdict to the U.S. Supreme Court.

What emerged was one of the landmark judicial decisions in our history. Speaking for a unanimous Supreme Court, Chief Justice Marshall declared constitutional Congress' creation of a national bank and declared unconstitutional Maryland's attempt to weaken it through taxation. On the first point, Marshall elaborated the view of federal power associated with Alexander Hamilton, an expansive view based on a strong union.

On the second point, regarding Maryland's attack on the Second Bank, Marshall invoked the Supremacy Clause—paragraph 2 of Article VI—holding that the Constitution of the United States, and the laws promulgated under it, are the law of the land and carry a presumption of supremacy over the states. "The States," Marshall affirmed, "have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations" of any agency created by lawful exercise of federal authority.

But, the states could still send elected representatives to Washington to accomplish the same end by federal legislation or presidential authority, and under President Andrew Jackson, legislation to extend the life of the Second Bank was vetoed.

With the loss of this centralizing and stabilizing influence, the U.S. banking system stumbled into disarray. Indeed, it was hardly a system at all, because standards and practices varied enormously from state to state. In states like Indiana and New York, new bank organizers were required to have real capital, and their operations were subject to some degree of government supervision. But in many states, banks could organize without a dollar's capital to their name, and supervision was virtually nonexistent. That permitted the shadiest of operators to enter the field—and dominate it in some states.

The currency of the country consisted of notes issued by those banks, and the practice of issuing bank notes with no or inadequate real assets backing them up became a national scandal and a huge burden on interstate commerce, which needed a reliable, nationally accepted currency. To keep redemption-minded note-holders at a safe distance, shady bank operators became experts at evasion, moving their hole-in-the-wall offices to frontier backwaters "where only the wildcats roamed." The term "wildcat banking" has its source in this experience.

Today, we would probably characterize such a situation, when a customer provides value and receives in return an instrument of uncertain and possibly dubious value, as a consumer protection problem. But in the mid-1800s, the lack of uniformity in the value of currency was a great flaw in our banking system before the Civil War, because it gave rise to confusion and uncertainty—two major obstacles to economic development.

This situation cried out for a remedy, and the Civil War provided the catalyst for a new system to deal with it. The Office of the Comptroller of the Currency was created to charter and supervise a new system of national banks, which would serve as the instruments of a uniform and sound national currency and help finance the Civil War.

When the Comptroller chartered a new national bank, a portion of the bank's paid-in capital was required to be used to purchase U.S. Treasury securities, which not only filled the Union's coffers but which were pledged as backing for a new species of circulating notes issued by the banks with the Comptroller's approval. Because these new national banks were to be subject to uniform federal supervision, with capital in the form of government securities, their circulating notes would hold a stable value and could be used, reliably, from state to state. The design of the new national banks thus solved the safety and soundness problem that plagued many state banks and, at the same time, addressed the fraud and deception that resulted from the issuance of notes of dubious value by many state banks.

But, in creating a system of national banks, Congress was not only aiming to solve an immediate problem. By establishing a national banking system, and creating the Office of the Comptroller of the Currency to oversee it, Congress also erected a framework for change, growth, integrity, and expansion of the business of banking, under the Comptroller's supervision, designed to support and foster the nation's economic development. As Carter Golembe put it in one of his famous commentaries: "The responsibility of the Office carries with it, in addition to safety and soundness considerations, the need for the Comptroller to assure that the national banking system is healthy, vigorous, competitive, profitable, innovative, and capable of serving in the best possible manner the banking needs of its customers."

This history—my prologue—helps to explain three defining characteristics of national banks and the national banking system, which are so important in the financial marketplace today:

1) The dynamic powers of national banks to engage in the business of banking, as that business evolves over time;

2) The role and responsibilities of the OCC as the charterer, supervisor, and regulator of national banks; and

3) The National Bank Act's preemption of state laws that would seek to direct or control activities of national banks that are authorized under federal law.

The Powers of National Banks

The long-range goals of Congress for the national banking system—supporting a stable national currency, financing commerce, acting as private depositories, and generally supporting the nation's economic growth and development—required a type of bank that was not just safe and sound, but whose powers were dynamic and capable of evolving, so that national banks could perform their intended roles, well beyond the aftermath of the Civil War. Key to these powers is language set forth at 12 USC 24(Seventh), which provides that national banks are authorized to 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. . . .

Congress had modeled this authority on the bank charter authorized by the New York Free Banking Act, a type of charter that the New York courts explicitly had found to possess flexible and adaptive powers. Shortly before enactment of the National Bank Act, the New York Court of Appeals described the dynamic nature of the New York bank charter, stating that "[t]he implied powers [of a bank] exist by virtue of the grant [to do the banking business] and are not enumerated and defined; because no human sagacity can foresee what implied powers may in the progress of time, the discovery and perfection of better methods of business, and the ever-varying attitude of human relations, be required to give effect to the express powers."[3]

The specifications of certain banking activities that were contained in the New York banking laws, (and subsequently copied into the National Bank Act), were "eminently useful," but "not indispensable," according to the court in that case. Based on this lineage, in construing the National Bank Act the OCC typically looks to the objectives in addition to simply the mechanics of the act, approaching the statute, as one commentator put it, as "an architect's drawing and not a set of specifications."[4] As a result, the powers of national banks to engage in the business and banking and activities that are "incidental" thereto have been continually updated and consistently interpreted by the OCC—and accepted by the courts—as evolutionary; capable of developing and adjusting as needed to support the evolving financial and economic needs of the nation.

Any doubt concerning this characterization of the powers of national banks was settled with the Supreme Court's decision in NationsBank v. Variable Annuity Life Insurance Co. ("VALIC") in which the Court expressly held that the "business of banking" is not limited to the enumerated powers in 24(Seventh) and that the Comptroller has discretion to authorize activities beyond those specifically enumerated in the statute.[5] In the same decision, the Court also reiterated a previous admonition that the Comptroller's determinations regarding the scope of permissible national bank activities pursuant to this authority should be accorded great deference, stating emphatically

[3] *Curtis* v. *Leavitt,* 15 N.Y. 9 (1857).

[4] Harfield, "The National Bank Act and Foreign Trade Practices," 61 *Harvard Law Review* 782 (1948).

[5] *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.,* 513 US 251.

that "it is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws."[6]

So, today, national banks operate pursuant to federal authority contained in a federally granted charter; that authority is recognized as flexible and adaptable to serve changing customer and business needs and desires, and the OCC is uniquely authorized to define and refine the content of the business of banking in order to enable national banks to best serve those changing needs on a safe and sound basis.

The Role and Responsibilities of the OCC as Supervisor of National Banks

The OCC's authority to regulate, supervise, and examine national banks is extensive, and in many respects, exclusive. The latter feature is not always popular with state authorities, but the scope of the OCC's exclusive "visitorial" power is firmly grounded in the National Bank Act and its history.

At the beginning of the national banking system, both proponents and opponents of the new system expected that it would supersede the existing system of state banks.[7] Given this anticipated impact on state banks and the resulting diminution of control by the states over banking in

[6] *Clarke* v. *Securities Industry Assn.,* 479 US 388, 403–404 (1987) (quoting *Investment Company Institute* v. *Camp,* 401 US 617, 626–627.

[7] Representative Samuel Hooper, who reported the bill to the House, stated in support of the legislation that one of its purposes was "to render the law [Currency Act] so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters." Congressional Globe, 38th Congress 1st Session 1256 (March 23, 1864). While he did not believe that the legislation was necessarily harmful to the state bank system, he did "look upon the system of State banks as having outlived its usefulness. . . ." Id. Opponents of the legislation believed that it was intended to "take from the States . . . all authority whatsoever over their own State banks, and to vest that authority . . . in Washington. . . ." Congressional Globe, 38th Congress, 1st Session 1267 (March 24, 1864) (statement of Representative Brooks). Representative Brooks made that statement to support the idea that the legislation was intended to transfer control over banking from the states to the federal government. Given that the legislation's objective was to replace state banks with national banks, its passage would, in Representative Brooks' opinion, mean that there would be no state banks left over which the states would have authority. Thus, by observing that the legislation was intended to take authority over state banks from the states, Representative Brooks was not suggesting that the federal government would have authority over state banks; rather, he was explaining the bill in a context that assumed the demise of state banks. Representative Pruyn opposed the bill stating that the legislation would "be the greatest blow yet inflicted upon the States. . . ." Congressional Globe, 38th Congress, 1st Session 1271 (March 24, 1864). See also John Wilson Million, "The Debate on the National Bank Act of 1863," 2 *Journal of Political Economy* 251, 267 (1893–94) regarding the Currency Act. ("Nothing can be more obvious from the debates than that the national system was to supersede the system of state banks.").

general,[8] proponents of the national banking system were concerned that states would attempt to undermine it. Remarks of Senator Sumner, addressing the prospect of state taxation of national banks, illustrate the sentiment of many legislators of the time. He said, "[c]learly, the bank must not be subjected to any local government, state or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions." [9]

The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with this need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and vested responsibility to carry it out in the newly created OCC. Congress granted the OCC the broad authority "to make a thorough examination of all the affairs of [a national] bank,"[10] and solidified this federal supervisory authority by vesting the OCC with exclusive "visitorial" powers over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protected national banks from potential state hostility by establishing that the authority to examine national banks is vested *only* in the OCC, unless otherwise provided by federal law.[11]

Courts have consistently recognized the distinct status of the national banking system and the limits placed on state involvement in national bank supervision and regulation by the National Bank Act. The Supreme Court stated in one of the first cases to address the role of the national banking system that "[t]he national banks organized under the [National Bank Act] are instruments designed to be used to aid the government in the administration of an important branch of the public service. They are means appropriate to that end."[12]

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[8] See, e.g., *Tiffany* v. *National Bank of the State of Missouri,* 85 US 409, 412–413 (1874) ("It cannot be doubted, in view of the purpose of Congress in providing for the organization of national banking associations, that it was intended to give them a firm footing in the different states where they might be located. It was expected they would come into competition with state banks, and it was intended to give them at least equal advantages in such competition. . . . National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks."). See also B. Hammond, *Banks and Politics in America from the Revolution to the Civil War,* 725–34 (1957); P. Studenski and H. Krooss, *Financial History of the United States,* 155 (1st ed., 1952).

[9] Congressional Globe, 38th Congress, 1st Session, at 1893 (April 27, 1864). See also *Anderson* v. *H&R Block,* __ F.3d __, 2002 US App. LEXIS 5978, at 15–16 (No. 01–11863, April 3, 2002) ("congressional debates amply demonstrate Congress's desire to protect national banks from state legislation. . . .").

[10] Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, codified at 12 USC 481.

[11] Writing shortly after the Currency Act and National Bank Act were enacted, then-Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that "Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments. . . ." Congressional Globe, 39th Congress, 1st Session, Misc. Doc. No. 100, at 2 (April 23, 1866).

[12] *Farmers' and Mechanics' National Bank* v. *Dearing,* 91 US 29, 33 (1875).

Subsequent opinions of the Court have been equally clear about national banks' distinct role and status.13 For example, in Guthrie v. Harkness,14 the Supreme Court stated that "Congress had in mind, in passing this section [section 484] that in other sections of the law it had made full and complete provision for investigation by the Comptroller of the Currency and examiners appointed by him, and, authorizing the appointment of a receiver, to take possession of the business with a view to winding up the affairs of the bank. It was the intention that this statute should contain a full code of provisions upon the subject, and that no state law or enactment should undertake to exercise the right of visitation over a national corporation. Except in so far as such corporation was liable to control in the courts of justice, this act was to be the full measure of visitorial power."15

The Supreme Court also has recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the Currency Act could develop and flourish. For instance, in *Easton v. Iowa,*[16] the Court stated that the National Bank Act "has in view the erection of a system extending throughout the country, and independent, so far as the powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States. . . . If [the states] had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities."[17]

The Court, in *Farmers*' *and Mechanics*' *Bank,* similarly found that "States can exercise no control over [national banks] nor in any wise affect their operation, except in so far as Congress may see proper to permit." Any thing beyond this is "an abuse, because it is the usurpation of power which a single State cannot give."[18]

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[13] See *Marquette National Bank* v. *First of Omaha Service Corp.,* 439 US 299, 314–315 (1978) ("Close examination of the National Bank Act of 1864, its legislative history, and its historical context makes clear that, . . . Congress intended to facilitate . . . a 'national banking system.'" (Citation omitted)); *Franklin National Bank of Franklin Square* v. *New York,* 347 US 373, 375 (1954) ("The United States has set up a system of national banks as Federal instrumentalities to perform various functions such as providing circulating medium and government credit, as well as financing commerce and acting as private depositories."); *Davis* v. *Elmira Savings Bank,* 161 US 275, 283 (1896) ("National banks are instrumentalities of the Federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States").

[14] 199 US 148 (1905).

[15] Id. at 159.

[16] 188 US 220 (1903).

[17] Id. at 229, 231-232.

[18] *Farmers' and Mechanics' Bank,* 91 US at 34 (citation omitted).

Consistent with the need for a uniform system of laws and uniform supervision that would foster the nationwide banking system, courts have interpreted the OCC's visitorial powers expansively. The Supreme Court in Guthrie noted that the term "visitorial" as used in section 484 derives from English common law, which used the term "visitation" to refer to the act of a superintending officer who visits a corporation to examine its manner of conducting business and enforce observance of the laws and regulations (citing First National Bank of Youngstown v. Hughes19).20 "Visitors" of corporations "have power to keep them within the legitimate sphere of their operations, and to correct all abuses of authority, and to nullify all irregular proceedings." The Guthrie Court also specifically noted that visitorial powers include bringing "judicial proceedings" against a corporation to enforce compliance with applicable law.21 Thus, section 484 establishes the OCC as the exclusive regulator of the business of national banks, except where otherwise provided by federal law.

Congress recently affirmed the OCC's exclusive visitorial powers with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 ("Riegle–Neal").22 Although Riegle–Neal makes interstate branches of national banks subject to specified types of laws of a "host" state in which the bank has an interstate branch (except when federal law preempts the application of such state laws to national banks), the statute then makes clear that even where the state law is applicable, authority to enforce the law is vested in the OCC.23

Federal Preemption of State Laws Under the National Bank Act

The OCC's exclusive visitorial authority complements principles of federal preemption, to accomplish the objectives of the National Bank Act. Again, the subject of preemption may not be popular in some quarters, but it flows directly from the Supremacy Clause of the U.S. Constitution,24 which provides that federal law prevails over any conflicting state law, and has long been

[19] 6 F. 737, 740 (6th Circuit 1881), appeal dismissed, 106 US 523 (1883).

[20] Guthrie, 199 US at 158. See also *Peoples Bank* v. *Williams,* 449 F. Supp. 254, 259 (Western District of Virginia 1978) (visitorial powers involve the exercise of the right of inspection, superintendence, direction, or regulation over a bank's affairs).

[21] Enforcement through judicial proceedings was the most common—and perhaps exclusive—means of exercising the visitorial power to enforce compliance with applicable law at the time section 484 was enacted into law. Administrative actions were not widely used until well into the 20th century. Thus, by vesting the OCC with exclusive visitorial power, section 484 vests the OCC with the exclusive authority to enforce, whether through judicial or administrative proceedings.

[22] Pub. L. 103–328, 108 Stat. 2338 (September 29, 1994).

[23] See 12 USC 36(f)(1)(B) ("The provisions of any State law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency.").

[24] U.S. Constitution Article VI, clause 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

recognized with respect to authority granted national banks under the National Bank Act. An extensive body of judicial precedent has developed over the 140 years of existence of the national banking system, explaining and defining the standards of federal preemption of state laws as applied to national banks.25 Together, federal preemption and the OCC's exclusive visitorial authority are defining characteristics of the national bank charter, and constitute one of the essential distinctions between the national banking system and the system of state-chartered and state-regulated banks that comprise the other half of our "dual banking system."

As described above, Congress established the national banking system in 1863 as a means of achieving the economic policy objectives of the United States, including furnishing a stable and reliable national currency through national bank circulating notes, and promoting the nationwide availability of private credit and sound banking services vital to economic development and opportunity though soundly operated and rigorously supervised banks. With the National Bank Act, Congress built a banking system intended to be nationwide in scope, built upon banks whose powers were intended to be uniform, established under federal law, regardless of where in the nation they were doing business. As the Supreme Court noted in Deitrick, Receiver v. Greaney,26 "[t]he National Bank Act constitutes 'by itself a complete system for the establishment and government of National Banks.'" In an earlier case, the Supreme Court stated that "[n]ational banks are instrumentalities of the federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States. It follows that an attempt, by a state, to define their duties or control the conduct of their affairs is absolutely void, wherever such

[25] See, e.g., *Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 US 25, 26, 32, 33 (1996) ("grants of both enumerated and incidental 'powers' to national banks [are] grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States may not "prevent or significantly interfere with the national bank's exercise of its powers."); *Franklin National Bank,* 347 US at 378–379 (1954) (federal law preempts state law when there is a conflict between the two; "The compact between the states creating the Federal Government resolves them as a matter of supremacy. However wise or needful [the state's] policy, . . . it must give way to contrary federal policy."); *Anderson National Bank* v. *Luckett,* 321 US 233, 248, 252 (1944) (state law may not "infringe the national banking laws or impose an undue burden on the performance of the banks' functions" or "unlawful[ly] encroac[h] on the rights and privileges of national banks"); *First National Bank* v. *Missouri,* 263 US 640, 656 (1924) (federal law preempts state laws that "interfere with the purposes of [national banks'] creation, tend to impair or destroy their efficiency as federal agencies or conflict with the paramount law of the United States."); *First National Bank of San Jose* v. *California,* 262 US 366, 368–369 (1923) ("[National banks] are instrumentalities of the federal government. . . . [A]ny attempt by a state to define their duties or control the conduct of their affairs is void, whenever it conflicts with the laws of the United Sates or frustrates the purposes of the national legislation, or impairs the efficiency of the bank to discharge the duties for which it was created."); *McClellan* v. *Chipman,* 164 US 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destro[y] or hampe[r]" national bank functions); *First National Bank of Louisville* v. *Commonwealth of Kentucky,* 76 US (9 Wall.) 353, 362–63 (1870) (national banks subject to state law that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government"); *Association of Banks in Insurance, Inc.* v. *Duryee,* 270 F.3d 397, 403–404 (6th Circuit 2001) ("The Supremacy Clause 'invalidates state laws that "interfere with, or are contrary to," federal law.' . . . A state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach th[at] goal.") (citations omitted).

[26] 309 US 190, 194 (1939).

attempted exercise of authority expressly conflicts with the laws of the United States, and either frustrates the purpose of the national legislation or impairs the efficiency of these agencies of the Federal government to discharge the duties, for the performance of which they were created."27

This independence from state direction and control both recognizes the essentially federal character is national banks and protects them from conflicting local laws that may undermine the uniform, nationwide character of the national banking system. Indeed, the Supreme Court has consistently held that subjecting national banks' exercise of their federally authorized powers to state regulation or supervision would be inconsistent with the system that Congress designed.28 The Court also has recognized that because national banks are federal creations, state law aimed at regulating national banks and their activities applies to national banks only when Congress directs that result,29 and "the States can exercise no control over them, nor in any wise affect their operation, except in so far as Congress may see proper to permit."30

The Court's decisions also have agreed that Congress was concerned not just with the application of certain states' laws to individual national banks but also with the application of multiple states' standards, which would undermine the uniform, national character of the powers of national banks throughout the system. This point was highlighted by the Supreme Court in *Talbott* v. *Silver Bow County Commissioners* where the Court stressed that the "entire body of the Statute respecting national banks emphasize that which the character of the system implies—an intent to create a national banking system co-extensive with the territorial limits of the United States, and with uniform operation within those limits. . . ."31 A similar point was made by the Court in the Easton case, which stressed that the national banking system was "a system extending throughout the country, and independent, so far as the powers conferred are concerned, of state legislation

[27] Davis, 161 US at 283.

[28] See, e.g., *Marquette Nat. Bank of Minneapolis,* 439 US at 314–315 ("Congress intended to facilitate a 'national banking system.'"); *First National Bank of San Jose,* 262 US 366, 369 (1923) (national banks are instrumentalities of the federal government; "any attempt by a State to define their duties or control the conduct of their affairs is void, whenever it conflicts with the laws of the United States or frustrates the purpose of national legislation or impairs the efficiency of the bank to discharge the duties for which it was created.").

[29] Of course, Congress may specifically require the application of state law to national banks for certain purposes. See, e.g., 12 USC 92a(a) (the extent of a national bank's fiduciary powers is determined by reference to the law of the state where the national bank is located). Congress may also, more generally, establish standards that govern when state law will apply to national banks' activities. See, e.g., 15 USC 6701 (codification of section 104 of the Gramm–Leach–Bliley Act, which establishes standards for determining the applicability of state law to different types of activities conducted by national banks, other insured depository institutions, and their affiliates). In such cases, the OCC applies the law or the standards that Congress has required or established.

[30] *Farmers' & Mechanics' National Bank,* 91 US at 33–34.

[31] *Talbott* v. *Silver Bow County Commissioners,* 139 US 438, 443 (1891).

which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States."32

This federal character has consistently informed the decisions of the Supreme Court when the Court has considered whether particular state laws apply to national banks. In a recent instance in which the Supreme Court had occasion to review the federal constitutional foundations of the national banking system, the Court concluded that, because of the federal status and purpose of national banks, national bank powers are not normally limited by state law.[33]

In sum, operating under a broad and potent grant of enumerated powers and such "incidental powers as shall be necessary to carry on the business of banking," national banks were designed from the outset to carry on their business under uniform federally granted powers, uniform federal supervision, and uniform, federally set standards.

While this means that the national banking system and the state banking system are distinct—indeed that difference is the essence of the dual banking system that we highly value today—the distinct character of the national banking system definitely does not mean that national banks operate with lesser standards or less rigorous oversight than generally applicable to state banks. While state laws necessarily will vary state-by-state, national banks are subject to rigorous standards and supervision, administered from the federal level, that applies uniformly to their business, wherever and in whatever form, they conduct it.

The OCC thus bears a heavy responsibility as administrator of the national banking system. The national banking system portion of the dual banking system is designed and premised on the OCC carrying out multiple responsibilities that trace to the agency's origins: ensuring the safety and soundness of the national banking system, overseeing the standards by which national banks operate, and assuring that national banks are playing an appropriate role in the national economy. In this mix, the safety and soundness of national banks is of obvious importance, but so too is the fairness and integrity national banks display in conducting their business. As Judge Posner of the Seventh Circuit observed in Central National Bank of Mattoon v. U.S. Department of the Treasury, "[national] banks are [the Comptroller's] wards, and his only wards; if they fail in droves, he will be blamed."[34] And so too is the Comptroller responsible if national banks commit modern-day versions of the customer frauds and deception that plagued the pre–Civil War banking scene. And so too will he be criticized if national banks fail to provide products and services that support a healthy, stable, and growing economy.

[32] *Easton,* 188 US at 229, 231–232.

[33] *Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 US 25, 32 (1996) (the history of the legal concept of national bank powers "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law").

[34] 912 F 2.2d 897, 905 (7th Circuit 1990).

The OCC's Place in the Dual Banking System and the Tripartite Banking Agency Regulatory System[35]

The OCC carries out these duties from a somewhat unusual status within the federal government. The original decision to create the OCC as an independent agency was a landmark step, and it was one that reflected Congress's understanding of the importance of bank supervision in the nation's overall economic scheme. While formally a "bureau" of the Treasury Department—indeed, until the 1970s, the Comptroller's offices were actually housed within the main Treasury building in Washington—the OCC has always enjoyed considerable operational autonomy. Although appointed by the President with Senate confirmation, the President cannot remove the Comptroller before the expiration of the statutory five-year term without providing to the Senate in writing a statement of his reasons for doing so. Wisely, many administrations have recognized that sound supervision and regulation of the banking system is a responsibility that should not be politicized.

Today, supervision of the U.S. banking industry is split between the OCC for national banks and the Federal Reserve and the FDIC dividing up federal-level supervision of state banks. As already mentioned, at the time of creation of the national banking system, most in Congress apparently hoped for, or at least anticipated, the elimination of state-chartered banks and believed that the offer of easy conversion to the national charter would provide sufficient incentive for state banking to liquidate itself. But the lagging pace of voluntary conversions led Congress to adopt the Marshall dictum so nicely expressed in the *McCulloch* case—"the power to tax is the power to destroy." It imposed a "death tax" on the notes of state banks, a tax that congressional backers promised would be every bit as effective in driving out state banks as an outright ban, which was also considered.

They were wrong. State banking was able to adapt simply by substituting deposit-taking for note-issuing and by taking advantage of state regulations deliberately tailored to permit them to engage in many activities deemed too risky for national banks. The dual banking system was thus born. Reflecting the country's basic ambivalence about banking and the use of national power, a less confrontational Congress then reconciled itself over time to a dual banking system rather than a unified one, embracing a more benign view of state banking as a legitimate expression of state sovereignty and a source of salutary competition for national banks.

Dual banking made for a complicated regulatory system that would soon grow more complicated. Today we entrust the Federal Reserve and the Federal Deposit Insurance Corporation with significant responsibilities for state bank supervision. State-chartered banks, in addition to their state supervisors, each have one primary federal bank supervisor—the FDIC if it's a state-chartered bank that is not a member of the Federal Reserve system (membership is optional for all state banks and mandatory for most OCC-supervised national banks), and the Federal Reserve if the state bank is a Fed member.

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[35] Thanks again to Jesse Stiller for much of the content of this section.

We are sometimes asked to explain why this complicated regulatory structure arose—and why we have not attempted systematically to simplify it. The question of origins has a relatively straightforward answer and takes us back to a theme from the beginning of these remarks—Americans' ambivalence toward banking institutions, their suspicion of concentrated political authority, and their belief that establishing multiple and competing government bureaucracies would serve to check their ambitions and excesses. Thus, when the Federal Reserve System was created in 1914—becoming the second federal agency with a bank supervisory mission—Congress simply layered it on top of the existing supervisory structure and parceled supervisory authority between the new Fed and the OCC. The same pattern held in 1933, when the FDIC—the third of the federal banking agencies—was created.

Why has this system persisted? Perhaps because it has produced some valuable benefits, albeit inadvertently. Competition can be a good thing in the public as well as private sector, and competition among the banking agencies challenges each agency to excel. Our system shows that competition among regulatory agencies can be a force to enhance the quality of supervision, and help prevent any one regulator from becoming unduly rigid. As Ken Lewis, chairman and chief executive officer of Bank of America, said in a speech just last week, "[w]e don't always think of competition as a desirable aspect of regulation, but in our industry it has worked well. Healthy competition among the agencies leads to market-inspired innovation. . . ."

Issues of the Day at the OCC

As we celebrate the OCC's 140th anniversary this year, many of the most significant issues facing the OCC and national banks today have their roots in essential characteristics of the national bank charter and the OCC's fundamental responsibilities as administrator of the national banking system.

Preemption and visitorial powers. Today, the original design of the national bank charter and national banking system is the source of preemption and visitorial powers issues in connection with many facets of national banks' operations. In recent years, national banks have encountered state and municipal efforts to limit the amount of fees that national banks may charge—such as ATM fees—and have argued in response that such restrictions are preempted under the National Bank Act, since the authority of national banks to do business under federal law necessarily includes the ability to charge for, and make a profit on, the products and services the banks provide.

Because of the value of being able to operate under uniform national standards, preemption is an important characteristic of the national bank charter, and some nonbank companies, such as payday lenders, have even tried to enter into contracts with national banks whereby the banks would book the payday loans originated through the payday company's facilities, enabling the nonbank company to conduct that aspect of its business through the national charter and prompting the company then to claim that its activities enjoyed federal preemption as if it were a national bank. While the OCC has been supportive of national banks when preemption issues arise, it has vigorously opposed such "rent-a-charter" arrangements.

The lending authorities of national banks also have raised preemption issues in connection with state restrictions on the interest rates that national banks may charge and state limitations on other terms and conditions of extensions of credit by national banks. State and local limitations and restrictions on loan terms contained in "anti-predatory lending" legislation and ordinances have raised preemption questions that the OCC is now considering. At the same time, in order to assure that national banks do not directly or indirectly participate in abusive or predatory lending practices, the OCC has issued two advisory letters setting out the factors that national banks should take into account in developing polices and standards for their operations to enable them to avoid such practices.

With respect to permissible interest rates, national banks operate under a standard set by federal law, 12 USC 85, which references state law in part but does not completely defer to it. Twice in the last decade, issues concerning the nature of national banks' authority under that section have been addressed by the Supreme Court. The second instance is a case now pending before the High Court, which will be argued at the end of April.

Closely related to preemption, issues concerning the scope of the OCC's exclusive visitorial powers to supervise and examine national banks have arisen recently in connection with activities national banks conduct through "operating subsidiaries." Under OCC regulations, national bank operating subsidiaries conduct their activities pursuant to the same authorization, terms, and conditions that apply to the conduct of those activities by their parent national bank and are subject to state law only to the extent of their parent bank. Recent state efforts to examine and regulate mortgage lending "op subs" of national banks has led to litigation that is currently pending in California.

Safety and soundness and bank capital. One of the original objectives of the OCC, establishing a nationwide system of uniformly sound banking institutions, is highly relevant to the OCC's supervisory responsibilities today, as the fragile economy continues to present challenges for banks of all sizes. High corporate and consumer leverage and stressed real estate conditions in several markets persist. Credit weakness continues to be centered primarily in corporate portfolios. Yet, improved credit risk management practices, a strong capital base, and diversified earnings have enabled banks to continue to post record earnings despite the adverse credit conditions. Notably, an important component of the earnings diversification that helps enhance national banks' soundness today results from decisions in years past by the OCC to recognize new types of activities and risk management techniques as permissible for national banks as part of the dynamic and evolving nature of the business of banking.

We also continue to refine our supervisory tools. The OCC's "Project Canary" is a groundbreaking initiative to develop computer-based analytical products to support early risk identification and evaluation at national banks. Examiners are integrating "Canary" tools (i.e., analytical programs) into their bank supervision. Senior staff will use the "Canary" data to supplement analyses from other sources to develop an ongoing assessment of risk in the national banking system.

National banks can even access the Canary analysis of their own institution through the OCC's "National BankNet" Internet-based network for national banks.

Credit quality issues resulting from softness in the economy make it particularly important that bank capital is robust. Exactly what constitutes adequate capital—particularly for the larger, internationally active banks—is currently under review on an international basis. The Basel Committee on Banking Supervision, as a forum for international cooperation on bank supervision, is undertaking a major revision of its 1988 Capital Accord. Initiatives in 2003 will include issuance of its latest proposal for public comment. The OCC and other U.S. financial regulators expect to issue an advance notice of proposed rulemaking to enable the industry to formally comment of the details of the proposal this summer.

Privacy and customer treatment. The historically grounded responsibilities of the OCC to oversee the integrity of national banks' operations have a present-day incarnation in the highly visible topic of customer privacy. Today, privacy issues test the balance between customer concerns regarding protection of their nonpublic information and banks' desire to utilize such information to manage and control their risk as well as to market financial services.

Privacy-related issues will be in the spotlight in 2003 for several reasons. First is the scheduled expiration, on December 31st, of various preemption provisions of the Fair Credit Reporting Act. Second is a set of consumer concerns involving particular privacy-related issues such as identity theft and obnoxious, often dinnertime-disturbing, telemarketing practices. And third may be the generally agreed poor quality of the privacy notices that consumers have received in the last several years pursuant to the new privacy standards contained in the Gramm–Leach–Bliley Act. I say that the quality of the notices is generally agreed to be poor, not because banks have not been trying hard to do a good job. They have. Unfortunately, the requirements of the law are complex, and the agencies, in promulgating the privacy regulations, didn't make them any easier.

OCC Comptroller Jerry Hawke recently took aim at this very issue in a speech he delivered earlier this month. He said that "unreadable, unfathomable, and costly disclosures may be no better—and they're probably worse—than no disclosures at all." He particularly singled out privacy disclosures as an area that could be improved with a layered approach under which consumers would receive a short-form with a few basic facts presented in a simple standardized format. "This disclosure," he said "would provide the basic information—such as the fact that the institution shares the consumer's information with third parties for marketing purposes and that the consumer has the right to block such sharing arrangements. But it would also advise consumers about where to turn—with a phone number or a Web site address, for example—to obtain a more detailed disclosure with all the information required by the Gramm–Leach–Bliley Act."

In recent years, the OCC also has taken a pioneering position to protect national bank customers against unfair treatment, by using our enforcement authority under section 8 of the Federal Deposit Insurance Act to enforce section 5 of the Federal Trade Commission Act. Section 5 declares unfair and deceptive acts and practices in or affecting commerce to be unlawful but assigns enforcement of the act with respect to banks to the federal banking agencies. We are the only federal banking agency that, in recent years, has taken enforcement actions to combat unfair and deceptive practices using our cease-and-desist powers.

PATRIOT Act and Sarbanes–Oxley Implementation. The PATRIOT Act has established a formidable arsenal of new standards to combat facilitation of financing of terrorist activities. The OCC has worked extensively as part of interagency efforts to adopt implementing regulations and continues to support the act's objectives though ongoing supervision of banks' anti-money-laundering systems, including terrorist financing controls, and PATRIOT Act compliance.

