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Catastrophe Securities and the Market Sharing of Deposit Insurance Risk

by Kevin P. Sheehan *(page 1)*

The Federal Deposit Insurance Corporation (FDIC) and the property/casualty insurance industry have both faced a considerable increase in concentration risk over the past several decades. Property/casualty insurance companies have attempted to address their increased exposure through reinsurance, using either conventional reinsurers or innovative market instruments. The article examines a number of issues the FDIC will face if it takes a similar approach to reducing its exposure to large-bank failure.

Risk Assessment: Results of an International Survey of Deposit Insurers

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This regular feature of the *FDIC Banking Review* contains information on regulatory agency actions, state legislation and regulation, and articles and studies pertinent to banking and deposit insurance issues.

Catastrophe Securities and the Market Sharing of Deposit Insurance Risk

*by Kevin P. Sheehan**

Over the past two decades, the U.S. banking industry has experienced an unprecedented wave of consolidation. Today the 100 largest banking organizations hold nearly three-quarters of all industry assets. With the industry now dominated by a small number of institutions, any banking crisis could involve the failure of one or more of these large banks. Thus, although the history of the Federal Deposit Insurance Corporation (FDIC) is primarily a record of small-bank failures, the consolidation of the industry suggests a future of possible large-bank failures that might expose the Corporation to unprecedented deposit insurance losses.

This outlook is comparable to the one projected by recent trends in property/casualty insurance. Catastrophic insurance losses from earthquakes, hurricanes, and other natural disasters have already reached unparalleled levels, and property/casualty insurers are anticipating even larger losses in the future.

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The disasters of hurricane Andrew and the Northridge earthquake alone cost the insurance industry more than the cumulative insured losses from catastrophes in the decade before those events. Losses from the two disasters totaled over $45 billion in 1997 dollars, with insured losses running about $30 billion. These insured losses compare with cumulative insured losses from natural catastrophes in the previous decade of only about $25 billion.[1] Yet, although the Atlantic and Gulf coastal regions of Florida are exposed to hurricanes and much of California is vulnerable to earthquakes, the population in these states has grown at two or three times the national average for the last three decades. Given this population growth, scenarios constructed by catastrophe modelers now suggest the possibility of a $76 billion hurricane in Florida, a $72 billion earthquake in California, and even a $21 billion hurricane in the Northeast. [2]

Faced with this increased exposure and seeking an alternative to traditional methods of managing their risk load, property/casualty insurance compa-

[1] See Froot (1997).
[2] See Cummins, Doherty, and Lo (2002).

nies have turned to capital markets. The securities market appears to offer insurance companies an avenue for diversifying their natural disaster risk.

This type of diversification requires securitizing property catastrophe risk. Such securities transfer property catastrophe risk to investors. One example is a catastrophe bond that offers an insurance company some degree of debt forgiveness in the event of a hurricane or some other predefined natural disaster. Another innovative instrument is a catastrophe equity put that allows an insurance company to recapitalize after a catastrophe by exercising a put option on its own stock. Other insurance-based financial instruments include exchange-traded property catastrophe options and property catastrophe swaps.

Property/casualty insurers have recently begun to issue these catastrophe securities. Surprisingly, property/casualty insurers use little reinsurance. These insurers overwhelmingly retain, rather than share, their large-event risks; and even with the introduction of catastrophe securities, the amount of risk sharing has not increased. The limited risk sharing in private insurance markets can be partly attributed to the presence of moral-hazard problems. Froot (1997) presents a number of other explanations for the limited sharing of catastrophe risk. These include behavioral explanations, market power on the part of reinsurers, and price regulation at the state level. Like property/casualty insurers, the FDIC is exposed to large-event risk: a large-bank failure does not happen often, but such an event could result in huge deposit insurance losses. If the FDIC attempted to shift its risk, the Corporation might find itself limited by many of the same factors.

This article investigates issues that property/casualty insurance companies are facing and that the FDIC should consider if it, too, decides to address its increased exposure by securitizing the risk it faces—in the case of the FDIC, the risk of large-bank failure. Specifically, the article details how the insurance companies and the FDIC might reduce their exposure either by entering the reinsurance market directly or by issuing their own catastrophe securities. The article concludes that both kinds of risk shifting are likely to be limited by a number of factors. The one this article focuses on is the moral-hazard problem, because such a focus leads to a number of interesting implications for the market sharing of deposit insurance risk.

Property Catastrophe Risk and Conventional Reinsurance

Figure 1 illustrates that losses are highly predictable for some large pools of insurance risk. For a noncatastrophic event such as fire loss, an insurance company diversifies its risk by creating a large portfolio of independent risks so that (by the law of large numbers) the average loss approaches the mean of the loss distribution (that is, the expected value of losses). Risk-averse individuals are willing to pay something for fire insurance, and one can show that this amount is greater than the expected value of losses.[3] Given the willingness to pay this amount, an insurer holding a large portfolio of fire insurance policies can provide coverage by simply charging policyholders a premium approximately equal to its average loss (per dollar of insurance).

Figure 2 illustrates that property/casualty insurers cannot effectively reduce the variance of cost from natural disasters by creating large pools. Unlike other lines of insurance, losses from earthquakes, hurricanes, and other natural disasters are highly

[3] To see this, consider a risk-averse individual whose wealth, W, is subject to a random loss, L. Risk aversion can be represented by a concave utility function, $U()$. Given the concavity of $U()$, one can show that $EU(W - L) < U(W - \bar{L})$, where E is an expectation operator and $\bar{L}$ is the expected value of losses. This result lends itself to the interpretation that follows. First note that the expression $EU(W - L)$ defines the expected utility of random wealth while the expression $U(W - \bar{L})$ defines the utility for a specific amount of certain wealth. Certain wealth can be obtained by purchasing complete insurance, and the amount of this wealth equals the initial wealth less an insurance payment. Now, if a risk-averse individual acquires complete insurance by paying a premium equal to the expected value of losses, the utility from insured (i.e., certain) wealth, $U(W - \bar{L})$, is greater than the expected utility from uninsured (i.e., random) wealth, $EU(W - L)$. Such an individual is therefore better off purchasing insurance, and this would be true even if the premium were slightly larger than $\bar{L}$.

Figure 1

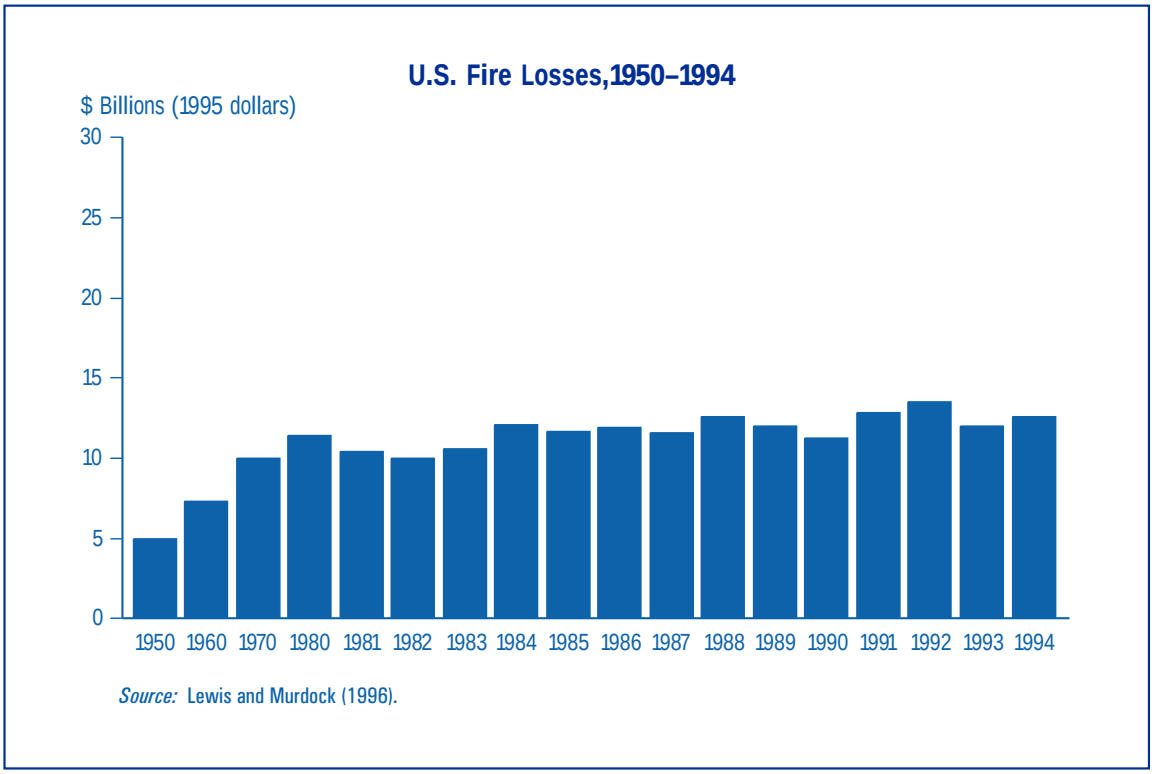
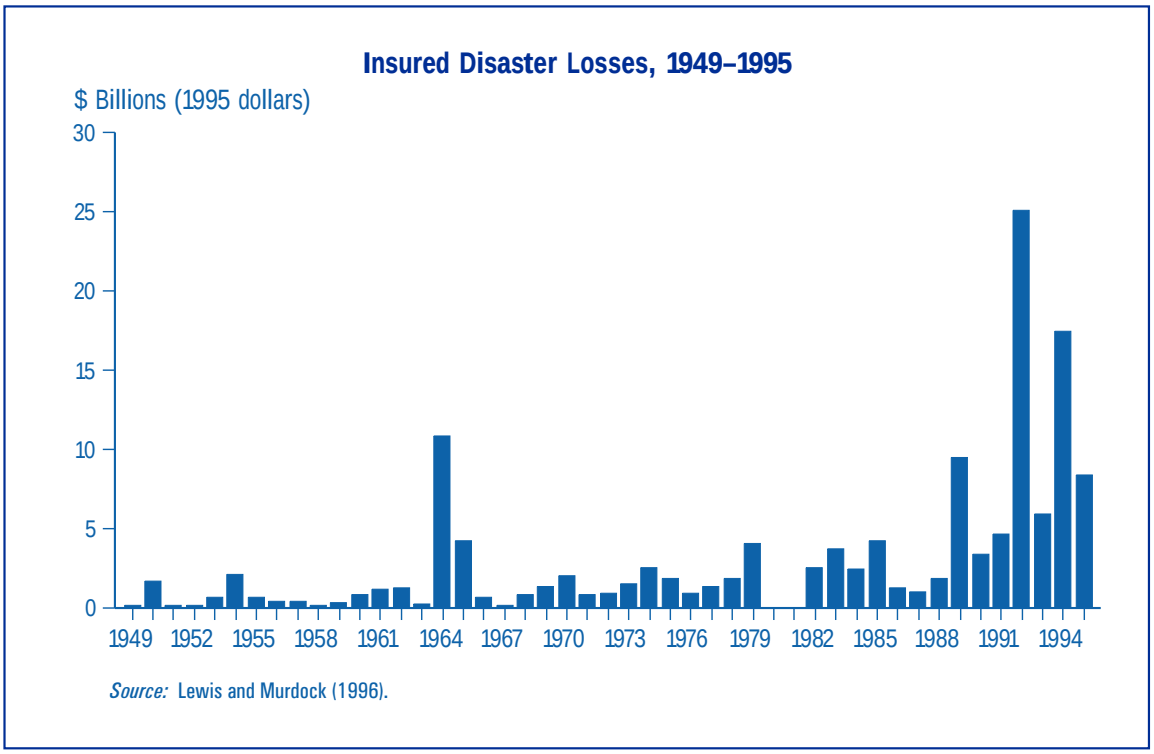


Figure 2



correlated. When a hurricane hits the coast of Florida, for example, most homes in the region incur some damage. Insurance companies typically reduce the variance of their cost by pooling risk across policyholders, but given the highly correlated nature of natural disaster risk, property/casualty insurers cannot fully diversify by using traditional insurance methods.

In the case of independent risk (such as fire loss), an insurer can plan to pay losses out of premium income.[4] Because costs are relatively certain, an insurance company provides coverage by charging a premium approximately equal to its average loss (per dollar of insurance). For catastrophe risk, in contrast, the annual pattern of losses is highly variable, and large amounts of capital are required to cover potentially huge losses. In this case, an insurer provides coverage by holding enough capital to cover potentially huge insurance losses.[5] This capital finances the purchase of liquid securities, and in the case of a natural catastrophe, the insurance company liquidates these securities to pay policy claims.

Reinsurance allows an insurer to provide catastrophe coverage while holding only a limited amount of capital. When broadly used, reinsurance can be interpreted as a pooling arrangement that mutualizes the industry's risk. Under this risk-sharing arrangement, individual insurance companies hold only limited amounts of capital, and each insurer is accountable for a proportion of total industry losses. That is, each insurer pays a proportion of total losses, and the pooling of industry resources through reinsurance contracts ensures that adequate capital is in place to provide this catastrophe coverage.

Thus a major objective of reinsurance is to share or distribute the risk of loss.[6] The primary insurance market is characterized by the sale of insurance policies from a primary insurer to the insured, and primary insurers may then cede or pass on some or all of their insurance risk to a reinsurer. Through reinsurance transactions, primary (or direct) insurers share the risk of loss with reinsurers (and/or other primary insurers). In return for a premium payment, an insurer transfers some of its loss exposure to a reinsurer, and the reinsurer agrees to indemnify the insurer for losses falling within the reinsurance agreement.

Reinsurance contracts take the form of either *facultative agreements* or *treaties*. With facultative reinsurance, the primary insurer negotiates a separate contract for each policy that it reinsures. Treaties are agreements whereby the reinsurer agrees to accept all policies of a particular type—property/casualty policies, for example. In both cases, reinsurers charge a premium for assuming this risk. In addition, this reinsurance can be broadly categorized as either *pro rata* coverage or *excess-of-loss* protection. A pro rata policy provides the primary insurer with coverage against a fixed percentage of losses, whereas an excess-of-loss policy provides protection for a fixed amount of losses above a specified threshold, or attachment point.

As mentioned above, however, primary property/casualty insurers use reinsurance to cover only a relatively small amount of their catastrophic exposures.[7] Swiss Re (1997) reports that only a fraction of the exposure in United States' hazard-

[4] Even so, an insurance fund is necessary to cover unexpected losses. However, little capital is needed when insurance losses are relatively constant through time.

[5] In theory this capital should be readily available. Modern portfolio theory tells us that a security should be priced in terms of its correlation with the market portfolio. The return on Treasury securities is not correlated with the returns on stocks and bonds. Given that catastrophe exposures are not correlated with the returns on a market portfolio, an insurance company could attract capital by promising to pay an expected return equal to the return on Treasury securities. To generate this required return, holders of these zero-beta assets would receive the interest earnings from the insurer's portfolio of liquid securities as well as additional compensation for expected insurance losses. The insurance company would fund this risk premium by charging policyholders an amount equal to the expected value of the losses. However, since risk-averse individuals are willing to pay amounts greater than the expected value of losses, the insurer could fund an even larger premium and offer investors excess returns for the use of this risk-taking capital. Of course, capital constraints may exist, and possible sources of this market friction are identified below.

[6] Geographical diversification is another important objective of reinsurance. See Cummins and Weiss (2000) for a general discussion of reinsurance.

[7] This article argues that such limited coverage can be explained to some degree by the presence of moral-hazard and adverse-selection problems. Again, see Froot (1997) for additional explanations for the limited use of catastrophe reinsurance coverage.

prone states is covered by catastrophe reinsurance. In fact, an analysis by Froot of a large sample of reinsurance contracts finds that "reinsurance coverage as a fraction of exposure is high at first (after some small retention) and declines markedly with the size of the event, falling to a level of less than 30 percent for events of only $8 billion."[8]

The reason property/casualty insurers use relatively little reinsurance is that it is available only in limited quantities and at very high prices. Limited quantities are evidenced by the fact that reinsurance coverage typically involves deductibles and insurance limits. The high cost of reinsurance is illustrated by a reinsurance transaction involving the California Earthquake Authority (CEA). In late 1996 CEA purchased reinsurance from National Indemnity, a subsidiary of Berkshire Hathaway. According to Froot, "[u]nder the structure of the reinsurance contract with National Indemnity the actuarially expected loss was 1.7 percent and the [insurance] limit was $1.05 billion. In return for bearing the earthquake risk National Indemnity received an annual premium of $113 million—or 6.3 times the actuarially expected losses of $18 million."[9]

Industry-wide prices on reinsurance contracts seem to match almost exactly the pricing of the CEA contract. However, further analysis shows that much of the high premium-to-expected-loss ratio (which is averaged across all layers) comes from coverage for the highest layers of losses—that is, coverage for low-frequency, high-severity events. Around the time of the CEA transaction, reinsurance coverage for these low-frequency, high-severity events required premiums greater than 25 times expected losses, as Figure 3 indicates. The figure shows the premium-to-expected-loss ratios (by year) for different layers of reinsurance coverage. The axis labeled "exceedence decile" identifies the likelihood (from high to low) that insurance losses will exceed the deductible on a reinsurance contract. On this axis, a value of 10 corresponds to the small probability that insurance losses will exceed a very large deductible. Since reinsurance coverage for the highest layers of losses involves contracts with very large deductibles, the back row of the figure identifies the spread over expected losses for catastrophic coverage.

The evidence of high prices provided by Figure 3 is consistent with a limited demand for reinsurance services. High prices are inferred from the observation that insurance premiums are significantly greater than expected losses. Such large spreads can explain the limited demand for reinsurance; however, expected losses may be underestimated because we are dealing with extremely rare events. If expected losses are underestimated, the actual spreads are somewhat smaller than those appearing in the figure. Nevertheless, even if one were to revise expected losses substantially upward, the magnitude of the spreads would remain large, and the revised spreads would still indicate the high cost of reinsurance coverage.

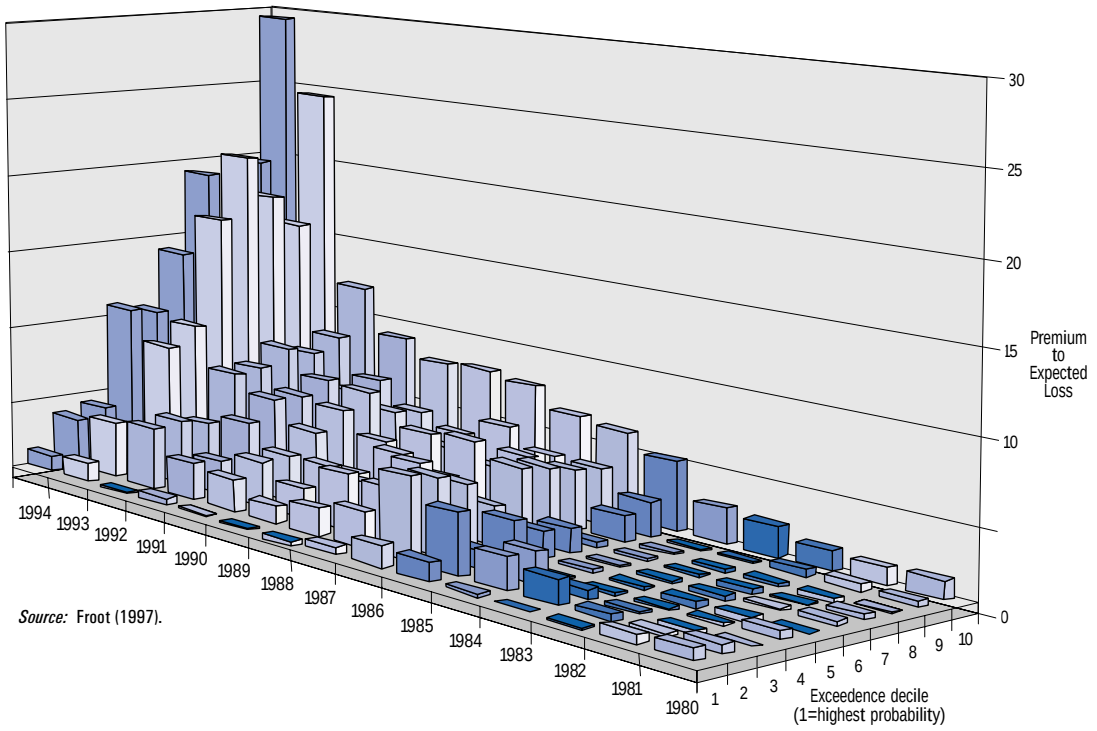
Reinsurance markets are subject to price and availability cycles, which often result in price increases and supply restrictions following catastrophic events. "The market alternates between 'soft markets,' when coverage is [somewhat] plentiful and prices are relatively low, and 'hard markets,' when availability of coverage is limited and prices are relatively high."[10] The CEA transaction occurred just after hurricane Andrew and the Northridge earthquake, so temporary supply restrictions might have significantly affected prices.

More generally, however, high prices can be explained by a couple of different factors. First, the high cost of coverage for the upper layers of natural disaster risk can be explained to some extent by the size of the losses as well as the difficulty of estimating such losses. In addition, the high cost of reinsurance coverage for low-frequency, high-severity events can be partly explained by

[8] Froot (1999), 12.
[9] Ibid., 6.
[10] Cummins and Weiss (2000), 181.

Figure 3

Premium to Expected Loss, by Exceedence Probability and Year



Source: Froot (1997).

the presence of severe ex post moral-hazard problems. As Doherty explains,

> Ex post moral-hazard problems arise when the loss-settlement practices of the insurer are relaxed because of the presence of reinsurance. This is a particular problem for catastrophe losses. The loss-settlement capacity of any insurer—and the industry as a whole—is geared to its normal loss frequency. When an event such as hurricane Andrew arises, primary firms simply do not have the capacity to inspect and negotiate claim settlements thoroughly. Thus, it becomes more difficult to prevent the "build up" of claims (from policyholders' tendency to include uninsured damage in the claim or exaggerate the size of the losses) or outright fraud on the part of policyholders. However, the incentive for the primary insurer to control its claims will be relaxed if it has reinsurance protection.[11]

[11] Doherty (1997), 87.

For catastrophe losses, concern exists that the primary insurer might pass on the costs of excess settlements to its reinsurer. "For moderate losses, the primary firm may well consider its reputation in the reinsurance market before engaging in such opportunism. . . . [But when] insurers are facing financial stress [from catastrophe losses], maintaining their reputation in reinsurance markets is likely to become a secondary concern."[12] Thus, ex post moral-hazard problems are likely to be restricted to coverage for catastrophic events, and the presence of such distortions may partly explain the existence of large premiums for the highest layers of reinsurance coverage.[13]

[12] Ibid.

[13] Catastrophe reinsurance contracts are typically issued with insurance limits that preclude coverage for the very highest layers of losses. A possible explanation for this lack of coverage is that ex post moral-hazard problems are most severe for the very highest layers of losses. According to this explanation, insurance limits are in place because the presence of such severe moral-hazard problems precludes the provision of reinsurance coverage.

Securitization of Property Catastrophe Risk

Property/casualty insurers overwhelmingly retain, rather than share, their large event risks—in other words, these insurers provide coverage by holding their own capital. But because the U.S. commercial property/casualty insurance industry has only a limited amount of capital, a major California earthquake or Florida hurricane would stress the capacity of this industry.[14] More capital is needed, but raising additional equity capital would not be an efficient solution to this problem of capital adequacy. Jaffee and Russell (1997) point out that holding capital in an insurer is costly because of the regulatory and agency costs of operating an insurance company, as well as accounting and tax rules that penalize the accumulation of equity capital.

Although a $100 billion catastrophe might wipe out the capital of the property/casualty insurance industry, a loss of that magnitude is less than one-half of 1 percent of the value of stocks and bonds traded in U.S. securities markets. Securities markets have the capacity to absorb huge losses, and insurers have recently sought to address their increased exposure and the problem of capital adequacy by introducing reinsurance-like contracts that would facilitate the sharing of catastrophe risk more broadly across these markets. This securitization of insurance risk is potentially a more efficient approach to financing catastrophic losses than conventional insurance and reinsurance. Cummins and Weiss point out that "[s]ecurities markets are more efficient than insurance markets in reducing information asymmetries and facilitating price discoveries, potentially smoothing or eliminating insurance price cycles. Moreover, insurance-linked securities cover zero-beta events and thus are valuable to investors for diversification purposes."[15]

As noted earlier, despite these advantages, catastrophe securities have done little to expand reinsurance capacity. Reinsurance capacity is limited by the presence of moral-hazard and other transaction costs. Reducing these transaction costs would expand reinsurance capacity; however, it appears that these new securities have failed to reduce costs. As shown below, catastrophe options greatly reduce moral-hazard problems but only by introducing basis risk. On the other hand, catastrophe bonds do not reduce costs because they fail to adequately address moral hazard. Without effectively solving moral-hazard problems, these securities are nothing more than synthetic reinsurance that is plagued by the same incentive conflicts as conventional reinsurance.

Catastrophe Options

The similarity between an excess-of-loss reinsurance contract and a call spread (defined below) allows for an easy transformation of insurance risk into exchange-traded options. Catastrophe options can be found on the Bermuda Commodities Exchange, and until recently, catastrophe option contracts were also traded on the Chicago Board of Trade (CBOT). Catastrophe option contracts are based on various industry indices of property liability losses. For example, a contract on the CBOT was based either on a national index, a regional index (Western, Midwestern, Southeastern, Northeastern, and Eastern), or a state index (California, Florida, and Texas).