We also are implementing, when appropriate, the new requirements of the Sarbanes–Oxley Act. This means some additional rulemaking activity, but even more importantly, Sarbanes–Oxley has heightened sensitivities to issues of operational integrity and sound corporate governance. In addition to what the new law may require, we, and the banking industry, are keeping a closer watch on how banks identify, assess, and address activities or transactions that pose reputation risk to the bank.

Another corporate governance issue of particular interest to us is assuring that the reputation and interests of national banks within financial conglomerates are properly respected and maintained. While a typical conglomerate, made up of multiple corporations, might be able to ignore the legal entity distinctions of the companies in the corporate family, when one of the members of the family is a federally insured bank, the situation is quite different. Banks enjoy particular government-derived benefits, such a federal deposit insurance, and they are also subject to special protections, such as the transaction-with-affiliates standards of section 23A and 23B of the Federal Reserve Act. Equally important, banks' reputation for soundness and integrity is a priceless asset. We intend to make sure that it is not tarnished.

Conclusion

This journey from the roots of the national banking system, to the present-day issues we face at the OCC, provides context for how we face those issues—and the future. The national banking system is a unique asset of the U.S. financial system and valuable pillar of our national economy. At the OCC, our responsibilities for overseeing the system are in fact, multi-dimensional, as Carter Golembe put it—"to assure that national banks are safe and sound, competitive and profitable, and capable of serving in the best possible manner the banking needs of their customers."

Statement of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the U.S. House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, on relieving the regulatory burden on the financial services industry, Washington, D.C., March 27, 2003

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

Chairman Bachus, Ranking Member Sanders, and members of the subcommittee, I appreciate this opportunity to appear before you again to discuss with you ways in which we can reduce unnecessary regulatory burden on America's banking system, and to express the views of the Office of the Comptroller of the Currency ("OCC") on H.R. 1375, the Financial Services Regulatory Relief Act of 2003 ("FSRR Act"). Let me also thank Congresswoman Capito for again sponsoring a bill that includes sensible and appropriate regulatory burden relief for national banks and other financial institutions.

Many of the provisions in the FSRR Act were also in H.R. 3951, the financial services regulatory relief legislation that was prepared for floor action in the House last year after being reported by the Committee on Financial Services. I want to thank the committee for including almost all of the items suggested by the OCC in these bills. In addition to the provisions that were in H.R. 3951, the FSRR Act also includes some important new amendments that will advance the goal of reducing unnecessary burdens and costs on our nation's banks.

Effective bank supervision demands that regulators achieve a balance between promoting and maintaining the safety and soundness of the banking system and fostering banks' ability to conduct their business profitably and competitively. This is only possible if banks are free from burdensome constraints that are not necessary to further the purposes of the banking laws or to protect safety and soundness. Unnecessary burdens drive up the costs of doing business for banks and their customers and prevent banks from effectively serving the public. Periodic review of the banking statutes and regulations is an essential means of ensuring that banks are not needlessly encumbered by requirements that are no longer appropriate for today's banking environment.

The OCC has a continuing commitment to review its regulations and make changes, consistent with safety and soundness, to enable banks to keep pace with product innovation, new technologies, and changing consumer demand. We constantly reassess the effectiveness and efficiency of our supervisory processes to focus our efforts on the institutions and activities that present the greatest risks and to reduce unnecessary burdens on demonstrably well-run banks. An exciting new development in this regard is the OCC's new "E-corp" system, which enables national banks to file their corporate applications electronically. Using National BankNet, the OCC's Internet-based system for national banks, national banks can now file new branch and branch relocation applications electronically. We will be adding more applications to the system on a rolling basis.

In addition, we also are currently working with the other banking agencies to prepare for the regulatory review required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Section 2222 requires the Federal Financial Institutions Examination Council and each federal banking agency to conduct a review of all regulations every 10 years to identify outdated, unnecessary regulatory requirements. We and the other federal banking agencies have identified our teams for this project and our work is already under way.

However, the results that Congress can achieve today by removing or reducing regulatory burden imposed by federal statutes can be broader and more far-reaching than regulatory changes that we can make under the current law. The FSRR Act contains a number of important provisions that will help banks remain profitable and competitive by eliminating unnecessary burden. My testimony will highlight several of these provisions.[1]

The FSRR Act also contains provisions that further our ability to promote and maintain the safety and soundness of the banking system. I will mention a few of these provisions in my testimony. I will also take this opportunity to briefly discuss our suggestions to improve some of the provisions in the FSRR Act and our recommendations for additional changes that you may wish to consider as the legislation advances.

National Bank Provisions

The FSRR Act contains several provisions that would streamline and modernize aspects of the corporate governance and interstate operations of national banks. The OCC strongly supports these provisions.

For example, section 101 of the act relieves a restriction in current law that impedes the ability of national banks to operate as "Subchapter S" corporations. The National Bank Act currently requires all directors of a national bank to own at least $1,000 worth of shares of that bank or an equivalent interest in a bank holding company that controls the bank. The requirement means that all directors must be shareholders, making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for treatment as a Subchapter S corporation. These banks are thus ineligible for the benefit of Subchapter S tax treatment, which avoids a double tax on the bank's earnings. Community banks suffer most from this result.

Section 101 authorizes the Comptroller to permit the directors of banks seeking Subchapter S status to satisfy the qualifying shares requirement by holding a debt instrument that is subordinated

[1] A detailed section-by-section review of the provisions of Title I, IV, and VI of the FSRR Act that are relevant to the OCC's responsibilities is attached to this testimony as an appendix.

to the amounts owed by the bank to its depositors and general creditors. The holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S. The subordinated liability has features resembling an equity interest, however, since the directors could only be repaid if all other claims of depositors and nondeposit general creditors of the bank were first paid in full, including the claims of the FDIC, if any. The new requirement would thus ensure that directors retain the requisite personal stake in the financial soundness of their bank, but yet would allow the bank to take advantage of Subchapter S tax treatment.

Similarly, section 102 of the act eliminates a requirement in current law that precludes a national bank from prescribing, in its articles of association, the method for election of directors that best suits its business goals and needs. Unlike most other companies and state banks, national banks cannot choose whether or not to permit cumulative voting in the election of their directors. Instead, current law requires a national bank to permit its shareholders to vote their shares cumulatively. Section 102 provides that a national bank's articles of association may permit cumulative voting. This amendment would conform the National Bank Act to modern corporate codes and provide national banks with the same corporate flexibility available to most corporations and state banks.

An important new provision that was added to FSRR Act is section 110. This provision is strongly supported by the OCC and clarifies that the OCC may permit a national bank to organize in any business form, in addition to a "body corporate." An example of an alternative form of organization would be a limited liability national association, comparable to a limited liability company. The provision also clarifies that the OCC's rules will provide the organizational characteristics of a national bank operating in an alternative form, consistent with safety and soundness. Except as provided by these organizational characteristics, all national banks, notwithstanding their form of organization, will have the same rights and privileges and be subject to the same restrictions and enforcement authority.

Allowing a national bank to choose the business form that is most consistent with the banks' business plans improves the efficiency of a national bank's operations. For example, if the OCC should permit a national bank to organize as a limited liability national association, this may be a particularly attractive option for community banks. The bank may then be able to take advantage of the pass-through tax treatment for comparable limited liability entities under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends. Some states currently permit state banks to be organized as unincorporated limited liability companies ("LLCs") and the Federal Deposit Insurance Corporation (FDIC) recently adopted a rule that allows certain state bank LLCs to qualify for federal deposit insurance. This amendment would clarify that the OCC can permit national banks to organize in an alternative business form, such as an LLC.

Section 401 of the act also simplifies the requirements that apply to a national bank that wishes to expand interstate by establishing branches de novo. Under the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. Under the time frames set by the statute, interstate bank *mergers* were permissible in all 50 states as of September 2001. By contrast, de novo *branching* still requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state. Some states have done so, generally conditioning such de novo branching on reciprocal de novo branching being allowed by the home state of the bank proposing to branch in such a state.

The effect of current law is to require that, in many cases, banks must structure artificial and unnecessarily expensive transactions in order to establish a new branch across a state border—which in some cases, is simply across town in a multi-state metropolitan area. Section 401 repeals the requirement that a state must adopt an express "opt-in" statute to permit the de novo branching form of interstate expansion for national banks and contains parallel provisions for state member and nonmember banks. Both state and national banks and their customers would benefit significantly by this change, which would permit a bank to freely choose which form of interstate expansion is most efficient for its needs and customer demands. In today's Internet age, when customers can communicate remotely with banks located in any state, restrictions on where a bank may establish "branch" facilities to directly serve customers are an unnecessary legacy from a protectionist era that detract from healthy competition and customer service.

Federal Branches and Agencies of Foreign Banks

The OCC also licenses and supervises federal branches and agencies of foreign banks. federal branches and agencies generally are subject to the same rights and privileges, as well as the same duties, restrictions, penalties, liabilities, conditions, and limitations and laws that apply to national banks. Thus, federal branches and agencies will benefit equally from the provisions in the FSRR Act that reduce burden on national banks. Branches and agencies of foreign banks, however, also are subject to other requirements under the International Banking Act of 1978 (IBA) that are unique to their organizational structure and operations in the U.S. as an office of a foreign bank. The FSRR Act also includes provisions amending the IBA that are intended to reduce certain unnecessary burdens on federal branches and agencies. We are supportive of these efforts. However, we believe that one of the provisions can be improved to achieve the full benefits of burden reduction and to preserve national treatment with national banks.

Section 107 provides that the OCC can set the capital equivalency deposit (CED) requirements for a federal branch or agency as necessary to protect depositors and other investors and to be consistent with safety and soundness. However, that amount cannot be less than the amount required by a state for a state-licensed branch or agency in which the federal branch or agency is located. This approach is a substantial improvement over the inflexibility of the current law. However, the CED requirements could be made even more risk-focused. The OCC has provided the committee with an alternate that allows the OCC, after consultation with the Federal Financial Institutions Examination Council, to adopt regulations allowing the CED to be set on a risk-based institution-by-institution basis. Such an approach would more closely resemble the risk-based capital framework that applies to both national and state banks.

Information Sharing With Foreign Supervisors

A new provision added to the bill will be particularly helpful to the OCC and the other banking agencies in negotiating information-sharing agreements with foreign supervisors. Section 610 clarifies that the OCC, Federal Reserve Board, FDIC, and Office of Thrift Supervision ("OTS") cannot be compelled to disclose information obtained from a foreign regulator under an information-sharing agreement, or pursuant to other lawful procedures, if public disclosure of the information would cause the foreign authority to violate foreign law. However, nothing in this provision would allow the agency to withhold information from Congress or prevent the agency from complying with a court order in an action commenced by the United States or the agency. This clear statement in the law will facilitate information sharing and will provide foreign supervisors with assurances that public disclosure of confidential supervisory information will be limited in cases in which such disclosures will violate foreign laws.

Safety and Soundness Provisions

The FSRR Act also contains a number of provisions that further the objective of promoting and maintaining the safety and soundness of the banking system. One of the most important of these provisions is section 405, which expressly authorizes the federal banking agencies to enforce written agreements and conditions imposed in writing in connection with an application or when the agency imposes conditions as part of its decision not to disapprove a notice, *e.g.,* a Change in Bank Control Act (CBCA) notice.

This provision also would supersede recent federal court decisions that conditioned the agencies' authority to enforce such conditions or agreements on a showing that the nonbank party to the agreement was "unjustly enriched." Section 405 also contains a valuable measure that clarifies that controlling parties and affiliates of banks many not evade their capital commitments to the bank through bankruptcy. These changes will enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses. Finally, as stated earlier, this section also clarifies the banking agencies' authority to impose and enforce conditions in connection with the agency's decision not to object to a CBCA or other notice.

The act also contains another provision that promotes safety and soundness by providing the federal banking agencies with greater flexibility to manage resources more efficiently and deal more effectively with problem situations. Current law mandates that most banks be examined on-site on prescribed schedules. This can, in certain circumstances, interfere with the ability of the banking agencies to concentrate their supervisory oversight on the most problematic institutions. Section 601 of the bill would permit the agencies, when necessary for safety and soundness purposes, to adjust their mandatory examination schedules to concentrate resources on particularly troubled or risky institutions.

We also recommend that we and the other banking agencies have more flexibility in assigning our examiners to particular institutions. To further that goal, the banking agencies worked together to develop an amendment that broadly addresses particular ethical issues facing our examiners and we thank the committee for including this provision in section 613 of the bill. Current law provides that criminal penalties may be imposed on a federal bank examiner who examines a bank from which the examiner receives an extension of credit, including a credit card issued by that institution. The financial institution that extends such credit to the examiner also is subject to criminal penalties. This limits the flexibility of the OCC and the other banking agencies to assign examiners to particular institutions or examination teams, even if the extension of credit is on the bank's customary terms and the examiner's skills or expertise would contribute materially to the examination.

Section 613 provides that the federal financial institutions regulatory agencies, including the federal banking agencies, may grant exemptions from the prohibition to their examiners by regulation or on a case-by-case basis if an extension of credit would not affect the integrity of the examination. The agencies must consult with each other in developing regulations providing for the exemptions and case-by-case exemptions only may be granted after applying certain specific factors. In addition, the amendment expressly provides that examiners may have credit cards without disqualification or recusal, but subject to the safeguard that the cards must be issued under the same terms and conditions as cards issued to the general public.

Section 603 of the FSRR Act also improves the federal banking agencies' ability to keep bad actors out of our nation's depository institutions. This provision gives the federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an uninsured national or state bank or uninsured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to insured depository institutions. Section 611 further would amend the law to provide the Federal Reserve Board with the authority to keep persons convicted of these offenses from participating in the affairs of a bank holding company or its nonbank subsidiaries, or an Edge or Agreement corporation. To further strengthen this authority, we recommend that this provision be expanded to clarify that the federal banking agencies also can prohibit these persons from participating in the affairs of nonbank subsidiaries of the banks that we supervise.

Two other important new provisions have been added to the FSRR Act to promote safety and soundness. These provisions were developed on an interagency basis by the federal banking agencies and, in my testimony last year, I recommended that these provisions be included in the bill.

First, under current law, independent contractors for insured depository institutions are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution ("institution-affiliated parties"). To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a federal banking agency to take action against the accountant for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This standard is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. Section 614 of the FSRR Act removes the "knowing and reckless" requirement to hold independent contractors to a standard that is more like the standard that applies to other institution-affiliated parties.

Second, section 409 amends the CBCA to address issues that have arisen for the banking regulators when a stripped-charter institution (i.e., an insured bank that has no ongoing business operations because, for example, all of the business operations have been transferred to another institution) is the subject of a change-in-control notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a de novo charter and an application for deposit insurance. In general, the scope of review of a de novo charter application or deposit insurance application is more comprehensive than the statutory grounds for denial of a notice under the CBCA. There also are significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. To address these concerns, section 409 of the FSRR Act expands the criteria in the CBCA that allow a federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider business plan information and would allow the agency to use that information in determining whether to disapprove the notice.

Additional Suggestion To Improve Information Sharing

Another item that we recommend be included in the bill is an amendment that would permit all of the federal banking agencies—the OCC, FDIC, OTS, and the Federal Reserve Board—to establish and use advisory committees in the same manner. Under current law, only the Board is exempt from the public disclosure requirements of the Federal Advisory Committee Act (FACA). The OCC, FDIC, and OTS, however, also supervise insured depository institutions and these institutions and their regulators have the same need to share information and to be able to conduct open and frank discussions about important supervisory and policy issues. Because of the potentially sensitive nature of this type of information, the public meeting and disclosure requirements under FACA could inhibit the supervised institutions from providing the OCC, FDIC, or OTS with their candid views. Our amendment would enhance the free exchange of information between all depository institutions and their federal bank regulators with resulting safety and soundness benefits.

Bank Parity with Special Provisions for Thrifts

Finally, I note that the bill contains provisions providing beneficial treatment to federal thrifts in areas where there is no reason to particularly distinguish federal thrifts from national banks or state banks. These provisions include section 213 (federal court diversity jurisdiction determined only on the basis of where an institution has its main office, eliminating consideration of where it has its principal place of business) and section 503 (eliminating geographic restrictions on thrift service companies). Similar issues may exist with respect to some of the other sections. The nature of these provisions is such that, if they are considered appropriate by the subcommittee, there is no basis not to make them applicable to banks as well as thrifts.

Conclusion

Once again, Mr. Chairman, on behalf of the OCC, I thank you for your leadership in pursuing this legislation. As I have indicated, the OCC supports the act and believes that many of its provisions will go far to promote the objectives I have described today. In the areas in which we have recommended that you consider additional improvements, we would be pleased to work with your staff to develop appropriate legislative language for the subcommittee's consideration.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

APPENDIX: H.R. 1375: The Financial Services Regulatory Relief Act of 2003

Summary and Comments of the Office of the Comptroller of the Currency on Titles I, IV, and VI

Title I—National Bank Provisions

Section 101. National Bank Directors

Summary: This section would amend section 5146 of the Revised Statutes of the United States (12 USC 72) to provide more flexible requirements regarding director qualifying shares for national banks operating, or seeking to operate, as Subchapter S corporations. The National Banking Act currently requires all directors of a national bank to own "shares of the capital stock" of the bank having an aggregate par value of at least $1,000, or an equivalent interest, as determined by the Comptroller, in a bank holding company that controls the bank. The amendment would permit the Comptroller to allow the use of a debt instrument that is subordinated to the interests of depositors, the Federal Deposit Insurance Corporation (FDIC), and other general creditors to satisfy the qualifying shares requirement for directors of national banks seeking to operate in Subchapter S status.

OCC comments: The OCC supports this change to the law. The requirement in current law creates difficulties for some national banks that operate in Subchapter S form. It effectively requires that all directors be shareholders, thus making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for the benefit of Subchapter S tax treatment, which avoids double tax on the bank's earnings. Such a subordinated debt instrument would have features resembling an equity interest, since the directors could only be repaid if all other claims of depositors and nondeposit creditors of the bank were first paid in full, including the FDIC's claims, if any. It would thus ensure that directors retain their personal stake in the financial soundness of the bank. However, the holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S.

Section 102. Voting in Shareholder Elections

Summary: This section would amend section 5144 of the Revised Statutes of the United States (12 USC 61). Section 5144 imposes mandatory cumulative voting requirements on all national banks. This law currently requires that, in all elections of national bank directors, each shareholder has the right to (1) vote for as many candidates as there are directors to be elected and to cast the number of votes for each candidate that is equal to the number of shares owned, *or* (2) cumulate his or her votes by multiplying the number of shares owned by the number of directors to be elected and casting the total number of these votes for only one candidate or allocating them in any manner among a number of candidates. This amendment would permit a national bank to provide in its articles of association which method of electing its directors best suits its business goals and needs and would provide the OCC with authority to issue regulations to carry out the purposes of this section.

OCC comments: The OCC supports this change to national banking law. The Model Business Corporation Act and most states' corporate codes provide that cumulative voting is optional. This amendment would conform this provision of the National Bank Act to modern corporate codes and would provide national banks with the same corporate flexibility available to most state corporations and state banks.

Section 103. Simplifying Dividend Calculations for National Banks

Summary: This section would amend section 5199 of the Revised Statutes of the United States (12 USC 60) to simplify the formula for calculating the amount that a national bank may pay in dividends. The current law requires banks to follow a complex formula that is unduly burdensome and unnecessary for safety and soundness. The proposed amendment would retain certain safeguards in the current law that provide that national banks (and state member banks)[1] need the approval of the Comptroller (or the Federal Reserve Board (FRB) in the case of state member banks) to pay a dividend that exceeds the current year's net income combined with any retained net income for the preceding two years. For purposes of the approval requirement, these federal regulators would retain the authority to reduce the amount of a bank's "net income" by any required transfers to funds, such as a sinking fund for retirement of preferred stock.

OCC comments: The OCC supports this amendment. The amendment would reduce burden on banks in a manner that is consistent with safety and soundness. Among other things, the amendment would ensure that the OCC (and the FRB for state member banks) will continue to have the opportunity to deny any dividend request that may deplete the net income of a bank that may be moving towards troubled condition. Importantly, the amendment would not affect other safeguards in the National Bank Act (12 USC 56). These provisions generally prohibit national banks from withdrawing any part of their permanent capital or paying dividends in excess of undivided profits except in certain circumstances.

Moreover, other safeguards, such as Prompt Corrective Action, have been enacted in the last 10 years that provide additional safety and soundness protections for all insured depository institutions. The proposed amendment would not affect the applicability of these safeguards. These additional safeguards prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 USC 1831o (d)(1)).

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[1] See 12 USC 324 and 12 CFR 208.5 generally applying the national bank dividend approval requirements to state member banks.

Section 104. Repeal of Obsolete Limitation on Removal Authority of the Comptroller of the Currency

Summary: This provision amends section 8(e)(4) of the Federal Deposit Insurance Act (FDIA) (12 USC 1818(e)(4)) relating to the procedures for the removal of an institution-affiliated party (IAP) from office or participation in the affairs of an insured depository institution. With respect to national banks, current law requires the OCC to certify the findings and conclusions of an Administrative Law Judge to the FRB for the FRB's determination as to whether any removal order will be issued. This amendment would remove this certification and FRB approval process and allow the OCC directly to issue the removal order with respect to national banks.

OCC comments: The OCC supports this amendment. This present system stems from historical decisions made by Congress on circumstances that are no longer applicable. Originally, the role of the OCC in removal cases was to certify the facts of the case to the FRB. The FRB then made the decision to pursue the case and made the final agency decision. At that time, the Comptroller was a member of the FRB and therefore participated in the FRB's final removal decision. However, Congress later removed the Comptroller from the FRB and gave the OCC the authority to issue suspensions and notices of intention to remove.

All of the federal banking agencies, except the OCC, may remove a person who engages in certain improper conduct from the banking business. In the case of the OCC, the determination of whether to remove an individual from a national bank (and thus from the banking business) is made by the FRB. This amendment would give the Comptroller the same removal authority as the other banking agencies to issue orders to remove persons who have been determined under the statute to have, for example, violated the law or engaged in unsafe or unsound practices in connection with an insured depository institution. Like the other banking agencies, the Comptroller should make these decisions about persons who engage in improper conduct in connection with the institutions for which the Comptroller is the primary supervisor. This is a technical change to streamline and expedite these actions and has no effect on a person's right to seek judicial review of any removal order. The FRB also supports this amendment.

Section 105. Repeal of Intrastate Branch Capital Requirements

Summary: This provision would amend section 5155(c) of the Revised Statutes of the United States (12 USC 36(c)) to repeal the requirement that a national bank, in order to establish an intrastate branch in a state, must meet the capital requirements imposed by the state on state banks seeking to establish intrastate branches.

OCC comments: The OCC supports this technical amendment to repeal the obsolete capital requirement for the establishment of intrastate branches by national banks. This amendment passed the House on October 9, 1998 in Section 306 of H.R. 4364, the Depository Institution Regulatory Streamlining Act of 1998, and was also included in later legislation introduced in the House. This requirement is not necessary for safety and soundness. Branching restrictions are already imposed under other provisions of law to limit the operations of a bank if it is in troubled condition. See 12 USC 1831o(e) (prompt corrective action).

Section 106. Clarification of Waiver of Publication Requirements for Bank Merger Notices

Summary: This section would amend sections 2(a) and 3(a)(2) of the National Bank Consolidation and Merger Act (12 USC 215(a) and 215a(a)(2), respectively) concerning the newspaper publication requirement of a shareholder meeting to vote on a consolidation or merger of a national bank with another bank located within the same state. This change would clarify that the publication requirement may be waived by the Comptroller in the case of an emergency situation *or* by unanimous vote of the shareholders of the national or state banks involved in the transaction.

This amendment does not affect other requirements in the law. The current law also requires that the consolidation or merger must be approved by at least a 2/3 vote of the shareholders of each bank involved in the transaction. In addition, the shareholders of the banks generally must receive notice of the meeting by certified or registered mail at least 10 days prior to the meeting. These provisions are not changed.

OCC comments: The OCC supports this amendment. The amendment would clarify the intent of the statute and remove any ambiguity as to its meaning.

Section 107. Capital Equivalency Deposits for Federal Branches and Agencies of Foreign Banks

Summary: This section would amend section 4(g) of the International Banking Act of 1978 (IBA) (12 USC 3102(g)) with respect to the Comptroller's authority to set the amount of the capital equivalency deposit (CED) for a federal branch or agency. The CED is intended to ensure that assets will be available in the U.S. for creditors in the event of liquidation of a U.S. branch or agency. The current CED statute that applies to foreign banks operating in the United States through a federal license may impose undue regulatory burdens without commensurate safety and soundness benefits. These burdens include obsolete requirements about where the deposit must be held and the amount of assets that must be held on deposit. As a practical matter, the IBA sets the CED at 5 percent of total liabilities of the federal branch or agency and provides that the CED must be maintained in such amount as determined by the Comptroller. As a result, federal branches and agencies often must establish a CED that is larger than the capital that would be required for a bank of corresponding size or for a similar size state-chartered foreign branch or agency in major key states.

Section 107 provides that the OCC can set the CED requirements for a federal branch or agency as necessary to protect depositors and other investors and to be consistent with safety and soundness. However, that amount cannot be less than the amount required by a state for a state-licensed branch or agency in the state in which the federal branch or agency is located.

OCC comments: Section 107 represents a substantial improvement over the inflexibility of current law; however, the CED standards could be made even more risk-focused. Last year and again this year the OCC provided the committee with an amendment that allows the OCC, after consultation with the Federal Financial Institutions Examination Council (FFIEC), to adopt regulations allowing the CED to be set on a risk-based institution-by-institution basis. Such an approach would more closely resemble the risk-based capital framework that applies to national and state banks. The FRB has no objections to the OCC's amendment.

Section 108. Equal Treatment for Federal Agencies of Foreign Banks

Summary: This section would amend section 4(d) of the IBA (12 USC 3102(d)) to provide that the prohibition on uninsured deposit-taking by federal agencies of foreign banks applies only to deposits from U.S. citizens or residents. As a result, a federal agency would be able to accept uninsured foreign source deposits from non-U.S. citizens. State agencies of foreign banks may accept uninsured deposits from parties who are neither residents nor citizens of the United States, if so authorized under state law. However, due to slight language differences in the IBA, the D.C. Circuit Court of Appeals has held that federal agencies cannot accept any deposits, including those from noncitizens who reside outside of the United States. *Conference of State Bank Supervisors* v. *Conover,* 715 F.2d 604, 623 (D.C. Cir. 1983).

OCC comments: The OCC supports this amendment. This amendment would allow federal agencies to accept the limited uninsured foreign source deposits that state agencies may accept under the IBA. As a result, the amendment would repeal an unnecessary regulatory burden that has competitively disadvantaged federal agencies and prevented them from offering the same services to foreign customers that may be offered by state agencies. Because these deposits are not insured, this amendment does not pose any risks to the deposit insurance fund.

Section 109. Maintenance of a Federal Branch and a Federal Agency in the Same State

Summary: This section would amend section 4(e) of the IBA (12 USC 3102(e)) to provide that a foreign bank is prohibited from maintaining both a federal agency and a federal branch in the same state only *if* state law prohibits maintaining both an agency and a branch in the state. Current law prohibits a foreign bank from operating both a federal branch and a federal agency in the same state notwithstanding that state law may allow a foreign bank to operate both types of offices.

OCC comments: The OCC supports this change. According to the legislative history of the current provision, this prohibition was included in the IBA to maintain parity with state operations. However, today some states permit foreign banks to maintain both a branch and agency in the same state. Florida law permits a foreign bank to operate more than one agency, branch, or representative office in Florida (see Fla. Stat. Ann. 663.06). Other states, such as Connecticut, also may permit a foreign bank to have both a state branch and a state agency (see Conn. Gen. Stat.

Ann. 36a–428). This amendment would repeal an outdated regulatory burden in current law and permit a foreign bank to maintain both a federal branch and a federal agency in those states that do not prohibit a foreign bank from maintaining both of these offices. This change would enhance national treatment and give foreign banks more flexibility in structuring their U.S. operations.

Section 110. Business Organization Flexibility for National Banks

Summary: This section would amend the Revised Statutes of the United States (12 USC 21 et seq.) to clarify the Comptroller's authority to adopt regulations allowing national banks to be organized in different business forms. Notwithstanding the form of organization, however, all national banks would continue to have the same rights and be subject to the same restrictions and requirements except to the extent that differences are appropriate based on the different forms of organization.

OCC comments: The OCC strongly supports this amendment. This amendment would reduce burden on national banks and allow them to choose among different business organizational forms, as permitted by the Comptroller, and to select the form that is most consistent with the their business plans and operations so that it may operate in the most efficient manner. Certain alternative business structures may be particularly attractive for community banks. For example, if the Comptroller should permit a national bank to be organized as a limited liability national association and establish the characteristics of such a national bank, the bank then may be able to take advantage of the pass-through tax treatment for comparable limited liability entities under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends.

Some states currently permit state banks to be organized as unincorporated limited liability companies (LLCs) and the FDIC recently adopted a rule that will result in certain state bank LLCs being eligible for federal deposit insurance. Clarifying that national banks also may be organized in alternative business forms will provide a level playing field.

Section 111. Clarification of the Main Place of Business of a National Bank

Summary: This section would amend two sections in the Revised Statutes of the United States (12 USC 22 and 81). The amendment would replace obsolete language that is used in these two sections with the modern term "main office."

OCC comments: The OCC supports these technical amendments. The change to 12 USC 22 would clarify that the information required to be included in a national bank's organization certificate is the location of its *main office*. The change of 12 USC 81 would clarify that the general business of a national bank shall be transacted in its *main office* and in its branch or branches. Both statutes currently use obsolete terms to describe a main office of a national bank.

Title IV—Depository Institution Provisions

Section 401. Easing Restrictions on Interstate Branching and Mergers

Summary: This section would amend section 5155(g) of the Revised Statutes of the United States (12 USC 36(g)), section 18(d)(4) of the FDIA (12 USC 1828(d)(4)), section 9 of the Federal Reserve Act (12 USC 321), and section 3(d)(1) of the Bank Holding Company Act (BHCA) (12 USC 1842(d)(1)) to ease certain restrictions on interstate banking and branching. Under the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle–Neal Act), an out-of-state national or state bank may establish a de novo branch in a state only if that state has adopted legislation affirmatively "opting in" to de novo branching. This amendment would repeal the requirement that a state expressly must adopt an "opt-in" statute to permit the de novo branching form of interstate expansion.

In addition, the Riegle–Neal Act permits a state to prohibit an out-of-state bank or bank holding company from acquiring an instate bank that has not been in existence for up to five years. This amendment also would repeal the state age requirement.

Also, the amendment would amend the FDIA to authorize consolidations or mergers between an insured bank and a noninsured bank with different home states and amend national banking law relating to consolidations or mergers between noninsured national banks and other noninsured banks with different home states.

OCC comments: The OCC supports the changes to the law to remove the restrictions on interstate de novo branching. Enactment of this amendment should enhance competition in banking services with resulting benefits for bank customers. Moreover, it will ease burdens on banks that are planning interstate expansion through branches and would give banks greater flexibility in formulating their business plans and in making choices about the form of their interstate operations.

Under the Riegle–Neal Act, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. While two states "opted out" at the time, interstate bank *mergers* are now permissible in all 50 states. By contrast, de novo *branching* by banks requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state. This requires banks in many cases to structure artificial and unnecessarily expensive transactions in order for a bank to simply establish a new branch across a state border. However, federal thrifts are not similarly restricted and generally may branch interstate without the state law "opt-in" requirements that are imposed on banks.

In addition, the OCC supports the amendments that would repeal the state age requirement. This additional limitation on bank acquisitions by out-of-state banking organizations is no longer necessary if interstate de novo branching is permitted.

Section 402. Statute of Limitations for Judicial Review of Appointment of a Receiver for Depository Institutions

Summary: This provision would amend section 2 of the National Bank Receivership Act (12 USC 191) and section 11(c)(7) of the FDIA (12 USC 1821(c)(7)) to provide for a 30-day period to judicially challenge a determination by the OCC to appoint a receiver for a national bank under the National Bank Receivership Act or by the FDIC to appoint itself as receiver under the FDIA under certain conditions. Current law generally provides that challenges to a decision by the OTS to appoint a receiver or conservator for an insured savings association or the FDIC to appoint itself as receiver or conservator for an insured state depository institution must be raised within 30 days of the appointment. 12 USC 1464(d)(2)(B), 1821(c)(7). There is, however, no statutory limit on a national bank's ability to challenge a decision by the OCC to appoint a receiver of an insured or uninsured national bank.[2] As a result, the general six-year statute of limitations for actions against the United States applies to the OCC's receiver appointments. See *James Madison, Ltd.* v. *Ludwig,* 82 F.3d 1085 (D.C. Cir. 1996).

Moreover, under the FDIA, there are some circumstances under which FDIC may be appointed or appoint itself as receiver or conservator for an insured depository institution that are not specifically subject to the general 30-day judicial review period. As a technical matter, the amendment also would harmonize these provisions in the FDIA with the general 30-day rule.

Finally, the amendment would provide that the changes made in the statute of limitations under these provisions applies with respect to conservators, receivers, or liquidating agents appointed on or after the date of enactment of the new law.