A typical excess-of-loss reinsurance contract provides an insurer with protection above an agreed-upon dollar amount of insurance losses. For example, a 10/30 excess-loss layer provides indemnification for the first $10 million (limit) in insurance losses over $30 million (the attachment point). This excess-of-loss policy is similar to the insurer hedging its risk by buying a catastrophe option at a strike price of $30 million and simultaneously selling a catastrophe option with a strike price of $40 million.[16] This combination of being

[14] Greenberg (2001) reports that just before the September 11, 2001, terrorist attacks, the U.S. commercial property/casualty insurance industry had between $100 billion and $125 billion in aggregate capital.

[15] Cummins and Weiss (2000), 207.

[16] On the CBOT, the level of industry-wide losses was converted to an index, and the catastrophe option contracts were written in terms of the index. Since an index point represented $10 million insurance losses, the long position described above, for example, was an option with a strike price of 3 index points.

long (that is, buying a catastrophe option) at one strike price and at the same time short (that is, selling a catastrophe option) at a higher strike price is known as a call spread.

When insurance losses have exceeded the strike price, the buyer of a catastrophe option receives (or the seller of the option pays) the difference between the industry-wide insurance losses and the striking price. Thus a long position with a strike price of $30 million enables an insurer to receive payment for the excess loss over $30 million, whereas a short position with the strike price of $40 million places a cap on this payment of $10 million. With industry-wide insurance losses of $100 million, for example, the payment is capped at $10 million because a $70 million gain on the long position is offset by a $60 million loss on the short position.[17]

Moral hazard arises whenever an insured party, by virtue of being insured, fails to take precautions to prevent the event being insured against. Reinsurance protection can relax the normal incentives for the primary insurer to underwrite carefully and settle claims efficiently. As Doherty explains,

> [T]he primary may [become] lax in its underwriting procedures, pay inadequate attention to its own spread of risk, and fail to provide adequate risk audits for potential new policies. . . . [Moreover the] primary may be able to avoid the abnormal transaction costs of settling claims, and even buy some goodwill with its policyholders by making generous settlements with policyholders and passing on the costs of excess settlements to its re-insurer.[18]

Catastrophe options seek to control this moral hazard by using industry (or sub-industry) indices. The basic idea is to define the contract payoff in relation to some variable that is correlated with insurer losses but over which the insurer has little or no control. Then when using catastrophe options, a primary insurer that is able to practice cost mitigation will receive much of the benefit of that activity in the form of reduced claims.

To illustrate, suppose an insurer has a portfolio that represents 5 percent of the market covered by an index. This insurer can obtain upper-layer coverage by purchasing a catastrophe option that pays 0.05 times the payoff on the amount by which industry losses exceed a strike price. Loss-control efforts by the insurer may lower industry losses and therefore reduce its option payoff. But, since the insurer is hedging only 5 percent of the index, every $100 reduction in direct claims reduces the option payoff for the insurer by only $5. In other words, the insurer receives a net benefit from any cost mitigation equal to 95 percent of the reduction in its direct claims.

Niehaus points out that, "various methods are used to mitigate [moral-hazard] problems, including costly monitoring (both ex ante and ex post) and incomplete risk sharing of catastrophe risk (i.e., deductibles, coinsurance, and [insurance] limits)."[19] Catastrophe options have attempted to facilitate a more complete shifting of risk by moving away from deductibles and coinsurance. These securities control incentive conflicts by tying the payoff to an index that, for the most part, cannot be influenced by the actions of market participants. Indexing greatly reduces or eliminates moral hazard, but this approach has failed to significantly increase risk sharing because it has been found to expose insurers to unacceptable levels of basis risk.

Insurers use reinsurance to hedge their underwriting risk. A conventional reinsurance contract provides an insurer with a perfect hedge; that is, the reinsurance payment exactly offsets insurance losses. The option payoff is based on aggregate claim payments, but since industry and firm losses are not perfectly correlated, the payoff will not necessarily offset the insurance losses suffered by the primary insurer. In fact, if little correlation

[17] A call option provides the holder with the right to buy an underlying asset at a fixed price, called the strike price. The holder exercises a call option only if the value of the underlying asset is greater than the strike price. A catastrophe option is a call option in which insurance losses determine the value of the underlying asset. In the example above, the holder exercises the option because the level of industry-wide insurance losses sets the value of the underlying asset to an amount that is greater than the strike price.

[18] Doherty (1997), 87.

[19] Niehaus (2002), 590.

exists between industry and firm losses, then it would be highly probable that an insurer would suffer large underwriting losses while at the same time receiving a zero payment on its option position. This hedging risk is referred to as basis risk, and as Harrington and Niehaus point out, "[catastrophe options] can have considerable basis risk, i.e., the losses on a particular insurer's book of business may not be highly correlated with the indices underlying the contracts so that little underwriting risk can be eliminated."[20]

Ideally, insurers would bear some amount of hedging risk in exchange for reducing moral hazard. However, the significance of basis risk can be observed from contract design. Conventional reinsurance has no basis risk since the payoff is based on insurer-specific (or hedger-specific) losses. Conventional reinsurance contracts can always be structured so that the payoff is triggered by industry losses rather than the insurance firm's own losses. "But the fact that reinsurance contracts traditionally have not been designed in this way suggests that basis risk is an important consideration."[21] In fact, "the perception among insurers that index securities are subject to unacceptable levels of basis risk has been identified [by the American Academy of Actuaries (1999)] as the primary obstacle to the more rapid development of the market."[22]

Today, trading in catastrophe options is limited to the Bermuda Commodities Exchange. In 1992 the CBOT launched an option contract based on the U.S. Property Claims Service (PCS) Index, but the volume of PCS index option contracts peaked at only 15,706 contracts in 1997 and declined to 561 contracts in 1999. The CBOT has since delisted these options because of a lack of interest.

In addition to basis risk, the lack of interest might also be attributed to credit risk. A seller of a call spread is required to deposit liquid securities with the option exchange, but the size of the deposit amounts to only a fraction of the largest possible loss. With less than full collateralization, the buyer of a call spread faces credit risk similar to that involved in purchasing reinsurance. Conventional reinsurance involves the risk that the reinsurer will be unable to pay its obligations to the primary insurer. With a call spread, the insurer has a claim only on the counterparty, so these transactions expose the insurer to credit risk associated with potential counterparty default. Exchanges typically address counterparty credit risk by guaranteeing contract performance, but huge potential losses raise questions about an exchanges' ability to ensure the performance of any significant volume of contracts linked to property liability losses.

Catastrophe Bonds

Like catastrophe options, the market for catastrophe bonds has been rather slow in developing. Cummins, Lalonde, and Phillips (2000) report that markets have accommodated only about 20 catastrophe-bond issues, totaling around $3 billion of insurance coverage. High cost explains the limited interest in these securities, and, as illustrated below, high prices can be attributed to the failure of the securities to adequately address moral hazard.

United Services Automobile Association (USAA), the fourth largest U.S. homeowner insurer, issued one of the first catastrophe bonds in mid-1997, selling $477 million of one-year bonds tied to hurricane losses.[23] Buyers of these catastrophe bonds could generally expect to receive full payment; however, in the event of a hurricane, bondholders

[20] Harrington and Niehaus (1999), 50.
[21] Doherty (1997), 87.
[22] Cummins, Lalonde, and Phillips (2000), 2. However, a few studies have concluded that the basis risk associated with derivative contracts based on state-specific indices is not large. See, for example, Harrington and Niehaus (1999) and Cummins, Lalonde, and Phillips (2000).

[23] The bonds were actually sold by a special purpose reinsurer called Residential Re. For tax and regulatory purposes, this company had to be run independently of USAA. USAA paid Residential Re a monthly premium, and Residential Re used this payment plus the earnings on a portfolio of liquid securities to pay interest to bondholders. If USAA were to incur insurance losses greater than $1 billion, Residential Re would provide insurance coverage by liquidating its portfolio.

could forfeit interest and/or principal if USAA's insurance losses were greater than $1 billion.[24] By purchasing a security with event-linked payments, bondholders provided catastrophe excess-of-loss coverage for 80 percent of the $500 million risk layer between $1 billion and $1.5 billion of insured losses suffered by USAA during a one-year period in certain U.S. coastal states. That is, coverage would pay for insurance losses in excess of $1 billion, with the maximum payment capped at $400 million.

The generic design of these instruments can allow for interest and/or principal forgiveness, and the extent of the forgiveness can be total, partial, or scaled to the size of the loss. In the case of USAA, a portion of the bond issue was principal protected. Of the $477 million that USAA raised from the sale of notes, the company used $77 million to purchase ten-year U.S. Treasury strips with a maturity value equal to the $164 million of principal-protected notes. If an event resulted in USAA losses exceeding $1.5 billion, $400 million of debt would be forgiven, while the principal-protected notes would be repaid (with no interest) in ten years from the proceeds of the Treasury securities.

Debt-forgiveness instruments like catastrophe bonds avoid the credit risk that is common to reinsurance transactions—that is, the risk that the reinsurer will be unable to pay its obligations. Bondholders provide a hedge to the insurer by forgiving existing debt. Thus, the value of the hedge is independent of bondholder wealth, and the issuing primary insurer faces no risk of nondelivery of the hedge.

A catastrophe bond can be forgiven on the basis of either the primary insurer's own catastrophe losses or some industry index of catastrophe losses. Moral hazard is limited when debt forgiveness is triggered by an industry index of catastrophe losses. In the case of USAA, however, the company's book was concentrated at military establishments, so the basis risk from a debt issue with forgiveness tied to an industry index was large. Since little correlation existed between industry and firm losses, debt-forgiveness triggered by a level of industry losses would not necessarily offset catastrophe losses suffered by USAA. For this reason, USAA chose to issue bonds with debt forgiveness triggered by the level of the company's own insurance losses.

USAA's failure to use an industry index to address moral hazard may partly explain the high cost of issue for the company. Catastrophe exposures are not correlated with the returns on stocks and bonds.[25] Under the assumptions of the capital asset pricing model, the required rate of return on a zero-beta asset is the risk-free rate of return. Theoretically the interest rate on USAA bonds would be the risk-free rate plus a premium large enough to offset the expected loss of principal and/or interest due to a catastrophic event. USAA paid bondholders 451 basis points above the London interbank offer rate (LIBOR) for principal and interest forgiveness. For the principal-protected notes, USAA paid bondholders 125 basis points over LIBOR.[26] Although the estimated probability of a loss exceeding the trigger was only 1 percent, interest rates included a premium for principal and interest forgiveness of over seven times the expected loss and about twice the expected loss for only interest forgiveness.

Moral-hazard problems appear to explain the existence of such large premiums. Cummins, Lalonde, and Phillips (2000) reports that Goldman Sachs & Company estimated a median risk-premium to expected-loss ratio of 6.8 for all catastrophe bonds

[24] Notice the similarity between catastrophe bonds and the historical marine insurance described by Jaffee and Russell (1997, p. 207): "[A] market for marine insurance operated among ancient Greeks and Phoenicians and flourished in London from as early as the seventeenth century. [The insurance took the form of a loan that offered the ship owner some degree of debt forgiveness.] In . . . the so-called contract of bottomry, a lender advanced the ship-owning merchant the full cost of the voyage as a loan. If the voyage was successful, the ship owner repaid the bank at an interest rate which included a premium to reflect the risk of loss. If the ship was lost, the loan was forgiven."

[25] See Froot et al. (1995) for a discussion of the lack of correlation between catastrophic risk and traditional asset classes.

[26] USAA paid a total premium of 576 basis points for this layer of coverage. The premium for essentially identical coverage fell to 412 basis points in 1998 and to 366 basis points in 1999. These bonds provided no principal protection and the reduction in costs can be attributed to lower estimates of expected losses.

issued through March 2000. Employing a sampling of Florida call spread transactions, the authors in this paper estimated a median risk-premium to expected-loss ratio on Florida calls of 2.1. Like catastrophe bonds, the risk premium on call spreads might be attributed to illiquidity, uncertainty about expected loss estimates, and/or investor unfamiliarity with the contracts. However, such factors should be somewhat similar across both securities. But since only catastrophe options resolve incentive conflicts by employing industry (or sub-industry) indices, the higher premium on catastrophe bonds is likely attributable to the failure of these securities to address moral hazard by indexing.

Catastrophe Swaps and Catastrophe Equity Puts

A catastrophe swap enables insurers to diversify their risk by trading blocks of insurance policies. "Each swap [is] a bilateral agreement, creating reciprocal reinsurance between two insuring entities. . . . Property catastrophe risk varies by location, and [with a swap] participants [are] able to [trade different] types of risk (for example, hurricane risk on the North Carolina coast for tornado risk in Kansas)."[27] Since August of 1997, property catastrophe swaps have been trading on the Catastrophe Risk Exchange (CATEX). Over 1,400 listings have appeared on CATEX, and the 500-plus completed transactions involved nearly $3 billion of insured coverage. However, only a portion of these transactions involved property catastrophe risk.

A catastrophe equity put (CEPut) is a post-loss financing arrangement in which the price of the equity issue is fixed. More specifically, a CEPut is an option contract that gives the insurer the right to sell a given number of shares to a specific counterparty for a fixed price, and this option can be exercised only after the occurrence of a catastrophe of an agreed-upon magnitude (whereas the typical option can be exercised at any time during the contract period). To minimize potential moral hazard, the trigger is most often defined in terms of a level of industry-wide losses. However, defining the trigger in this way introduces basis risk. The contract also exposes the insurer to the credit risk associated with potential counterparty default, but, again, some degree of credit risk is present in all reinsurance transactions.

Reinsurance or Securitization for Deposit Insurance Risk?

As pointed out above, catastrophic insurance losses from earthquakes, hurricanes, and other natural disasters are highly correlated, with a hurricane (for example) causing damage to many homes in a particular region. Similarly, the failure of a financial institution may cause all depositors across a bank to suffer losses. Furthermore, because of population growth in exposed areas such as Florida, property/casualty losses are increasingly more correlated: one can expect *more* homes to be damaged when a hurricane hits the coast. For the FDIC, too, deposit insurance losses are *more* correlated today: because of bank consolidation, a bank failure is likely to be associated with much larger deposit insurance losses.[28] Thus, for property/casualty insurers and the FDIC alike, insuring against risk from highly correlated losses requires either reinsurance or having access to a larger pool of liquid capital to cover the larger insurance losses.

Ideally, the FDIC would obtain reinsurance coverage for its exposure to large-bank failure. The Federal Deposit Insurance Corporation Improvement Act authorized the FDIC to transfer up to 10 percent of its risk exposure to market participants, and in fact the Corporation is currently exploring a limited reinsurance program. Although reinsurance might allow the Corporation to reduce its exposure, deposit reinsurance would also involve moral-hazard and other prob-

[27] Borden and Sarkar (1996), 5.

[28] Even though potential insurance losses have increased, consolidation may be responsible for a decline in the likelihood of losses. That is, consolidated banks hold portfolios that are more diversified, so the probability of bank failure may be lower.

lems. The presence of these distortions suggests that, unless the factors producing them are accounted for appropriately, deposit reinsurance coverage would probably be available only in limited quantities and at high prices. Indeed, the cost of coverage for this large-event risk would probably mirror the pricing for catastrophe reinsurance coverage for the highest layers of risk. A recent survey of reinsurers estimated initial deposit reinsurance capacity at about $2 billion; the survey also found that reinsurers would expect to receive a premium as high as 4 percent for a layer of coverage with an annual expected loss of only 1 percent.[29]

Like reinsurance coverage for the upper layers of natural disaster risk, deposit reinsurance coverage for large banks would be characterized by the problems of size and parameter uncertainty. In addition, deposit reinsurance would probably include a premium that accounted for the presence of significant regulatory risk, including the risk of ex post moral-hazard problems. These problems arise because the reinsurer's losses could be materially affected by the FDIC's actions in regulating bank activities, resolving failed institutions, liquidating assets of failed institutions, and accounting for such activities.

Moving to an event-oriented contract might mitigate concerns about regulatory risk. Such a contract would call for a specified payment if a bank failed, rather than an amount contingent on the ultimate resolution and liquidation costs. While a contract of this type would reduce risks associated with FDIC actions related to asset sales or receivership accounting policies, it would not address regulatory risks associated with the regulation of troubled banks. Thus the challenge facing the FDIC would be to identify a contract design that minimized these and similar moral-hazard problems.

Even with such a contract, deposit reinsurance coverage would probably be subject to price and availability cycles. After the failure of a large bank, renewing reinsurance coverage would probably require the FDIC to pay premiums significantly greater than expected losses. (Of course, in the opposite phase of the market cycle, the FDIC might enjoy premiums that were lower than actuarial pricing would dictate.) And even in the absence of a large-bank failure, renewing reinsurance coverage would probably be difficult during down economic times.

Proponents of deposit reinsurance argue that reinsurance premiums could provide the FDIC with valuable pricing information. That is, the FDIC would acquire reinsurance coverage for individual banks (or groups of banks) and then use reinsurance prices to price its own risk more effectively. However, reliable pricing signals might be limited by the presence of moral-hazard and other transaction costs. Deposit reinsurance would probably involve a premium reflecting the presence of these transaction costs. As shown above, such a phenomenon exists in the pricing of catastrophe securities. Recall that the premium was found to be significantly higher on catastrophe bonds than on catastrophe options. "The most likely explanation for the difference between the premium-to-expected-loss ratios of CBOT options and catastrophe (CAT) bonds is investor concern about moral hazard—CAT bonds, most of which settle on losses of specific insurers, are potentially subject to significant moral hazard whereas moral hazard is a relatively minor concern for CBOT options."[30] If such premiums could not be disentangled from the observed prices, the cost of deposit reinsurance would provide misleading information about the underlying price of deposit insurance.

As pointed out above, property/casualty insurers are turning not to reinsurance to manage the problem of increased exposure, but to securitization—catastrophe bonds, catastrophe options, and so forth. The FDIC, too, might gain access to the pool of liquid capital it would need by similarly securitizing its deposit insurance risk.

[29] See Marsh & McLennan Companies (2001), 5 and 21.

[30] Cummins, Lalonde, and Phillips (2000), 32.

The FDIC could securitize its insurance risk by issuing its own catastrophe securities. More specifically, the Corporation could issue bonds (or options) with payments linked to deposit insurance losses at large banks.[31] The catastrophe in this case would be the failure of a large bank, and by issuing these catastrophe bonds, the FDIC would cede a portion of its risk to investors. In this way, the FDIC would take a less-prominent role in insuring large-bank deposits, since private markets would now absorb a larger amount of the risk of bank failure.

However, just as property/casualty securitization of risk is limited by the presence of moral-hazard and other transaction costs, securitized deposit insurance risk would probably face similar distortions. Thus, to evoke interest in its catastrophe securities, the FDIC would have to be more successful than property/casualty insurers in addressing moral hazard.

Moreover, the cost of such synthetic reinsurance coverage might be prohibitive. For the few property/casualty insurers that found a market for their catastrophe securities, investors required premiums that were significantly greater than expected losses. The FDIC could expect to pay even higher premiums. Bank failure is not completely independent of movements in the market, so catastrophe securities issued by the FDIC would not be valuable to investors for diversification purposes. It is this inability to provide the same diversification benefits as property catastrophe securities that would probably make the premium higher for securitized deposit insurance risk than for securitized property catastrophe risk.

[31] The FDIC could issue catastrophe bonds on individual banks, but such securities would introduce problems of adverse selection. Adverse selection arises when one side of a transaction has more reliable information than the other side. Disclosure is a common solution to this problem, and in an insurance market for catastrophic bank losses, the disclosure of information would address any such problems. However, it is highly unlikely that the FDIC or other federal regulators would provide investors with proprietary information on large banks. Still, the FDIC could address this problem by issuing a security with payments linked to deposit insurance losses across *all* large banks. The risk of adverse selection would then be minimized inasmuch as such a security would prevent the FDIC from (adversely) selecting only high-risk banks for securitization.

Conclusions

In an article that anticipated the capital asset pricing model (CAPM), Karl Borch (1962) defined the Pareto optimal risk-sharing arrangement in the market for reinsurance. According to Cummins and Weiss,

> In a market in which risk bearing is costly to firms but where transacting between firms is costless, the Pareto optimal risk-sharing arrangement is one in which the industry "mutualizes" its risk in the sense that all insurers hold the same net (after reinsurance) liability portfolio. According to Borch, the Pareto optimal reinsurance arrangement is one in which each insurer holds a net portfolio that is a proportionate claim on total insured losses. This result is equivalent to the CAPM proposition that each investor will hold a share of the market portfolio.[32]

In a world with no transaction costs, primary insurers would shed a large amount of their insurance risk by entering into reinsurance contracts. However, such risk shifting is constrained in the real world by reinsurance contracts that include deductibles, coinsurance, and insurance limits. Deductibles and coinsurance are introduced as a method of controlling incentive conflicts. "It may be that the most efficient form of reinsurance is to allow very little risk transfer at all: it is only by forcing . . . risk back upon insurers that reinsurers get insurers to expend resources to monitor and mitigate exposures."[33] A more complete shifting of risk would involve a movement away from deductibles and coinsurance; unfortunately, to this point, addressing moral hazard by alternative methods has been shown to expose insurers to unacceptable levels of basis risk.

The FDIC may find that it can shed a large amount of risk simply by entering the reinsurance market. Or the Corporation may find that this method of risk shifting is severely limited by the presence of moral-hazard and other problems. In

[32] Cummins and Weiss (2000), 165–66.
[33] Froot (1997), 13.

the latter case, the FDIC may decide to retain its risk. If the FDIC retains its risk, it may address its increased exposure from banking consolidation by increasing the size of the Bank Insurance Fund (BIF) (currently mandated to equal 1.25 percent of insured deposits). The appropriate size of the insurance fund will be hard to determine, but even so, setting aside huge sums of money for the rare event of a large-bank failure seems incredibly inefficient. Alternatively, the FDIC can minimize the funding of the BIF by using contingent capital, which it can do by increasing its line of credit with the Treasury (currently set at $30 billion). A larger line of credit will allow the FDIC to cover potentially huge losses while placing only limited demands on the economy's finite stock of capital.

Finally, the FDIC may consider increasing capital requirements of banks. If the Corporation requires large banks to hold more capital, this additional capital will not reduce the exposure of the FDIC to large-bank failure, even though it may reduce the likelihood that a large bank will fail. If such an event—although perhaps less likely—occurs, the FDIC will still be exposed to potentially huge deposit insurance losses. Exposure to such losses requires the FDIC to have access to a larger pool of capital, and this article has examined a number of ways that the Corporation might increase its insurance capital.

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Risk Assessment: Results of an International Survey of Deposit Insurers

*by Jane F. Coburn and John P. O'Keefe**

The success of the financial safety net that a country provides for its financial system is ultimately indistinguishable from the ability of government authorities to manage the risks to the safety net.[1] To do their job well, risk managers need information on the risk exposures of the financial institutions that are covered by the safety net, and they also need procedures for limiting their own risk exposure.

To learn more about how other countries address these and other important needs of a financial safety net, in January 2000 the Federal Deposit Insurance Corporation (FDIC) surveyed 73 foreign deposit insurance organizations in 64 locations (some locations have more than one deposit insurer). All the organizations had specific deposit insurance schemes. The survey consisted of 65 multiple-choice and essay questions not only on risk assessment but also on failure-resolution methods, asset liquidation and the role of the receiver, and funds availability. As of June 2000, 37 insurers in 34 locations had responded.[2]

This is the second in a three-part series on the results. The first part describes failure-resolution methods as well as asset-liquidation practices and the role of the receiver (as reported by the 37 participating deposit insurers).[3] This article discusses the risk-assessment practices of these same insurers, and a subsequent article will address funds availability (that is, the availability of resources to absorb unavoidable risk-related losses). The approach taken throughout the series is to provide context for survey responses by drawing on the academic literature and the experiences of the FDIC.

The majority of the 37 insurers that responded to the risk-assessment section of the survey are located in Europe. Ten of the 37 respondents—Austria, Belgium, Canada, France, Germany, Italy,

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[1] The financial safety net may be broadly defined as government support of private sector borrowers through explicit and implicit guarantees and other means (Walter and Weinberg (2002)). Defined in this way, the financial safety net extends to both financial and nonfinancial businesses. This article, however, defines the financial safety net more narrowly as the deposit insurance system for banks and thrift institutions.

[2] Austria, Germany, and Italy have multiple deposit insurers. Not every question was answered by every respondent, so for each question there may have been fewer than 37 responses.

[3] Bennett (2001).

Japan, the Netherlands, Spain, the United Kingdom—hold 62 percent of the world's banking assets and encompass 41 percent of the world's gross domestic product and 15.5 percent of the world's population. Comparable figures for the United States are 17.2 percent of the world's banking assets, 28.8 percent of the world's gross domestic product, and 4.6 percent of the world's population. Borrowing terms from the International Monetary Fund, we categorize the locations of the respondents as "advanced economies," "developing economies," or "economies in transition," but we combine the two categories of "developing economies" and "economies in transition" into one.[4]

In any business, potential creditors and equity shareholders cannot make sound investment decisions without accurate and timely information on the condition of, and risks to, the relevant business entities. This need for information creates incentives for the business entities to prepare and make public financial statements regularly. The availability and use of such information are necessary for markets to allocate financial resources efficiently; such allocation makes possible the market discipline that rewards good management and punishes bad management.