OCC comments: The OCC supports this amendment to national banking law. This amendment passed the House on October 9, 1998 in Section 304 of H.R. 4364, the Depository Institution Regulatory Streamlining Act of 1998, and was also included in later legislation introduced in the House. The six-year protracted time period under current law severely limits the OCC's authority to manage insolvent national banks that are placed in receivership by the agency and the ability of the FDIC to wind up the affairs of an insured national bank in a timely manner with legal certainty. (In the case of an insured national bank that is placed in receivership by the OCC, the FDIC must be appointed the receiver.) This amendment would make the statute of limitations governing the appointment of receivers of national banks consistent with the time period that generally applies to other depository institutions. The amendment would not affect a national bank's ability to challenge a decision by the OCC to appointment a receiver, but simply require that these challenges must be brought in a timely manner and during the same time frame that generally applies to other depository institutions.

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[2] Under current law, there is a 20-day statute of limitations for challenges to the OCC's decision to appoint a *conservator* of a national bank. 12 USC 203(b)(1).

Section 403. Reporting Requirements Relating to Insider Lending

Summary: This provision would amend section 22(g) of the Federal Reserve Act (12 USC 375a) and section 106(b)(2) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972(2)) to eliminate certain reporting requirements concerning loans made to insiders. Specifically, the reports that would be eliminated are—

1) The report that must be filed with a bank's board of directors when an executive officer of the bank obtains certain types of loans from another bank that exceeds the amount the officer could have obtained from his or her own bank,

2) The supplemental report a bank must file with its quarterly call report identifying any loans made to executive officers during the previous quarter, and

3) An annual report filed with a bank's board of directors by its executive officers and principal shareholders regarding outstanding loans from correspondent banks.

OCC comments: The OCC supports these amendments. Nothing in these amendments affects the insider lending restrictions that apply to national banks or the OCC's enforcement of those restrictions. Moreover, the OCC believes that it will continue to have access to sufficient information during the examination process to review a national bank's compliance with the insider lending laws. Under the OCC's regulations, national banks are required to follow the FRB's regulations regarding insider lending restrictions and reporting requirements (see 12 CFR 31.2). The FRB's regulations require member banks to maintain detailed records of all insider lending. In addition, the OCC has the authority under 12 USC 1817(k) to require any reports that it deems necessary regarding extensions of credit by a national bank to any of its executive officers or principal shareholders, or the related interests of such persons.

Section 404. Amendment to Provide an Inflation Adjustment for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act

Summary: This provision would amend section 203(1) of the Depository Institutions Management Interlock Act (DIMIA) (12 USC 3202(1)). Under current law, generally a management official may not serve as a management official of any other nonaffiliated depository institution or depository institution holding company if (1) their offices are located or they have an affiliate located in the same MSA, or (2) the institutions are located in the same city, town, or village, or a city, town, or village that is contiguous or adjacent thereto. For institutions of less than $20 million in assets, the SMSA restriction does not apply. The amendment would increase the current $20 million exemption to $100 million.

OCC comments: The OCC supports this amendment. This $20 million cap has not been amended since the current law was originally enacted in 1978. However, the asset size of FDIC-insured commercial banks between 1976 and 2000 has increased over five fold. Depository institutions of all sizes will continue to be subject to the city, town, or village test.

Section 405. Enhancing the Safety and Soundness of Insured Depository Institutions

Summary: This provision would add a new section to the FDIA (12 USC 1811, et seq.) to provide that the federal banking agencies may enforce the terms of (1) conditions imposed in writing in connection with an application, notice, or other request, and (2) written agreements. The amendment also would clarify the existing authority of the FDIC as receiver or conservator to enforce written conditions or agreements entered into between insured depository institutions and IAPs.

Finally, the amendment would amend section 18(u) of the FDIA (12 USC 1828(u)). This section of the law provides that certain transfers to depository institutions to bolster their capital cannot be reversed under the Bankruptcy Code or other law if the affiliate or controlling shareholder making the transfer later becomes bankrupt. The amendment would delete the requirement that the insured depository institution had to be undercapitalized at the time of the transfer for the transfer to be protected under this provision.

OCC comments: The OCC supports these changes to the law. This amendment enhances the safety and soundness of depository institutions and protects the deposit insurance funds from unnecessary losses. This amendment is intended to reverse some court decisions that question the authority of the agencies to enforce such conditions or agreements against institution-affiliated parties (IAP) without first establishing that the IAP was unjustly enriched. In addition, the amendment would clarify that a condition imposed by a banking agency in connection with the nondisapproval of a notice, e.g., a notice under the Change in Bank Act, can be imposed and enforced under the FDIA. Finally, the OCC also supports the change to section 18(u) of the FDIA. The amendment enhances safety and soundness by protecting the capital of insured depository institutions.

Section 406. Investments by Insured Savings Associations in Bank Service Companies Authorized

Summary: This section would amend the Bank Service Company Act (12 USC 1861, et seq.) to allow an insured savings association to be an investor in a bank service company. Under current law, a bank service company must be owned by one or more insured *banks* and, thus, a savings association cannot invest in these entities. In addition, this provision would amend section 5(c)(4)(B) of the Home Owners' Loan Act (HOLA) (12 USC 1464(c)(4)(B)) to provide that a federal savings association may invest in a service company under HOLA if the company is owned by state and federal *depository institutions*. Under current law, a federal savings association may invest in a service company under HOLA only if the corporation is organized under the laws of the state in which the association's home office is located and the corporation is owned only by state and federal *savings associations* having their home offices in such state. Another provision in this bill, Section 503, would amend HOLA to eliminate the geographic limits on service companies authorized under that law and, thus, would no longer require that the company must be located in the investors' home state.

OCC comments: The OCC does not object to section 406, but suggests that if, under section 503, geographic limits on thrift service companies are eliminated, geographic restrictions on bank service companies should similarly be lifted.

Section 407. Cross Guarantee Authority

Summary: This section would amend section 5(e)(9)(A) of the FDIA (12 USC 1815(e)(9)(A)) to provide that, for purposes of determining liability of commonly controlled depository institutions for FDIC losses, institutions are commonly controlled if they are controlled by the same company. Under current law, institutions are only commonly controlled if controlled by the same "depository institution holding company." Such a holding company includes only a bank holding company or savings and loan holding company. However, if the subsidiary institution is, for example a credit card bank or a trust company, it is not a "bank" for purposes of the BHCA. Because the holding company is not a bank holding company, there is no cross guarantee liability under current law.

OCC comments: The OCC supports this amendment, which would correct a gap in the current law to ensure that cross guarantee liability applies equally to any company that controls more than one insured depository institution.

Section 408. Golden Parachute Authority and Nonbank Holding Companies

Summary: This section would amend section 18(k) of the FDIA (12 USC 1828(k)) to clarify the FDIC's authority to limit golden parachute payments or indemnification payments made by any company that controls an insured depository institution. Similar to the provision summarized in Section 407, current law only applies to "depository institution holding companies."

OCC comments: The OCC also supports this amendment to correct a gap in the law.

Section 409. Amendments Relating to Change in Bank Control

Summary: This section would amend the Change in Bank Control Act (CBCA) in section 7(j) of the FDIA (12 USC 1817(j)) to expand the criteria that would allow a federal banking agency to extend the time period to consider a CBCA notice. Under the CBCA, a federal banking agency must disapprove a CBCA notice within certain time frames or the transaction may be consummated. Initially, the agency has up to 90 days to issue a notice of disapproval. The agency may extend that period for up to an additional 90 more days if certain criteria are satisfied and this amendment provides for new criteria that would allow an agency to extend the time period under this additional up to 90-day period. The new criteria that an agency could use to extend the time period can provide the agency more time to analyze the future prospects of the institution or the safety and soundness of the acquiring party's plans to sell the institution or make changes in its business operations, corporate structure, or management. Moreover, the amendment would permit the agencies to use that information as a basis to issue a notice of disapproval.

OCC comments: The OCC supports this amendment, which is jointly recommended by the federal banking agencies. This amendment will address issues that have arisen for the banking regulators when a stripped-charter institution (i.e., an insured bank that has no ongoing business operations because, for example, all of the business operations have been merged into another institution) is the subject of a CBCA notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a de novo charter and an application for deposit insurance. In general, the scope of review of a de novo charter application or deposit insurance application is more comprehensive than the statutory grounds for the denial of a notice under the CBCA. There are also significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the requirement for prior approval and without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. Section 409 expands the criteria in the CBCA that allows a federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider the acquiring party's business plans and the future prospects of the institution and use that information in determining whether to disapprove the notice.

Title VI—Banking Agency Provisions

Section 601. Waiver of Examination Schedule in Order to Allocate Examiner Resources

Summary: This section would amend section 10(d) of the FDIA (12 USC 1820(d)) to provide that an appropriate federal banking agency may make adjustments in the examination cycle for an insured depository institution if necessary for safety and soundness and the effective examination and supervision of insured depository institutions. Under current law, insured depository institutions must be examined by their appropriate federal banking agencies at least once during a 12-month period in a full-scope, on-site examination unless an institution qualifies for the 18-month rule. Small, insured depository institutions with total assets of less than $250 million and that satisfy certain other requirements may be examined on an 18-month basis rather than a 12-month cycle. The amendment would permit the banking agencies to make adjustments in the scheduled examination cycle as necessary for safety and soundness.

OCC comments: The OCC supports this amendment. It would give the appropriate federal banking agencies the discretion to adjust the examination cycle of insured depository institutions to ensure that examiner resources are allocated in a manner that provides for the safety and soundness of insured depository institutions. For example, as deemed appropriate by a federal banking agency, a well-capitalized and well-managed bank's examination requirement for an annual or

18-month examination could be extended if the agency's examiners were needed to immediately examine troubled or higher risk institutions. This amendment would permit the agencies to use their resources in the more efficient manner.

Section 602. Interagency Data Sharing

Summary: This section would amend the FDIA (12 USC 1811, et seq.). The amendment would provide that a federal banking agency has the discretion to furnish any confidential supervisory information, including a report of examination, about a depository institution or other entity examined by the agency to another federal or state supervisory agency and to any other person deemed appropriate. Similar changes are also made to the Federal Credit Union Act.

OCC comments: The OCC supports this provision. This provision will give the other federal banking agencies parallel authority to share confidential information that was given to the FRB in Section 727 of the Gramm–Leach–Bliley Act (GLBA). We note, however, that this provision is discretionary and nothing in this provision would compel a banking agency to disclose confidential supervisory information that it has agreed to keep confidential pursuant to an information sharing or other agreement with another supervisor. See also Section 610.

Section 603. Penalty for Unauthorized Participation by Convicted Individual

Summary: This section would amend section 19 of the FDIA (12 USC 1829) to give the federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an uninsured national or state bank or uninsured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to *insured* depository institutions. Section 611 also would amend 12 USC 1829 to give the FRB the authority to keep persons convicted of these offenses from participating in the affairs of a bank holding company or its nonbank subsidiaries, or an Edge or Agreement corporation.

OCC comments: The OCC supports these changes to the law. This amendment will help to provide for the safe and sound operations of uninsured, as well as insured, institutions. We recommend, however, that the provision be clarified so that the federal banking agencies also may prevent a person convicted of such offenses from participating in the affairs of nonbank subsidiaries of depository institutions.

Section 604. Amendment Permitting the Destruction of Old Records of a Depository Institution by the FDIC After the Appointment of the FDIC as Receiver

Summary: This provision would amend section 11(d)(15)(D) of the FDIA (12 USC 1821(d)(15)(D)) to modify the record retention requirement of old records that must be maintained by the FDIC after a receiver is appointed for a failed insured depository institution. Under current law, the FDIC must preserve all records of a failed institution for six years from the date a receiver is appointed. This requirement is not dependent on the actual age of the records at the time the receiver is appointed. After the six-year period, the FDIC may destroy any unnecessary records, unless directed to retain the records by a court or a government agency or otherwise prohibited from destroying the records by law. The amendment would permit the FDIC to destroy unnecessary records that are 10 or more years old on the date the receiver is appointed unless prohibited from doing so by a court, a government agency, or law.

OCC comments: The OCC supports this change and recommends that a similar provision be included in national banking law. The OCC appoints receivers for all national banks, both insured and uninsured. The FDIC only is required to accept the appointment for insured national banks. Thus, a receiver for an uninsured national bank would not be the FDIC. Adding a similar provision to national banking law also would clarify for a receiver of a national bank, other than the FDIC, that these outdated records may be destroyed.

Section 605. Modernization of FDIC Recordkeeping Requirement

Summary: This section would amend section 10(f) of the FDIA (12 USC 1820(f)) to provide that the FDIC may retain records in electronic or photographic form and that such documents shall be deemed to be an original record for all purposes, including as evidence in court and administrative proceedings.

OCC comments: The OCC supports this amendment and recommends that it be expanded to apply to all of the federal banking agencies.

Section 606. Clarification of Extent of Suspension, Removal, and Prohibition Authority of Federal Banking Agencies in Cases of Certain Crimes by Institution-Affiliated Parties

Summary: This provision would amend section 8(g) of the FDIA (12 USC 1818(g)) to clarify that the appropriate federal banking agency may suspend or prohibit IAPs charged with or convicted of certain crimes (including those involving dishonesty, breach of trust, or money laundering) from participating in the affairs of *any* depository institution and not only the institution with which the party is or was last affiliated. The amendment would also clarify that the section 8(g) authority applies even if the IAP is no longer associated with any depository institution at the time the order is considered or issued or the depository institution with which the IAP was associated is no longer is existence.

Under current law, if an IAP is charged with such a crime, the suspension or prohibition will remain in effect until the charge is finally disposed of or until terminated by the agency. If the individual is convicted of such a crime, the party may be served with a notice removing the party from office and prohibiting the party for further participating in the affairs of a depository institution without the consent of the appropriate federal banking agency. Before an appropriate federal banking agency may take any of these actions under section 8(g), the agency must find that service by the party may pose a threat to interests of depositors or impair public confidence in a depository institution. The statute further provides that an IAP that is suspended or removed under section 8(g) may request a hearing before the agency to rebut the agency's findings. Unless otherwise terminated by the agency, the suspension or order of removal remains in effect until the hearing or appeal is completed. Current law, however, applies only to the depository institution with which the IAP is associated. Similar amendments are made to the Federal Credit Union Act.

OCC comments: The OCC supports the amendment to the FDIA. This amendment will help to ensure that, if a federal banking agency makes the required findings, the agency has adequate authority to suspend or prohibit an IAP charged with or convicted of such crimes from participating in the affairs of any depository institution.

Section 607. Streamlining Depository Institution Merger Application Requirements

Summary: This section would amend the Bank Merger Act (BMA) (12 USC 1828(c)). The amendment would provide that the responsible agency in a merger transaction, which is generally the federal banking agency that has the primary regulatory responsibility for the resulting bank, must request a competitive factors report only from the attorney general, with a copy to the FDIC. Under current law, this report must be requested from all of the other federal banking agencies but the other agencies are not required to file a report.

OCC comments: The OCC supports this amendment. It appropriately streamlines the agencies' procedures in processing BMA transactions.

Section 608. Inclusion of Director of the Office of Thrift Supervision in List of Banking Agencies Regarding Insurance Customer Protection Regulations

Summary: This provision would amend section 47(g)(2)(B)(i) of the FDIA (12 USC 1831x(g)(2)(B)(i)) to add OTS to the list of the federal banking agencies that must jointly make certain determinations before certain state customer protection laws may be preempted. Under current law, OTS is one of the federal banking agencies that are required to adopt the federal regulations that would provide the basis for the preemption determination but is not included in the list of agencies that must make the preemption determination.

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

Section 609. Shortening of Post-Approval Antitrust Review Period with the Agreement of the Attorney General

Summary: This provision would amend section 11(b)(1) of the BHCA (12 USC 1849(b)(1)) and section 18(c)(6) of the BMA (12 USC 1828(c)(6)) to permit the shortening of the post-approval waiting period for certain bank acquisitions and mergers. Under current law, the post-approval waiting period generally is 30 days from the date of approval by the appropriate federal banking agency. The waiting period gives the attorney general time to take action if the attorney general determines that the transaction will have a significant adverse effect on competition. The waiting period under both the BHCA and BMA, however, may be shortened to 15 days if the appropriate banking agency and the attorney general agree that no such effect on competition will occur. The proposed amendment would shorten the mandatory 15-day waiting period to five days.

OCC comments: The OCC supports this change. It will give the banking agency and the attorney general more flexibility to shorten the post-approval waiting period as appropriate for those transactions that do not raise competitive concerns. If such concerns exist, the 30-day waiting period will continue to apply. This change will not affect the waiting periods for transactions that involve bank failures or emergencies. In those cases, the statute already provides for other time frames.

Section 610. Protection of Confidential Information Received by Federal Banking Regulators from Foreign Banking Supervisors

Summary: This section would amend section 15 of the IBA (12 USC 3109) to add a provision that ensures that the FRB, OCC, and FDIC cannot be compelled to disclose information obtained from a foreign supervisor if public disclosure of this information would be a violation of foreign law and the U.S. banking agency obtained the information pursuant to an information sharing arrangement with the foreign supervisor or other procedure established to administer and enforce the banking laws. The banking agency, however, cannot use this provision as a basis to withhold information from Congress or to refuse to comply with a valid court order in an action brought by the United States or the agency.

OCC comments: The OCC supports this provision. This amendment would provide assurances to foreign supervisors that the banking agencies cannot be compelled to disclose publicly confidential supervisory information that the agency has committed to keep confidential, except under the limited circumstances described in the amendment. This authority is similar to the authority provided to the Securities and Exchange Commission under the securities laws (15 USC 78q(h)(5)). Some foreign supervisors have been reluctant to enter into information sharing agreements with U.S. banking agencies because of concerns that the U.S. agency may not be able to keep the information confidential and public disclosure of the confidential information provided could subject the supervisor to a violation of its home country law. This amendment will be helpful to ease those concerns and will facilitate information sharing agreements that enable U.S. and foreign supervisors to obtain necessary information to supervise institutions operating internationally.

Section 611. Prohibition on the Participation in the Affairs of Bank Holding Company or Edge Act or Agreement Corporations by Convicted Individual

Summary: This section also would amend section 19 of the FDIA (see also Section 603). It will give the FRB the authority to prohibit a person convicted of an offense involving dishonesty, breach of trust, or money laundering from participating in the affairs of a bank holding company, its nonbank subsidiaries, or an Edge or Agreement Corporation without the consent of the FRB.

OCC comments: The OCC supports expanding the banking agencies' authority to keep bad actors out of our financial firms. We recommend, however, that the provision be clarified so that the federal banking agencies may prevent persons convicted of such offenses from participating in the affairs of nonbank subsidiaries of depository institutions.

Section 612. Clarification that Notice after Separation from Service May Be Made by an Order

Summary: This section would amend section 8(i)(3) of the FDIA (12 USC 1818(i)(3)) to clarify that, when a federal banking agency takes an enforcement action against an IAP who has resigned or is otherwise separated from an insured depository institution, the agency can take such action by notice *or* issuing an order.

OCC comments: The OCC supports this technical clarification to the law. Enforcement actions under 12 USC 1818 generally provide that actions against IAPs can be taken in the form of a notice or an order and this amendment clarifies that the same is true for actions against IAPs under this provision of 1818.

Section 613. Examiners of Financial Institutions

Summary: This section would amend sections 212 and 213 of title 18 of the United States Code (18 USC 212, 213). Current law provides that criminal penalties may be imposed on a federal bank examiner who examines a bank from which the examiner receives an extension of credit, including a credit card issued by that institution. The financial institution that extends such credit to the examiner also is subject to criminal penalties. The amendment would provide that the federal financial institutions regulatory agencies, including the federal banking agencies, may grant exemptions from the prohibition in the law to their examiners by regulation or on a case-by-case basis if an extension of credit would not likely affect the integrity of the examination. The agencies must consult with each other in developing regulations providing for the exemptions and case-by-case exemptions only may be granted after considering certain specific factors. In addition, the amendment expressly provides that examiners may obtain any credit card without disqualification or recusal, but subject to the safeguard that the cards must be issued under the same terms and conditions as cards issued to the general public.

OCC comments: The banking agencies worked together to develop this amendment. Current law limits the flexibility of the OCC and the other banking agencies to assign examiners to particular institutions or examination teams, even if the extension of credit is on the bank's customary terms and the examiner's skills or expertise would contribute materially to the examination. This amendment would clarify and update the law to permit the agencies to grant appropriate exemptions to the prohibition on extending credit while continuing to ensure that the integrity of our examiners is not compromised.

Section 614. Parity in Standards for Institution-Affiliated Parties

Summary: This section would amend section 3(u)(4) of the FDIA (12 USC 1813(u)(4)) to remove the "knowing and reckless" requirement to hold independent contractors to a standard that is more like the standard that applies to other IAPs. Under current law, independent contractor IAPs are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution. To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a federal banking agency to take action against the accountant as an IAP for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This amendment would strike the "knowing and reckless" requirement.

OCC comments: The federal banking agencies jointly recommend this amendment. The knowing and reckless standard in the current law is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. The amendment will strengthen the agencies' enforcement tools with respect to accountants and other independent contractors.

Interpretations—January 1 to March 31, 2003

Contents

Interpretive Letters

949—September 19, 2002

12 USC 24(7)

Kieran J. Fallon, Esq.
Senior Counsel
Board of Governors of the Federal Reserve System
Washington, DC 20551

Re: Authority of National Banks to Engage in Financial Intermediation Transactions Involving Equity Options and Forwards

Dear Mr. Fallon:

This is in response to your request that the Office of the Comptroller of the Currency ("OCC") confirm that it is permissible for national banks to engage in cash-settled options and forwards on equity securities (the "equity derivatives transactions").[1] The equity derivatives transactions involve exchanges of payments between a bank and its customers based on changes in the value of equity securities. As discussed below, the OCC views the equity derivatives transactions as permissible if they are part of a bank's customer-driven, non-proprietary financial intermediation business and if the bank has in place an appropriate risk measurement and management process for its derivatives and hedging activities. This risk measurement and management process is necessary for a bank to achieve its customer risk management objectives in a safe and sound manner, and thus must be established before the OCC can determine that the proposed activities are permissible. In the absence of particular facts and supervisory knowledge of an individual institution, the OCC is unable to opine whether particular equity derivatives transactions are permissible.

I. Background

You have indicated that the Board of Governors of the Federal Reserve System has received an application from a state member bank for approval to acquire equity securities solely for the purpose of hedging exposure arising from the equity derivatives transactions. You have asked for this

[1] The owner of an equity option contract has the right to buy or sell a specified equity security or group of securities at a specified price on or before a specified date. The owner of an equity forward contract has the obligation to purchase a specified equity security or group of securities at a specific date in the future. The equity forward contract is purchased by the owner immediately, but the securities are not paid for until some future date. Because the equity derivatives transactions are cash-settled, the counterparties do not actually take or make delivery of the underlying equity securities, but rather take or make cash payments based on the changes in market price of those securities. We understand from you that all the transactions in question would be cash-settled as far as the bank engaging in the activity is concerned. If under the terms of certain contracts the customer is permitted to elect physical settlement, an affiliate of the bank will make or receive physical delivery.

opinion to determine whether engaging in the equity derivatives transactions is permissible for a national bank, and therefore permissible for a state-chartered bank pursuant to 12 USC 1831a.[2]

II. Discussion

The equity derivatives transactions may be permissible under 12 USC 24(Seventh)[3] as part of a customer-driven, non-proprietary financial intermediation business if a bank has an appropriate risk measurement and management process for its derivatives and hedging activities.

A. Derivatives Transactions May be Permissible as Part of a Financial Intermediation Business

The OCC has concluded that national banks may engage in customer-driven, non-proprietary derivatives transactions involving exchanges of payments as part of a financial intermediation business.[4] Through a derivatives business, a bank may engage in a modern form of the traditional financial intermediation functions that banks perform in providing payment, loan, and deposit

[2] Under 12 USC 1831a, an insured state bank may not engage as principal in any type of activity that is not permissible for a national bank, unless (1) the Federal Deposit Insurance Corporation has determined that the activity would pose no significant threat to the appropriate insurance fund and (2) the state bank is, and continues to be, in compliance with applicable capital standards prescribed by the appropriate federal banking agency.

[3] A national bank may engage in activities pursuant to 12 USC 24(Seventh) if the activities are part of, or incidental to, the business of banking. The Supreme Court has held that this authority is a broad grant of power to engage in the business of banking, including, but not limited to, the five enumerated powers and in the business of banking as a whole. *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("VALIC").

[4] In the 1980s the OCC opined on the permissibility of national banks engaging in interest rate, currency, and commodity price index swaps and caps. See OCC No-Objection Letter No. 87–5 (July 20, 1987), reprinted in [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 ("matched commodity swap letter"); OCC Interpretive Letter No. 462 (December 19, 1988), reprinted in [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,686; and OCC letter from J. Michael Shepherd, senior deputy comptroller, Corporate and Economic Programs (July 7, 1988) (unpublished). Then, in the 1990s, the OCC recognized that national banks may advise, structure, arrange, and execute transactions, as agent or principal, in connection with interest rate, basis rate, currency, currency coupon, and cash-settled commodity and equity swaps; swaptions, captions, and other option-like products; forward rate agreements, rate locks and spread locks, as well as similar products that national banks are permitted to originate and trade in and in which they may make markets. See OCC Interpretive Letter No. 725 (May 10, 1996), reprinted in [1995–1996 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81,040; OCC Interpretive Letter No. 652 (September 13, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600; OCC letter from Jimmy F. Barton, deputy comptroller, Multinational Banking, to Carl Howard, associate general counsel, Citibank, N.A. (May 13, 1992) (unpublished); OCC letter from Horace Sneed, senior attorney, LASD (March 2, 1992) (unpublished); and OCC No-Objection Letter No. 90–1 (February 16, 1990), reprinted in [1989–1990 Transfer Binder] Fed. Banking L. Rep. ¶ 83,095 ("unmatched commodity swap letter"). The unmatched commodity swap letter and the matched commodity swap letter predate VALIC and characterized the commodity price index swaps as a financial intermediary activity incidental to a bank's express power to engage in deposit and lending activities under 12 USC 24(Seventh). The OCC has since concluded that swap and funds intermediation activities are part of the business of banking. See OCC Interpretive Letter No. 937 (June 27, 2002), reprinted in [____-____ Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ ______; OCC Interpretive Letter No. 892 (September 13, 2000), reprinted in [2000–2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81,411 ("equity hedge letter"); OCC letter from Ellen Broadman, director, Securities and Corporate Practices Division, OCC, to Barbara Moheit, regional counsel, FDIC (October 20, 1998) (unpublished).

services. In conducting a derivatives business, a bank makes payments to, or receives payments from, customers who want to manage financial risks resulting from the variations in interest rates or prices of commodities or equity securities. Customers do not deal directly with one another in these transactions, but instead make payments to or receive payments from an intermediary bank. Thus, a customer-driven derivatives business may be permissible as a modern form of traditional bank financial intermediation activities involving exchanges of payments with a bank acting as an intermediary between customers and not in a proprietary capacity.

Under this rationale, the OCC has found that national banks, as part of a financial intermediation business, may offer equity and equity index swaps.[5] Equity swaps are agreements between two parties to exchange payments. One party makes a stream of payments based on a short-term interest rate index. The other party makes payments tied to the performance of an equity security or equity market index. National banks may hedge risks arising from these transactions either on a matched or portfolio basis and thus act in the traditional role of a financial intermediary exchanging payments with customers on agreed terms.

Cash-settled equity options and forwards may be permissible for national banks under the same rationale provided in OCC precedent addressing equity and equity index swaps.[6] Similar to equity swaps, cash-settled equity options and forwards are privately negotiated contracts between parties that enable customers to manage financial risks relating to price fluctuations in equities and market uncertainties. Similar to swaps, those option and forward products fundamentally involve exchanges of payments based on changes in the value of equities. In fact, comparable payment obligations may be created using equity swaps, options, and forwards.[7] Also, through equity option and forward transactions and hedging activities, banks similarly may act in their traditional roles of financial intermediaries exchanging payments with bank customers. Accordingly, national banks have engaged in cash-settled equity options and forwards and the OCC has viewed these transactions as permissible if they are part of a financial intermediation business and an appropriate risk measurement and management process is established.

[5] See OCC Interpretive Letter No. 725, supra; and equity hedge letter.

[6] See OCC Interpretive Letter No. 937, supra.

[7] A swap transaction is nothing more than a series of forward contracts. Under a swap, one party owes the other a stream of payments linked to the performance of an equity security (or equity market index) and receives a stream of payments based on a short-term interest rate. The payment obligations typically are settled with one party paying the other the difference between these two payment streams. Periodic payments made under a swap agreement can mirror the payment stream on a series of cash-settled forward transactions. Under a cash-settled forward transaction, the parties also exchange the difference between the current market value of the underlying equity and the negotiated contract price for that equity. Cash-settled equity options similarly may generate payment streams comparable to equity and equity index swaps.

B. The Activity Must be Conducted in a Safe and Sound Manner

Cash-settled options and forwards on equity securities offered as part of a customer-driven, non-proprietary financial intermediation business do not automatically qualify as an activity that is part of the business of banking. The nature of these derivatives transactions requires sophisticated risk measurement and management capacities on the part of a bank, and qualified personnel, in order for the activity to actually function as permitted and to operate in a safe and sound manner. Thus, in order for the OCC to conclude that the derivatives transactions are permissible for a national bank as "part of the business of banking," the bank must establish an appropriate risk measurement and management process.[8] As detailed further in the OCC derivatives booklet[9] and Banking Circular No. 277,[10] an effective risk measurement and management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process.

In addition to a risk management program, a bank's process must include an independent compliance monitoring program to ensure ongoing compliance with the specific commitments made by the bank, including its commitment to conduct its financial intermediation activities as a customer-driven, and non-proprietary trading business. The bank must have an adequate and effective compliance monitoring program that includes policies, training, independent surveillance, and well-defined exception approval and reporting procedures.

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[8] In other words, a proposed activity cannot be part of the "business of banking" if the bank in question lacks the capacity to conduct the activity on a safe and sound basis. Courts have long recognized this linkage between qualifying activities and safety and soundness. See, e.g., *First National Bank* v. *Exchange National Bank,* 92 U.S. 122, 127 (1875); *Merchants National Bank* v. *Wehrmann,* 202 U.S. 295 (1906). In addition, the OCC considers safety and soundness issues when determining whether an activity is part of, or incidental to the business of banking. See, e.g., equity hedge letter (national bank may engage in equity hedging activities only if it has an appropriate risk management process in place); OCC Banking Bulletin 96–5 (September 20, 1996) (replaced by OCC Bulletin 2000–23 (July 20, 2000) (national bank's purchase of life insurance is incidental to banking if it is convenient or useful in connection with the conduct of the bank's business and consistent with safe and sound banking practices)); OCC Interpretive Letter No. 684, supra (commodity hedging is a permissible banking activity provided the activity is conducted in accordance with safe and sound banking practices); Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Investment Deposit Account (August 8, 1988) (national bank may buy and sell futures on the S&P 500 Index to hedge deposits with interest rates tied to the S&P 500 Index); OCC Interpretive Letter No. 376 (October 22, 1986) reprinted in [1985–1986 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,600 (indemnification from losses resulting from participation in the bank's fiduciary securities lending program is a permissible incidental activity provided the indemnification is consistent with OCC guidance and safety and soundness); and OCC Interpretive Letter No. 274 (December 2, 1983) reprinted in [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,438 (a national bank's authority to lease its office space provides the authority for it to establish appropriate lease terms if consistent with safe and sound banking practices).

[9] "Risk Management of Financial Derivatives," (*Comptroller's Handbook*, January 1997).

[10] OCC Banking Circular No. 277 (October 27, 1993), reprinted in 6 CCH Fed. Banking L. Rep. ¶ 62–152 ("BC 277").

III. Conclusion

The OCC believes that national banks may engage in equity forward and option transactions as part of a customer-driven, non-proprietary financial intermediation business if the banks have in place appropriate risk measurement and management processes for their derivatives and hedging activities. These processes are necessary for the banks to achieve their customer risk management objectives in a safe and sound manner, and thus must be established before the OCC can determine that the proposed activities are permissible. In the absence of particular facts and supervisory knowledge of an individual institution, we are not able to opine whether particular equity option and forward transactions would be permissible for a particular bank.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

950—December 18, 2002

12 USC 29B
12 USC 84(a)(1)
12 USC 371D

Re: Loans made by a national bank to an entity used as part of the bank's like-kind exchange of bank premises

Dear [ ]:

This letter is in response to your October 18, 2002, letter addressed to Julie L. Williams, first senior deputy comptroller and chief counsel. In your letter, you ask how the Office of the Comptroller of the Currency (OCC) would apply the legal lending limit statute, 12 USC 84, to a national bank ("bank") using the tax-deferred exchange provisions under section 1031 of the Internal Revenue Code of 1986 to effect a like-kind exchange of bank premises.

Briefly, the bank enters into a contract to purchase a piece of new property upon which will be constructed its new office building, assigns the contract to an unrelated entity ("Newco"), and extends credit to Newco to purchase the new property. Newco will be responsible for constructing the new office building. At the same time, the bank enters into a lease with Newco, with the lease payments being large enough to cover debt service on the loan to Newco plus Newco's fee for participating in the transaction. Ultimately, the bank's existing main office is sold, the sales contract is assigned to an affiliate of Newco, and the affiliate sells the old office building. The affiliate then uses the proceeds to buy the new building from Newco and transfers the new building to the bank. At that time, any amount due on the loan to Newco is repaid.