In banking, however, when countries extend a safety net to creditors of financial institutions, the information needs of some creditors are greatly reduced. More specifically, insured depositors, who make up the vast majority of the creditors of most insured banks and thrifts in the United States, have little incentive to monitor the risks of insured depositories (henceforth, "banks").[5] But this need for information is not eliminated. Rather, it is transferred to the deposit insurer, which stands in place of insured depositors among banks' creditors when banks fail.[6]

Regardless of how countries organize their financial system safety nets, therefore, it is clear that the government agencies responsible for managing the safety net need accurate and timely information on the condition of, and risks to, the financial institutions to which the safety net extends. That information can come from on-site inspections of banks and off-site analyses of the financial statements that banks make available to government authorities and the public.[7] In addition, the responsible agencies must be able to place the information on banks in its proper economic and political context. Thus, they require information about the markets (local, national, and international economic conditions) in which banks operate and about the legislative and other political developments affecting the environment in which banks compete. All the information about banks, their markets, and their competitive environment enables risk managers to take the next step in the process of assessing banks' financial health, which is to forecast bank failures. Finally, the responsible government agencies must also be concerned with limiting the deposit insurer's own risk exposure—for example, by terminating deposit insurance or by closing failed and failing banks. (As mentioned above, closing failed or failing banks is discussed in the first article in the series, and the availability of resources when losses are unavoidable is the subject of the next article.)

Accordingly, the risk-assessment section of the survey asked whether the deposit insurance organization has access to examination and accounting information about banks, how information about economic trends is used, whether legislative or other political developments are monitored, whether the health of insured depository institutions is assessed and whether bank failures are forecasted, and whether deposit insurance is

[4] Table 1 lists the survey respondents in their respective categories.

[5] Should a bank fail, insured depositors typically receive full compensation for their insured deposits from the FDIC within one to two business days. However, they still face the risk of having to re-deposit their funds in banks that offer lower interest rates or charge higher service costs or do both.

[6] To the extent that the deposit insurer (or another government authority) has other "safety-net" duties aside from meeting insured depositors' claims, it might have additional needs for information. The additional duties that entail additional needs for information include selecting failure-resolution methods, acting as receiver and liquidator of failed banks, supervising banks for safety and soundness, pricing deposit insurance, and managing the insurance fund. Those and other additional duties are not discussed in this article.

Countering these demands for financial disclosure is banks' need to shield their proprietary information from competitors and to protect any proprietary information that they require their customers to disclose. In addition, the costs and burdens of providing information limit the extent to which it is feasible to disclose information to financial markets and government authorities.

[7] Research on U.S. banks suggests that bank safety-and-soundness examinations (discussed below) provide some important auditing functions that private sector auditors do not seem to provide; see Dahl, Hanweck, and O'Keefe (1998).

Table 1

Survey Respondents, Summary Statistics, 1999

Deposit Insurer	Population: Total Population (millions)	Population: Share of World Population (percent)	GDP: Total GDP (US$ millions)	GDP: Share of World GDP (percent)	Banking Industry: Number of Banks	Banking Industry: Banking Assets (US$ billions)	Banking Industry: Share of World Banking Assets (percent)
Advanced Economies							
Austria	8.18	0.14%	$ 208,949	0.69%	844	$ 608.3	1.32%
Belgium	10.15	0.17	245,706	0.81	84	938.1	2.03
Canada	30.49	0.52	612,049	2.03	112	584.6	1.27
France	59.10	1.01	1,410,262	4.67	328	3,506.3	7.59
Germany	82.09	1.40	2,081,202	6.89	2,517	6,877.7	14.89
Greece	10.63	0.18	123,934	0.41	28	82.1	0.18
Isle of Man[a]	0.08	0.00	985	0.00	49	n.a.	n.a.
Italy	57.34	0.98	1,149,958	3.81	363	2,263.2	4.90
Japan	126.51	2.15	4,395,083	14.55	177	7,620.0	16.50
Netherlands	15.81	0.27	384,766	1.27	80	1,328.5	2.88
Portugal	9.96	0.17	107,716	0.36	50	334.2	0.72
Spain	39.42	0.67	562,245	1.86	154	1,470.1	3.18
Sweden	8.86	0.15	226,338	0.75	40	260.1	0.56
Taiwan Province of China	22.00	0.37	362,000	1.20	49	n.a.	n.a.
United Kingdom	58.74	1.00	1,373,612	4.55	302	3,628.3	7.86
Subtotal	539.36	9.18%	$13,244,805	43.85%	5,177	>$29,501.5	>63.88%
Developing Economies and Economies in Transition							
Africa							
Nigeria	108.95	1.85	43,286	0.14	81	9.5	0.02
Tanzania	32.79	0.56	8,777	0.03	10	1.3	0.00
Uganda	21.62	0.37	6,349	0.02	21	0.9	0.00
Europe							
Czech Republic	10.28	0.17	56,379	0.19	36	84.5	0.18
Hungary	10.07	0.17	48,355	0.16	46	26.7	0.06
Latvia	2.43	0.04	6,664	0.02	25	3.2	0.01
Lithuania	3.66	0.06	10,454	0.03	11	2.7	0.01
Poland	38.65	0.66	154,146	0.51	87	76.2	0.17
Romania	22.46	0.38	33,750	0.11	18	8.0	0.02
Slovak Republic	5.40	0.09	19,307	0.06	25	15.6	0.03
Turkey	64.39	1.10	188,374	0.62	67	96.2	0.21
Middle East							
Bahrain	0.67	0.01	5,350	0.02	36	8.1	0.02
Oman	2.46	0.04	14,962	0.05	18	9.4	0.02
Western Hemisphere							
Brazil	163.95	2.79	760,345	2.52	208	286.5	0.62
El Salvador	6.15	0.10	12,229	0.04	18	7.6	0.02
Jamaica	2.56	0.04	6,134	0.02	16	4.1	0.01
Mexico	97.37	1.66	474,951	1.57	63	202.7	0.44
Peru	25.23	0.43	57,318	0.19	20	20.4	0.04
Trinidad and Tobago	1.29	0.02	6,998	0.02	17	3.7	0.01
Subtotal	620.38	10.54%	$ 1,914,128	6.34%	823	$ 867.3	1.88%
Total	1,159.74	19.72	15,158,933	50.18	6,000	>30,368.8	>65.77
United States	273.13	4.65	8,708,870	28.83	8,907	7,956.9	17.23
World	5,879.00	100.00%	$30,211,993	100.00%	n.a.	$46,177.5	100.00%

Note:

Population–1999 midyear estimates. *Source:* International Monetary Fund (June 2000), *International Financial Statistics*. Taiwan Province of China and Isle of Man statistics from CIA (1999), *World Factbook*.

GDP–1999. *Source:* World Bank, 2000, Development Indicators. Taiwan Province of China and Isle of Man statistics are 1998 estimates from CIA (1999), *World Factbook*.

Banking Industry–Number of banks. *Source:* Thomson Bank Directory (2000), Thomson Financial Publishing. Banking assets as of 1999: International Monetary Fund (June 2000), *International Financial Statistics* (bank assets are summations of lines 20 through 22 in the International Financial Statistics, converted to December 1999 U.S. dollars). World total does not include Afghanistan, Dem. Rep. of Congo, People's Dem. Rep. of Yemen, St. Pierre & Miquelon, and Vietnam. December 1999 data were not available for Djibouti, Greece, Guinea, Republic of Yemen, so data from second-quarter 1998 were used.

[a]British Crown Dependency.

revocable. Survey results for each of those topics are presented below, preceded in each case by a discussion of important issues and an outline of the FDIC's practice.

Information on Banks' Condition and Riskiness

In the United States, information on banks' condition and riskiness comes from two sources: on-site examinations and off-site analysis of banks' financial statements (accounting information).

Access to Examination Information

The purpose of examining banks in the United States is to assess an institution's overall financial condition, review management practices and policies, monitor adherence with banking laws and regulations, review internal control systems, identify risks, and uncover fraud or insider abuse. The FDIC's safety-and-soundness examinations consist of three-parts: pre-examination planning, on-site examination, and completion of the report of examination. Pre-examination planning takes place off-site at the field office, where the examiner-in-charge completes an analysis and review of the institution, contacts the institution for financial records, and develops an examination work plan. During this stage, the examiner-in-charge decides on areas that need special attention and on the work that will be done first; these decisions will make for an efficient and orderly examination. The examiner-in-charge also notifies the institution of the date when the examination team will be visiting the bank, typically within the next two weeks. This interval allows the institution enough time to respond to any pre-examination requests for information.

Once the examination team enters the institution, the examiners concentrate on the institution's asset quality, financial condition, and operations. The examination team also evaluates the institution's adherence to banking laws and regulations, the adequacy of the institution's internal controls and procedures, and the capability of management reporting systems to provide reliable and accurate data.

In 2001, the FDIC employed 1,500 safety-and-soundness examiners to examine 2,640 banks on a schedule mandated by the Federal Deposit Insurance Act: healthy, small institutions (those with a composite examination rating of 1 or 2 and less than $250 million in assets) must be examined every 18 months, and all larger institutions, as well as those small institutions whose composite examination rating is 3, 4, or 5, must be examined every 12 months.[8] The FDIC conducts examinations of all the banks for which it is the primary regulator, that is, FDIC-insured state-chartered banks that are not members of the Federal Reserve System. In most cases involving well-managed institutions, however, the FDIC alternates examinations with the respective state authorities and has entered into agreements with the state banking departments governing the manner in which examination responsibilities are shared.

For institutions of which the FDIC is the primary regulator, therefore, the FDIC determines firsthand if they are in the "problem" category. For institutions whose primary regulator is another agency—that is, for national banks, state-chartered banks that are members of the Federal Reserve System, and savings associations—the FDIC relies on the examinations conducted by other regulators to determine a bank's overall condition and the risks posed to the deposit insurance fund.[9] The FDIC is in close contact with the other regulatory agencies and is constantly aware

[8] All federal and state bank examiners use a rating system that focuses on six *components* of the on-site examination findings: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Each of those components is rated. At the end of the examination, the overall condition of the institution is evaluated and a *composite* rating from 1 to 5 is determined. An institution performing well above average receives a composite rating of 1 (the best rating), and an institution in severe financial difficulties with a strong probability of failure within 12 months receives a composite rating of 5 (the worst rating).

[9] Garcia ((2001), 51) states that a deposit insurance agency "should be able to request the [relevant] supervisor to undertake a special examination of any insured financial institution that [the deposit insurance agency] feels may be in financial difficulties. Whether [the deposit insurance agency] staff should be able to participate in onsite inspections would vary from country to country."

of their examination activities. Through its case manager program, the FDIC monitors non-FDIC-supervised banks, and the case managers are responsible for sharing information with other regulators. Thus, whether by direct examination or by monitoring and sharing information, the FDIC compiles information, including examination reports, on all insured banks. Interagency agreements and statements of policy encourage the process of sharing information. In 1997, the FDIC issued a policy statement that outlines a program for sharing examination findings and establishes guidelines for resolving differences in examination findings between federal regulators.

In addition, the FDIC has special backup examination authority for the institutions of which it is not the primary regulator, and in early 2002 the federal banking regulators agreed to a process for determining when the FDIC would use its backup examination authority. Its backup activities generally take the form of participation in the examinations conducted by the primary federal regulator or the state authority, or attendance at meetings where the findings of an examination are discussed. The FDIC's participation in such activities usually involves assessing the potential risk the particular institution may pose to the deposit insurance fund.

The report of examination—the third part of the examination process—factually presents the bank's condition, identifies problems, provides management with suggestions and recommendations, and discloses the examination ratings. The report of examination, in other words, documents the results of the examination and the basis on which the composite rating was determined. This report is a confidential document shared only with the institution's senior management and board of directors, and its contents can be disclosed only with the FDIC's authorization.

Of the 37 deposit insurers that responded to the survey, 19 answered "Yes" to the following question: *On a regular basis, do you collect or have access to the report of examination from individual insured depository institutions?* (See Table 2.) Of the 19 replying yes, 10 were in advanced economies and 9 were in developing economies and economies in transition. Only 2 of the 19 receive less than the full report of examination.

Access to Accounting Information

Demirgiic-Kunt and Kane, offering advice to countries that are considering adopting deposit insurance systems, write that ". . . upgrading accounting and disclosure rules so that accurate information reaches the markets in a timely fashion [exempliflies] the kinds of institution reforms that improve incentive structures and limit excess risk-taking."[10] To the extent that bank creditors are not covered by deposit insurance and therefore seek to exert market discipline, accurate disclosure of financial information can serve to control excessive risk taking by banks. Besides uninsured bank creditors, the deposit insurer that stands in the place of insured creditors also relies on accurate financial disclosure to manage the insurance system and limit risks to that system.

U.S. banks are required to file reports of income and condition with their primary federal bank regulator on a quarterly basis. These reports contain detailed balance-sheet and income-statement information, as well as a great deal of supporting financial information. The financial reports are available to the public 75 days after the end of each quarter.[11] Net income, equity capital, and problem loans are readily ascertainable from these required quarterly reports, as are numerous financial statistics for individual banks and aggregate values. The FDIC publishes a summary of the quarterly financial results for FDIC-insured commercial banks and savings institutions in its *Quarterly Banking Profile*, each issue of which includes aggregate data on condition and income and on performance and condition ratios. The FDIC makes extensive use of these data in pre-examination planning, off-site monitoring programs, assessments of an institution's capital adequacy and financial strength, and economic research.

[10] Demirgüç-Kunt and Kane (2001), 25.

[11] Some reported information is made available only to bank regulators and is not publicly disclosed.