It is my opinion that the bank's loan to Newco would be an extension credit for purposes of 12 USC 84. Section 84(b)(1) defines "loans and extensions of credit" to "include all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person. . . ." Based upon your fact pattern, the loan by the bank to Newco meets this definition. Therefore, under section 84(a)(1), the total outstanding loans made by the bank to Newco would be limited to 15 percent of the bank's unimpaired capital and surplus.

However, because Newco would hold bank premises,[1] the bank may take advantage of 12 USC 371d. Section 371d provides in part that:

[1] Under 12 USC 29(First), a national bank may invest in real estate that is necessary for the transaction of its business. Twelve CFR 7.1000(a)(2)(i) provides that this real estate includes "[p]remises that are owned and occupied *(or to be occupied, if under construction)* by the bank . . ." (emphasis added). Section 7.1000(a)(3) further provides that national banks may acquire and hold such real estate by means of a leasehold estate. Therefore, the new property that the bank is leasing and upon which the bank's new building is being constructed by Newco is bank premises.

> No national bank or State member bank shall invest in bank premises, or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of such bank, or make loans to or upon the security of any such corporation— . . . (2) unless the aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any such corporation that is an affiliate of the bank, is less than or equal to the amount of the capital stock of such bank; . . .

Under this section, a national bank must aggregate its direct investments in bank premises and corporations that hold bank premises, its loans to such corporations, and any indebtedness incurred by such corporations that are affiliates of the national bank.[2] This total may not exceed an amount equal to the bank's capital stock (unless certain other requirements are satisfied).

If a national bank has no other "investments" in bank premises, then section 371d would authorize the national bank to lend money to an unaffiliated corporation holding bank premises in an amount equal to the bank's capital stock.[3] Therefore, if section 371d's aggregate limits are otherwise satisfied, it is my opinion that the bank could loan Newco an amount which would exceed the limitations contained in 12 USC 84. Rules of statutory interpretation strongly presume that "[w]here there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one."[4] For example, with respect to extensions of credit made by national banks to their affiliates, the OCC has determined that the more specific affiliate transaction statute, 12 USC 371c, takes precedence over the general lending limits in section 84.[5]

While the section 84 lending limits would not apply, any extension of credit by the bank to Newco must conform with safe and sound banking practices. If you have any questions, please contact me at (202) 874–5300.

Steven V. Key
Senior Attorney

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[2] Section 371d does not require that corporations holding bank premises be affiliates of the national bank. *See* letter from James J. Saxon, Comptroller of the Currency (March 26, 1964) (unpublished). Rather, this section requires only that the national bank include in its aggregate investment in bank premises any indebtedness incurred by corporations that are affiliates of the bank.

[3] In this case, the bank would have two such "investments"—the investment in its current office building and the loan to—that must be aggregated.

[4] *AT&T Corp*. v. *Iowa Utilities Bd*., 525 U.S. 366, 410 (1999), (*quoting Crawford Fitting Co*. v. *J.T. Gibbons, Inc*., 482 U.S. 437, 445 (1987)). *Accord Morton* v. *Marconi*, 417 U.S. 535, 550–51 (1974).

[5] *See* 12 CFR 32.1(c); letter from Rosemarie Oda, senior attorney, Legal Advisory Services Division (January 25, 1985) (unpublished).

951—January 17, 2002

12 USC 84(d)(2)(b)

Dear [ ]:

This is in response to your letter of December 17, 2001. You have requested the Office of the Comptroller of the Currency's ("OCC's") opinion as to the application of the legal lending limit at 12 USC 84 to loans by [National Bank], [City, State] ("bank") to [ ] ("[Co.]"), Mr. and Mrs. [Mates] (as co-makers), and two land trusts. Based on the information in your letter and subsequent phone conversations, as well as information previously submitted by National Bank Examiners Jeff Leigh and Jason Joy, it is my opinion that for purposes of the legal lending limit at 12 USC 84 the existing loans to [Co.] are attributed to Mr. [Mates] and therefore are combined with the loans to Mr. and Mrs. [Mates], and 50 percent of the loans to the two land trusts are attributed to Mrs. [Mates] and therefore combined with the loans to Mr. and Mrs. [Mates]. However, based on the facts presented, I do not believe that the loans to all five borrowers—[Co.], Mr. [Mates], Mrs. [Mates], and the two land trusts—should be aggregated as a whole for purposes of the legal lending limit.

I. Facts

The bank has five outstanding loans to [Co.] with an aggregate outstanding balance of $2,485,434, net of participations sold, to other financial institutions. [Co.] is a Subchapter S corporation owned 100 percent by [Mr. Mates]. The company is engaged in the business of acquiring and developing lots and constructing single-family residences. The proceeds of the five loans were used for the acquisition of real estate and construction of residential properties. [Mr. Mates] provides a limited personal guaranty of the [Co.] loans.

The bank also has three outstanding loans to [Mr. Mates] and his spouse, as co-makers: a home equity line of credit secured by his personal residence with a current balance of $293,000, a home equity line of credit secured by a rental property owned by Mr. and Mrs. [Mates] with a current balance of $201,000, and a $2,000 credit reserve loan (collectively the "[Mates] loans"). The proceeds of the two home equity loans were used for working capital for [Co.]. The [Mates]' sources of income for the years 1997 through 2000 were as follows (in thousands):[1]

[1] On their joint federal tax returns the [Mates] also report the gross income from [Co.] as part of their adjusted gross income. As a Subchapter S corporation, [Co.]'s gross income and deductions are allocated to its shareholder [Mates] *for federal tax purposes only*. *See* I.R.C. § 1366. Notwithstanding that allocation for tax purposes, [Co.]' undistributed earnings have not been paid to [Mates] and from legal and financial accounting perspectives they remain the property of the corporation. Thus, a more accurate reflection of [Mr. Mates]'s income from [Co.] is the distributions paid to him by [Co.] in the form of salary, dividends, or other cash or property distributions, rather than the corporation's gross income that is allocated to him for tax purposes. Accordingly, for the purposes of the legal lending limit analysis only the salary, dividends, and other cash or property distributions paid by [Co.] to [Mr. Mates] will be included in the [Mr. Mates]' income figures.

Table 1—[Mates]' Sources of Income, 1997–2000

Sources of Income	1997	1998	1999	2000
Salary from [Co.]—[Mr. Mates]	120	120	120	120
Non-Salary Distributions from [Co.]	0	0	0	0
Rental Income—Joint	41	42	46	45
Rental Income—Land Trust	56	100	101	107
Total	**217**	**262**	**267**	**272**

Finally, the bank has two loans to two separate land trusts (the "land trusts") in the amounts of $758,296 and $589,087 (the "land trust loans"). Mrs. [Mates] is a 50 percent beneficiary of each of the land trusts. [Mr. Mates] personally guarantees $100,000 of each of the trust loans. The proceeds of the trust loans were used to acquire rental properties. The expected source of repayment of the trust loans is rental cash flow from the properties, and that cash flow is sufficient to service the trust loans.

II. Legal Analysis

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.[2] A "borrower" includes a person who is named a borrower or debtor in a loan or extension of credit.[3] Also, loans to one borrower will be attributed to another person and both will be considered 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.

The proceeds of a loan to borrower will be deemed to be used for the direct benefit of another person and will be attributed to that other person when the proceeds, or assets purchased with such proceeds, are transferred to that other person, other than in a bona fide arm's-length transaction where the proceeds are used to acquire property, goods, or services.[4]

A *common enterprise* is deemed to exist 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;

[2] *See* 12 USC 84(a); 12 CFR 32.3(a).

[3] 12 CFR 32.2(a).

[4] 12 CFR 32.5(b).

3) The borrowers use the loan proceeds to acquire more than 50 percent of a business enterprise; or

4) The OCC determines that a common enterprise exists based on the facts and circumstances of particular transactions.[5]

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 one direct benefit test and the four common enterprise tests—to the specific facts of each loan relationship.[6]

1. Direct Benefit Test

The proceeds of the [Co.] loans were used to acquire real property and construct residential housing. The proceeds of the two [Mates] home equity loans were used for working capital for [Co.]. Since the proceeds of the home equity, or assets purchased with such proceeds, were transferred to [Co.], [Mates]'s home equity loans are attributed to [Co.] under the direct benefit test at 12 CFR 32.5(b). Accordingly, the [Mates] home equity loans and the [Co.] loans are combined for purposes of the legal lending limit.

Also, 50 percent of the loans to the land trusts will be combined with all of the [Mates] loans for the purposes of the lending limit under the direct benefit test. In Illinois, true ownership of real estate held in a land trust remains with the beneficiary, even though legal and equitable title to the land lies with the trustee.[7] The bank's loans to the land trusts were used to acquire and improve real estate. Mrs. [Mates] has a 50 percent beneficial interest in the land trust and, therefore, is the true owner of a 50 percent interest in the property held by the trust. Since Mrs. [Mates] is one of the true owners of the assets purchased with the proceeds of the land trust loans, she has directly benefited from those loan proceeds in proportion to her beneficial interest in the land trusts. Thus, 50 percent of each of the land trust loans is attributed to Mrs. [Mates] for lending limit purposes pursuant to 12 CFR 32.5(b). Since Mrs. [Mates] is a borrower on the [Mates] loans, 50 percent of the loans to the land trusts will be combined with the [Mates] loans for the purposes of the lending limit under the direct benefit test.

[5] *See* 12 CFR 32.5(c).

[6] In addition to the general limit on loans to one borrower, there is an additional limit that applies to loans to a corporate group. *See* 12 CFR 32.5(d). Loans to a corporate group may not exceed 50 percent of a national bank's capital and surplus. 12 CFR 32.5(d)(1). A corporate group is defined as a person and all of its subsidiaries. *Id*. For the purpose of this rule, a corporation or limited liability company is a subsidiary of a person if that person owns more than 50 percent of the voting interests of the corporation or company. *Id*. This limit is independent of the general 15 percent limit on loans to one borrower set forth at 12 USC 84 and 12 CFR 32.3. This special limit applies to a corporate group regardless of whether loans to different members of the corporate group are combined for the general 15 percent limit.

[7] *Podvinec* v. *Popov*, 658 N.E.2d 433, 436 (1995) (*citing People* v. *Chicago Title & Trust Co*., 389 N.E.2d 540 (1979)).

Since the proceeds of the [Co.] loans were not transferred to the land trusts, and the proceeds of the land trust loans were not transferred to [Co.], the [Co.] and land trust loans will not be combined under the direct benefit test.

2. Common Enterprise Test No. 1—Common Expected Source of Repayment

A common enterprise is deemed to exist when:

1) the expected source of repayment for each loan is the same, and

2) neither borrower has another source of income from which the loan and the borrower's other obligations can be repaid.

The expected source of repayment on the [Co.] loans is cash flow from the business' operations and the sale of lots or residences securing the loans. The expected source of repayment for the land trust loans is rental cash flow from the properties held in the trust. Since the expected sources of repayment for the [Co.] loans and the land trust loans are not the same, then the loans to those two borrowers will not be combined with each other for purposes of the legal lending limit under the common source of repayment test at 12 CFR 32.5(c)(1).

The expected source of repayment on the [Mates] loans is the personal income of the [Mates]. Part of the [Mates]' joint income comes from [Mr. Mates]'s salary from [Co.]. As such, [Co.] may be the ultimate source of repayment for the [Mates] loans. I note, however, that the [Mates] have other sources of income, and that other income may be sufficient to repay the [Mates] Loans together with their other obligations. If the [Mates]' other income in not sufficient by itself to repay those loans and their other obligations, then there may be grounds to combine the [Mates] loans with the loans to [Co.] under the common source of repayment test.[8]

3. Common Enterprise Test No. 2—Common Control and Substantial Financial Interdependence

As stated above, one way in which a common enterprise is deemed to exist is when:

1) the borrowers are related through common control, and

2) there is substantial financial interdependence between or among the borrowers.[9]

[8] The common source of repayment test at 12 CFR 32.5(c)(1) specifically states that an employer ([Co.]) will not be treated as a source of repayment because of wages or salaries paid to an employee ([Mr. Mates]), unless the standards of the common control and substantial financial interdependence at 12 CFR 32.5(c)(2) are met. However, as noted in section II.3. below, there is common control and substantial financial interdependence between [Co.] and [Mr. Mates]. Thus, [Co.] can be viewed as a source of repayment on the [Mates] loans under the common source of repayment test because of the salary it pays to [Mr. Mates].

[9] *See* 12 CFR 32.5(c)(2).

Borrowers are related through common control when one person or entity controls another, or two or more entities are each controlled by the same person or entity. For the purposes of this combination rule, control is deemed to exist if a person directly or indirectly, or acting through or together with one or more persons either (1) owns or controls 25 percent or more of the voting securities of another person, (2) controls in any manner the election of a majority of the directors or trustees of another person, or (3) has the power to exercise a controlling influence over the management or policies of another person.[10]

Based on the information in your letter, the land trusts are not related through common control to either [Co.] or [Mr. Mates]. However, [Co.] is related to [Mr. Mates] because of his 100 percent ownership interest in the company. The next question, then, is to determine whether substantial financial interdependence exists between [Co.] and [Mr. Mates]. Substantial financial interdependence is deemed to exist when 50 percent or more of one person's annual gross receipts or gross expenditures are derived from transactions with the other person.[11] In determining whether substantial financial interdependence exists, we look at the borrower's gross receipts or gross expenditures on an annual basis.

Accordingly, if 50 percent or more of [Co.]'s annual gross receipts or gross expenditures were received from or paid to [Mr. Mates], then substantial financial interdependence would exist between [Co.] and [Mr. Mates]. As a result, loans to [Co.] would be attributed to [Mr. Mates] and combined with the bank's other loans to [Mr. Mates]. Similarly, if 50 percent or more of [Mr. Mates]'s annual gross receipts or gross expenditures were received from or paid to [Co.], then substantial financial interdependence would exist between [Mr. Mates] and [Co.], the loans to [Co.] would be attributed to [Mr. Mates], and they would be combined with the [Mates] loans.

Here, for the past four years [Mates]'s salary from [Co.] has represented more than 50 percent of his gross receipts.[12] Thus, substantial financial interdependence exists between [Co.] and [Mr.

[10] *See* 12 CFR 32.2(g). The term "person" as used section 32.2(g) means, among other things, a corporation, limited liability company, partnership or a trust. *See* 12 CFR 32.2(k).

[11] 12 CFR 32.5(c)(2)(ii).

[12] For the fiscal year 2000, Mr. [Mates]'s salary and distributions from [Co.] represented 73 percent of his gross receipts for that period ($120,000 salary/($120,000 salary + $45,000 joint rental income). The [Co.] salary and distributions represented 72 percent, 74 percent, and 75 percent of Mr. [Mates]'s gross receipts for the years 1999, 1998, and 1997, respectively.

As discussed in note 1 *supra*, [Co.]'s gross income that is reported as income on the [Mates]' federal tax return is not included as part of the [Mates]'s "gross receipts" for the purposes of determining whether substantial financial interdependence exists. The lending limit regulation defines the term "gross receipts" to include gross revenues, intercompany loans, dividends, capital contributions, and similar receipts. These examples represent actual transfers of cash, property, or rights to cash or property. Although a Subchapter S corporation's gross income is allocated to its shareholders for federal income tax purposes, the undistributed portion of that income remains the property of the corporation and therefore cannot be considered part of a shareholder's gross receipts. Only distributions paid by a Subchapter S corporation to a shareholder, such as salary and dividends, should be included as part of the shareholder's gross receipts.

Mates], two borrowers that are related through common control. Accordingly, loans to [Co.] are combined with loans to [Mr. Mates] for the purposes of the legal lending limit under common enterprise test at 12 CFR 32.5(c)(2).

4. Common Enterprise Test No. 3—Borrowing to Acquire Control

[Co.], the [Mates], and the land trusts did not use the proceeds of their loans to collectively acquire a 50 percent or more interest in a single business enterprise. Thus, this test is not applicable to the loans to [Co.], the [Mates], and the land trusts.

5. Common Enterprise Test No. 4—Facts and Circumstances

OCC rulings and interpretations reveal that a very strong evidentiary record based upon a number of factors must exist before a common enterprise will be found to exist solely on the basis of the facts and circumstances test.[13] Instances in which the facts and circumstances test will apply where the other direct benefit and common enterprise tests do not will be rare.[14] In administrative opinions and interpretive letters, the OCC has indicated that the facts and circumstances test will be applicable when enterprises "engage in supporting lines of business, use common facilities, have common arrangements, or generally mingle their assets and borrowings."[15] A key factor in this analysis is evaluating the extent of the entities' interrelationships and financial and operational interdependence, and determining whether the failure of one borrower would directly effect the other. Other factors considered include the interchange of goods or services between the borrowers, the extent to which one borrower receives income from the other borrower, the volume of operating transactions between the borrowers, and whether the same collateral secures loans to the borrowers.

Without knowing all of the facts relating to the interrelationships among Mr. [Mates], Mrs. [Mates], [Co.], and the land trusts, I am unable to determine with certainty whether the loans to those entities should be combined for lending limit purposes under the facts and circumstances test. However, based on the information provided by you and the examiners, it does not appear that [Co.] and the land trusts are a common enterprise under the facts and circumstances test. The entities do not operate supporting lines of business, use common facilities, or commingle assets or borrowings. Moreover, the success of one of the entities is not dependent on the success of the other.

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[13] Interpretive Letter No. 563, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. ¶83,314, at 71,439 (September 6, 1991).

[14] *Id.*

[15] Id. (citing Comptroller's Decision AA–EC–87–77 (August 12, 1988)); *see also* letter from Richard V. Fitzgerald, chief counsel (October 11, 1984) (unpublished) (loans will be combined where corporations are commonly owned, are engaged in the same line of business, interchange services and personnel, and are not completely separate in their operations and financial affairs); Rojc, "National Bank Lending Limits—A New Framework," 40 *The Business Lawyer* 903, 923–24 (May 1985) (citing various OCC interpretive letters).

A remaining issue is whether Mr. [Mates] and Mrs. [Mates] are a common enterprise, i.e., whether loans attributed to Mr. [Mates] should be combined with loans attributed to Mrs. [Mates] under the facts and circumstances test. If so, then the [Co.] loans and 50 percent of the land trust loans would be combined with the [Mates] loans. There are some facts here that would lend support to such a conclusion. For instance, both individuals are makers on the home equity and credit reserve loans, proceeds from those loans (secured by jointly owned collateral) were used by Mr. [Mates]'s corporation, and Mr. [Mates] has personally guaranteed a portion of the land trust loans that benefit Mrs. [Mates]. These facts evidence the commingling of certain assets and liabilities, indicating some level of financial interdependence between the two individuals.

Nonetheless, based on the limited facts available, I believe Mr. and Mrs. [Mates] should not be considered a common enterprise for the purposes of the lending limit. Although there is evidence of commingling of assets and liabilities between each other, there does not appear to be any commingling of assets and liabilities between their separate borrowing entities—[Co.] and the land trusts. Indeed, the successful operation of the properties beneficially owned by Mrs. [Mates] through the land trusts is not dependent upon the successful operations of [Co.], Mr. [Mates]'s principal asset, and vice versa. Based upon the facts presented, it appears that the failure of [Co.] should not materially affect the ability of the land trusts to repay their loans. Likewise, the failure of the land trusts should not materially affect the ability of [Co.] to repay its loans. In my opinion, this apparent lack of interdependence between [Co.] and land trusts argues against treating Mr. and Mrs. [Mates] as a common enterprise for the purposes of the lending limit, especially since the result of finding such a common enterprise would be the combination of the loans to both [Co.] and the land trusts to the [Mates]' loans. Nonetheless, additional facts might justify a different conclusion.

In summary, all of the loans to Mr. and Mrs. [Mates] and all of the loans to [Co.] are combined for legal lending limit purposes under the common control and substantial financial interdependence test at 12 CFR 32.5(c)(2). The two [Mates] home equity loans are combined with all of the loans to [Co.] under the direct benefit test at 12 CFR 32.5(b). Finally, 50 percent of the land trust loans are combined with the [Mates] loans under the direct benefit test at 12 CFR 32.5(b). These loan combinations are summarized in the chart below.

Table 2—Possible Combinations of Loans to [Mates] and [Co.]

Combination Tests	[Mates] Home Equity Loans	[Mates] Credit Reserve Loan	Land Trust Loans	[Co.] Loans	Aggregate Subject to Lending Limit
[Mates]/[Co.] Combination under Common Control and Substantial Financial Interdependence Test 12 CFR 32.5(c)(2)	$494,000	$2,000		$2,485,434	$2,981,434
[Mates]/[Co.] Combination under Direct Benefit Test 12 CFR 32.5(b)	$494,000			$2,485,434	$2,979,434
Mrs. [Mates] Land Trusts Combination under Direct Benefit Test 12 CFR 32.5(b)	$494,000	$2,000	$1,347,383 X 50% $ 673,692		$1,169,692

6. Guarantees

In your letter you inquire about the impact of Mr. [Mates]'s guaranty of the loans to [Co.] and the land trusts on the lending limit calculations. The fact that Mr. [Mates] personally guarantees loans to the land trusts and [Co.] does not necessarily mean that those loans are combined with his personal loans for lending limit purposes. The OCC's lending limit regulation provides that a guarantor is considered a "borrower" for the purposes of the lending limit only if that guarantor is deemed to be a borrower under the direct benefit or common enterprise tests set forth at 12 CFR 32.5.[16] In other words, a loan will not be attributed to the loan's guarantor and combined with any of the guarantor's direct loans unless one of the five loan combination/attribution tests discussed above has been met.

Mr. [Mates] personally guarantees a portion of the land trust loans. As discussed above, the land trust loans are not attributed to Mr. [Mates] under the direct benefit, common source of repayment, common control and substantial financial interdependence, or the borrowing to acquire control tests. Assuming the loans to the land trust are not attributable to Mr. [Mates] under the facts and circumstances test, then Mr. [Mates] will not be deemed a "borrower" with respect to the land trust loans. Accordingly, the land trust loans will not be combined with Mr. [Mates]'s personal loans at the bank, notwithstanding his personal guaranty of the land trust loans.

Mr. [Mates] also guarantees a portion of the [Co.] loans. As noted above, all of the loans to [Co.] will be attributed to Mr. [Mates] under the common control and substantial financial interdependence test. The fact that Mr. [Mates] is a guarantor of the [Co.] loan was not relevant to the application of that loan combination/attribution test. Consequently, the loans to [Co.] will be combined with loans to Mr. [Mates] regardless of whether he guarantees some or all of the [Co.] loans.

III. Conclusion

In my opinion the facts presented indicate that the loans to all five borrowers—[Co.], Mr. [Mates], Mrs. [Mates], and the two land trusts—are not combined as a whole for purposes of the legal lending limit. However, in my opinion the [Co.] loans are combined with the [Mates] loans for purposes of the legal lending limit. Further, the 50 percent of the land trust loans are combined with the [Mates] loans.

This opinion is based on the facts set forth in this letter, as provided in your letter and subsequent phone conversations and by National Bank Examiners Leigh and Joy. Different facts may warrant different conclusions.

I trust this is responsive to your request. If you have any further questions, please contact me at (312) 360–8805.

Christopher G. Sablich
Senior Counsel
Central District Office

[16] *See* 12 CFR 32.2(a).

952—October 23, 2002

12 USC 21–23
12 USC 30B

Mr. Scott A. Cammarn, Esq.
Associate General Counsel
Bank of America, National Association
101 South Tryon Street
Charlotte, North Carolina 28255

Dear Mr. Cammarn:

This is in response to your letter of October 4, 2002, on behalf of Bank of America, National Association, Charlotte, North Carolina, ("Bank of America" or "the bank") requesting the views of the Office of the Comptroller of the Currency (the "OCC") concerning the location of the bank for corporate status purposes in the national banking laws and in determining the bank's citizenship for federal diversity jurisdiction under 28 USC 1332 and 1348. As explained below, we believe the corporate location of the bank is determined by the place where the bank's main office is currently located (Charlotte, North Carolina), not the place where it was located in the bank's historical organization certificate (San Francisco, California).

Background

Bank of America, N.A., is the result of an interstate merger that occurred in 1999. In that merger, NationsBank, N.A., Charlotte, North Carolina, (Charter Number 14448) was merged into the Bank of America National Trust & Savings Association, San Francisco, California, (Charter Number 13044). Charter Number 13044 survived the merger. The historical organization certificate for Charter Number 13044, executed by the organizing directors of the Bank of Italy National Trust and Savings Association on February 26, 1927, stated that its original place of business was San Francisco, California. In the 1999 merger, however, the resulting bank retained the main office of NationsBank in Charlotte as its main office, as it was authorized to do under 12 USC 1831u(d)(1).[1] Hence, the main office of Charter Number 13044 today is in Charlotte. The resulting bank also changed its name to Bank of America, N.A.

Corporate Location of a National Bank under the National Bank Act

The location of a national bank for corporate status purposes under the National Bank Act and other banking laws is determined by the place where the national bank's main office is located. As explained below, at the time of chartering, the main office is located in the place designated

[1] See Decision to Merge Bank of America National Trust & Savings Association, San Francisco, California, and NationsBank, N.A., Charlotte, North Carolina (OCC CRA Decision No. 94, May 20, 1999).

in the bank's organization certificate and original articles of association. Subsequently, if the bank changes the location of its main office to a new place, then the new location determines the location of the bank for corporate status purposes. Such changes of location are evidenced in the bank's articles of association, since the articles must be amended to reflect the change of the main office to a new place.

When organizers propose to form a national bank, they apply to the OCC. Among the materials and information they must submit are an organization certificate and articles of association. 12 USC 21–23. The articles of association and the organization certificate are typically prepared at the same time at the first meeting of the organizers and sent to the OCC together. *See Comptroller's Corporate Manual,* "Corporate Organization," at 19–20 (April 1998) (sample minutes for first meeting of organizers). Both the organization certificate and the articles contain the name of the proposed bank, its location, and the amount and structure of its capital stock.[2] In particular, both documents will include "[t]he place where its operations of discount and deposit are to be carried on, designating the State, Territory, or District, and the particular county and city, town, or village." 12 USC 22(Second).

The national bank's "main office" (a term used in 12 USC 30(b) and other banking statutes) is located within the "city, town, or village" designated as the "place where its operations of discount and deposit are to be carried on." Indeed, for location purposes, the "main office" and the "place where its operations of discount and deposit are to be carried on" are the same. Section 30(b) now uses the term "main office." But when originally enacted in 1886, the provisions now codified in 12 USC 30(b) used the same terminology as section 22:

> SEC. 2. That any national banking association may change its name or the place where its operations of discount and deposit are to be carried on, to any other place within the same State, not more than thirty miles distant with the approval of the Comptroller of the Currency, by the vote of shareholders owning two-thirds of the stock of such association.

Act of May 1, 1886, ch. 73, 2, 24 Stat. 18 (1886). When the statute was amended in 1959, the provision limiting moves to places within the same state was removed, and the new term "main office," was introduced. Pub. L. No. 86–230, §3, 73 Stat. 457 (1959).[3]

Another relevant provision is 12 USC 81. Under section 81, the "general business of each national banking association shall be transacted in the place specified in its organization certificate and in the branch or branches, if any, established or maintained by it" under 12 USC 36. When

[2] 12 USC 22 (organization certificate); *Comptroller's Corporate Manual,* "Corporate Organization." at 33–35 (April 1998) (instructions for organization certificate and sample document); *Comptroller's Corporate Manual,* "Corporate Organization." at 21–32 (April 1998) (instructions for articles of association and sample document).

[3] See generally Decision on the Applications of Bank Midwest of Kansas, N.A., Lenexa, Kansas, and Bank Midwest, N.A., Kansas City, Missouri (OCC Corporate Decision No. 95–05, February 16, 1995) (pages 12–18), reprinted in Fed. Banking L. Rep. (CCH) ¶ 90,474 (discussion of sections 22, 30, and 81).

section 30 was added allowing changes in location and then amended to refer to the main office, an apparent inconsistency with section 81 was created, inasmuch as section 30 allowed the bank to move to a new place and even to cease operations in the old place, but section 81 continued to refer only to the place specified in the organization certificate. The OCC addressed the inconsistency by concluding that the “place specified in its organization certificate” in section 81 “is meant to include not only the place originally specified in the organization certificate but also subsequent changes of location as authorized under section 30.” *OCC Bank Midwest Decision* at page 13, note 5. Thus, for location purposes, the terms are interchangeable. The main office defines the place, because the place is the city or town (and state) within which the main office is located.

While many national banks continue to operate at the place originally designated, a national bank can change its place of operations under other statutory authority. Under 12 USC 30(b), a national bank may change the location of its main office to another location within the original city or to another location outside the original city, but within 30 miles of the city limits of the original city. Once the bank moves its main office outside its original city, the bank is now located at the new place, and the old place is no longer the place where its banking operations are carried on, in the section 22 sense, even if it retains branches in that city.[4] Moreover, a national bank can change the location of its main office into a new state.[5] It can do so without retaining any branches or other operations in its original state.

A national bank may also change the location of its main office in the context of an interstate merger with another bank under the Riegle–Neal Act. Under 12 USC 215a-1 and 1831u(a), an insured national bank may merge with another insured bank with a different home state. When such a merger occurs, the resulting bank may retain, as its main office, any office that any bank involved in the merger was operating as a main office or a branch immediately before the merger. 12 USC 1831u(d)(1). In other words, the resulting bank may designate as its main office, any one of main offices or branches of any of the banks in the merger, including a main office or branch in a state other than the state in which the acquiring bank’s former main office was located. Bank of America, N.A., is the result of such an interstate merger.

[4] In the organization certificate and original articles, even if a bank proposes to have branches in several cities upon opening, only one place is the place designated in section 22 and the articles. The articles will also refer to conducting business at authorized branches. In this regard, it is important to note that the main office is primarily a term of legal, rather than business, significance. It is the office designated as such. The bank must carry on the business of banking at its main office, but the main office need not be the office at which the bank conducts the principal portion, or any required minimum portion, of its business. See *OCC Bank Midwest Decision* at page 12. See also *Ramapo Bank* v. *Camp*, 425 F.2d 333, 341–42 (3d Circuit 1970).

[5] See, e.g., *Synovus Financial Corporation* v. *Board of Governors of the Federal Reserve System*, 952 F.2d 426 (D.C. Circuit 1991) (moving main office into new state under section 30, keeping no branches in old state); *McEnteer* v. *Clarke*, 644 F. Supplement 290 (U.S. District Court for the Eastern District of Pennsylvania 1986) (same). See also *OCC Bank Midwest Decision*, supra (moving main office into new state, and keeping branches in old state).

If a national bank's main office is changed to a different place (a different city, town, or village), that change must be reflected in the articles of association.[6] But there is no statutory provision or regulatory procedure to change the organization certificate to reflect current conditions. It is a fixed historical document that was used in the organizing process but is not used subsequent to the issuance of the charter by the OCC and, therefore, has no reason to reflect the current status of the institution.[7]

When a national bank has changed the location of its main office to a new place, it is the new place that determines the bank's location for corporate purposes. Moreover, the location of a national bank, and in particular the location of its main office, is a factor in determining the applicability of many banking statutes. Some of the statutes use the location as a reference point for a substantive provision of federal law. Others use the location to determine which state's law is made applicable to the national bank by federal law. In all these determinations, the place used is the location of the current main office as shown in the bank's current articles of association, not the place designated in the organization certificate and the original articles.[8] For example, in the OCC's recently adopted regulation addressing electronic activities, the rule specifies the manner to determine the location, for purposes of 12 USC 85, of a national bank that operates exclusively through the Internet. It provides that the main office of such a bank is "the office identified by the bank under 12 USC 22(Second) or as relocated under 12 USC 30 or other appropriate authority." See 67 Fed. Reg. 34992, 35006 (May 17, 2002) (to be codified at 12 CFR 7.5009).

Finally, when Congress had occasion to identify a national bank's home state, it used the location of the bank's main office as the reference point. In the Riegle–Neal Act, Congress authorized mergers between insured banks with different home states. The "home state" of a national bank

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[6] *See* 12 USC 21a (authorizing amendments to articles of association); 12 CFR 5.40(d)(2)(ii) (amendment of articles if main office location is changed outside original city, town, or village). Similarly, when other items that were included in the organization certificate and original articles are changed, the articles of association must be amended to reflect the changes. *See* 12 CFR 5.42(d)(2) (amendment of articles for change of name); 12 CFR 5.46(g)(2) and 5.46(i)(3)(iv) (amendments of articles for changes in capital stock).

[7] *Compare Comptroller's Corporate Manual,* "Corporate Organization." at 21 (instructions for articles include directions regarding amendment) *with Comptroller's Corporate Manual,* "Corporate Organization," at 33 (instructions for organization certificate cover only original filing). *See also Decision on the Applications of American Security Bank, N.A., Washington, D.C., and Maryland National Bank, Baltimore, Maryland* (OCC Corporate Decision No. 94–05, February 4, 1994) (at page 11, note 4), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 89,695. In addition, the certificate of corporate existence the OCC issues to a national bank, when requested, to certify it is a national bank formed under the laws of the United States and authorized to transact the business of banking on the date of the certificate lists the location of the bank at the main office on the date of the certificate, not the original location in the organization certificate. The certificates the OCC has issued to Bank of America (Charter Number 13044) since the 1999 merger show Charlotte, North Carolina, as the bank's location.