Table 2

Report of Examination

Deposit Insurer	On a regular basis, do you collect or have access to the report of examination from individual insured depository institutions? Yes	No	Do you receive less than the full report of examination? Yes	No
Advanced Economies				
Austria (AAR)	X			X
Austria (AABB)	X			X
Belguim		X		X
Canada	X			X
France		X		
Germany (EdB)	X			X
Germany (E)	X			X
Greece		X		
Isle of Man[a]	X			X
Italy (IDPF)		X	X	
Italy (DPFCB)		X	X	
Japan		X		X
Netherlands	X			X
Portugal	X			
Spain		X		X
Sweden		X		X
Taiwan Province of China	X			X
United Kingdom	X			
Subtotal	10	8	2	12
Developing Economies and Economies in Transition				
Africa				
Nigeria	X			
Tanzania	X			X
Uganda	X		X	
Europe				
Czech Republic		X		X
Hungary		X		X
Latvia		X		X
Lithuania		X		X
Poland		X	X	
Romania		X		X
Slovak Republic		X	X	
Turkey		X		
Middle East				
Bahrain		X		X
Oman	X			X
Western Hempishere				
Brazil	X		X	
El Salvador	X			X
Jamaica	X			X
Mexico	X			X
Peru	X			X
Trinidad and Tobago		X		
Subtotal	9	10	4	12
Total	19	18	6	24

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

[a] British Crown Dependency.

AAR = Association of Austrian Raiffesenbanks
AABB = Association of Austrian Banks and Bankers
EdB = Entschadigungseinrichtung deutscher Banken
E = Einlagensicherungs
IDPF = Interbank Deposit Protection Fund
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The data are also publicly available at the FDIC's Web site through two products: *Institution Directory* and *Statistics on Depository Institutions*. The *Institution Directory* provides a comprehensive financial profile of each FDIC-insured bank, and the *Statistics on Depository Institutions* provide detailed financial reports that enable the user to analyze the banking industry. The user can create reports containing customized peer groups of FDIC-insured banks and bank holding companies. Demographic data are available, along with an institution's most-recent quarterly financial statement and performance ratios.

Most insurers that responded to the survey regularly receive balance-sheet and income data from banks. Of the 37 respondents to the following survey question, 27 replied "Yes": *On a regular basis, do you collect or have access to regularly reported balance-sheet and income data from individual insured depository institutions?* (See Table 3.) Of those replying yes, 13 were in advanced economies and 14 were in developing economies and economies in transition.

Effective March 31, 1997, generally accepted accounting principles (GAAP) were adopted as the reporting basis for the balance sheet, income statement, and supporting schedules for U.S. banks. According to Garcia, "Internationally accepted accounting and auditing standards will facilitate realistic loan valuations and empower market discipline."[12] Of the 26 respondents to the following survey question, 21 answered "Yes": *Do these data [balance sheet, etc.] meet internationally accepted accounting standards?* (See Table 4.) Of the 21 that answered yes to the question, 10 operate in advanced economies and 11 in developing economies and economies in transition.[13]

The survey also queried deposit insurers about their ability to determine net income, equity capital, and troubled loans. The FDIC is able to determine these values for all FDIC-insured banks on a quarterly basis, and most foreign deposit insurers are able to determine them as well. Of the 26 respondents to the following survey question, 23 answered "Yes": *Do these data allow you to accurately determine the insured depository institution's net income?* (See Table 5.) Of the 23 that answered yes, 10 operate in advanced economies and 13 in developing economies and economies in transition. Of the 26 respondents to the following survey question, 24 answered "Yes": *Do these data allow you to calculate an accurate level of the insured depository institution's equity capital or surplus?* (See Table 6.) Of the 24 that answered yes, 10 operate in advanced economies and 14 in developing economies and economies in transition. Of the 25 respondents to the following survey question, 18 answered "Yes": *Do these data include the amount of the insured depository institution's troubled or past-due loans?* (See Table 7.) Of the 18 that answered yes, 8 operate in advanced economies and 10 in developing economies and economies in transition.

Information on the Economic and Political Contexts

Obtaining accurate and timely information on banks is the first step for risk assessment. The second step is understanding that information in the economic and political contexts of bank operations. The goal, of course, is to use that information in a systematic way that permits one to assess the health of insured depository institutions.

Analysis of Local, National, and International Economic Trends

The nonfinancial and financial segments of the economy are interdependent. On the one hand, consumers and businesses—the nonfinancial segments—rely on financial intermediaries and direct credit markets to finance expenditures; financial intermediaries support the payments system; and a significant increase in the cost of credit or in the non-price rationing of credit can adversely affect the financial condition of consumers and business-

[12] Garcia (2001), 19.

[13] Significant differences exist between U.S. generally accepted accounting standards and internationally accepted accounting standards. The U.S. Securities and Exchange Commission requires financial statements that were prepared in accordance with international accounting standards to be reconciled with the U.S. GAAP.

Table 3

Accounting Information

Deposit Insurer	On a regular basis, do you collect or have access to regularly reported balance-sheet and income data? If yes, how frequently are these data reported?		
	Yes	No	Frequency
Advanced Economies			
Austria (AAR)	X		Four per year
Austria (AABB)	X		Monthly or quarterly plus annual report
Belguim	X		Annually
Canada	X		Varies
France		X	
Germany (EdB)	X		
Germany (E)	X		
Greece		X	
Isle of Man[a]	X		Quarterly Banking Returns
Italy (IDPF)	X		Semiannually for banks in Order; quarterly for banks in "watch"
Italy (DPFCB)	X		Semiannually for Cooperative Banks; quarterly for banks in "watch"
Japan		X	
Netherlands	X		Monthly balance-sheet data; yearly income data
Portugal	X		Average amount of monthly credit balances is reported annually
Spain		X	
Sweden		X	
Taiwan Province of China	X		Quarterly
United Kingdom	X		Annual Report and Accounts
Subtotal	13	5	
Developing Economies and Economies in Transition			
Africa			
Nigeria	X		Varies
Tanzania	X		Monthly
Uganda	X		Monthly balance sheets, quarterly statements, annual final accounts
Europe			
Czech Republic		X	
Hungary	X		Quarterly
Latvia		X	
Lithuania	X		Quarterly
Poland	X		Monthly, quarterly
Romania		X	
Slovak Republic		X	
Turkey	X		Quarterly
Middle East			
Bahrain		X	
Oman	X		Quarterly
Western Hempishere			
Brazil	X		Monthly
El Salvador	X		Monthly
Jamaica	X		Monthly balance-sheet data; quarterly income data
Mexico	X		Quarterly
Peru	X		Monthly
Trinidad and Tobago	X		Published Annual Reports
Subtotal	14	5	
Total	27	10	

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

[a] British Crown Dependency.

AAR = Association of Austrian Raiffesenbanks

AABB = Association of Austrian Banks and Bankers

EdB = Entschadigungseinrichtung deutscher Banken

E = Einlagensicherungs

IDPF = Interbank Deposit Protection Fund

DPFCB = Deposit Protection Fund for Co-operative Banks

Table 4

Accounting Standards

Deposit Insurer	Do these data [balance sheet, etc.] meet internationally accepted accounting standards? Yes	No
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)	X	
Belguim		X
Canada	X	
France		
Germany (EdB)	X	
Germany (E)	X	
Greece		
Isle of Man[a]	X	
Italy (IDPF)	X	
Italy (DPFCB)	X	
Japan		
Netherlands	X	
Portugal		X
Spain		
Sweden		
Taiwan Province of China	X	
United Kingdom		
Subtotal	10	2
Developing Economies and Economies in Transition		
Africa		
Nigeria	X	
Tanzania	X	
Uganda	X	
Europe		
Czech Republic		
Hungary	X	
Latvia		
Lithuania	X	
Poland	X	
Romania		
Slovak Republic		
Turkey		X
Middle East		
Bahrain		
Oman	X	
Western Hempishere		
Brazil	X	
El Salvador		X
Jamaica	X	
Mexico		X
Peru	X	
Trinidad and Tobago	X	
Subtotal	11	3
Total	21	5

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

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Table 5

Net Income

Deposit Insurer	Do these data allow you to accurately determine the insured depository institution's net income? Yes	No
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)		X
Belguim	X	
Canada	X	
France		
Germany (EdB)	X	
Germany (E)	X	
Greece		
Isle of Man[a]	X	
Italy (IDPF)	X	
Italy (DPFCB)	X	
Japan		
Netherlands	X	
Portugal		X
Spain		
Sweden		
Taiwan Province of China	X	
United Kingdom		
Subtotal	10	2
Developing Economies and Economies in Transition		
Africa		
Nigeria	X	
Tanzania	X	
Uganda	X	
Europe		
Czech Republic		
Hungary	X	
Latvia		
Lithuania	X	
Poland	X	
Romania		
Slovak Republic		
Turkey	X	
Middle East		
Bahrain		
Oman	X	
Western Hempishere		
Brazil	X	
El Salvador	X	
Jamaica		X
Mexico	X	
Peru	X	
Trinidad and Tobago	X	
Subtotal	13	1
Total	23	3

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

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IDPF = Interbank Deposit Protection Fund

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Table 6

Equity Capital or Surplus

Deposit Insurer	Do these data allow you to calculate an accurate level of the insured depository institution's equity capital or surplus? Yes	No
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)	X	
Belguim		X
Canada	X	
France		
Germany (EdB)	X	
Germany (E)	X	
Greece		
Isle of Man[a]	X	
Italy (IDPF)	X	
Italy (DPFCB)	X	
Japan		
Netherlands	X	
Portugal		X
Spain		
Sweden		
Taiwan Province of China	X	
United Kingdom		
Subtotal	10	2
Developing Economies and Economies in Transition		
Africa		
Nigeria	X	
Tanzania	X	
Uganda	X	
Europe		
Czech Republic		
Hungary	X	
Latvia		
Lithuania	X	
Poland	X	
Romania		
Slovak Republic		
Turkey	X	
Middle East		
Bahrain		
Oman	X	
Western Hempishere		
Brazil	X	
El Salvador	X	
Jamaica	X	
Mexico	X	
Peru	X	
Trinidad and Tobago	X	
Subtotal	14	0
Total	24	2

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

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Table 7

Troubled or Past-Due Loans

Deposit Insurer	Do these data include the amount of the insured depository institution's troubled or past-due loans? Yes	No
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)	X	
Belguim		X
Canada	X	
France		
Germany (EdB)		X
Germany (E)		X
Greece		
Isle of Man[a]	X	
Italy (IDPF)	X	
Italy (DPFCB)	X	
Japan		
Netherlands	X	
Portugal		X
Spain		
Sweden		
Taiwan Province of China	X	
United Kingdom		
Subtotal	8	4
Developing Economies and Economies in Transition		
Africa		
Nigeria	X	
Tanzania	X	
Uganda	X	
Europe		
Czech Republic		
Hungary		X
Latvia		
Lithuania	X	
Poland	X	
Romania		
Slovak Republic		
Turkey	X	
Middle East		
Bahrain		
Oman		
Western Hempishere		
Brazil		X
El Salvador	X	
Jamaica		X
Mexico	X	
Peru	X	
Trinidad and Tobago	X	
Subtotal	10	3
Total	18	7

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

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es, as can a serious disruption of the payments system. On the other hand, national and regional economic recessions and declines in sectors of the economy (for example, agriculture, real estate, or other commodity or service markets) can negatively affect the financial segment by impairing borrowers' ability to repay loans, thus causing lenders' financial condition to deteriorate. Similar concerns apply to international markets, given the importance of foreign trade and finance to sectors of the domestic economy. For these reasons, deposit insurers might have an interest in monitoring local, national, and international economic trends. Moreover, deposit insurers might be interested in how those trends could affect banks.

In 1995, the FDIC took steps to more actively address market trends and emerging risks before they become problems for banks.[14] From the unique perspective of the deposit insurer, the FDIC began to analyze more closely the risks to the deposit insurance fund and translated this analysis into guidance for examiners and bankers. Developing a dynamic approach that combined traditional examination methods and new initiatives, the FDIC sought to (1) identify major problems, national or regional, that might threaten the viability of the bank insurance fund, and (2) mitigate the adverse effects that future events might have on the financial health of banks.

The FDIC continues to assess local, national, and international economic trends to determine their implications for banks and for the deposit insurance fund. The FDIC identifies and monitors existing and emerging risks and translates this information into specific and useful guidance for its examination workforce. The FDIC's analysts work closely with examiners, providing comprehensive regional economic data and analyses to help them assess emerging risk exposures for individual banks and groups of banks.

The FDIC also employs subject-matter experts who collect and analyze data and monitor economic and financial risks. These subject-matter experts study many areas, including the global economy and country exposures, the domestic economy, industry sectors, capital markets, underwriting standards, and commercial real estate. This information is published in numerous reports and surveys that are available to bankers, the public, and government oversight groups.

The majority of the deposit insurers surveyed do not regularly assess local, national, and international economic trends. Of the 37 respondents to the following question, 14 answered "Yes": *Do you regularly assess local, national, and international economic trends to determine their implications for insured depository institutions?* (See Table 8.) Of the 14 that answered yes, 6 operate in advanced economies and 8 in developing economies and economies in transition.