[8] For some statutes, a national bank may also be "located" in states in which it has branches. That is a separate matter from the issue here whether the current main office or the original place is the place used when referring to a bank's location.

is the state in which its main office is located. 12 USC 1831u(g)(4)(A)(i). Moreover, the home state of a state bank is the state by which the bank is chartered. 12 USC 1831u(g)(4)(A)(ii). This suggests Congress viewed the main office of a national bank as a way to designate a state that was comparable to the state of incorporation for a state bank.

Location of a National Bank for Federal Court Jurisdiction

For purposes of diversity jurisdiction in federal courts, "[a]ll national banking associations shall, for the purposes of all other actions by or against them, be deemed citizens of the States in which they are respectively located." 28 USC 1348.

Over the years, the courts have taken three positions regarding the location of a national bank for diversity purposes. Recently, some district courts adopted the position that a national bank was located in, and hence a citizen of, every state in which it maintains a branch or otherwise has a substantial presence.[9] On the other hand, an older court of appeals decision and some district courts took the position that a national bank was located for this purpose only in the state of its principal place of business.[10]

However, the leading recent court of appeals case followed neither of those approaches. In *Firstar Bank, N.A.* v. *Faul*, 253 F.3d 982 (7th Circuit 2001), the Seventh Circuit, relying upon the history and context of the provision, determined the national bank jurisdiction statute should be construed to maintain jurisdictional parity between national banks and state banks or other state corporations. 253 F.3d at 987–93.[11] For diversity jurisdiction purposes, state banks and other state corporations are potentially citizens of two states—the state of incorporation and the state where it has its principal place of business. See 28 USC 1332(c)(1). And so the court concluded that national banks should be similarly treated. Since a national bank is not incorporated by a state, the court looked to the state designated in a national bank's organization certificate to serve as an analogue and concluded that a national bank is a citizen, for jurisdiction purposes, both of the state of its principal place of business and the state listed in its organization certificate. 253 F.3d at 993–94.

[9] The first case to adopt that position was *Connecticut National Bank* v. *Iacono,* 785 F. Supplement 30 (U.S. District Court for the District of Rhode Island 1992). Others have followed it. *See, e.g., Ferraiolo Construction, Inc.* v. *Key-Bank, N.A.,* 978 F. Supplement 23 (U.S. District Court for the District of Maine 1997); *Norwest Bank Minnesota, N.A.* v. *Patton,* 924 F. Supplement 114 (U.S. District Court for the District of Colorado 1996); *Bank of New York* v. *Bank of America,* 861 F. Supplement 225 (U.S. District Court for the Southern District of New York 1994).

[10] *American Surety Company v. Bank of California, N.A.,* 133 F.2d 160 (9th Circuit 1943); *Baker* v. *First American National Bank,* 111 F. Supplement.2d 799 (U.S. District for the Western District of Louisiana, 2000); *Financial Software Systems, Inc.* v. *First Union National Bank,* 84 F. Supplement 2d 594 (U.S. District Court for the Eastern District of Pennsylvania 1999).

[11] The OCC filed an amicus brief in *Firstar Bank, N.A.* v. *Faul,* arguing in support of the position that section 1348 should be interpreted in a manner to achieve jurisdictional parity with state entities.

We believe the interpretation of the statute and fundamental reasoning of the *Firstar Bank, N.A.* v. *Faul* court are correct. National banks are to be treated for diversity jurisdiction purposes in a manner similar to state banks. However, the court's use of the state listed in the organization certificate as the analogue to the state of incorporation was incomplete. While most national banks do not change the location of their main office from the state originally listed in the organization certificate, some do. As set out above, the state that was listed in the original organization certificate can be changed under statutes that provide for changing the location of the main office. When this occurs, the original organization certificate document itself is not changed. The change in designation of the place of operations (including state) is reflected in other documents, particularly the articles of association.[12]

Thus, a more complete statement of the position would be that a national bank is a citizen of the state in which its principal place of business is located and of the state that was originally designated in its organization certificate and articles of association or, if applicable, the state to which that designation has been changed under other authority (i.e., the state in which its main office is currently located). We think this better comports with the underlying national bank corporate statutes and practice. It is also consistent with the reasoning in *Firstar Bank, N.A.* v. *Faul*. A national bank's change of its original designated state is akin to a state entity changing its state of organization by reincorporating in a new state. Moreover, if only the state actually listed in the original organization certificate is used, without some method to take account of later changes of main office, that could lead to the result of a national bank being deemed a citizen of a state with which it no longer had any contacts whatsoever.

Conclusion

Accordingly, we conclude that, since Bank of America's main office is now in Charlotte, North Carolina, the bank should be treated as a citizen of North Carolina for that part of the test in *Firstar Bank, N.A.* v. *Faul*.

Eric Thompson
Director
Bank Activities and Structure

[12] In *Firstar Bank, N.A.* v. *Faul,* the city and state of the bank's main office (Cincinnati, Ohio) was the same as it was when the bank was chartered in 1863 as The First National Bank of Cincinnati (Charter Number 24). Thus, the facts in the case did not present the issue raised by a subsequent change in the designation of the place of operations.

953—December 4, 2002

12 USC 24(7)
12 USC 24(10)

Re: Proposal to enter into residual purchase agreements

Dear Mr. [ ]

This responds to your letter requesting the OCC's concurrence that [bank], [*City, State*] ("bank") may enter into residual purchase agreements with other unrelated, third-party equipment lessors ("proposed activities"). For the reasons discussed below, we believe the proposed activities are permissible.

A. Background

The bank engages in the leasing of personal property pursuant to 12 USC 24(Tenth) and 12 CFR Part 23 ("CEBA leasing").[1] In the normal course of its CEBA leasing, the bank purchases equipment, relies upon its expertise to estimate the residual value of the equipment at the end of the lease term, and determines the lease payments it will receive. For each lease, the bank then uses its reasonable estimate of the residual value in determining whether the lease qualifies as full-payout.

The bank proposes to use the expertise it has developed in estimating the residual value of leased equipment to enter into the residual purchase agreements described below. Prior to entering into any agreement, the bank will undertake its normal CEBA leasing analysis, including review of the equipment to be leased. The same professionals who perform this analysis for the bank's CEBA leasing business will perform the analysis for the proposed activities. Furthermore, if any leased equipment suffers a loss—from theft or physical damage—during the term of the lease, the bank's obligation under the residual purchase agreements will be extinguished.

The bank proposes, for a fee, to enter into agreements with unrelated, third-party equipment lessors such that:

- *at lease expiration*, the lessor must either sell the off-lease equipment to the bank for the pre-determined purchase price ("purchase price")[2] or appoint the bank to serve as its exclusive agent to sell the equipment.[3] As the exclusive agent of the lessor, the bank will

[1] A permissible CEBA ease must be of personal property, be a net, full-payout lease, and have a minimum term of 90 days.

[2] If the bank is required to purchase the off-lease equipment pursuant to an agreement with the lessor, the bank represents that it would dispose of the off-lease equipment within the period allowed by Part 23.

[3] The agreement between the bank and the lessor would prohibit the lessor from selling or re-leasing the equipment or extending or renewing the subject lease.

arrange the sale of the equipment. Regardless of the sale price, the lessor will receive the purchase price, with the bank entitled to any excess of the net sales proceeds over the purchase price as a commission;

- *if a lease terminates early,* the lessor must either sell the off-lease equipment to the bank for the greater of its then fair market value ("FMV") or the pre-designated purchase price or appoint the bank to serve as its exclusive agent to sell the equipment. As the exclusive agent of the lessor, the bank will arrange the sale of the equipment. Again, regardless of the actual sale price, the lessor will receive the greater of the FMV or the purchase price, with the bank entitled to any excess of the net sales proceeds over the FMV or purchase price as a commission.

The bank proposes to enter into this residual purchase agreement both for CEBA leases originated by unrelated third parties and for CEBA leases originated and sold by the bank. The bank represents that all leases for which it will enter into this residual purchase agreement will meet the requirements for CEBA leasing in Part 23. The bank further represents that it will not be involved in the underlying lease negotiations between the third-party lessor and the lessee (except in those instance in which the bank itself originates the CEBA leases).

The bank expects that its estimates of the purchase prices, essentially the off-lease equipment's residual values, would be accurate on a portfolio basis. For this reason, and because the bank will receive fee income for entering into the residual purchase agreements, the bank believes that the proposed activities would be profitable.

B. Discussion

The Supreme Court has held that the National Bank Act, in 12 USC 24(Seventh), contains a broad grant of the power to engage in the "business of banking." Specifically, the Court has said that the business of banking "is not limited to the enumerated powers in Section 24(Seventh) and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated."[4] In exercising this discretion, the OCC is guided by several factors reflected in case law and followed by OCC precedent: (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; (3) does the activity involve risks similar in nature to those already assumed by banks; and (4) whether the activity is expressly authorized by law for state-chartered banks.[5]

[4] *NationsBank of North Carolina, N.A.* v. *Variable Life Annuity Co*., 512 U.S. 251, 258–59, n.2 (1995).

[5] The OCC recently codified these four principles in the electronic banking regulation. *See* 12 CFR 7.5001(c).

The proposed activities need not satisfy all four factors in order to be permissible as part of the business of banking. Rather, the OCC recognizes that one or more of the factors may predominate, depending on the specific facts and circumstances presented.[6] For the reasons discussed below, we believe that the proposed activities are part of the business of banking.

1. The proposed activities are the functional equivalent of and a logical outgrowth of recognized banking activities.

The proposed activities are the functional equivalent of a recognized national banking activity—originating or purchasing loans, and specifically loans with balloon payments.[7] One example is an automobile loan with a balloon payment. Such a loan is an installment loan, secured by the automobile, with a large (or "balloon") payment equal to the estimated residual value of the automobile included in the final monthly installment. At the time of the final monthly payment, the borrower typically may choose (i) to sell the vehicle, pay the residual value, and keep the difference; (ii) to use the vehicle as a trade-in, paying the residual value as part of the transaction; (iii) to refinance the residual value as a used vehicle loan; or (iv) to return the vehicle to the lending bank.

When originating or purchasing a balloon loan, a national bank assumes the necessity of disposing of the collateral if, at the time of the final monthly payment, the borrower chooses to return the vehicle to the bank in lieu of the balloon payment ("residual disposal risk"). In addition, when estimating a residual value for the vehicle, the bank assumes the risk that the estimated residual value is set too high. If the estimated residual value is set too high and the borrower opts to return the collateral, the bank may receive an amount less than the estimated residual value when disposing of the returned vehicle ("residual value risk").

The proposed activities represent a functionally equivalent activity. Before the bank enters into a residual purchase agreement with an unrelated, third-party lessor to purchase, or act as exclusive agent for the sale of, off-lease equipment, it would establish the purchase price for the off-lease equipment. Establishing the purchase price for off-lease equipment is the functional equivalent of estimating the residual value of collateral in a balloon loan. In both instances, the bank would be assigning the value at which it will accept the property—either the off-lease equipment or the balloon loan collateral. Then, by entering into a residual purchase agreement with a third-party

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[6] *See* 67 *Federal Register* 34855, 34994–95 (May 17, 2002); Interpretive Letter No. 928, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–453 (December 24, 2001); *Merchants' Bank* v. *State Bank*, 77 U.S. 604, 608 (1871); *M&M Leasing Corp*. v. *Seattle First Nat'l Bank*, 536 F.2d 1377, 1382–83 (9th Circuit 1977), *cert. denied*, 436 U.S. 987 (1978); *American Ins. Assoc*. v. *Clarke*, 865 F.2d 278, 282 (D.C. Circuit 1988).

[7] National banks may originate and purchase such loans. Interpretive Letter No. 364, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,534 (July 9, 1986); letter from Wallace S. Nathan, district counsel (December 2, 1985) (unpublished). *See* 12 CFR 5.34(e)(5)(v)(D) ("[p]urchasing . . . extensions of credit, or interests therein"); Corporate Decision No. 2001–27 (September 27, 2001) (national bank may purchase loan participations).

equipment lessor, the bank is agreeing to engage in an activity that is the equivalent of disposing of collateral returned in lieu of a balloon payment. The bank would receive off-lease equipment (or, in the case of a balloon loan, returned collateral) that has been used for a period of time and would employ its expertise in disposing the equipment (or collateral).

Moreover, the proposed activities rely upon the core competencies developed by the bank in originating and purchasing both balloon loans and CEBA leases.[8] The bank proposes to purchase equipment residuals after using the same expertise and the same analytical criteria the bank applies when it originates or purchases a whole lease. The bank would then dispose of these residuals in the same manner, with the same expertise, and subject to the same criteria in which it disposes of off-lease property from CEBA leases it originates or purchases. The same professionals who perform CEBA lease analysis and sales for the bank today would undertake this analysis and sales activity.

2. The proposed activities involve risks similar in nature to those already assumed by the bank.

By originating or purchasing a balloon loan, the bank would assume the residual value risk and, if the borrower opts to return the collateral in lieu of making the balloon payment, the residual disposal risk. The proposed activities place the bank in a comparable position, with an agreement to accept the off-lease equipment and the residual value risk. As described above, the bank represents that the risk analysis and risk management that it would undertake in connection with the proposed activities in estimating the residual value, in assigning a purchase price, and ultimately in selling the off-lease equipment is identical to the risk analysis and risk management that the bank currently undertakes in connection with its origination and acquisition of CEBA leases.

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[8] The development of core competencies has important implications under the logical outgrowth analysis. As the OCC has observed:

> Among other things, the "logical outgrowth" test recognizes that the "business of banking" is defined not only by the services and products that banks provide, but also the core competencies that banks use to produce them. . . .
>
> Clearly, "the business of banking is not static. . . ." *New York State Ass'n of Life Underwriter*s v. *New York State Banking Dept*., 632 N.E.2d 876, 880 (N.Y. 1994). OCC recognizes that the evolution of "business of banking" is not restricted to lines of business reflecting only products banks have sold or functions banks have served previously. Rather, the "business of banking" must be—and is—sufficiently flexible to enable banks to develop and exploit their unique core competencies and optimize the return on those competencies by marketing products and services reflecting or using those competencies. . . .

Interpretive Letter No. 928, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–453 (December 24, 2001). In Interpretive Letter No. 743, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,108 (October 17, 1996), the OCC concluded that providing mortgage reinsurance on mortgage loans originated or purchased by a bank was the functional equivalent to or a logical outgrowth of the lending business because, *inter alia*, it involved credit decisions based on core competencies developed in the lending business—the same underwriting criteria and comparable credit risks.

Satisfactory risk analysis and management systems are an important part of identifying, measuring, and controlling risk. Therefore, the bank may not commence the proposed activities unless and until the bank has received the approval of its examiner-in-charge that the risk analysis and management systems for the proposed activities are satisfactory.[9]

C. Conclusion

For the reasons set forth above, the proposed activities are part of the business of banking and, therefore, are permissible for national banks.[10] If you have any questions, please contact Steven Key, senior attorney, at (202) 874–5300.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[9] Subject to the same requirement, we believe that the bank may also engage in the proposed activities as a correspondent service. A national bank may offer correspondent services to its affiliates or any other financial institution. 12 CFR 7.5007. Because national banks assume the residual value risk of off-lease equipment and disposal of that equipment in connection with their personal property leasing activities, they may perform these services for other lessors. As described above, the bank represents that it has developed an expertise in these activities. One rationale for authorizing a national bank to provide correspondent services is to permit the bank to pass on the benefits of its expertise in certain activities which are central to banking. Interpretive Letter No. 137, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,218 (December 27, 1979); letter from Peter Liebesman, assistant director, Legal Advisory Services Division (May 2, 1990) (unpublished). OCC precedents generally support the position that the bank may engage in the proposed activities as a correspondent service. *See* Interpretive Letter No. 567, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 83,337 (October 29, 1991) (disposal of off-lease property for other lessors); letter from Peter Liebesman, assistant director, Legal Advisory Services Division (June 15, 1981) (unpublished).

[10] This letter does not address accounting and capital issues raised by the proposed activities. These issues will be addressed in later communications with the bank.

954—December 16, 2002

12 USC 85

Dear [ ]:

This is in response to your inquiry on behalf of [ ] ("bank"), and its wholly owned operating subsidiary [ ] ("the mortgage subsidiary"). In that letter, you request confirmation that the mortgage subsidiary may rely on 12 USC 85 and export Michigan's interest rate for real estate-secured loans made by the mortgage subsidiary to residents of states other than Michigan or secured by real estate located in states other than Michigan. For the reasons described below, as a national bank operating subsidiary, the mortgage subsidiary may export the Michigan interest rates under the same terms and conditions applicable to the bank.[1]

Both the bank and the mortgage subsidiary are headquartered in Michigan. The mortgage subsidiary makes real estate-secured loans to residents of all states except Hawaii. At this time, the mortgage subsidiary is principally involved in making first-lien, residential mortgage loans, but it intends to expand its subordinate-lien, residential mortgage lending activity in the future. The bank, through the mortgage subsidiary, seeks to establish lending programs in certain states with uniform pricing policies based on the interest allowed by its home state of Michigan, including fees that are considered interest under federal law and regulations. The mortgage subsidiary would include in its loan documents a governing law clause disclosing to borrowers that interest and loan charges that are considered to be interest under federal law would be governed by federal and Michigan law. The mortgage subsidiary also would comply with all requirements and limitations imposed by section 85 and OCC regulations and interpretations regarding section 85.

Because the mortgage subsidiary is a subsidiary of the bank within the meaning of 12 CFR 5.34(e)(2), and engages solely in activities that are permissible for the bank to engage in directly, the mortgage subsidiary qualifies as an operating subsidiary of the bank under 12 CFR 5.34. As such, it is subject to the same terms and conditions that apply to the bank. As stated in the relevant OCC regulations—

[1] Our review of the preemption issues involved in the bank's inquiry is not subject to the notice-and-comment procedures required under certain circumstances by 12 USC 43. That provision requires the OCC to publish in the *Federal Register* notice of any preemption inquiry concerning a state law in the areas of community reinvestment, consumer protection, fair lending, and the establishment of interstate branches. However, notice is not required for requests that raise issues of federal preemption that are essentially identical to those on which we have previously issued an opinion letter or interpretive rule. Id. Section 43(c)(1)(A). As explained in this letter, the request involves two issues that are resolved by OCC regulations: (1) the ability of a national bank to export interest rates (see 12 CFR 7.4001(c)), and (2) the extent to which state law applies to an operating subsidiary of a national bank (see id. Sections 5.34(e)(3) and 7.4006). This letter simply outlines the relationship between these two well-settled principles of federal banking law.

> *Examination and supervision*. An operating subsidiary conducts activities authorized under this section pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank.[2]

Elsewhere, our regulations specify that "[s]tate laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank."[3] Recent legislation also has recognized the permissibility of national banks engaging in activities through operating subsidiaries. In section 121 of the Gramm–Leach–Bliley Act, Congress expressly acknowledged that national banks may own subsidiaries that engage "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks."[4] Operating subsidiaries are often described as equivalent to a department or division of their parent bank, and our regulations ensure that operating subsidiaries will be subject to the same federal laws and standards that govern their parent bank, including any state laws and standards that are made applicable to the parent bank by federal law.[5]

One such law is the limit imposed by section 85 on the maximum amount of interest a national bank may charge. Under section 85, a national bank is authorized to establish interest based on the laws of the state in which the bank is located.[6] OCC regulations provide that:

> A national bank located in a state may charge interest at the maximum rate permitted to any state-chartered or licensed lending institution by the law of that state.[7]

This "most favored lender" lender status permits a national bank to contract with borrowers in any state for interest at the maximum rate permitted by the law of the state in which the national bank is located. Generally, that is the state in which the main office of the national bank is located.[8] Under certain circumstances, national banks with branches in more than one state may be required to impose interest rates permitted by the law of a state in which they have a branch. That would happen in circumstances where three functions—loan approval, communication of loan

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[2] 12 CFR 5.34(e)(3).

[3] 12 CFR 7.4006.

[4] Pub. L. No. 106–102, § 121, 113 Stat. at 1378, codified at 12 USC 24a(g)(3).

[5] Letter from Charles F. Byrd, assistant director, Legal Advisory Services Division (October 30, 1977), reprinted in [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,051 (national bank operating subsidiaries are in effect incorporated departments of the bank).

[6] 12 USC 85.

[7] 12 CFR 7.4001(b).

[8] *Marquette National Bank of Minneapolis* v. *First of Omaha Service Corp*, 439 U.S. 299 (1978).

approval, and disbursal of loan proceeds—all occur in a branch or branches in the same branch state.[9] Absent this set of circumstances, a national bank may impose rates permitted by the state where its main office is located.

Accordingly, pursuant to 12 CFR 5.34(e)(3) and 7.4006, the limit on the maximum amount of interest the mortgage subsidiary may charge is governed by section 85, to the same extent as section 85 is applicable to its parent bank.[10]

I hope the foregoing is helpful in your analysis of your client's lending programs. Please do not hesitate to contact my office at (202) 874-5200 or MaryAnn Nash, counsel, in our Law Department at (202) 874-5090, if you have any questions or if you need any additional information.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[9] OCC Interpretive Letter No. 822 (Feb. 17, 1998), reprinted in [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–265.

[10] See *Moss* v. *Southtrust Mobile Services, Inc.*, No. CV–95–P–1647–W, 1995 U.S. District LEXIS 21770 (U.S. District Court for the Northern District of Alabama September 22, 1995). In this case, the court concluded, without analysis, that section 85 applied to the operating subsidiary in question pursuant to 12 CFR 5.34 because it was an operating subsidiary of a national bank.

955—January 31, 2003

12 USC 84
12 CFR 32.3(C)(10)

Dear [ ]:

This is in response to your letter of December 2, 2002, in which you request the Office of the Comptroller of the Currency ("OCC") to reconsider its determination that [bank], [City, State] ("bank") had advanced funds to [ ] ("[ ]") in excess of the legal lending limit in violation of 12 USC 84. Your letter describes proposed modifications to the bank's loans to [ ] that you believe will result in those loans satisfying the exception to the lending limit for certain loans to leasing companies set forth at 12 CFR 32.3(c)(10).

For the reasons set forth below, the bank's loans to [ ] as modified under the proposal will satisfy the requirements of 12 CFR 32.3(c)(10). Accordingly, the loans to [ ], as modified, should be treated as loans to each lessee for the purposes of the legal lending limit.

Background

[ ] is an equipment leasing company. The bank has extended three non-recourse loans to[ ] to finance three pools of existing personal property leases. The original term of the leases in the pools is on average fifty-three months. The leases had been originated by [ ] between two and seventeen months prior to the bank's loans to [ ]. [ ] financed its acquisition of the assets being leased through working capital or borrowings from other banks. The proceeds of the bank's loans to [ ] were used to reimburse it for the purchase of the leased equipment by restoring working capital or repaying the acquisition debt. The loans to [ ] are secured by an assignment of all of [ ]'s rights to specified leases and security interests in the equipment being leased. The bank has analyzed the creditworthiness of each lessee before making the loans to [ ]. The bank represents that the terms of the underlying leases meet the same limitations that would apply to a national bank acting as lessor. The assignment and security agreement provides that lease payments are to be made:

> by each Lessee to [[ ]], in care of [bank], at [bank's] address set forth above and [[ ]] authorizes [bank] to endorse, in [[ ]'s] name, all Lease Payments.

However, in practice the lessees made their payments to [ ] and [ ] remitted the amount it owed on the promissory notes to the bank on a monthly basis.

In the June 30, 2002, report of examination, the OCC cited the loans to [ ] as a violation of 12 USC 84 since the aggregate amount of those loans exceeded the bank's legal lending limit. The examiners determined that the three loans to [ ] failed to satisfy the requirements of the lending limit exception at 12 CFR 32.3(c)(10) and noted that the lessees were making their lease payments to [ ], rather than to the bank.

The bank has proposed a modification to the manner in which lease payments are processed. Under the proposed modification, [ ] will open and maintain a lock box at the bank and notify all lessees to direct all present and future payments due on the leases to the lock box. On the monthly payment due date, the bank will deduct the amount of the monthly payment owed under the note and apply it to the [ ] loan. At the end of each month, the bank will remit any funds remaining in the lockbox to [ ]. [ ] will remain responsible for billing and collections, but will carry out these functions as an independent contractor and not as the bank's agent.

Legal Analysis

Generally, a national bank's total outstanding loans or extensions of credit 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.[1] A "borrower" includes a person who is named a borrower or debtor in a loan or extension of credit.[2] "Loans or extensions of credit" are defined as:

> a bank's direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds *or repayable from specific property pledged by or on behalf of the borrower*.[3] (Emphasis added).

Here, [ ] is named the borrower on each of the three promissory notes it has executed with the bank. Further, the notes are all repayable from the collateral it has pledged to the bank. Thus, unless an exception to the legal lending limit applies, the bank's advances to [ ] under the three promissory notes are deemed to be loans to [ ] for the purpose of the lending limit, notwithstanding the non-recourse nature of those notes.

However, under 12 CFR 32.3(c)(10) a loan to a leasing company:

> for the purpose of purchasing equipment for lease will be deemed to be a loan to the lessee and not the leasing company, provided that—
>
> (i) The bank evaluates the creditworthiness of the lessee before the loan is extended to the leasing corporation;
>
> (ii) The loan is without recourse to the leasing corporation;
>
> (iii) The bank is given a security interest in the equipment and in the event of default, may proceed directly against the equipment and the lessee for any deficiency resulting from the sale of the equipment;

[1] See 12 USC 84(a); 12 CFR 32.3(a).

[2] 12 CFR 32.2(a).

[3] 12 CFR 32.2(j); see also 12 USC 84(b)(1).

(iv) The leasing corporation assigns all of its rights under the lease to the bank;

(v) The lessee's lease payments are assigned and paid to the bank; and

(vi) The lease terms are subject to the same limitations that would apply to a national bank acting as a lessor.

The exception at section 32.3(c)(10) incorporated a longstanding OCC interpretive position regarding lease-note financing known as the "U.S. Leasing" exception.[4] In 1974 the OCC issued an interpretive letter concerning a lease-note financing arrangement proposed by United States Leasing Corporation.[5] The OCC concluded that in lease-note financing arrangements such as those proposed by U.S. Leasing, the leasing company should be viewed merely as a nominal lessor and servicer of the lease acting on behalf of the lending bank.[6] Under an arrangement that meets the U.S. Leasing exception, the lessee's rent payments are the primary source of repayment of the loan and are understood to be such by all parties to the transaction. As a result, the lending bank should be able to treat the transaction as the equivalent of a secured loan to the lessee. In the event of default by the lessee, the bank has all the rights of a secured creditor, including the right to demand from the lessee any portion of the rent remaining unpaid after the equipment is sold. In essence, the lender must be placed in the same position as if it had directly leased the property to the lessee for the U.S. Leasing exception to apply.[7] The OCC has repeatedly emphasized in its interpretive letters that the U.S. Leasing exception is extremely narrow.

The bank and [ ] attempted to structure the loans so as to satisfy the requirements of the exception at 32.3(c)(10). During the recent examination the OCC determined that the bank's loans to [ ] met only five of the six enumerated conditions to the exception. The lessees were not making their lease payments to the bank as required by 12 CFR 32.3(c)(10)(v).[8] At issue here is whether the revised manner in which the bank proposes to collect payments satisfies the condition at 12 CFR 32.3(c)(10)(v).

[4] See 59 *Federal Register* 6593, Proposed Rule (February 11, 1994); 60 *Federal Register* 8526, Final Rule (February 15, 1995).

[5] See OCC Interpretive Letter, December 5, 1974 [1973–1978 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 97,003 ("U.S. Leasing letter").

[6] Id. See also letter from Peter Liebesman, assistant director, Legal Advisory Services Division (October 21, 1987) (unpublished) ("Liebesman letter"); OCC Interpretive Letter No. 287, April 19, 1984 [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,451.

[7] See OCC Interpretive Letter No. 327, March 15, 1985 [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,497.

[8] The OCC has opined that lease payments collected by the lessor that are forwarded to the lending bank within one business day of the receipt will satisfy the requirement that the "lessee's lease payments are . . . paid to the bank." Liebesman letter. In this case, the lessees made their payments to [ ], and [ ] remitted the amount owing to the bank under the loan on a monthly basis. Since [ ] did not remit the lease payments it received from the lessees to the bank within one business day, the loans did not meet the condition at 12 CFR 32.3(c)(10)(v).

Under the proposed modification to the loan agreement, all lessees will be directed to make all future payments due on the leases to a lock box at the bank. The bank will have sole control over the lock box. On the due date for [ ]'s monthly payment to the bank under the three notes, the bank will deduct the amount of the monthly payment owed and apply it to the [ ] loan. At the end of each month, the bank will remit any funds remaining in the lockbox to [ ]. This manner of payment satisfies the condition at 12 CFR 32.2(c)(10)(v) since the lessees will make their payments directly to the bank. Accordingly, the bank's loans to [ ], as modified under the proposal, will satisfy the six conditions of 12 CFR 32.3(c)(10).

Accordingly, the bank's loans to [ ], as modified under the proposal, will satisfy the requirements of 12 CFR 32.3(c)(10). Consequently, the loans to [ ] as modified should be treated as loans to each lessee for the purposes of the legal lending limit.[9]

The opinion set forth above is based on the facts and representations included in your correspondence dated December 2, 2002, and December 6, 2002, and our subsequent phone conversations. Any changes to the facts may warrant a different conclusion. Also, please note that this letter responds only to the legal lending limit issue raised in your letter and does not address any safety and soundness aspects of the current loans to [ ] or the proposed modifications to those loans.

If you have any questions regarding this letter, please contact me at (312) 360–8805.

Christopher G. Sablich
Senior Counsel
Central District Office

[9] The proceeds of the bank's loans to [ ] were used to reimburse it for its purchase of the leased equipment by restoring working capital or repaying the acquisition debt. Thus, the purpose of the bank's loans to [ ] was to indirectly finance the purchase of the leased equipment securing the loans. The indirect use of proceeds does not offend the theoretical foundation for the exception that the transactions are the functional equivalent of direct lease transactions between the bank and the lessees.

956—January 31, 2003

12 USC 24(7)

Re: Request for Opinion

Dear [ ]:

This letter is in response to your request for a legal opinion confirming the permissibility of several aspects of an agreement entered into by [bank], [City, State] ("bank") and [ ], a California corporation ("[ ]"). The bank and [ ] have executed an opportunity development agreement ("agreement"), pursuant to which the bank finances [ ]'s purchase of real properties and then benefits from the appreciation in such properties. You have requested that we confirm that this lending arrangement is permissible pursuant to Interpretive Ruling 7.1006, 12 CFR 7.1006 (2002), the Office of the Comptroller of the Currency's ("OCC's") regulation permitting national banks to take a share of the borrower's profits as part of the interest on the loan. You have also requested that we confirm that each of the lender covenants imposed by the bank as part of the financing it provides to [ ] is legally permissible. Finally, you have requested that we confirm that the nature of compensation paid by the bank to [ ] is consistent with OCC precedent. For the reasons discussed below, we confirm each of your requests.

A. Background

As represented by the bank, the facts are as follows. The relationship between the bank and [ ]'s principals ("the principals") began in the 1980s when the parties entered into an agreement for the principals to manage certain of the bank's other real estate owned ("OREO") portfolio. Based upon the principals' successful management of the OREO assets, the bank and [ ] entered into the agreement.

Pursuant to the agreement, [ ] seeks out potential real estate investment opportunities for the bank to finance. After identifying an opportunity, [ ] gathers comprehensive information regarding the property and presents that information to the bank to assist the bank in evaluating the lending opportunity.[1] The bank then applies its underwriting criteria to determine whether to make the loan. If the bank extends credit for [ ] to purchase the property ("bank loan"), the purchase money for the property consists of the proceeds of the bank loan (95 percent) and an equity contribution from the principals (5 percent). With limited exceptions, each bank loan has been an unsecured, five-year loan with an 8 percent rate of interest. The agreement requires that [ ] personally manage each property after purchase.

In consideration for the performance of [ ]'s services, the bank contributes to the cost of

[1] The agreement provides that neither [ ] nor its principals are employees or agents of the bank. Further, the agreement states that the bank and [ ] are not engaged in a partnership or joint venture.

[ ]'s general expenses, including the expenses associated with the pre-investment evaluation of potential real property financing opportunities. The bank does so (i) by providing [ ] with office space and associated services and (ii) by contributing, each calendar quarter, $100,000 for [ ]'s expenses.[2] Once the bank approves a bank loan, the deal-specific expenses are included in the loan to [ ] if the deal is consummated or, if not consummated, the expenses are shared 95 percent by the bank and 5 percent by [ ].

In addition to the bank loans, the bank has a right of first refusal to provide conventional, secured commercial financing to either [ ] or the business entity in which [ ] is investing ("primary loan"). Even if the bank chooses to make a bank loan, it may decline to make a primary loan. The bank has made several primary loans secured by the ultimate real estate assets; in other instances, another lender has made the primary loan.

The agreement provides for the use of funds received by [ ], whether realized from the sale or refinance of a property or from some other source. These funds are used first to repay principal and interest on the primary loan and the principal amounts of the bank loan and the principals' equity contribution. Any remaining funds are used next to pay the base interest amount on the bank loan and to provide the principals with a base return on their equity contribution. Finally,

[ ] pays any remaining funds as contingent interest, in the amount of 80 percent to the bank and 20 percent to [ ].[3]

Consistent with its role as a lender, the bank imposes certain lender covenants to protect its loans to [ ].