Analysis of Legislative and Other Political Developments

The legal and political environment in which banks operate can influence their financial condition indirectly and directly. In the United States, changes in federal and state laws in areas that have a direct influence on consumers and businesses can affect banks indirectly. For example, a change in federal tax law on real estate investments in 1986 was one factor that contributed to the decline in real estate markets in the late 1980s, and this decline in turn contributed to the subsequent failures of banks with large loan concentrations in commercial real estate development.[15] Alternatively, regulation of banking activities is often used as a direct means of promoting the health and stability of the banking industry. For example, regulatory capital requirements are defined in terms of minimum capitalization standards for safe and sound banks, and banks that are not safe and sound have higher capital requirements.

The FDIC's Office of Legislative Affairs interacts with Congress and publishes a weekly report

[14] FDIC (1995), 31.

[15] FDIC (1997), 1:140–41.

Table 8

Economic Trends

Deposit Insurer	Do you regularly assess local, national, and international economic trends to determine their implications for insured depository institutions? Yes	No
Advanced Economies		
Austria (AAR)		X
Austria (AABB)		X
Belguim		X
Canada	X	
France		X
Germany (EdB)		X
Germany (E)	X	
Greece		X
Isle of Man[a]	X	
Italy (IDPF)		X
Italy (DPFCB)	X	
Japan		X
Netherlands	X	
Portugal	X	
Spain		X
Sweden		X
Taiwan Province of China		X
United Kingdom		X
Subtotal	6	12
Developing Economies and Economies in Transition		
Africa		
Nigeria		X
Tanzania	X	
Uganda	X	
Europe		
Czech Republic		X
Hungary	X	
Latvia		X
Lithuania		X
Poland	X	
Romania		X
Slovak Republic		X
Turkey		X
Middle East		
Bahrain		X
Oman	X	
Western Hempishere		
Brazil		X
El Salvador		X
Jamaica	X	
Mexico	X	
Peru		X
Trinidad and Tobago	X	
Subtotal	8	11
Total	14	23

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

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describing current congressional activities affecting banks. The FDIC's Chairman frequently testifies about topics of concern to Congress, especially topics important for congressional oversight of the FDIC.

The responses to the survey of deposit insurers indicate that a majority of respondents monitor legislative or other political developments. Of the 37 deposit insurers that responded to the following survey question, 33 answered "Yes": *Do you routinely monitor legislative or other political developments that may have implications for insured depository institutions?* (See Table 9.) Of the 33 that answered yes, 15 operate in advanced economies and 18 in developing economies and economies in transition.

Use of Information to Forecast Potential Failures

As mentioned above, risk management assumes that the goal of collecting and analyzing information is to assess the health of insured depository institutions.[16] A subset of assessing health is forecasting potential failures, for it is inevitable that some banks will fail. Between 1980 and 1994 the United States saw the failure of more than 1,600 FDIC-insured banks, holding $206 billion in assets and constituting 9 percent of the assets of all U.S. insured depository institutions.[17] In 1988 the FDIC suffered its first operating-income loss; the losses continued through 1991, totaling $25.3 billion for the four-year period.[18]

The FDIC is, however, responsible (but not solely) for minimizing the financial cost of bank failures, and one way to do this is to identify financially troubled banks and intervene before failure occurs. Thus, using examination and financial data and off-site monitoring programs and systems

[16] Many of the survey respondents are able to assess the health of insured depository institutions. Of the 35 respondents to the following survey question, 20 answered "Yes": *Do you use the data available to you to regularly assess the health of insured depository institutions?* (See Table 10.) Eleven of the "Yes" respondents operate in advanced economies and 9 in developing economies and economies in transition.

[17] FDIC (1997), 15.

[18] FDIC (2000a), 109.

Table 9

Legislative and Other Political Developments

Deposit Insurer	Do you routinely monitor legislative or other political developments that may have implications for insured depository insitutions? Yes	No
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)	X	
Belguim	X	
Canada	X	
France	X	
Germany (EdB)		X
Germany (E)	X	
Greece	X	
Isle of Man[a]	X	
Italy (IDPF)		X
Italy (DPFCB)	X	
Japan	X	
Netherlands	X	
Portugal	X	
Spain		X
Sweden	X	
Taiwan Province of China	X	
United Kingdom	X	
Subtotal	15	3
Developing Economies and Economies in Transition		
Africa		
Nigeria	X	
Tanzania	X	
Uganda	X	
Europe		
Czech Republic	X	
Hungary	X	
Latvia	X	
Lithuania	X	
Poland	X	
Romania	X	
Slovak Republic	X	
Turkey	X	
Middle East		
Bahrain	X	
Oman	X	
Western Hempishere		
Brazil	X	
El Salvador	X	
Jamaica	X	
Mexico	X	
Peru	X	
Trinidad and Tobago		X
Subtotal	18	1
Total	33	4

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

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Table 10

Assessment of Health of Institutions

Deposit Insurer	Do you use the data available to you to regularly assess the health of insured depository institutions? Yes	No
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)	X	
Belguim		X
Canada	X	
France		X
Germany (EdB)		X
Germany (E)	X	
Greece		X
Isle of Man[a]	X	
Italy (IDPF)	X	
Italy (DPFCB)	X	
Japan		X
Netherlands	X	
Portugal	X	
Spain		X
Sweden	X	
Taiwan Province of China	X	
United Kingdom		X
Subtotal	11	7
Developing Economies and Economies in Transition		
Africa		
Nigeria	X	
Tanzania	X	
Uganda	X	
Europe		
Czech Republic		
Hungary	X	
Latvia		X
Lithuania		X
Poland	X	
Romania	X	
Slovak Republic		X
Turkey		X
Middle East		
Bahrain		
Oman	X	
Western Hempishere		
Brazil		X
El Salvador	X	
Jamaica	X	
Mexico		X
Peru		X
Trinidad and Tobago		X
Subtotal	9	8
Total	20	15

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

[a] British Crown Dependency.

AAR = Association of Austrian Raiffesenbanks
AABB = Association of Austrian Banks and Bankers
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IDPF = Interbank Deposit Protection Fund
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to identify problem institutions, the FDIC's Financial Risk Committee meets quarterly to project the cost of bank failures that may occur in the next year. (Although the committee meets quarterly, failure projections are prepared more often than quarterly, and off-site monitoring is conducted continually.) The committee's primary function is to set a loss reserve for anticipated failures of FDIC-insured banks. The committee also identifies areas of risk to the industry, assesses the level of risk among banks, and meets with other federal banking regulators to discuss risk exposures, compare trends, and review adverse events to determine their implications for various approaches to risk.

If a country funds deposit insurance before failure losses are incurred, the insurer needs to forecast insurance losses and provide at a minimum for expected losses.[19] If the insurer has duties related to providing insurance—resolving failed banks, liquidating assets, and managing receiverships—failure forecasts might assist in planning for these other duties as well. If the insurer has duties not related to providing insurance—conducting monetary policy or fiscal policy or both—failure forecasts might be useful to the extent that failures would disrupt financial markets and the economy.[20]

Of the 37 respondents to the following survey question, 12 answered "Yes": *Do you have a committee or group that meets regularly whose mission is to forecast potential insured depository institution failures?* (See Table 11.) Of the 12 that answered yes, 6 operate in advanced economies and 6 oper-

[19] If deposit insurance is funded after failure losses are incurred, the insurer might still need to predict bank failures. If insurance losses are fully funded by the government, forecasts might be needed for government budget planning; and if insurance losses are fully funded by banks, banks might also need forecasts for budgetary reasons.

[20] The Federal Deposit Insurance Act has provisions to ensure that failure resolutions do not seriously disrupt financial markets and the economy. If written recommendations from the FDIC Board of Directors, the Board of Governors of the Federal Reserve System, and the secretary of the U.S. Department of the Treasury (in consultation with the president) indicate that the use of regular statutory (least-cost) failure-resolution procedures might have serious adverse effects on economic conditions or financial stability, a less-disruptive procedure must be used even if it increases the costs of resolution.

Table 11

Forecasting Failures

	Do you have a committee or group that meets regularly whose mission is to forecast potential insured depository institution failures?	
Deposit Insurer	**Yes**	**No**
Advanced Economies		
Austria (AAR)	X	
Austria (AABB)	X	
Belguim		X
Canada		X
France		X
Germany (EdB)		X
Germany (E)	X	
Greece		X
Isle of Man[a]	X	
Italy (IDPF)		X
Italy (DPFCB)	X	
Japan		X
Netherlands		X
Portugal		X
Spain		X
Sweden		X
Taiwan Province of China	X	
United Kingdom		X
Subtotal	6	12
Developing Economies and Economies in Transition		
Africa		
Nigeria		X
Tanzania	X	
Uganda		X
Europe		
Czech Republic		X
Hungary		X
Latvia	X	
Lithuania		X
Poland		X
Romania		X
Slovak Republic		X
Turkey		X
Middle East		
Bahrain	X	
Oman	X	
Western Hempishere		
Brazil		X
El Salvador		X
Jamaica		X
Mexico	X	
Peru	X	
Trinidad and Tobago		X
Subtotal	6	13
Total	12	25

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

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ate in developing economies and economies in transition.

Procedures to Limit the Insurer's Risk Exposure: Terminating Deposit Insurance

Once potential failures are forecast, the question becomes whether the government authorities charged with managing the financial safety net can take active measures to limit the risks to which these failures will expose them. The primary means of preventing failures is to use bank regulation and supervision to promote safe and sound banking practices, but when those measures fail to rein in unsafe or unsound practices, more severe action is needed. Although such actions can take many forms, Garcia recommends "[giving] the supervisor a system of prompt remedial actions."[21]

The most serious remedial action available to the FDIC is to terminate deposit insurance. Because deposit insurance is so important to a bank's ability to attract deposits, termination of deposit insurance can effectively lead to a bank's closing. A proposal to terminate deposit insurance can be used as a remedial measure—a final attempt to encourage a bank's management to improve its financial condition and alter its banking practices, especially if bank management has previously not cooperated with supervisory officials. If the bank is unable to improve its financial condition, however, terminating deposit insurance can reduce failure-resolution costs.

Deposit insurance can be terminated in two ways: involuntarily (the FDIC initiates it) and voluntarily (the bank initiates it). The standard for involuntary termination of deposit insurance is high and involves either unsafe and unsound banking conditions or practices or violations of laws or regulations (for example, crimes of money laundering, engaging in monetary transactions in property derived from specific unlawful activities, and structuring transactions to evade reporting requirements). Involuntary termination of deposit insurance does not occur if (1) the financial institution will be closed within the next 90 days, (2) open-bank assistance is possible, or (3) the financial institution is actively seeking new capital.

Initially, the FDIC will notify the bank's primary regulator (and send a copy to the bank) of the facts and circumstances underlying the proposed termination and the specific corrective actions needed, and will state that corrections must occur in the next 30 days. If the bank does not correct the problems, the FDIC issues a notice of intent to terminate insured status. The notice gives the reasons for terminating insurance and lists a hearing date, which is usually within 120 days of the notice, although the applicable statute allows for a hearing date within 30 days of the notice.

If the bank contests the notice, an administrative law judge will hear the case (hearings are open to the public) and will decide whether the FDIC may proceed to terminate insurance. However, this decision is a recommendation, not a final ruling. The administrative law judge is not involved in the case after this hearing.

When terminating deposit insurance, the FDIC may issue a temporary order suspending insurance, usually within 10 days of the vote of the FDIC Board of Directors to terminate insurance. Temporary suspension of insurance addresses certain emergency situations that cannot wait for a formal hearing date, and an expedited hearing takes place as soon as possible. In these situations the FDIC must have evidence of either abnormal risk of loss or damage to the insurance fund. The temporary suspension order reduces the risk that the insurance fund will suffer losses while the procedures for a permanent order are being followed.

Banks have a right to judicial review of enforcement actions in the court of appeals. Unless the court of appeals or the FDIC Board of Directors changes the enforcement action, the FDIC will pursue its termination of deposit insurance. The FDIC will notify depositors that their deposits will

[21] Garcia (2001), 11.

remain insured for a certain period between six months and two years (the FDIC Board usually selects two years).

When a bank is notified that its deposit insurance will be terminated, the bank may ask to enter into two agreements with the FDIC—a settlement agreement and a procedure agreement. The settlement agreement states that if changes do not occur within a short, fixed period, the bank agrees to the termination order and waives its legal right to challenge the action. The procedure agreement clearly defines the changes referred to in the settlement agreement and the way in which depositors will be notified if insurance is terminated.