- First, the bank conditions the continuation of the agreement upon the principals' maintaining 100 percent ownership of [ ];
- Second, the bank requires that the principals maintain a personal services agreement with [ ], pursuant to which they agree to devote as much time as "reasonably necessary for a satisfactory performance of their duties";
- Third, the bank precludes [ ] from purchasing properties not financed by bank loans;
- Fourth, the bank retains approval rights upon the sale of a portion (as opposed to all) of a real property and the distribution of [ ]'s assets;

[2] One-half of this amount is reimbursable out of [ ]'s cash flow. Pursuant to the personal services agreement entered into by the principals, which is described *infra*, [ ] pays the principals $45,000 each quarter for their services.

[3] The agreement also provides that, prior to the payment of contingent interest, [ ] must use any remaining funds to pay the bank an amount equal to the full principal amount of any other bank loan as to which the bank has determined that the prospect of repayment from the related real property underlying such bank loan is for any reason impaired.

- Fifth, the bank imposes a debt to equity ratio of 19-to-1 in cases where it provides the bank loan. As described above, the bank finances 95 percent of the acquisition costs and [ ]'s principals put up the remaining 5 percent; and

- Sixth, the bank requires [ ] to provide various financial statements and reports.

B. Discussion

1. The Lending Arrangement

a. Interpretive Ruling 7.1006, 12 CFR 7.1006

The OCC has long recognized the authority of national banks to share in the profit, income, or earnings from a business enterprise as a full or partial substitute for interest on a loan.

> [a] national bank may take as consideration for a loan a share in the profit, income, or earnings from a business enterprise of a borrower. . . . The share . . . may be taken in addition to, or in lieu of, interest. The borrower's obligation to repay principal, however, may not be conditioned upon the value of the profit, income, or earnings of the business enterprise . . .

This ruling recognizes that extensions of credit may take many forms. In order for national banks to have a greater degree of flexibility in their lending activities, Interpretive Ruling 7.1006 makes clear that repayment of an extension is not necessarily limited to a bank's receipt of principal and a specified amount of interest on a demand or installment basis over time.[4] Moreover, this ruling represents the OCC's long-standing position on the authority of national banks to employ participatory financing arrangements. In November 1966, the OCC added Paragraph 7312 to the *Comptroller's Manual for National Banks*. Paragraph 7312 provided that:

> [a] national bank may take as consideration for a loan a share in the profit, income or earnings from a business enterprise of a borrower. Such share may be in addition to or in lieu of interest. The borrower's obligation to repay principal, however, shall not be conditioned upon the profit, income, or earnings of the business enterprise.

Several interpretive letters in 1969 and 1970, citing to Paragraph 7312, confirmed that a national bank could accept a share in the profit, income, or earnings of a business enterprise as consideration for a loan in lieu of interest or partially in lieu of interest.[5] However, the authority to share

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[4] *See* letter from John G. Heimann, Comptroller of the Currency (May 21, 1980) (unpublished); letter from Charles F. Byrd, assistant director, Legal Advisory Services Division (Oct. 18, 1977) (unpublished).

[5] Letter from Patrick Parise, regional counsel (Oct. 16, 1970) (unpublished) (warrants); letter from Thomas G. DeShazo, deputy comptroller of the currency (August 26, 1969) (unpublished) (profits); letter from Robert Bloom, chief counsel (May 26, 1969) (unpublished) (warrants). In 1971, the OCC codified Paragraph 7312 as Interpretive Ruling 7.7312, 12 CFR 7.7312. The current ruling, Interpretive Ruling 7.1006, replaced Interpretive Ruling 7.7312 without substantive change in April 1996.

in the profit, income, or earnings from a business enterprise as a full or partial substitute for interest pursuant to Interpretive Ruling 7.1006 is subject to certain limitations. These limitations are designed to ensure that the bank's role in providing such financing is that traditionally assumed as a lender.[6] First, there must be no risk to loan principal other than that arising from a borrower's default; in this regard, Interpretative Ruling 7.1006 requires that the obligation to repay principal shall not be conditioned upon the profit, income, or earnings of the business enterprise. Second, in keeping with the provisions of 12 USC 24(7) and 29, a national bank can have no possessory or ownership interest in a borrower's business or real estate.

Within these parameters, a national bank may calculate its share of the profit, income, or earnings on the basis of either the appreciation of the borrower's business or the appreciation of individual assets.[7] The OCC has never limited the amount of contingent interest—in the form of a share of the profit, income, or earnings—that a national bank may accept. Rather, OCC precedent treats the percentage of profit, income, or earnings that a bank accepts as a contractual matter to be agreed upon by the parties.

Based upon the facts as represented, we find that the arrangement, as described, between the bank and [ ] is permissible pursuant to Interpretive Ruling 7.1006. The bank provides financing for [ ] to acquire real properties. The principal of these loans is not at risk, beyond the general default risk inherent in any loan transaction. [ ] is obligated to pay the principal and base interest on all outstanding loans regardless of the ultimate profitability of any transactions financed by the bank. Moreover, the bank has not assumed a possessory or ownership interest in [ ]'s business or any real property. By agreeing to "take as consideration for a loan a share in the profit, income, or earnings from a business enterprise" of [ ], the bank is merely exercising its authority under Interpretive Ruling 7.1006. The bank's share is based upon the available funds of [ ] as a business enterprise, and such basis is consistent with Interpretive Ruling 7.1006. Finally, because OCC precedent treats the percentage of profit, income, or earnings that a bank accepts as a contractual matter to be agreed upon by the parties, the bank's 80 percent share is consistent with such precedent.

b. Lender covenants

From a national banking perspective, it is sound public policy for banks to include covenants in

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[6] *See*, *e.g.*, Interpretive Letter No. 620, *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,502 (July 15, 1992); Interpretive Letter No. 204, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,285 (June 17, 1981).

[7] Interpretive Letter No. 244, *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,408 (January 26, 1982) (bank may accept a set percentage of the sales price upon sale of each developed real estate unit; bank may also accept a set percentage of the appreciation in the value of a business developed and operated on the mortgaged property); Interpretive Letter No. 216, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,297 (September 8, 1981) (bank may accept a set percentage share of the net appreciation of the mortgaged property at the end of a stated term).

their lending relationships.[8] Indeed, the more lender covenants that a bank includes, the more protection the bank has. In this case, the bank imposes a series of lender covenants. First, the bank conditioned continuation of the agreement upon the principals' maintaining 100 percent ownership of [ ]. Second, the bank required the principals to enter into a personal services agreement with [ ]. With respect to both covenants, the bank believes that the principals' continued involvement is essential to the overall success of its relationship with [ ] and the on-going stability of the bank's unsecured loans. We find that these covenants are permissible prudential measures designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Third, the bank precludes [ ]'s purchase of properties not financed by bank loans. The bank's outstanding loans to [ ] are unsecured and its contingent interest payment is based upon the success of [ ]. The bank believes it has a vested interest in ensuring that [ ]'s subsequent investments are economically sound. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Fourth, the bank imposes approval rights upon the sale of a portion (as opposed to all) of a real estate property and the distribution of [ ]'s assets. The bank believes doing so protects its right to be repaid on its outstanding loans. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Fifth, the bank imposes a debt to equity ratio of 19-to-1 in cases where it provides the bank loan. The bank does so to ensure that [ ] has an equity interest in each transaction. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Sixth, the bank requires [ ] to provide various financial statements and reports to permit the bank to monitor the financial condition of the business. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Finally, we find that these covenants, taken collectively, are a permissible prudential measure designed to protect the bank's position.

[8] *See* Interagency Guidelines for Real Estate Lending Policies, at Appendix A to Subpart D of 12 CFR Part 34. *See generally Comptroller's Handbook*, "Agricultural Lending" (December 1998), "Loan Portfolio Management" (April 1998), and "Commercial Real Estate and Construction Lending" (November 1995).

2. Compensation Paid by Bank to [ ]

Rather than paying a per-loan fee, the bank compensates [ ] for its services by providing [ ] with office space and paying a portion of [ ]'s operating expenses. Twelve CFR 7.1004(a) provides that "a national bank may use the services of, and compensate persons not employed by, the bank for originating loans." As a legal matter, the OCC has neither specified nor limited the nature and amount of compensation that a bank may pay a third party for originating loans.[9] Therefore, the nature and amount of the bank's compensation to [ ], in the form of office space and expenses, is consistent with OCC precedent.

C. Conclusion

For the reasons discussed above, we conclude that the bank's lending arrangement with [ ] is permissible pursuant to Interpretive Ruling 7.1006. We further conclude that the lender covenants described above, individually and collectively, are permissible prudential measures designed to protect the bank's position. Finally, we conclude that the nature of compensation paid by the bank to [ ] is permissible. If you have any questions about the foregoing analysis, please feel free to contact me at (202) 874–5300.

Eric Thompson
Director
Bank Activities and Structure Division

[9] *See* letter from Charles F. Byrd, assistant director, Legal Advisory Services Division (October 30, 1977) (unpublished). As a supervisory matter, the bank must not compensate the third party in a manner that adversely affects the safety and soundness of the bank.

957—January 27, 2003

12 USC 484
12 CFR 5.34(e)(3)
12 CFR 7.4006

Scott A. Cammarn, Esq.
Associate General Counsel
Bank of America
NC1–002–29–01
101 South Tryon Street
Charlotte, NC 28255

Dear Mr. Cammarn:

This responds to your letter of January 23, 2003, on behalf of Bank of America, N.A. ("bank") in which you request a determination (i) whether federal law prevents the California Department of Corporations (the "department") from conducting an examination of the bank's operating subsidiary, BA Mortgage LLC ("operating subsidiary"), and (ii) whether the operating subsidiary is required to maintain a license under the California Residential Mortgage Lending Act.

You represent that the operating subsidiary is a wholly owned operating subsidiary of the bank and engages solely in the servicing of residential mortgage loans originated or held by its predecessor, NationsBanc Mortgage Corporation, or by its parent, the bank. As an operating subsidiary of a national bank, the operating subsidiary is subject to ongoing supervision and examination by the Office of the Comptroller of the Currency ("OCC") in the same manner and to the same extent as the bank.[1] You represent that the operating subsidiary has maintained a license under the California Residential Mortgage Lending Act ("California Act"). The bank believes, however, that recent changes to the OCC's regulations clarify that the operating subsidiary is not required to maintain a license under the California Act. The bank further believes that the department is

[1] Twelve CFR 5.34(e)(3) provides that:—

> [a]n operating subsidiary conducts activities authorized under this section pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank. If, upon examination, the OCC determines that the operating subsidiary is operating in violation of law, regulation, or written condition, or in an unsafe or unsound manner or otherwise threatens the safety or soundness of the bank, the OCC will direct the bank or operating subsidiary to take appropriate remedial action, which may include requiring the bank to divest or liquidate the operating subsidiary, or discontinue specified activities. OCC authority under this paragraph is subject to the limitations and requirements of section 45 of the Federal Deposit Insurance Act (12 USC 1831v) and section 115 of the Gramm-Leach-Bliley Act [GLBA] (12 USC 1820a).

The provisions of the Federal Deposit Insurance Act and the GLBA referenced in the regulation pertain to the functional regulation of securities, insurance, and commodities firms. These provisions are not relevant to mortgage lending and servicing activities conducted by the operating subsidiary.

barred by federal law from conducting an examination of the operating subsidiary. The bank is requesting a determination that the OCC concurs with the bank's positions.[2]

As discussed in detail below, pursuant to 12 USC 484, and 12 CFR 5.34(e)(3) and 7.4006, the OCC has exclusive visitorial authority over national banks and their operating subsidiaries except where *federal* law provides otherwise. This authority pertains to activities expressly authorized or recognized as permissible for national banks under federal law or regulation, or by OCC issuance or interpretation, including the content of those activities and the manner in which, and standards whereby, those activities are conducted. As a result, states are precluded from examining or requiring information[3] from national banks or their operating subsidiaries or otherwise seeking to exercise visitorial powers with respect to national banks or their operating subsidiaries in those respects. Thus, federal law precludes examination of the operating subsidiary by the department. Moreover, for the reasons discussed below, operating subsidiaries—like their parent national banks—need not obtain the approval of a state to engage in an activity permissible under federal law. Accordingly, state licensing requirements do not apply to the bank or the operating subsidiary.[4]

Background

The OCC's exclusive visitorial authority over national bank operations is established by 12 USC 484.[5] Paragraph (a) of that section states that—

[2] OCC Advisory Letter 2002–9 (Nov. 25, 2002) ("AL 2000–9") generally describes the principles that govern the applicability of state law and the OCC's exclusive visitorial authority to national banks and their operating subsidiaries. That advisory letter indicates that national banks should contact the OCC in situations where a state official seeks to assert supervisory authority or enforcement jurisdiction over the bank.

[3] The OCC currently maintains information sharing agreements with 48 states, the District of Columbia, and Puerto Rico. These agreements provide a mechanism through which state regulators may seek and obtain supervisory information from the OCC. Typically, the OCC will make confidential bank examination information available to state bank regulatory agencies if they demonstrate a specific regulatory need for the examination information (*e.g*., in connection with a merger of a national bank into a state bank, where the state bank regulator must approve the transaction), and if the state agency has entered into an appropriate information sharing/confidentiality agreement with the OCC governing the use of the information. In AL 2002–9, the OCC outlined a procedure to address circumstances when state officials raise issues concerning potential violations of laws by national banks, including when state officials may seek information from a national bank about its compliance with any law or for other purposes. The advisory letter is available on the OCC's Web site at www.occ.treas.gov/ftp/advisory/2002-9.txt.

[4] We note that the California Act already contains an exemption from state licensing requirements for national banks, Cal. Fin. Code 50003(g), but fails to recognize the status of national bank operating subsidiaries under federal law and regulations.

[5] "Visitorial powers" generally refers to the power to "visit" a national bank to examine the conduct of its business and to enforce its observance of applicable laws. *See, e.g., Guthrie* v. *Harkness*, 199 U.S. 148, 158 (1905) (the word "visitation" means "inspection; superintendence; direction; regulation") (internal quotations omitted).

> [n]o national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

Paragraph (b) of the statute then permits lawfully authorized state auditors or examiners to review a national bank's records "solely to ensure compliance with applicable state unclaimed property or escheat laws upon reasonable cause to believe that the bank has failed to comply with such laws."

This provision, enacted with the creation of the national banking system in 1863, is integral to the design and structure of the national banking system and fundamental to the character of national banks. Congress enacted the National Currency Act ("Currency Act") in 1863 and the National Bank Act the year after for the purpose of establishing a new national banking system that would operate distinctly and separately from the existing system of state banks. At that time, both proponents and opponents of the new national banking system expected that it would supersede the existing system of state banks.[6] Given this anticipated impact on state banks and the resulting diminution of control by the states over banking in general,[7] proponents of the national banking system were concerned that states would attempt to undermine it.

The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with the need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and created a federal agency within the Department of the Treasury—the OCC—to carry it out. Congress granted the OCC

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[6] Representative Samuel Hooper, who reported the bill to the House, stated in support of the legislation that one of its purposes was "to render the law [*i.e.,* the Currency Act] so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters." *Congressional Globe,* 38th Congress, 1st Session 1256 (March 23, 1864). Opponents of the legislation believed that it was intended to "take from the States . . . all authority whatsoever over their own State banks, and to vest that authority . . . in Washington . . . ." *Congressional Globe,* 38th Congress, 1st Session 1267 (March 24, 1864) (statement of Representative Brooks). *See also* statement of Representative Pruyn (stating that the legislation would "be the greatest blow yet inflicted upon the States . . . . ") *Congressional Globe,* 38th Congress, 1st Session 1271 (March 24, 1864); statement of Senator Sumner ("Clearly, the [national] bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions.") *Congressional Globe,* 38th Congress, 1st Session, at 1893 (April 27, 1864).

[7] *See, e.g., Tiffany* v. *National Bank of the State of Missouri*, 85 U.S. 409, 412–413 (1874) ("It cannot be doubted, in view of the purpose of Congress in providing for the organization of national banking associations, that it was intended to give them a firm footing in the different states where they might be located. It was expected they would come into competition with state banks, and it was intended to give them at least equal advantages in such competition. . . . National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks."). *See also* B. Hammond, *Banks and Politics in America from the Revolution to the Civil War*, 725–34 (1957); P. Studenski & H. Krooss, *Financial History of the United States*, 155 (1st ed. 1952).

the broad authority "to make a thorough examination of all the affairs of [a national] bank,"[8] and solidified this federal supervisory authority by vesting the OCC with exclusive visitorial powers over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protected national banks from potential state action by establishing that the authority to examine and supervise national banks is vested *only* in the OCC, unless otherwise provided by *federal* law.[9]

In *Guthrie* v. *Harkness*, 199 U.S. 148 (1905), the Supreme Court recognized how the National Bank Act was designed to operate:

> Congress had in mind, in passing this section [*i.e.*, section 484] that in other sections of the law it had made full and complete provision for investigation by the Comptroller of the Currency and examiners appointed by him, and, authorizing the appointment of a receiver, to take possession of the business with a view to winding up the affairs of the bank. It was the intention that this statute should contain a full code of provisions upon the subject, and that no state law or enactment should undertake to exercise the right of visitation over a national corporation. Except in so far as such corporation was liable to control in the courts of justice, this act was to be the full measure of visitorial power.

Id. at 159. The Supreme Court also has recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the Currency Act could develop and flourish. For instance, in *Easton* v. *Iowa*, 188 U.S. 220 (1903), the Court stated that federal legislation affecting national banks—

> has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States . . . . It thus appears that Congress has provided a symmetrical and complete scheme for the banks to be organized under the provisions of the statute . . . . [W]e are unable to perceive that Congress intended to leave the field open for the States to attempt to promote the welfare and stability of national banks by direct legislation. If they had such power it would have to be exercised and limited by their own discretion, and *confusion would necessarily result from control possessed and exercised by two independent authorities*.

Id. at 229, 231–232 (emphasis added). The Court in *Farmers*' *and Mechanics' Bank*, 91 U.S. 29 (1875), after observing that national banks are means to aid the government, stated—

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[8] Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, *codified at* 12 USC 481.

[9] Writing shortly after the Currency Act and National Bank Act were enacted, then-Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that "Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments. . . ." *Congressional Globe,* 39th Congress, 1st Session, Miscellaneous Document No. 100, at 2 (April 23, 1866).

> Being such means, brought into existence for this purpose, and intended to be so employed, the States can exercise no control over them, nor in any wise affect their operation, except in so far as Congress may see proper to permit. Any thing beyond this is "an abuse, because it is the usurpation of power which a single State cannot give."

Id. at 34 (citation omitted).

Congress recently affirmed the OCC's exclusive visitorial powers with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 ("Riegle–Neal").[10] Riegle–Neal makes interstate operations of national banks subject to specified types of laws of a "host" state in which the bank has an interstate branch to the same extent as a branch of a state bank of that state, unless the state law is preempted by federal law. For those state laws that are not preempted, the statute makes clear that the authority to enforce the law is vested in the OCC. See 12 USC 36(f)(1)(B) ("The provisions of any State law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency."). This approach is another, and very recent, recognition of the broad scope of the OCC's exclusive visitorial powers with respect to national banks.

The OCC's exclusive visitorial authority complements principles of federal preemption, to accomplish the objectives of the National Bank Act. The Supremacy Clause of the United States Constitution[11] provides that federal law prevails over any conflicting state law. An extensive body of judicial precedent has developed over the nearly 140 years of existence of the national banking system, explaining and defining the standards of federal preemption of state laws as applied to national banks.[12] Visitorial power is a closely related authority, which Congress specifically addressed in section 484 to enable national banks to avoid inconsistent and potentially disruptive application of standards by state authorities. Together, federal preemption and the OCC's exclusive visitorial authority are defining characteristics of the national bank charter.

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[10] Pub. L. 103-328, 108 Stat. 2338 (September 29, 1994).

[11] U.S. Constitution Article VI, clause 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

[12] *See, e.g., Barnett Bank of Marion County, N.A.* v. *Nelson*, 517 U.S. 25, 26, 32, 33 (1996) ("grants of both enumerated and incidental 'powers' to national banks [are] grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States may not "prevent or significantly interfere with the national bank's exercise of its powers."); *Franklin National Bank*, 347 U.S. at 378–379 (1954) (federal law preempts state law when there is a conflict between the two; "The compact between the states creating the Federal Government resolves them as a matter of supremacy. However wise or needful [the state's] policy, . . . it must give way to contrary federal policy."); *Anderson National Bank* v. *Luckett*, 321 U.S. 233, 248, 252 (1944) (state law may not "infringe the national banking laws or impose an undue burden on the performance of the banks' functions" or "unlawful[ly] encroac[h] on the rights and privileges of national banks"); *First National Bank* v. *Missouri*, 263 U.S. 640, 656 (1924) (federal law preempts state laws that "interfere with the purposes of [national banks'] creation, tend to impair or destroy their efficiency as federal

Application of Federal Law to the Operating Subsidiaries

In section 121 of the GLBA, Congress expressly acknowledged that national banks may own subsidiaries that engage "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks."[13]

Consistent with section 121, the OCC regulations state that "[a]n operating subsidiary conducts activities authorized under [12 CFR 5.34] pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank."[14] Addressing this point in the context of state laws, our regulations state that "[u]nless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank."[15]

The operating subsidiary conducts mortgage servicing activities permissible for a national bank pursuant to 12 USC 24(Seventh), 12 USC 371, and 12 CFR 5.34(e)(5)(v). As such, it is subject to the OCC's exclusive visitorial authority, and, pursuant to 12 USC 484, state regulatory authorities do not have the right to exercise visitorial powers over the bank or the operating subsidiary in the conduct of these activities, except where that visitorial authority is specifically granted by *federal* law, which is not the case here.

It is relevant to observe that while state authorities may not examine and supervise the operating subsidiary, the operating subsidiary is subject to an extensive regime of federal law and regulations and the bank and the operating subsidiary are subject to comprehensive and continuous supervision by the OCC. Since the bank is part of the OCC's Large Bank Program, its activities and

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agencies or conflict with the paramount law of the United States."); *First National Bank of San Jose* v. *California*, 262 U.S. 366, 368–369 (1923) ("[National banks] are instrumentalities of the federal government. . . . [A]ny attempt by a state to define their duties or control the conduct of their affairs is void whenever it conflicts with the laws of the United States or frustrates the purposes of the national legislation, or impairs the efficiency of the bank to discharge the duties for which it was created."); *McClellan* v. *Chipman*, 164 U.S. 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destro[y] or hampe[r]" national bank functions); *First National Bank of Louisville* v. *Commonwealth of Kentucky*, 76 U.S. (9 Wall.) 353, 362–63 (1870) (national banks subject to state law that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government"); *Bank of America et al.* v. *City and County of San Francisco et al.*, 309 F.3d 551, 561 (9th Circuit 2002) ("[s]tate attempts to control the conduct of national banks are void if they conflict with federal law, frustrate the purposes of the National Bank Act, or impair the efficiency of national banks to discharge their duties.") (citation omitted); *Association of Banks in Insurance, Inc.* v. *Duryee*, 270 F.3d 397, 403–404 (6th Circuit 2001) ("The Supremacy Clause 'invalidates state laws that "interfere with, or are contrary to," federal law.' . . . A state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach th[at] goal.") (citations omitted).

[13] Pub. L. No. 106–102, § 121, 113 Stat. at 1378, *codified at* 12 USC 24a(g)(3).

[14] 12 CFR 5.34(e)(3).

[15] 12 CFR 7.4006.

those of its subsidiaries are examined on a continuous basis by teams of examiners specifically assigned to, and in most cases physically present at the facilities of, the bank and its subsidiaries.

Finally, a state may not condition a national bank's exercise of a permissible federal power on obtaining the state's prior approval. It is well established that a national bank's exercise of its federally authorized powers is not subject to conditions or restrictions imposed by state law,[16] including state licensing requirements.[17] Accordingly, pursuant to 12 CFR 7.4006, the operating subsidiary also is not subject to state or local licensing requirements and is not required to obtain a license from the State of California in order to conduct business in that state.

This conclusion that the OCC's exclusive visitorial powers preclude the State of California from asserting supervisory authority or enforcement jurisdiction over the operating subsidiary is not intended to imply that any of the substantive provisions of the California Act apply to the operating subsidiary. Instead, under federal law[18] and principles of preemption established by the courts,[19] provisions of the California Act may well be preempted. This opinion, however, addresses only the issues of licensing and visitorial authority.

I hope the foregoing is helpful in explaining the applicability of the OCC's exclusive visitorial powers and the inapplicability of state licensing laws to the operating subsidiary. Please do not hesitate to contact my office at (202) 874-5200 or MaryAnn Nash, counsel, in our Law Department at (202) 874-5090 if you have any questions or if you need any additional information.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[16] *See Barnett Bank of Marion County, N.A.* v. *Nelson*, 517 U.S. 25, 34 (1996); *Franklin National Bank of Franklin Square* v. *New York*, 347 U.S. 373, 378 (1954); *Bank of America National Trust & Savings Association* v. *Lima*, 103 F. Supplement 916, 918, 920 (District of Massachusetts 1952); Letter from Julie L. Williams, first senior deputy comptroller and chief counsel, to Thomas A. Plant and Daniel W. Morton ("To the extent that a state asserts the right to restrict or condition a national bank's exercise of . . . Federally granted powers, that state's law will be preempted."). 66 *Federal Register* 28593 (May 23, 2001).

[17] *See First National Bank of Eastern Arkansas* v. *Taylor*, 907 F.2d 775, 780 (8th Circuit 1990) (the National Bank Act precludes a state regulator from prohibiting a national bank, through either enforcement action or a license requirement, from conducting an activity that the Comptroller has reasonably determined is authorized by the National Bank Act); *Ass'n. of Banks in Insurance, Inc*. v. *Duryee,* 55 F. Supplement 2d 799, 812 (U.S. District Court for the Southern District of Ohio 1999), *aff'd,* 270 F.3d 397 (6th Circuit 2001) (even the most limited aspects of state licensing requirements such as the payment of a licensing fee are preempted because they "constitute impermissible conditions upon the authority of a national bank to do business within the state"). The OCC also has opined previously that state laws purporting to require the licensing of activities authorized for national banks under federal law are preempted. *See* OCC Interpretive Letter No. 749 (Sept. 13, 1996) *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–114 (state law requiring national banks to be licensed by the state to sell annuities would be preempted); OCC Interpretive Letter. No. 644 (March 24, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,553 (state registration and fee requirements imposed on mortgage lenders would be preempted).

[18] *See*, *e.g*., 12 USC 371, 1735f–7, 1735f–7a, and 3801 *et seq*.

[19] *See, e.g.,* the cases cited in note 12, *supra*.

958—January 27, 2003

12 USC 484
12 CFR 5.34(e)(3)
12 CFR 7.4006

Thomas A. Plant, Esq.
Senior Vice President
Assistant General Counsel
National City Corporation
1900 East Ninth Street
Cleveland, OH 44114

Dear Mr. Plant:

This responds to your letter of November 8, 2002, on behalf of National City Bank of Indiana ("bank") and its wholly owned operating subsidiaries, National City Mortgage Company, First Franklin Financial Corporation, and Altegra Credit Company ("subsidiaries"). In that letter, you request guidance as to the ability of state regulatory authorities to exercise visitorial powers over the bank and the subsidiaries in the conduct of their mortgage banking and servicing businesses.

You represent that the subsidiaries conduct mortgage lending and mortgage servicing activities as permitted for a national bank and its operating subsidiaries pursuant to 12 USC 24(Seventh). As operating subsidiaries of a national bank, the subsidiaries are subject to ongoing supervision and examination by the OCC in the same manner and to the same extent as the bank.[1] You represent that state governmental authorities have sought to exercise examination or other visitorial powers over the subsidiaries, including by requesting documents and other information. You question the extent to which state authorities may engage in such activities in connection with national banks and their operating subsidiaries.

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[1] Twelve CFR 5.34(e)(3) provides that—

> [a]n operating subsidiary conducts activities authorized under this section pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank. If, upon examination, the OCC determines that the operating subsidiary is operating in violation of law, regulation, or written condition, or in an unsafe or unsound manner or otherwise threatens the safety or soundness of the bank, the OCC will direct the bank or operating subsidiary to take appropriate remedial action, which may include requiring the bank to divest or liquidate the operating subsidiary, or discontinue specified activities. OCC authority under this paragraph is subject to the limitations and requirements of section 45 of the Federal Deposit Insurance Act (12 USC 1831v) and section 115 of the Gramm–Leach–Bliley Act [GLBA] (12 USC 1820a).

The provisions of the Federal Deposit Insurance Act and the GLBA referenced in the regulation pertain to the functional regulation of securities, insurance, and commodities firms. These provisions are not relevant to mortgage lending and servicing activities conducted by the subsidiaries.

As discussed in detail below, pursuant to 12 USC 484, and 12 CFR 5.34(e)(3) and 7.4006, the OCC has exclusive visitorial authority over national banks and their operating subsidiaries except where *federal* law provides otherwise. This authority pertains to activities expressly authorized or recognized as permissible for national banks under federal law or regulation, or by OCC issuance or interpretation, including the content of those activities and the manner in which, and standards whereby, those activities are conducted. As a result, states are precluded from examining or requiring information[2] from national banks or their operating subsidiaries or otherwise seeking to exercise visitorial powers with respect to national banks or their operating subsidiaries in these respects. Thus, states may not exercise visitorial powers over the bank and the subsidiaries in the conduct of their mortgage banking and servicing business.

Background

The OCC's exclusive visitorial authority over national bank operations is established by 12 USC 484.[3] Paragraph (a) of that section states that—

> [n]o national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

Paragraph (b) of the statute then permits lawfully authorized state auditors or examiners to review a national bank's records "solely to ensure compliance with applicable state unclaimed property or escheat laws upon reasonable cause to believe that the bank has failed to comply with such laws."

This provision, enacted with the creation of the national banking system in 1863, is integral to the design and structure of the national banking system and fundamental to the character of national banks. Congress enacted the National Currency Act ("Currency Act") in 1863 and the National Bank Act the year after for the purpose of establishing a new national banking system that would

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[2] The OCC currently maintains information-sharing agreements with 48 states, the District of Columbia, and Puerto Rico. These agreements provide a mechanism through which state regulators may seek and obtain supervisory information from the OCC. Typically, the OCC will make confidential bank examination information available to state bank regulatory agencies if they demonstrate a specific regulatory need for the examination information (*e.g*., in connection with a merger of a national bank into a state bank, where the state bank regulator must approve the transaction), and if the state agency has entered into an appropriate information-sharing/confidentiality agreement with the OCC governing the use of the information. In Advisory Letter 2002–9 (November 25, 2002), the OCC outlined a procedure to address circumstances when state officials raise issues concerning potential violations of laws by national banks, including when state officials may seek information from a national bank about its compliance with any law or for other purposes. The advisory letter is available on the OCC's Web site at www.occ.treas.gov/ftp/advisory/2002-9.txt.

[3] "Visitorial powers" generally refer to the power to "visit" a national bank to examine the conduct of its business and to enforce its observance of applicable laws. *See, e.g., Guthrie* v. *Harkness*, 199 U.S. 148, 158 (1905) (the word "visitation" means "inspection; superintendence; direction; regulation") (internal quotations omitted).

operate distinctly and separately from the existing system of state banks. At that time, both proponents and opponents of the new national banking system expected that it would supersede the existing system of state banks.[4] Given this anticipated impact on state banks and the resulting diminution of control by the states over banking in general,[5] proponents of the national banking system were concerned that states would attempt to undermine it.

The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with the need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and created a federal agency within the Department of the Treasury—the OCC—to carry it out. Congress granted the OCC the broad authority "to make a thorough examination of all the affairs of [a national] bank,"[6] and solidified this federal supervisory authority by vesting the OCC with exclusive visitorial powers over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protected national banks from potential state action by establishing that the authority to examine and supervise national banks is vested *only* in the OCC, unless otherwise provided by *federal* law.[7]

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[4] Representative Samuel Hooper, who reported the bill to the House, stated in support of the legislation that one of its purposes was "to render the law [*i.e.,* the Currency Act] so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters." *Congressional Globe,* 38th Congress, 1st Session 1256 (March 23, 1864). Opponents of the legislation believed that it was intended to "take from the States . . . all authority whatsoever over their own State banks, and to vest that authority . . . in Washington . . . ." *Congressional Globe,* 38th Congress, 1st Session 1267 (March 24, 1864) (statement of Representative Brooks). *See also* statement of Representative Pruyn (stating that the legislation would "be the greatest blow yet inflicted upon the States . . . .") *Congressional Globe,* 38th Congress, 1st Session 1271 (March 24, 1864); statement of Senator Sumner ("Clearly, the [national] bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions.") *Congressional Globe,* 38th Congress, 1st Session, at 1893 (April 27, 1864).

[5] *See, e.g., Tiffany* v. *National Bank of the State of Missouri*, 85 U.S. 409, 412–413 (1874) ("It cannot be doubted, in view of the purpose of Congress in providing for the organization of national banking associations, that it was intended to give them a firm footing in the different states where they might be located. It was expected they would come into competition with state banks, and it was intended to give them at least equal advantages in such competition. . . . National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks."). *See also* B. Hammond, *Banks and Politics in America from the Revolution to the Civil War*, 725–34 (1957); P. Studenski & H. Krooss, *Financial History of the United States*, 155 (1st ed. 1952).

[6] Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, *codified at* 12 USC 481.

[7] Writing shortly after the Currency Act and National Bank Act were enacted, then-Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that "Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments. . . ." *Congressional Globe,* 39th Congress, 1st Session, Miscellaneous Document No. 100, at 2 (April 23, 1866).

In *Guthrie* v. *Harkness*, 199 U.S. 148 (1905), the Supreme Court recognized how the National Bank Act was designed to operate:

> Congress had in mind, in passing this section [*i.e.,* section 484] that in other sections of the law it had made full and complete provision for investigation by the Comptroller of the Currency and examiners appointed by him, and, authorizing the appointment of a receiver, to take possession of the business with a view to winding up the affairs of the bank. It was the intention that this statute should contain a full code of provisions upon the subject, and that no state law or enactment should undertake to exercise the right of visitation over a national corporation. Except in so far as such corporation was liable to control in the courts of justice, this act was to be the full measure of visitorial power.

Id. at 159. The Supreme Court also has recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the Currency Act could develop and flourish. For instance, in *Easton* v. *Iowa,* 188 U.S. 220 (1903), the Court stated that federal legislation affecting national banks—

> has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States. . . . It thus appears that Congress has provided a symmetrical and complete scheme for the banks to be organized under the provisions of the statute. . . . [W]e are unable to perceive that Congress intended to leave the field open for the States to attempt to promote the welfare and stability of national banks by direct legislation. If they had such power it would have to be exercised and limited by their own discretion, and *confusion would necessarily result from control possessed and exercised by two independent authorities*.

Id. at 229, 231–232 (emphasis added). The Court in *Farmers' and Mechanics' Bank*, 91 U.S. 29 (1875), after observing that national banks are means to aid the government, stated—

> Being such means, brought into existence for this purpose, and intended to be so employed, the States can exercise no control over them, nor in any wise affect their operation, except in so far as Congress may see proper to permit. Any thing beyond this is "an abuse, because it is the usurpation of power which a single State cannot give."

Id. at 34 (citation omitted).

Congress recently affirmed the OCC's exclusive visitorial powers with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 ("Riegle–Neal").[8] Riegle–Neal makes interstate operations of national banks subject to specified types of

[8] Pub. L. 103–328, 108 Stat. 2338 (Sept. 29, 1994).

laws of a "host" state in which the bank has an interstate branch to the same extent as a branch of a state bank of that state, *unless* the state law is preempted by federal law. For those state laws that are not preempted, the statute makes clear that the authority to enforce the law is vested in the OCC. *See* 12 USC 36(f)(1)(B) ("The provisions of any state law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency."). This approach is another, and very recent, recognition of the broad scope of the OCC's exclusive visitorial powers with respect to national banks.

The OCC's exclusive visitorial authority complements principles of federal preemption, to accomplish the objectives of the National Bank Act. The Supremacy Clause of the United States Constitution[9] provides that federal law prevails over any conflicting state law. An extensive body of judicial precedent has developed over the nearly 140 years of existence of the national banking system, explaining and defining the standards of federal preemption of state laws as applied to national banks.[10] Visitorial power is a closely related authority, which Congress specifically addressed in section 484 to enable national banks to avoid inconsistent and potentially disruptive application of standards by state authorities. Together, federal preemption and the OCC's exclusive visitorial authority are defining characteristics of the national bank charter.

[9] U.S. Constitution, Article VI, clause 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

[10] *See, e.g., Barnett Bank of Marion County, N.A.* v. *Nelson*, 517 U.S. 25, 26, 32, 33 (1996) ("grants of both enumerated and incidental 'powers' to national banks [are] grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States may not "prevent or significantly interfere with the national bank's exercise of its powers."); *Franklin National Bank*, 347 U.S. at 378–379 (1954) (federal law preempts state law when there is a conflict between the two; "The compact between the states creating the Federal Government resolves them as a matter of supremacy. However wise or needful [the state's] policy, . . . it must give way to contrary federal policy."); *Anderson National Bank* v. *Luckett*, 321 U.S. 233, 248, 252 (1944) (state law may not "infringe the national banking laws or impose an undue burden on the performance of the banks' functions" or "unlawful[ly] encroac[h] on the rights and privileges of national banks"); *First National Bank* v. *Missouri*, 263 U.S. 640, 656 (1924) (federal law preempts state laws that "interfere with the purposes of [national banks'] creation, tend to impair or destroy their efficiency as federal agencies or conflict with the paramount law of the United States."); *First National Bank of San Jose* v. *California*, 262 U.S. 366, 368–369 (1923) ("[National banks] are instrumentalities of the federal government. . . . [A]ny attempt by a state to define their duties or control the conduct of their affairs is void whenever it conflicts with the laws of the United States or frustrates the purposes of the national legislation, or impairs the efficiency of the bank to discharge the duties for which it was created."); *McClellan* v. *Chipman*, 164 U.S. 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destro[y] or hampe[r]" national bank functions); *First National Bank of Louisville* v. *Commonwealth of Kentucky*, 76 U.S. (9 Wall.) 353, 362–63 (1870) (national banks subject to state law that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government"); *Bank of America et al*. v. *City and County of San Francisco et al*., 309 F.3d 551, 561 (9th Circuit 2002) ("[s]tate attempts to control the conduct of national banks are void if they conflict with federal law, frustrate the purposes of the National Bank Act, or impair the efficiency of national banks to discharge their duties.") (citation omitted); *Association of Banks in Insurance, Inc*. v. *Duryee*, 270 F.3d 397, 403–404 (6th Circuit 2001) ("The Supremacy Clause 'invalidates state laws that "interfere with, or are contrary to," federal law.' . . . A state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach th[at] goal.") (citations omitted).

Application of the OCC's Visitorial Powers to Operating Subsidiaries

In section 121 of the GLBA, Congress expressly acknowledged that national banks may own subsidiaries that engage "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks."[11]

Consistent with section 121, the OCC regulations state that "[a]n operating subsidiary conducts activities authorized under [12 CFR 5.34] pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank."[12] Addressing this point in the context of state laws, our regulations state that "[u]nless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank."[13]

In order for a subsidiary to operate in the manner contemplated by section 121 of GLBA, the subsidiary must be subject to the same regulation and supervision as is its parent national bank. As described at the outset of this letter, our regulations at section 5.34(e)(3) require that result. The terms and conditions governing the conduct of activities in an operating subsidiary include being subject to the same visitorial powers as are exercised with respect to the parent. Accordingly, the OCC's exclusive visitorial authority extends to operating subsidiaries of national banks.

The subsidiaries are national bank operating subsidiaries conducting mortgage lending and servicing activities as permitted for a national bank pursuant to 12 USC 24(Seventh), 12 USC 371, and 12 CFR 5.34(e)(5)(v). As such, they are subject to the OCC's exclusive visitorial authority, and, pursuant to 12 USC 484, state regulatory authorities do not have the right to exercise visitorial powers over the bank or the subsidiaries in the conduct of these activities, except where that visitorial authority is specifically granted by *federal* law, which is not the case here.

It is relevant to observe that while state authorities may not examine and supervise the subsidiaries, the subsidiaries are subject to an extensive regime of federal law and regulations and the bank and the subsidiaries are subject to comprehensive and continuous supervision by the OCC. Since the bank is part of the OCC's Large Bank Program, its activities and those of its subsidiaries are examined on a continuous basis by teams of examiners specifically assigned to, and in most cases physically present at the facilities of, the bank and its subsidiaries.

Our conclusion that the OCC's exclusive visitorial powers preclude states from asserting supervisory authority or enforcement jurisdiction over the subsidiaries is not intended to imply that

[11] Pub. L. No. 106-102, § 121, 113 Stat. at 1378, *codified at* 12 USC 24a(g)(3).

[12] 12 CFR 5.34(e)(3).

[13] 12 CFR 7.4006.

any particular state laws concerning the mortgage banking and servicing business apply to the subsidiaries. Instead, under federal law[14] and principles of preemption established by the courts,[15] provisions of state law may well be preempted. This opinion, however, addresses only the issue of visitorial authority.

I hope the foregoing is helpful in explaining the applicability of the OCC's exclusive visitorial powers to the subsidiaries. Please do not hesitate to contact my office at (202) 874-5200 or Mary-Ann Nash, counsel, in our Law Department at (202) 874–5090 if you have any questions or if you need any additional information.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[14] *See*, *e.g*., 12 USC 371, 1735f–7, 1735f–7a, and 3801 *et seq*.

[15] *See, e.g*., the cases cited in note 10, *supra*.

959—February 13, 2003

12 CFR Part 3

Dear [ ]:

This letter responds to your letter dated August 6, 2002, concerning the risk weight for tax refund anticipation loans (RALs) and the timing for reporting capital ratios. With respect to the risk weight for RALs, the OCC (Office of the Comptroller of the Currency) has determined that 100 percent is the appropriate risk weight for this type of consumer lending. With respect to reporting, capital ratios are regularly reported on each quarterly Consolidated Reports of Condition and Income (call report). However, additional reporting requirements, which are described below, apply if a material event occurs that could cause a bank to be placed in a lower capital category.

Background

[ ] ("the bank"), has requested that the OCC consider a risk weight of 20 percent for RALs and has provided a legal opinion arguing the case for a lower risk weight.

RALs are bank loans made to individual taxpayers in anticipation of tax refund payments. To apply for a RAL from the bank, the taxpayer must retain tax preparation services from an IRS-approved *e-file* tax preparer with which the bank has an agreement, open a deposit account at the bank, and direct the refund to that account. The account, which the bank controls, is set up for the sole purpose of receiving the electronic refund from the IRS. The bank account is required because the IRS (Internal Revenue Service) will not pay a refund to a third party even though the IRS provides guidelines for RAL programs.

The bank charges an RAL borrower an application fee, a finance charge, and, if applicable, an earned income tax credit (EITC) fee. The RAL borrower also pays tax preparation, *e-file*, and other fees to the tax preparer. Based on an average maturity of 10 days, the APRs (annual percentage rates) for RALs with EITC ranged from an estimated 66.15 percent for a $5,000 RAL to an estimated 1880.3 percent for a $100 RAL according to the bank's 2000 RAL application.

The bank limits the amount of an RAL to $5,000 and further limits the amount of an RAL covered by an EITC refund to $1,200. The bank will not make the RAL until the IRS provides a debt indicator (DI) that verifies that there are no federal claims outstanding on the tax filer. If the DI indicates the IRS will offset the tax refund, the bank rejects the RAL application and only provides the deposit account and refund transfer services. Delinquent RALs from any prior year are deducted from the current refund due per an agreement among other banks that have RAL programs.

Activity in the bank's RAL program generally begins in mid-January, peaks in early to mid-February, and is virtually completed by the end of March. At the end of the second quarter, the bank writes off the balances of any outstanding RALs. According to the bank, past experience indicates that 1.5 percent of RAL borrowers manage to circumvent controls put in place by the IRS and the bank, which results in losses to the bank.

In November 2000, the bank set up a special purpose subsidiary corporation for the purpose of securitizing RALs. In the first quarters of 2001 and 2002, the bank sold some of its RAL assets into this conduit. By the end of the second quarter in each year, the securitization balances were reduced to zero. In 2002, the bank retained an 8 percent first loss position in the RAL assets it sold to the conduit.

In the opinion of the bank's outside counsel, a zero risk weight might be appropriate but counsel does not press the case. Rather, the legal opinion argues for a 20 percent risk weight on the basis that the RAL Program is (1) effectively collateralized by a direct obligation of the U.S. government and (2) a 20 percent risk weight is prudent and consistent with regulatory intent. The legal opinion argues that the bank's perfected security interest in the RAL borrower's bank account is the equivalent of an ownership interest in a claim on the U.S. government. The opinion also suggests that RALs are analogous to general obligations of states and other political subdivisions, instruments conditionally guaranteed by the U.S. government, and obligations guaranteed by Fannie Mae or Freddie Mac. Citing the OCC's reservation of authority[1], the opinion further argues that the OCC can determine that RALs merit a 20 percent risk weight even though the U.S. government does not actually guarantee a RALs transaction.

Discussion

Risk weights—The OCC's risk-based capital regulations permit a 20 percent risk weight for assets that are "conditionally guaranteed by the United States Government or its agencies"[2] or are "collateralized by cash or securities issued or directly and unconditionally guaranteed by the United States Government or its agencies . . . [and do] not qualify for the zero percent risk weight category."[3]

Lowering the risk weight on RALs from 100 to 20 percent relies primarily on the OCC's concurrence with the bank's position that the IRS conditionally guarantees payment of a tax refund claimed by an individual taxpayer, which effectively guarantees the repayment of a RAL. Despite the arguments in the bank's legal opinion, the bank's actual loss experience suggests RALs do not perform as if the U.S. government guarantees them. The bank has taken a number of steps to minimize losses including perfecting a security interest in the deposit account of the RAL borrower, requiring a positive DI from the IRS before making the RAL, providing incentives to tax

[1] 12 CFR Section 3.4(b).

[2] 12 CFR Part 3, Appendix A, Section 3(a)(2)(v).

[3] 12 CFR Part 3, Appendix A, Section 3(a)(2)(iv).

preparers based on above average-screening of tax returns and RAL applications, and signing the recovery agreement with other banks that offer RALs. Nonetheless, the bank's losses are larger than would be expected in the case of a U.S. government guaranteed obligation. [ ]'s 10Q for March 2002 describes the risks and losses as follows:

> There is a higher credit risk associated with refund loans than with other types of loans because (1) the Company does not have personal contact with the customers of this product; (2) the customers conduct no business with the Company other than this once a year transaction; and (3) contact subsequent to the payment of the advance, if there is a problem with the tax return, may be difficult because many of these taxpayers have no permanent address. . . . Credit risk has been lowered in the last three years because of the debt indicator provided by the IRS. . . . However, the charge off rate for RALs still remains approximately five times higher than for the rest of the Company's loan portfolios. (page 43)

Furthermore, the IRS does not compensate the bank for any losses that it has incurred. In the section of the *IRS e-file Handbook* that discusses RALs, the IRS specifically states that the "Department of the Treasury is not liable for any loss suffered by taxpayers, EROs, or financial institutions resulting from reduced refunds or Direct Deposits not being honored causing refunds to be issued by check."[4] The IRS also does not recognize the assignment of the payment of individual tax refunds to a third party. The extension of credit through an RAL relies primarily on information provided by the individual filer. If the IRS determines, pursuant to its statutory discretion, that the tax return is not accurate and reduces or denies the expected refund claim, the repayment of the RAL defaults to the individual's creditworthiness. Furthermore, there is no contractual relationship between the bank and the IRS establishing any form, express or implied, of government guarantee. Accordingly, the bank's RAL program does not meet collateral or guarantee provisions that would qualify RALs for a 20 percent risk weight. Nor does the RAL program have the characteristics that would make RALs analogous to general obligations of municipalities and assets issued by other entities that qualify for a 20 percent risk weight.

Reporting—In addition to the requirement to report capital levels and ratios in quarterly call reports, the OCC's prompt corrective action regulations[5] require notification if a material event occurs that may result in a lowering of the bank's capital level or capital category. If a bank determines that such an event may have lowered its capital category, the bank must notify the OCC in writing within 15 calendar days. The OCC will then determine whether the bank's capital category should be changed and advise the bank accordingly.

[4] *IRS e-file Handbook,* Publication 1345 (Rev. 1–2001), Internal Revenue Service, Department of the Treasury, p. 51.

[5] 12 CFR Section 6.3(c).

Conclusion

Based on a review of the bank's RALs program and the request for a lower risk weight, the OCC has determined that 100 percent is the appropriate risk weight for this type of consumer lending. In an August 6, 2002, letter, the bank states, "We have been told that we may assign RALs other risk-weightings we consider appropriate when capital ratios are computed at times other than at calendar quarter's end." This is not correct. For regulatory capital purposes, the risk weight for RALs is always 100 percent, whether the calculation is at quarter end or intra-quarter.

Furthermore, if the bank determines that a material event has occurred that may lower the bank's capital category, the bank must notify the OCC within 15 days of that event. The bank's notification, pursuant to this requirement, that such an event may have occurred does not, in and of itself, constitute in a change in a capital category.

Additional Significant Issue

During our review of your request, an additional significant issue related to the bank's securitization of RALs came to our attention. Revised risk-based capital rules for asset securitizations were published on November 29, 2001 (66 FR 59614; see OCC Bulletin 2001–49). These rules determine the capital charges that apply when a bank sells an asset and retains a larger than pro rata share of the credit risk associated with that asset. Among other things, the revised rules provide for a dollar-for-dollar capital charge on unrated, first loss positions retained on securitized assets. For example, if the bank sells RAL assets into a conduit and retains a first loss position on its balance sheet, the risk-based capital charge will equal at least the carrying value of the retained position, regardless of the risk-weights of the underlying assets.

If you have questions or need additional information, please contact Nancy Hunt at (202) 874–5070.

Tommy Snow
Director, Capital Policy

Mergers—January 1 to March 31, 2003

Contents

Most transactions in this section do not have accompanying decisions. In those cases with a decision, the OCC reviewed the competitive effects of the proposed transaction 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 U.S. 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, 2003

Title and location (charter number)	Total assets
Alabama	
First National Bank, Hamilton (016579)	174,490,995,000
and Bank of Carbon Hill, Carbon Hill, Alabama	32,616,000
merged on April 3, 2002, under the title of **First National Bank, Hamilton** (016579)	183,818,741,000
First National Bank, Hamilton (016579)	161,593,729,000
and The Bank of Berry, Berry, Alabama	12,897,000
merged on April 1, 2002, under the title of **First National Bank, Hamilton** (016579)	174,490,995,000
First National Bank, Hamilton (016579)	183,818,741,000
and The Bank of Parrish, Parrish, Alabama	22,225,000
merged on May 15, 2002, under the title of **First National Bank, Hamilton** 016579)	194,210,037,000
Indiana	
First Indiana Bank, National Association, Indianapolis (024256)	2,081,656,000
and Metrobank, Indianapolis, Indiana	172,018,000
merged on January 14, 2003, under the title of **First Indiana Bank, National Association, Indianapolis** (024256)	2,280,630,000
Missouri	
Community First National Bank of West Plains, West Plains (023481)	73,910,000
and Bank of Evening Shade, Mountain Home, Arkansas	500,000
merged on March 7, 2003, under the title of **Community First National Bank of West Plains, West Plains** (023481)	73,910,000
Oklahoma	
The First National Bank and Trust Co., Chickasha (005547)	161,136,000
and Tri Star National Bank, Blanchard, Oklahoma (018545)	51,223,000
merged on January 1, 2003, under the title of **The First National Bank and Trust Co., Chickasha** (005547)	217,249,000
Pennsylvania	
National Penn Bank, Boyertown (002137)	2,642,745,000
and FirstService Bank, Doylestown, Pennsylvania	383,243,000
merged on February 25, 2003, under the title of **National Penn Bank, Boyertown** (002137)	3,088,412,000
Texas	
Extraco Banks, National Association,Temple (013778)	752,059,000
and Heights State Bank, Harker Heights, Texas	59,939,000
merged on December 3, 2002, under the title of **Extraco Banks, National Association, Temple** (013778)	806,291,000

Nonaffiliated mergers—thrift (mergers consummated involving nonaffiliated national banks and savings and loan associations), from January 1 to March 31, 2003

Title and location (charter number)	Total assets
District of Columbia	
First Liberty National Bank , Washington (018739)	41,275,000
and Enterprise Federal Savings Bank, Largo, Maryland	44,433,000
merged on February 28, 2003, under the title of **First Liberty National Bank, Washington** (018739)	85,708,000

Affiliated mergers (mergers consummated involving affiliated operating banks), from January 1 to March 31, 2003

Title and location (charter number)	Total assets
Alabama	
MidSouth Bank, National Association, Dothan (010102)	98,429,000
and Barbour County Bank, Eufaula, Alabama	86,565,000
merged on January 1, 2003, under the title of **MidSouth Bank, National Association, Dothan** (010102)	184,994,000
Arizona	
The Harris Bank National Association, Scottsdale (024380)	291,510,000
and Harris Trust/Bank of Montreal, West Palm Beach, Florida	138,276,000
merged on March 3, 2003, under the title of **The Harris Bank National Association, Scottsdale** (024380)	429,786,000
Union Bank, National Association, Gilbert (023330)	24,657,000
and First Community National Bank, Corning, Iowa (014040)	25,904,000
merged on December 24, 2002, under the title of **Union Bank, National Association, Gilbert** (023330)	50,561,000
California	
First National Bank, Rancho Santa Fe (017212)	645,947,000
and Bank of Coronado, Coronado, California	77,251,000
merged on January 9, 2003, under the title of **First National Bank, Rancho Santa Fe** (017212)	723,198,000
Union Bank of California, National Association, San Francisco (021541)	35,614,880,000
and Cooper Mountain Trust Corporation, Portland, Oregon	4,219,000
merged on December 31, 2002, under the title of **Union Bank of California, National Association, San Francisco** (021541)	35,619,099,000
Georgia	
Synovus Trust Company, National Association, Columbus (024350)	5,961,000
and Synovus Trust Company, Pensacola, Florida	546,000
and Synovus Trust Corp., Birmingham, Alabama	1,731,000
merged on January 1, 2003, under the title of **Synovus Trust Company, National Association, Columbus** (024350)	5,961,000
Maine	
Acadia Trust, National Association, Portland (022475)	5,071,095,000
and Trust Company of Maine, Inc., Bangor, Maine	1,149,000
merged on January 1, 2003, under the title of **Acadia Trust, National Association, Portland** (022475)	5,072,244,000
New Jersey	
UBS PaineWebber Trust Company, National Association, Weehawken (024286)	5,235,000
and UBS PaineWebber Trust Company (Tennessee), Nashville, Tennessee	8,089,000
merged on January 1, 2003, under the title of **UBS PaineWebber Trust Company, National Association, Weehawken** (024286)	13,216,000
Ohio	
KeyBank National Association, Cleveland (014761)	73,722,592,000
and Union Bank & Trust, Denver, Colorado	475,500,000
merged on January 17, 2003, under the title of **KeyBank National Association, Cleveland** (014761)	74,198,092,000
Texas	
State National Bank, Lubbock (023117)	561,546,000
and State National Bank, El Paso, Texas (016369)	592,968,000
merged on February 14, 2003, under the title of **State National Bank, Lubbock** (023117)	1,154,513,000
Wisconsin	
National Bank of Commerce in Duluth, Duluth (014109)	47,038,000
and National Bank of Commerce in Superior, Superior, Wisconsin (023941)	224,888,000
merged on January 1, 2003, under the title of **National Bank of Commerce, Superior** (014109)	271,926,000

Affiliated mergers—thrift (mergers consummated involving affiliated national banks and savings and loan associations), from January 1 to March 31, 2003

Title and location (charter number)	Total assets
Maine	
Banknorth, National Association, Portland (024096)	21,240,851,000
and Warren Five Cents Savings Bank, Peabody, Massachusetts	459,811,000
merged on December 31, 2002, under the title of **Banknorth, National Association, Portland** (024096)	22,914,337,000
Banknorth, National Association, Portland (024096)	23,100,513,000
and American Savings Bank, New Britain, Connecticut	2,860,658,000
merged on February 14, 2003, under the title of **Banknorth, National Association, Portland** (024096)	26,355,293,000
Pennsylvania	
Union National Bank and Trust Company of Souderton, Souderton (002333)	1,150,947,000
and Pennview Savings Bank, Souderton, Pennsylvania	165,439,000
merged on January 18, 2003, under the title of **Univest National Bank and Trust Co., Souderton** (002333)	1,311,624,000

Financial Performance of National Banks

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**Assets, liabilities, and capital accounts of national banks
March 31, 2002, and March 31, 2003
(Dollar figures in millions)**

	March 31, 2002	March 31, 2003	Change March 31, 2002–March 31, 2003 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,118	2,065	(53)	(2.50)
Total assets	$3,570,650	$4,001,717	$431,067	12.07
Cash and balances due from depositories	180,504	215,350	34,846	19.30
Noninterest-bearing balances, currency and coin	129,481	155,243	25,762	19.90
Interest bearing balances	51,023	60,107	9,084	17.80
Securities	571,681	689,415	117,734	20.59
Held-to-maturity securities, amortized cost	25,493	25,613	120	0.47
Available-for-sale securities, fair value	546,188	663,802	117,614	21.53
Federal funds sold and securities purchased	144,713	152,541	7,829	5.41
Net loans and leases	2,218,064	2,415,469	197,405	8.90
Total loans and leases	2,265,916	2,463,822	197,906	8.73
Loans and leases, gross	2,268,743	2,466,360	197,618	8.71
Less: Unearned income	2,826	2,538	(288)	(10.19)
Less: Reserve for losses	47,852	48,353	501	1.05
Assets held in trading account	123,490	168,462	44,972	36.42
Other real estate owned	1,858	2,078	220	11.84
Intangible assets	90,891	90,476	(414)	(0.46)
All other assets	239,444	267,925	28,481	11.89
Total liabilities and equity capital	3,570,650	4,001,717	431,067	12.07
Deposits in domestic offices	1,979,950	2,231,407	251,457	12.70
Deposits in foreign offices	368,729	404,508	35,779	9.70
Total deposits	2,348,679	2,635,915	287,237	12.23
Noninterest-bearing deposits	477,537	570,325	92,788	19.43
Interest-bearing deposits	1,871,142	2,065,590	194,449	10.39
Federal funds purchased and securities sold	260,203	282,662	22,459	8.63
Other borrowed money	336,854	371,010	34,156	10.14
Trading liabilities less revaluation losses	27,065	24,007	(3,058)	(11.30)
Subordinated notes and debentures	65,582	68,107	2,525	3.85
All other liabilities	188,303	243,643	55,340	29.39
Trading liabilities revaluation losses	48,575	80,548	31,973	65.82
Other	139,728	163,095	23,367	16.72
Total equity capital	343,964	376,372	32,408	9.42
Perpetual preferred stock	1,097	2,684	1,587	144.73
Common stock	12,945	12,695	(249)	(1.93)
Surplus	197,440	202,226	4,786	2.42
Retained earnings and other comprehensive income	131,766	165,482	33,717	25.59
Other equity capital components	(24)	(25)	(1)	NM

NM indicates calculated percent change is not meaningful.

Quarterly income and expenses of national banks
First quarter 2002 and first quarter 2003
(Dollar figures in millions)

	First quarter 2002	First quarter 2003	Change First quarter 2002–first quarter 2003 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,118	2,065	(53)	(2.50)
Net income	$13,475	$15,092	$1,618	12.01
Net interest income	35,028	35,102	75	0.21
Total interest income	50,836	48,778	(2,057)	(4.05)
On loans	39,242	37,944	(1,299)	(3.31)
From lease financing receivables	1,835	1,626	(209)	(11.37)
On balances due from depositories	479	400	(79)	(16.44)
On securities	7,472	7,087	(385)	(5.15)
From assets held in trading account	748	803	54	7.26
On federal funds sold and securities repurchased	725	596	(129)	(17.75)
Less: Interest expense	15,808	13,676	(2,132)	(13.48)
On deposits	10,594	8,947	(1,647)	(15.55)
Of federal funds purchased and securities sold	1,309	1,057	(252)	(19.26)
On demand notes and other borrowed money*	3,124	2,934	(189)	(6.06)
On subordinated notes and debentures	781	738	(43)	(5.52)
Less: Provision for losses	8,223	6,495	(1,728)	(21.02)
Noninterest income	26,156	27,254	1,098	4.20
From fiduciary activities	2,203	2,022	(181)	(8.23)
Service charges on deposits	4,558	4,914	356	7.81
Trading revenue	1,680	1,645	(35)	(2.10)
From interest rate exposures	617	201	(416)	NM
From foreign exchange exposures	780	1,149	369	47.36
From equity security and index exposures	252	247	(5)	(1.89)
From commodity and other exposures	31	46	15	50.05
Investment banking brokerage fees	1,213	1,140	(72)	(5.95)
Venture capital revenue	168	(32)	(200)	NM
Net servicing fees	2,920	2,443	(478)	(16.35)
Net securitization income	3,572	3,633	62	1.72
Insurance commissions and fees	466	532	66	14.05
Insurance and reinsurance underwriting income	NA	98	NM	NM
Income from other insurance activities	NA	434	NM	NM
Net gains on asset sales	1,086	1,375	289	26.62
Sales of loans and leases	1,227	1,264	37	3.03
Sales of other real estate owned	(9)	(2)	8	NM
Sales of other assets(excluding securities)	(132)	112	244	NM
Other noninterest income	8,291	9,584	1,292	15.59
Gains/losses on securities	331	1,124	793	NM
Less: Noninterest expense	32,762	34,395	1,633	4.99
Salaries and employee benefits	13,700	14,927	1,227	8.96
Of premises and fixed assets	3,837	4,195	358	9.34
Goodwill impairment losses	3	40	38	NM
Amortization expense and impairment losses	894	1,037	142	15.90
Other noninterest expense	14,328	14,196	(132)	(0.92)
Less: Taxes on income before extraordinary items	6,976	7,485	509	7.30
Income/loss from extraordinary items, net of income taxes	(80)	(12)	67	NM
Memoranda:				
Net operating income	13,331	14,344	1,013	7.60
Income before taxes and extraordinary items	20,530	22,590	2,060	10.03
Income net of taxes before extraordinary items	13,554	15,105	1,551	11.44
Cash dividends declared	13,266	10,085	(3,180)	(23.97)
Net charge-offs to loan and lease reserve	8,184	6,839	(1,345)	(16.44)
Charge-offs to loan and lease reserve	9,422	8,073	(1,349)	(14.32)
Less: Recoveries credited to loan and lease reserve	1,238	1,234	(4)	(0.29)

* Includes mortgage indebtedness; NM indicates calculated percent change is not meaningful; NA—not available

**Year-to-date income and expenses of national banks
Through March 31, 2002, and through March 31, 2003
(Dollar figures in millions)**

	March 31, 2002	March 31, 2003	Change March 31, 2002—March 31, 2003 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,118	2,065	(53)	(2.50)
Net income	$13,475	$15,092	$1,618	12.01
Net interest income	35,028	35,102	75	0.21
Total interest income	50,836	48,778	(2,057)	(4.05)
On loans	39,242	37,944	(1,299)	(3.31)
From lease financing receivables	1,835	1,626	(209)	(11.37)
On balances due from depositories	479	400	(79)	(16.44)
On securities	7,472	7,087	(385)	(5.15)
From assets held in trading account	748	803	54	7.26
On federal funds sold and securities repurchased	725	596	(129)	(17.75)
Less: Interest expense	15,808	13,676	(2,132)	(13.48)
On deposits	10,594	8,947	(1,647)	(15.55)
Of federal funds purchased and securities sold	1,309	1,057	(252)	(19.26)
On demand notes and other borrowed money*	3,124	2,934	(189)	(6.06)
On subordinated notes and debentures	781	738	(43)	(5.52)
Less: Provision for losses	8,223	6,495	(1,728)	(21.02)
Noninterest income	26,156	27,254	1,098	4.20
From fiduciary activities	2,203	2,022	(181)	(8.23)
Service charges on deposits	4,558	4,914	356	7.81
Trading revenue	1,680	1,645	(35)	(2.10)
From interest rate exposures	617	201	(416)	NM
From foreign exchange exposures	780	1,149	369	47.36
From equity security and index exposures	252	247	(5)	(1.89)
From commodity and other exposures	31	46	15	50.05
Investment banking brokerage fees	1,213	1,140	(72)	(5.95)
Venture capital revenue	168	(32)	(200)	NM
Net servicing fees	2,920	2,443	(478)	(16.35)
Net securitization income	3,572	3,633	62	1.72
Insurance commissions and fees	466	532	66	14.05
Insurance and reinsurance underwriting income	NA	98	NM	NM
Income from other insurance activities	NA	434	NM	NM
Net gains on asset sales	1,086	1,375	289	26.62
Sales of loans and leases	1,227	1,264	37	3.03
Sales of other real estate owned	(9)	(2)	8	NM
Sales of other assets(excluding securities)	(132)	112	244	NM
Other noninterest income	8,291	9,584	1,292	15.59
Gains/losses on securities	331	1,124	793	NM
Less: Noninterest expense	32,762	34,395	1,633	4.99
Salaries and employee benefits	13,700	14,927	1,227	8.96
Of premises and fixed assets	3,837	4,195	358	9.34
Goodwill impairment losses	3	40	38	NM
Amortization expense and impairment losses	894	1,037	142	15.90
Other noninterest expense	14,328	14,196	(132)	(0.92)
Less: Taxes on income before extraordinary items	6,976	7,485	509	7.30
Income/loss from extraordinary items, net of income taxes	(80)	(12)	67	NM
Memoranda:				
Net operating income	13,331	14,344	1,013	7.60
Income before taxes and extraordinary items	20,530	22,590	2,060	10.03
Income net of taxes before extraordinary items	13,554	15,105	1,551	11.44
Cash dividends declared	13,266	10,085	(3,180)	(23.97)
Net charge-offs to loan and lease reserve	8,184	6,839	(1,345)	(16.44)
Charge-offs to loan and lease reserve	9,422	8,073	(1,349)	(14.32)
Less: Recoveries credited to loan and lease reserve	1,238	1,234	(4)	(0.29)

* Includes mortgage indebtedness; NM indicates calculated percent change is not meaningful; NA—not available

Assets of national banks by asset size
March 31, 2003
(Dollar figures in millions)

		National banks				
	All 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	2,065	918	976	125	46	7,864
Total assets	$4,001,717	$49,496	$264,451	$377,890	$3,309,881	$7,196,354
Cash and balances due from	215,350	3,242	12,849	22,729	176,530	378,833
Securities	689,415	12,223	66,472	81,836	528,884	1,381,537
Federal funds sold and securities purchased	152,541	3,240	10,842	21,150	117,309	349,458
Net loans and leases	2,415,469	28,490	160,730	226,290	1,999,959	4,114,613
Total loans and leases	2,463,822	28,901	163,116	229,740	2,042,065	4,192,058
Loans and leases, gross	2,466,360	28,938	163,303	229,835	2,044,285	4,195,532
Less: Unearned income	2,538	37	187	95	2,220	3,474
Less: Reserve for losses	48,353	411	2,386	3,450	42,106	77,445
Assets held in trading account	168,462	1	79	282	168,100	393,948
Other real estate owned	2,078	83	293	229	1,473	4,311
Intangible assets	90,476	153	1,783	7,506	81,034	129,283
All other assets	267,925	2,062	11,404	17,868	236,592	444,369
Gross loans and leases by type:						
Loans secured by real estate	1,160,866	17,406	108,409	133,826	901,225	2,109,323
1-4 family residential mortgages	578,256	7,242	39,207	60,030	471,777	952,903
Home equity loans	151,539	484	5,633	10,322	135,101	228,675
Multifamily residential mortgages	34,616	441	4,058	4,905	25,211	73,917
Commercial RE loans	257,864	5,390	42,539	41,171	168,763	567,640
Construction RE loans	96,515	1,745	11,930	15,278	67,562	212,843
Farmland loans	13,313	2,104	5,041	1,671	4,497	38,747
RE loans from foreign offices	28,763	0	0	448	28,314	34,598
Commercial and industrial loans	539,307	4,768	27,347	42,779	464,413	906,515
Loans to individuals	434,854	3,496	17,964	33,988	379,407	684,477
Credit cards*	191,950	122	2,869	7,636	181,323	250,367
Other revolving credit plans	32,682	50	345	1,023	31,264	37,545
Installment loans	210,222	3,323	14,750	25,329	166,820	396,565
All other loans and leases	331,333	3,268	9,584	19,242	299,239	495,216
Securities by type:						
U.S. Treasury securities	23,720	610	2,307	3,472	17,331	64,726
Mortgage-backed securities	425,087	3,451	25,566	44,062	352,007	759,829
Pass-through securities	305,292	2,581	16,264	26,327	260,120	492,458
Collateralized mortgage obligations	119,795	870	9,302	17,735	91,887	267,371
Other securities	191,929	8,141	38,203	33,586	111,998	458,886
Other U.S. government securities	71,831	5,572	21,952	17,376	26,931	232,422
State and local government securities	47,664	1,992	11,749	7,823	26,101	103,975
Other debt securities	65,434	389	3,379	7,531	54,136	105,040
Equity securities	6,999	189	1,124	857	4,830	17,449
Memoranda:						
Agricultural production loans	18,494	2,768	5,165	2,684	7,876	44,234
Pledged securities	339,146	4,583	29,599	38,545	266,418	700,585
Book value of securities	676,767	12,016	65,288	80,069	519,394	1,357,233
Available-for-sale securities	651,154	10,133	56,458	71,519	513,044	1,260,097
Held-to-maturity securities	25,613	1,883	8,829	8,550	6,350	97,136
Market value of securities	690,073	12,274	66,736	82,015	529,048	1,383,986
Available-for-sale securities	663,802	10,340	57,642	73,286	522,534	1,284,401
Held-to-maturity securities	26,271	1,934	9,094	8,729	6,514	99,585

Past-due and nonaccrual loans and leases of national banks by asset size
March 31, 2003
(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	2,065	918	976	125	46	7,864
Loans and leases past due 30-89 days	$25,601	$465	$1,996	$2,390	$20,751	$46,556
Loans secured by real estate	11,764	253	1,175	1,182	9,154	22,257
1-4 family residential mortgages	7,464	131	560	741	6,032	12,689
Home equity loans	791	2	27	37	725	1,164
Multifamily residential mortgages	192	3	21	16	153	389
Commercial RE loans	1,657	58	356	238	1,005	4,491
Construction RE loans	1,050	25	135	132	758	2,347
Farmland loans	210	34	76	17	83	616
RE loans from foreign offices	399	0	0	0	399	562
Commercial and industrial loans	4,063	77	362	465	3,159	7,950
Loans to individuals	7,936	84	336	619	6,898	13,213
Credit cards	4,103	3	85	193	3,822	5,882
Installment loans and other plans	3,833	81	251	426	3,076	7,331
All other loans and leases	1,838	51	123	124	1,540	3,136
Loans and leases past due 90+ days	8,306	113	373	609	7,211	13,155
Loans secured by real estate	3,014	63	201	147	2,603	4,637
1-4 family residential mortgages	2,400	32	86	87	2,195	3,240
Home equity loans	109	1	4	7	97	181
Multifamily residential mortgages	14	1	2	0	10	35
Commercial RE loans	299	12	71	28	188	718
Construction RE loans	123	5	22	19	77	277
Farmland loans	37	11	17	5	4	143
RE loans from foreign offices	32	0	0	0	32	43
Commercial and industrial loans	632	20	70	124	419	1,392
Loans to individuals	4,448	14	76	321	4,037	6,737
Credit cards	3,338	2	40	160	3,135	4,541
Installment loans and other plans	1,110	12	36	161	902	2,196
All other loans and leases	212	16	27	17	153	390
Nonaccrual loans and leases	28,441	263	1,299	1,665	25,214	45,582
Loans secured by real estate	8,307	139	739	1,023	6,407	14,349
1-4 family residential mortgages	3,330	40	213	434	2,643	5,423
Home equity loans	360	1	7	22	330	486
Multifamily residential mortgages	126	3	13	23	87	230
Commercial RE loans	2,715	54	374	389	1,898	5,078
Construction RE loans	826	17	71	123	616	1,749
Farmland loans	211	25	61	32	94	475
RE loans from foreign offices	739	0	0	0	739	908
Commercial and industrial loans	15,067	74	366	510	14,118	23,984
Loans to individuals	2,069	15	91	44	1,919	2,968
Credit cards	419	0	53	4	362	724
Installment loans and other plans	1,650	15	38	40	1,557	2,245
All other loans and leases	3,092	34	104	95	2,859	4,439

Liabilities of national banks by asset size
March 31, 2003
(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	2,065	918	976	125	46	7,864
Total liabilities and equity capital	4,001,717	49,496	264,451	377,890	3,309,881	7,196,354
Deposits in domestic offices	2,231,407	41,682	214,057	242,822	1,732,846	4,125,638
Deposits in foreign offices	404,508	0	108	2,804	401,595	652,808
Total deposits	2,635,915	41,682	214,165	245,626	2,134,441	4,778,446
Noninterest bearing	570,325	6,910	32,918	44,636	485,861	942,203
Interest bearing	2,065,590	34,773	181,247	200,991	1,648,580	3,836,242
Federal funds purchased and securities sold	282,662	460	7,104	35,284	239,813	589,469
Other borrowed funds	371,010	1,238	12,985	41,503	315,285	580,412
Trading liabilities less revaluation losses	24,007	0	0	23	23,983	77,814
Subordinated notes and debentures	68,107	6	187	3,075	64,840	95,332
All other liabilities	243,643	381	3,213	11,741	228,308	415,698
Equity capital	376,372	5,728	26,798	40,637	303,209	659,184
Total deposits by depositor:						
Individuals and corporations	2,055,789	25,894	148,705	194,331	1,686,859	3,706,918
U.S., state, and local governments	116,177	3,577	16,533	16,846	79,221	227,214
Depositories in the U.S.	69,176	736	2,713	3,550	62,177	99,011
Foreign banks and governments	78264.657	2	115	1,387	76,760	144,906
Domestic deposits by depositor:						
Individuals and corporations	1761762.758	25,894	148,698	192,177	1,394,994	3,234,729
U.S., state, and local governments	116,177	3,577	16,533	16,846	79,221	227,214
Depositories in the U.S.	32,240	736	2,678	3,546	25,280	53,945
Foreign banks and governments	5,330	2	49	749	4,530	10,035
Foreign deposits by depositor:						
Individuals and corporations	294026.313	0	7	2,154	291,865	472,189
Depositories in the U.S.	36936.007	0	35	4	36,897	45,067
Foreign banks and governments	72,935	0	66	639	72,230	134,871
Deposits in domestic offices by type:						
Transaction deposits	374,822	12,913	51,993	36,289	273,627	702,595
Demand deposits	302,895	6,779	29,303	28,017	238,796	526,211
Savings deposits	1,250,868	9,735	71,171	128,383	1,041,579	2,126,265
Money market deposit accounts	917027.781	5,425	41,711	89,884	780,008	1,523,755
Other savings deposits	333840.603	4,310	29,461	38,499	261,571	602,509
Time deposits	605,717	19,035	90,892	78,150	417,640	1,296,777
Small time deposits	331,219	12,767	56,993	44,844	216,614	694,319
Large time deposits	274,498	6,268	33,899	33,305	201,027	602,458

Off-balance-sheet items of national banks by asset size
March 31, 2003
(Dollar figures in millions)

		National banks				
	All 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	2,065	918	976	125	46	7,864
Unused commitments	$3,968,273	$79,716	$503,468	$355,336	$3,029,752	$5,379,517
Home equity lines	191,241	354	4,850	9,586	176,451	271,607
Credit card lines	2,704,551	75,613	473,038	301,581	1,854,320	3,394,339
Commercial RE, construction and land	78,805	923	8,028	11,976	57,878	162,726
All other unused commitments	993,675	2,826	17,551	32,194	941,103	1,550,845
Letters of credit:						
Standby letters of credit	169,063	114	1,614	4,402	162,932	275,736
Financial letters of credit	136,077	75	986	3,243	131,774	228,240
Performance letters of credit	32,985	39	628	1,159	31,159	47,496
Commercial letters of credit	14,495	23	379	513	13,581	21,229
Securities lent	141,506	28	92	6,565	134,822	646,603
Spot foreign exchange contracts	283,991	0	1	222	283,768	465,208
Credit derivatives (notional value)						
Reporting bank is the guarantor	118,185	0	25	0	118,159	319,794
Reporting bank is the beneficiary	159,081	0	50	0	159,031	390,144
Derivative contracts (notional value)	28,802,626	48	4,600	18,894	28,779,084	61,423,425
Futures and forward contracts	6,876,728	45	1,693	2,025	6,872,965	11,910,878
Interest rate contracts	4,641,769	45	1,681	1,864	4,638,179	8,034,218
Foreign exchange contracts	2,185,193	0	11	161	2,185,020	3,752,338
All other futures and forwards	49,766	0	0	0	49,766	124,323
Option contracts	5,975,921	3	1,708	4,912	5,969,297	13,088,976
Interest rate contracts	5,103,895	2	1,669	4,603	5,097,621	11,169,422
Foreign exchange contracts	713,721	0	0	306	713,415	1,158,206
All other options	158,305	1	39	3	158,261	761,348
Swaps	15,672,712	0	1,124	11,956	15,659,632	35,713,632
Interest rate contracts	15,010,259	0	1,108	8,006	15,001,144	34,243,687
Foreign exchange contracts	580,993	0	2	3,948	577,043	1,332,543
All other swaps	81,461	0	14	1	81,445	137,403
Memoranda: Derivatives by purpose						
Contracts held for trading	26,700,715	0	49	4,122	26,696,544	58,311,794
Contracts not held for trading	1,824,646	48	4,476	14,771	1,805,350	2,401,692
Memoranda: Derivatives by position						
Held for trading—positive fair value	503,194	0	0	71	503,123	1,184,130
Held for trading—negative fair value	493,390	0	0	53	493,337	1,157,562
Not for trading—positive fair value	27,243	0	35	124	27,084	33,747
Not for trading—negative fair value	17,297	0	39	317	16,940	22,212

Quarterly income and expenses of national banks by asset size
First quarter 2003
(Dollar figures in millions)

		National banks				Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,065	918	976	125	46	7,864
Net income	$15,092	$129	$834	$1,183	$12,946	$24,942
Net interest income	35,102	467	2,462	3,228	28,945	59,388
Total interest income	48,778	669	3,556	4,526	40,028	85,181
On loans	37,944	524	2,795	3,509	31,115	63,985
From lease financing receivables	1,626	3	20	66	1,538	2,395
On balances due from depositories	400	6	13	23	357	763
On securities	7,087	123	677	805	5,482	13,966
From assets held in trading account	803	0	1	3	799	2,135
On fed. funds sold & securities repurchased	596	9	34	85	469	1,326
Less: Interest expense	13,676	202	1,094	1,298	11,083	25,793
On deposits	8,947	187	936	862	6,962	17,097
Of federal funds purchased & securities sold	1,057	2	23	115	916	2,281
On demand notes & other borrowed money*	2,934	13	132	297	2,492	5,340
On subordinated notes and debentures	738	0	2	23	713	1,076
Less: Provision for losses	6,495	25	184	420	5,865	9,519
Noninterest income	27,254	185	1,308	2,312	23,449	44,458
From fiduciary activities	2,022	10	151	305	1,556	4,957
Service charges on deposits	4,914	58	297	376	4,183	7,555
Trading revenue	1,645	0	2	7	1,635	3,045
From interest rate exposures	201	0	2	(0)	199	1,150
From foreign exchange exposures	1,149	0	0	1	1,148	1,359
From equity security and index exposures	247	0	0	6	241	485
From commodity and other exposures	46	0	0	0	46	55
Investment banking brokerage fees	1,140	1	17	45	1,078	2,207
Venture capital revenue	(32)	0	(0)	(1)	(31)	(58)
Net servicing fees	2,443	36	92	142	2,173	3,054
Net securitization income	3,633	0	114	85	3,435	4,773
Insurance commissions and fees	532	6	23	53	449	835
Insurance and reinsurance underwriting income	98	0	3	3	92	146
Income from other insurance activities	434	6	21	51	356	689
Net gains on asset sales	1,375	11	118	146	1,099	2,894
Sales of loans and leases	1,264	10	116	137	1,001	2,677
Sales of other real estate owned	(2)	1	1	3	(7)	7
Sales of other assets (excluding securities)	112	(0)	1	6	105	209
Other noninterest income	9,584	63	494	1,153	7,874	15,196
Gains/losses on securities	1,124	8	44	39	1,033	2,113
Less: Noninterest expense	34,395	465	2,480	3,384	28,065	59,288
Salaries and employee benefits	14,927	237	1,168	1,313	12,210	26,980
Of premises and fixed assets	4,195	57	301	338	3,498	7,764
Goodwill impairment losses	40	0	0	0	40	43
Amortization expense and impairment losses	1,037	2	18	68	949	1,224
Other noninterest expense	14,196	169	993	1,665	11,368	23,277
Less: Taxes on income before extraordinary items	7,485	41	316	592	6,538	12,198
Income/loss from extraordinary items, net of taxes	(12)	(0)	1	(0)	(13)	(12)
Memoranda:						
Net operating income	14,344	122	801	1,155	12,265	23,520
Income before taxes and extraordinary items	22,590	170	1,149	1,775	19,496	37,153
Income net of taxes before extraordinary items	15,105	129	834	1,183	12,959	24,955
Cash dividends declared	10,085	53	585	1,049	8,398	15,614
Net loan and lease losses	6,839	17	129	331	6,362	9,637
Charge-offs to loan and lease reserve	8,073	24	174	411	7,464	11,498
Less: Recoveries credited to loan and lease reserve	1,234	7	45	80	1,102	1,861

* Includes mortgage indebtedness

Year-to-date income and expenses of national banks by asset size
Through March 31, 2003
(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	2,065	918	976	125	46	7,864
Net income	$15,092	$129	$834	$1,183	$12,946	$24,942
Net interest income	35,102	467	2,462	3,228	28,945	59,388
Total interest income	48,778	669	3,556	4,526	40,028	85,181
On loans	37,944	524	2,795	3,509	31,115	63,985
From lease financing receivables	1,626	3	20	66	1,538	2,395
On balances due from depositories	400	6	13	23	357	763
On securities	7,087	123	677	805	5,482	13,966
From assets held in trading account	803	0	1	3	799	2,135
On fed. funds sold & securities repurchased	596	9	34	85	469	1,326
Less: Interest expense	13,676	202	1,094	1,298	11,083	25,793
On deposits	8,947	187	936	862	6,962	17,097
Of federal funds purchased & securities sold	1,057	2	23	115	916	2,281
On demand notes & other borrowed money*	2,934	13	132	297	2,492	5,340
On subordinated notes and debentures	738	0	2	23	713	1,076
Less: Provision for losses	6,495	25	184	420	5,865	9,519
Noninterest income	27,254	185	1,308	2,312	23,449	44,458
From fiduciary activities	2,022	10	151	305	1,556	4,957
Service charges on deposits	4,914	58	297	376	4,183	7,555
Trading revenue	1,645	0	2	7	1,635	3,045
From interest rate exposures	201	0	2	(0)	199	1,150
From foreign exchange exposures	1,149	0	0	1	1,148	1,359
From equity security and index exposures	247	0	0	6	241	485
From commodity and other exposures	46	0	0	0	46	55
Investment banking brokerage fees	1,140	1	17	45	1,078	2,207
Venture capital revenue	(32)	0	(0)	(1)	(31)	(58)
Net servicing fees	2,443	36	92	142	2,173	3,054
Net securitization income	3,633	0	114	85	3,435	4,773
Insurance commissions and fees	532	6	23	53	449	835
Insurance and reinsurance underwriting income	98	0	3	3	92	146
Income from other insurance activities	434	6	21	51	356	689
Net gains on asset sales	1,375	11	118	146	1,099	2,894
Sales of loans and leases	1,264	10	116	137	1,001	2,677
Sales of other real estate owned	(2)	1	1	3	(7)	7
Sales of other assets (excluding securities)	112	(0)	1	6	105	209
Other noninterest income	9,584	63	494	1,153	7,874	15,196
Gains/losses on securities	1,124	8	44	39	1,033	2,113
Less: Noninterest expense	34,395	465	2,480	3,384	28,065	59,288
Salaries and employee benefits	14,927	237	1,168	1,313	12,210	26,980
Of premises and fixed assets	4,195	57	301	338	3,498	7,764
Goodwill impairment losses	40	0	0	0	40	43
Amortization expense and impairment losses	1,037	2	18	68	949	1,224
Other noninterest expense	14,196	169	993	1,665	11,368	23,277
Less: Taxes on income before extraordinary items	7,485	41	316	592	6,538	12,198
Income/loss from extraordinary items, net of taxes	(12)	(0)	1	(0)	(13)	(12)
Memoranda:						
Net operating income	14,344	122	801	1,155	12,265	23,520
Income before taxes and extraordinary items	22,590	170	1,149	1,775	19,496	37,153
Income net of taxes before extraordinary items	15,105	129	834	1,183	12,959	24,955
Cash dividends declared	10,085	53	585	1,049	8,398	15,614
Net loan and lease losses	6,839	17	129	331	6,362	9,637
Charge-offs to loan and lease reserve	8,073	24	174	411	7,464	11,498
Less: Recoveries credited to loan and lease reserve	1,234	7	45	80	1,102	1,861

* Includes mortgage indebtedness

**Quarterly net loan and lease losses of national banks by asset size
First quarter 2003
(Dollar figures in millions)**

		National banks				Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,065	918	976	125	46	7,864
Net charge-offs to loan and lease reserve	$6,839	$17	$129	$331	$6,362	$9,637
Loans secured by real estate	434	2	16	27	389	632
1-4 family residential mortgages	227	1	7	20	199	307
Home equity loans	82	(0)	0	2	79	104
Multifamily residential mortgages	3	0	0	1	3	5
Commercial RE loans	59	1	5	3	50	129
Construction RE loans	31	0	3	1	28	51
Farmland loans	0	(0)	1	0	(0)	4
RE loans from foreign offices	31	0	0	0	31	32
Commercial and industrial loans	2,030	8	31	100	1,892	3,166
Loans to individuals	3,933	6	75	189	3,663	5,281
Credit cards	2,779	1	49	117	2,612	3,733
Installment loans and other plans	1,155	5	27	72	1,051	1,549
All other loans and leases	441	1	7	16	418	557
Charge-offs to loan and lease reserve	8,073	24	174	411	7,464	11,498
Loans secured by real estate	530	3	21	36	469	780
1-4 family residential mortgages	263	2	10	24	227	363
Home equity loans	93	0	1	3	89	119
Multifamily residential mortgages	6	0	0	1	5	9
Commercial RE loans	84	1	7	6	70	172
Construction RE loans	46	0	3	2	41	72
Farmland loans	3	0	1	1	1	9
RE loans from foreign offices	35	0	0	0	35	36
Commercial and industrial loans	2,345	10	41	122	2,172	3,702
Loans to individuals	4,655	10	101	228	4,315	6,310
Credit cards	3,176	1	57	129	2,989	4,292
Installment loans and other plans	1,478	8	44	99	1,326	2,018
All other loans and leases	544	2	10	24	508	706
Recoveries credited to loan and lease reserve	1,234	7	45	80	1,102	1,861
Loans secured by real estate	96	1	5	10	80	148
1-4 family residential mortgages	35	1	2	4	28	56
Home equity loans	11	0	0	1	10	15
Multifamily residential mortgages	3	0	0	0	3	4
Commercial RE loans	25	0	2	3	20	43
Construction RE loans	15	0	0	1	13	21
Farmland loans	3	0	0	0	2	5
RE loans from foreign offices	4	0	0	0	4	4
Commercial and industrial loans	314	2	11	22	279	536
Loans to individuals	721	3	26	40	653	1,029
Credit cards	398	0	8	12	377	560
Installment loans and other plans	323	3	17	27	276	469
All other loans and leases	103	1	4	9	90	148

Year-to-date net loan and lease losses of national banks by asset size
Through March 31, 2003
(Dollar figures in millions)

		National banks				Memoranda:
	All national banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,065	918	976	125	46	7,864
Net charge-offs to loan and lease reserve	6,839	17	129	331	6,362	9,637
Loans secured by real estate	434	2	16	27	389	632
1-4 family residential mortgages	227	1	7	20	199	307
Home equity loans	82	(0)	0	2	79	104
Multifamily residential mortgages	3	0	0	1	3	5
Commercial RE loans	59	1	5	3	50	129
Construction RE loans	31	0	3	1	28	51
Farmland loans	0	(0)	1	0	(0)	4
RE loans from foreign offices	31	0	0	0	31	32
Commercial and industrial loans	2,030	8	31	100	1,892	3,166
Loans to individuals	3,933	6	75	189	3,663	5,281
Credit cards	2,779	1	49	117	2,612	3,733
Installment loans and other plans	1,155	5	27	72	1,051	1,549
All other loans and leases	441	1	7	16	418	557
Charge-offs to loan and lease reserve	8,073	24	174	411	7,464	11,498
Loans secured by real estate	530	3	21	36	469	780
1-4 family residential mortgages	263	2	10	24	227	363
Home equity loans	93	0	1	3	89	119
Multifamily residential mortgages	6	0	0	1	5	9
Commercial RE loans	84	1	7	6	70	172
Construction RE loans	46	0	3	2	41	72
Farmland loans	3	0	1	1	1	9
RE loans from foreign offices	35	0	0	0	35	36
Commercial and industrial loans	2,345	10	41	122	2,172	3,702
Loans to individuals	4,655	10	101	228	4,315	6,310
Credit cards	3,176	1	57	129	2,989	4,292
Installment loans and other plans	1,478	8	44	99	1,326	2,018
All other loans and leases	544	2	10	24	508	706
Recoveries credited to loan and lease reserve	1,234	7	45	80	1,102	1,861
Loans secured by real estate	96	1	5	10	80	148
1-4 family residential mortgages	35	1	2	4	28	56
Home equity loans	11	0	0	1	10	15
Multifamily residential mortgages	3	0	0	0	3	4
Commercial RE loans	25	0	2	3	20	43
Construction RE loans	15	0	0	1	13	21
Farmland loans	3	0	0	0	2	5
RE loans from foreign offices	4	0	0	0	4	4
Commercial and industrial loans	314	2	11	22	279	536
Loans to individuals	721	3	26	40	653	1,029
Credit cards	398	0	8	12	377	560
Installment loans and other plans	323	3	17	27	276	469
All other loans and leases	103	1	4	9	90	148

Number of national banks by state and asset size
March 31, 2003

	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	2,065	918	976	125	46	7,864
Alabama	20	11	8	1	0	150
Alaska	3	1	0	2	0	6
Arizona	17	6	6	3	2	45
Arkansas	42	12	30	0	0	168
California	82	36	34	9	3	279
Colorado	49	23	23	2	1	169
Connecticut	8	1	7	0	0	26
Delaware	12	1	6	2	3	28
District of Columbia	4	1	3	0	0	4
Florida	70	19	43	8	0	263
Georgia	61	27	31	3	0	321
Hawaii	1	0	1	0	0	7
Idaho	1	0	1	0	0	16
Illinois	173	65	98	7	3	676
Indiana	28	6	14	7	1	150
Iowa	51	27	22	2	0	408
Kansas	101	71	27	3	0	363
Kentucky	50	21	27	2	0	223
Louisiana	15	5	8	1	1	140
Maine	6	1	4	0	1	17
Maryland	11	2	9	0	0	73
Massachusetts	13	5	7	1	0	39
Michigan	26	9	16	0	1	159
Minnesota	120	72	44	2	2	466
Mississippi	20	8	10	2	0	97
Missouri	46	22	20	3	1	345
Montana	15	12	2	1	0	78
Nebraska	74	51	21	2	0	267
Nevada	7	1	3	1	2	33
New Hampshire	5	2	2	0	1	15
New Jersey	22	0	15	6	1	80
New Mexico	15	6	6	3	0	51
New York	57	11	39	6	1	137
North Carolina	6	0	4	0	2	70
North Dakota	15	6	6	3	0	104
Ohio	86	35	37	7	7	196
Oklahoma	91	49	38	3	1	273
Oregon	3	0	2	1	0	33
Pennsylvania	80	19	51	7	3	171
Rhode Island	4	2	0	1	1	8
South Carolina	26	12	12	2	0	77
South Dakota	19	8	8	2	1	93
Tennessee	28	6	18	1	3	189
Texas	329	192	125	11	1	665
Utah	7	2	3	0	2	56
Vermont	8	2	6	0	0	15
Virginia	37	7	27	3	0	131
Washington	14	9	5	0	0	79
West Virginia	21	9	10	2	0	69
Wisconsin	45	15	27	2	1	272
Wyoming	21	10	10	1	0	47
U.S. territories	0	0	0	0	0	17

Total assets of national banks by state and asset size
March 31, 2003
(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	National banks: $100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
All institutions	$4,001,717	$49,496	$264,451	$377,890	$3,309,881	$7,196,354
Alabama	4,156	696	2,045	1,415	0	205,192
Alaska	5,518	69	0	5,449	0	6,629
Arizona	46,722	221	2,925	5,324	38,252	49,281
Arkansas	8,846	687	8,158	0	0	32,470
California	281,481	2,152	11,053	19,854	248,422	441,708
Colorado	25,140	1,138	5,612	2,334	16,054	47,271
Connecticut	1,722	100	1,622	0	0	3,982
Delaware	108,853	68	1,322	3,803	103,659	150,572
District of Columbia	580	68	512	0	0	580
Florida	30,911	1,307	10,730	18,875	0	74,678
Georgia	21,263	1,667	6,203	13,393	0	191,828
Hawaii	393	0	393	0	0	23,317
Idaho	276	0	276	0	0	3,303
Illinois	350,894	3,435	25,330	16,559	305,569	497,173
Indiana	74,231	324	5,663	20,589	47,656	114,697
Iowa	17,436	1,448	5,759	10,229	0	50,602
Kansas	16,555	3,671	8,148	4,736	0	39,331
Kentucky	21,039	1,389	5,403	14,247	0	53,174
Louisiana	26,720	243	1,706	7,178	17,593	45,952
Maine	28,400	19	2,153	0	26,228	30,918
Maryland	2,729	134	2,595	0	0	50,083
Massachusetts	3,528	368	1,829	1,331	0	125,851
Michigan	52,548	385	4,540	0	47,623	157,715
Minnesota	79,174	3,688	9,621	3,535	62,330	104,835
Mississippi	11,022	460	2,345	8,217	0	38,328
Missouri	27,714	1,195	5,137	10,047	11,335	77,856
Montana	2,694	565	555	1,574	0	13,875
Nebraska	17,067	2,496	5,143	9,428	0	32,416
Nevada	26,472	47	1,481	4,277	20,668	42,061
New Hampshire	15,125	66	470	0	14,589	18,032
New Jersey	40,231	0	4,530	24,734	10,966	86,998
New Mexico	11,725	400	2,219	9,106	0	16,863
New York	543,491	725	12,905	15,058	514,803	1,507,985
North Carolina	899,749	0	1,556	0	898,193	1,015,595
North Dakota	12,174	283	1,812	10,080	0	18,970
Ohio	471,545	1,885	11,348	21,309	437,002	568,604
Oklahoma	28,633	2,551	8,090	7,120	10,872	48,525
Oregon	9,376	0	409	8,967	0	18,780
Pennsylvania	136,690	1,184	16,980	16,801	101,726	180,213
Rhode Island	198,533	36	0	6,397	192,100	210,666
South Carolina	6,787	706	2,503	3,578	0	30,510
South Dakota	58,153	259	3,057	13,702	41,134	67,510
Tennessee	87,415	472	6,086	1,154	79,703	112,297
Texas	95,866	10,134	31,598	29,937	24,197	158,570
Utah	29,710	76	674	0	28,960	130,948
Vermont	1,427	110	1,317	0	0	5,945
Virginia	25,531	332	8,010	17,189	0	89,927
Washington	1,958	460	1,498	0	0	25,113
West Virginia	6,890	521	2,229	4,139	0	19,435
Wisconsin	22,045	812	7,068	3,920	10,246	82,613
Wyoming	4,579	445	1,832	2,302	0	7,161
U.S. territories	0	0	0	0	0	69,412

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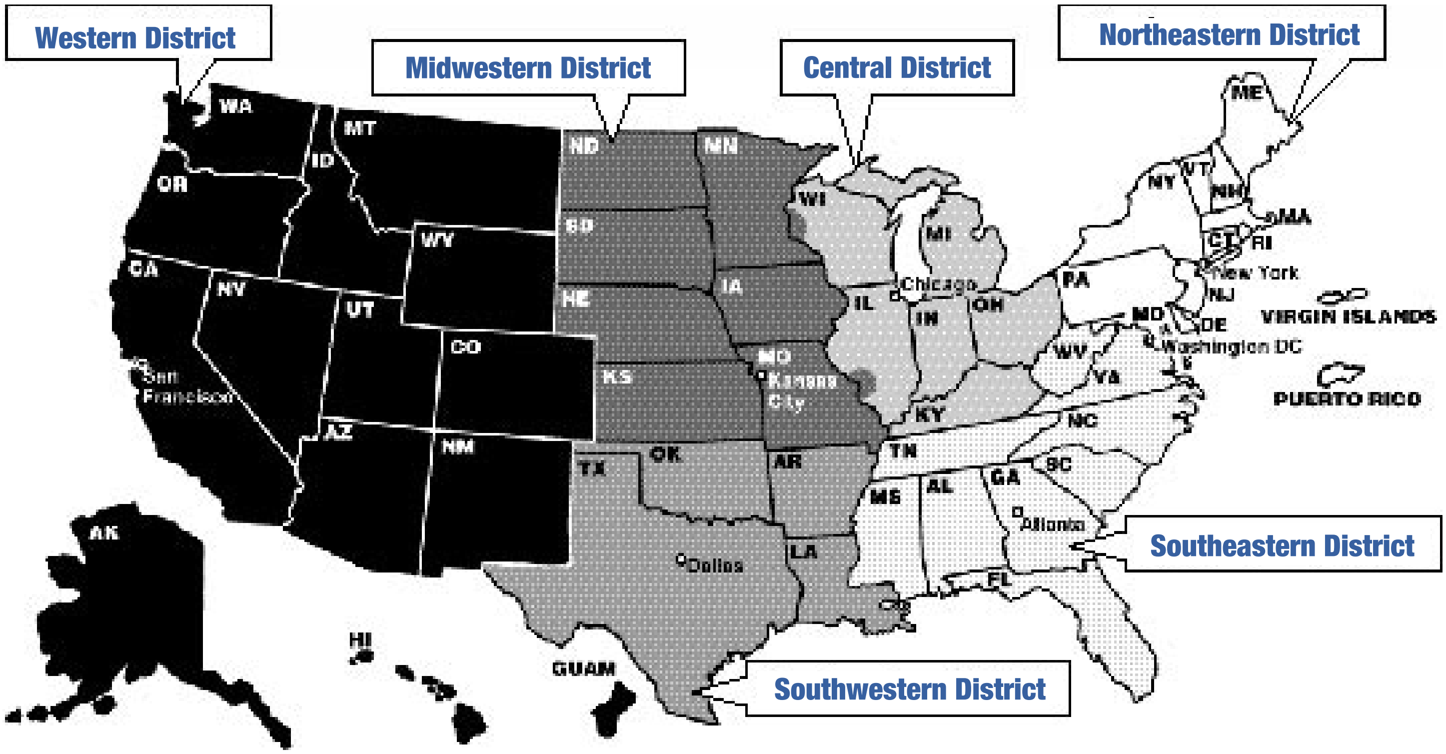

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