The FDIC is the only U.S. bank regulator with the authority to terminate federal deposit insurance. It uses this authority sparingly and, with respect to unsafe and unsound banking conditions or practices, only when a bank is unable to correct its financial problems. Garcia states that "the supervisor or the [deposit insurance agency] will have strong powers to deal in a strict manner with nonviable banks, terminate the interests of shareholders, and impose 'haircuts' on uninsured depositors and unsecured creditors."[22] The FDIC's authority to terminate deposit insurance is quite different from the authority of the deposit insurers that responded to the survey. Few deposit insurers outside the United States have the authority to revoke deposit insurance in cases in which an insured depository institution is operating in an unsafe and unsound manner. Of the 36 deposit insurers that responded to the following survey question, 11 answered "Yes": *Does the deposit insurer have the authority to revoke deposit insurance in cases where an insured depository institution is operating in an unsafe and unsound manner?* (See Table 12.) Of the 11 that answered yes, 7 operate in advanced economies and 4 in developing economies and economies in transition; only 2 of the respondents—both in advanced economies—had ever used this authority.

[22] Garcia (2001), 53. "Haircuts" is generally defined as full or partial losses on uninsured deposits when a bank fails.

Summary

The results of the survey indicate both similarities and differences between foreign deposit insurers and the FDIC. The similarities begin with access to information: one-half of the foreign deposit insurers that responded to the survey have access to reports of examination, and three-quarters regularly receive reported balance-sheet and income data. These financial data meet internationally accepted accounting standards; and most of the respondents are able to determine net income, equity capital, and troubled loans. Overwhelmingly the respondents follow legislative and other political developments. As a result, more than 50 percent of the respondents are able to assess the financial health of banks.

The differences mainly involve how information is used in risk assessment. Most deposit insurers that responded to the survey do not forecast potential bank failures nor do they follow economic trends. In addition, most respondents do not have the authority to terminate deposit insurance.

Table 12

Termination of Deposit Insurance

	Does the deposit insurer have the authority to revoke deposit insurance in cases where an insured depository institution is operating in an unsafe or unsound manner?		If yes, has this authority ever been used?	
Deposit Insurer	**Yes**	**No**	**Yes**	**No**
Advanced Economies				
Austria (AAR)		X		
Austria (AABB)		X		
Belguim		X		
Canada	X		X	
France		X		
Germany (EdB)		X		
Germany (E)	X			X
Greece	X			X
Isle of Man[a]	X			
Italy (IDPF)	X		X	
Italy (DPFCB)	X			X
Japan		X		
Netherlands		X		
Portugal		X		
Spain		X		
Sweden		X		
Taiwan Province of China	X			
United Kingdom		X		X
Subtotal	7	11	2	4
Developing Economies and Economies in Transition				
Africa				
Nigeria	X			X
Tanzania	X			X
Uganda		X		
Europe				
Czech Republic		X		
Hungary				
Latvia		X		
Lithuania	X			X
Poland		X		
Romania		X		
Slovak Republic		X		
Turkey		X		
Middle East				
Bahrain		X		
Oman	X			X
Western Hempishere				
Brazil		X		
El Salvador		X		
Jamaica		X		
Mexico		X		
Peru		X		
Trinidad and Tobago		X		
Subtotal	4	14	0	4
Total	11	25	2	8

Note: Classification of economies into "Advanced," "Developing," or "Economies in Transition" is from International Monetary Fund (2000). Deposit insurers without an "X" in either the Yes or No column did not answer the question on the survey or did not provide an answer that was easily categorized as yes or no.

[a] British Crown Dependency.

AAR = Association of Austrian Raiffesenbanks

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Recent Developments Affecting Depository Institutions

*by Lynne Montgomery**

REGULATORY AGENCY ACTIONS

Interagency Actions

Final Rule on Recourse Obligations and Residual Interests

On November 29, 2001, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) issued a final rule that changes their regulatory capital standards to address the treatment of recourse obligations, residual interests, and direct credit substitutes that expose banks, bank holding companies, and thrifts to credit risk. The final rule treats recourse obligations and direct credit substitutes more consistently than the agencies' current risk-based capital standards do; introduces a credit ratings–based approach to assigning risk weights within a securitization; and requires that, for certain types of residual interests that are not deducted from a bank's Tier 1 capital, capital must be set aside on a dollar-for-dollar basis. The new rule also limits the concentration of credit-enhancing interest-only strips—a form of residual interest that is commonly used in association with securitization of an asset pool—to 25 percent of an institution's Tier 1 capital. The excess will be deducted from Tier 1 capital. The risk-based capital treatment for recourse obligations, direct credit substitutes, and qualifying residual interests is determined by the application of a ratings-based methodology. For all three of these instruments, a risk weight ranging from 20 percent to 200 percent is assigned, depending on the particular instrument's ratings grade. The instruments rated one category below investment grade (BB) are subject to a 200 percent risk weight, whereas those rated AAA or AA receive a more favorable 20 percent risk weight. The new rule also allows an institution to use either its own internal risk-rating system or a qualifying rating-agency program to determine the capital requirements for some unrated recourse obligations and direct credit substitutes. The new rule was effective for covered transactions that settled on or after January 1, 2002. *BBR, 10/29/01, pp. 672–73; FR, Vol. 66, No. 230, pp. 59613–67; PR-82-2001, FDIC, 11/29/01.*

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Reference sources: *American Banker* (AB), *BNA's Banking Report* (BBR), and *Federal Register* (FR).

Final Rules on Regulatory Capital Treatment of Nonfinancial Equity Investments

On January 8, 2002, the FDIC, the FRB, and the OCC adopted final rules governing the regulatory capital treatment of equity investments in nonfinancial companies held by banks, bank holding companies, and financial holding companies. The new capital requirements apply symmetrically to equity investments that banks and their holding companies make in nonfinancial companies under the legal authorities specified in the final rules. Among others, these authorities include the merchant banking authority granted by the Gramm-Leach-Bliley Act and the authority to invest in small business investment companies (SBICs) granted by the Small Business Investment Act. Covered equity investments are subject to a series of marginal Tier 1 capital charges, with the size of the charge increasing as the organization's level of concentration in equity investments increases. The highest marginal charge requires a 25 percent deduction from Tier 1 capital for covered investments that aggregate more than 25 percent of an organization's Tier 1 capital. Equity investments through SBICs will be exempt from the new charges to the extent that the aggregate investments do not exceed 15 percent of the banking organization's Tier 1 capital. The new charges do not apply to individual investments made by banking organizations before March 13, 2000; also exempted from coverage are grandfathered investments made by state banks under Section 24(f) of the Federal Deposit Insurance Act. The final rules became effective on April 1, 2002. *PR-2-2002, FDIC, 1/8/02.*

FDIC's Expanded Powers to Review Problem Banks

A new policy approved by the federal bank and thrift regulators on January 29, 2002, gives the FDIC more authority to conduct special examinations of troubled banks and thrift institutions that are viewed as a threat to the deposit insurance funds. The policy allows the FDIC to examine—without the express permission or invitation of the bank's primary federal supervisor—any institution that has a CAMELS composite rating of 3, 4, or 5 or is considered undercapitalized. Previously, if the FDIC wanted to examine a problem bank that it did not supervise, it had to get permission to do so from the bank's regulator. The policy also allows the FDIC to examine an institution that exhibits "material deteriorating conditions or other adverse developments regardless of current rating," provided the agency gets the primary supervisor's permission. The policy also includes a new exam program that creates a dedicated FDIC examiner for each of the eight largest banking companies. The dedicated examiner must be informed of all developments in the supervision of the banks and will be the main FDIC contact for the supervisory personnel of an institution's primary regulator. *AB, 1/30/02; BBR, 2/4/02, pp. 189–90.*

Publication of Agencies' Guide to Privacy of Information

On February 6, 2002, several federal agencies released a guide to help consumers make informed choices about whether to allow their personal financial information to be shared. "Privacy Choices for Your Personal Financial Information" guides consumers through the choices they face as a result of the privacy provisions of the Gramm-Leach-Bliley Act of 1999. Federal privacy laws give consumers the right to prevent, or "opt out" of, the sharing of their personal financial information. The guide explains the privacy notices that consumers receive from their banks and other financial companies, the choices consumers face, and consumers' right to opt out of information sharing. The agencies that issued the guide include the FDIC, the FRB, the OCC, the OTS, the National Credit Union Administration, the Commodity Futures Trading Commission, the Federal Trade Commission, and the Securities and Exchange Commission. The guide can be accessed at www.consumer.gov or at any of the federal agencies' Web sites. *PR-13-2002, FDIC, 2/6/02.*

Common Form for Charter and Federal Deposit Insurance Applications

On March 11, 2002, the FDIC, the OCC, and the OTS issued a uniform application form, the "Interagency Charter and Federal Deposit Insurance Application," which will be used by financial institutions to apply for a national bank or federal savings association charter or for federal deposit insurance. The new form is part of an ongoing effort by the regulatory agencies to simplify procedures, eliminate duplicative or outdated policies, and reduce the regulatory burden on financial institutions. *PR-31-2002, FDIC, 3/11/02.*

Lower Risk Weighting for Claims on Securities Firms

On April 9, 2002, the FDIC, the FRB, the OCC, and the OTS issued a final rule amending their risk-based capital standards for banks, bank holding companies, and savings associations to reduce the risk weight applied to claims on, or guaranteed by, qualifying securities firms. The final rule reduces the risk weight applied to certain claims on qualifying securities firms from 100 percent to 20 percent. In addition, consistent with the existing rules of the FRB and the OCC, the FDIC and the OTS amended their risk-based capital standards to permit a zero percent risk weight for certain claims on qualifying securities firms that are collateralized by cash or by securities issued or guaranteed by the U.S. government or by the central governments of the members of the Organization for Economic Cooperation and Development (OECD). The rule became effective on July 1, 2002. *PR-FRB, 4/9/02.*

Guidance on Risks of Parallel-Owned Banking Organizations

On April 23, 2002, the FDIC, the FRB, the OCC, and the OTS issued guidance on the potential risks of parallel-owned banking organizations. The guidance defines parallel ownership as direct or indirect control of both a U.S. depository institution and a foreign bank by one person or by a group of persons who are closely associated in their business dealings. The definition specifically excludes organizations controlled by companies that are governed by the Bank Holding Company Act or the Savings and Loan Holding Company Act. The guidance describes various risks that may be increased because of the structure of parallel-owned banking organizations (for example, engaging in transactions that prefer the foreign bank member of the group over the U.S. depository institution). The agencies will address these risks by coordinating their supervision of the U.S. banking operations of parallel-owned banking organizations and by enhancing communication and cooperation with foreign bank supervisors. *PR-46-2002, FDIC, 4/23/02; BBR, 4/29/02, p. 732.*

Rule on Branches Used for Deposit Production

On June 6, 2002, the FDIC, the FRB, and the OCC issued a joint final rule banning banks from establishing or acquiring a branch outside their home states primarily for the purpose of generating deposits. The rule implements a provision on out-of-state deposit production that was contained in Section 106 of the Gramm-Leach-Bliley Act of 1999 (GLBA). The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 had prohibited any bank from establishing or acquiring a branch outside of its home state for the purpose of generating deposits, and provided guidelines for determining whether such bank is reasonably helping to meet the credit needs of the communities served by the branch. Section 106 of the GLBA expanded the deposit prohibition to cover any branch of a bank that is controlled by an out-of-state holding company. The new rule became effective October 1, 2002. *PR-FRB, 6/5/02; BBR, 6/17/02, p. 1054.*

Federal Deposit Insurance Corporation

Swearing-in of Powell as Chairman

On August 29, 2001, Donald E. Powell was sworn in as the 18th Chairman of the FDIC. He began his banking career in 1963 with First Federal Savings & Loan of Amarillo, Amarillo, Texas.

Before joining the FDIC, Mr. Powell was president and CEO of The First National Bank of Amarillo, Amarillo, Texas. *PR-57-2001, FDIC, 8/29/01.*

Appointment of Reich as Vice Chairman

On November 15, 2002, John M. Reich was appointed Vice Chairman of the FDIC Board of Directors. Mr. Reich had been a Director of the FDIC since January 16, 2001, and served as Acting Chairman between Chairman Donna Tanoue's resignation in July 2001 and Chairman Powell's assumption of office in August 2001. Before joining the FDIC, Mr. Reich served for 12 years on the Washington staff of former U.S. Senator Connie Mack (R-FL), initially as deputy chief of staff and later as chief of staff. Mr. Reich also spent 23 years as a community banker in Illinois and Florida, the last ten years of which were as president and CEO of the National Bank of Sarasota, Sarasota, Florida. *PR-122-2002, FDIC, 11/15/02.*

Web Page for Database of Unclaimed Funds

The FDIC launched a Web site that allows users to search a database of unclaimed funds from failed financial institutions that were closed by a regulatory agency between January 1, 1989, and June 28, 1993, and for which the FDIC was appointed receiver. The FDIC holds unclaimed funds in two ways: as unclaimed insured deposits of active receiverships and as undeliverable dividend checks. An active receivership is a receivership that the FDIC is still managing—disposing of the assets and administering the liabilities. A dividend check is considered undeliverable when the depositor's address is incorrect or the check has never been cashed. The Web site provides depositors of failed institutions who have not already claimed their funds, or whose dividend checks have been returned to the FDIC as undeliverable, an opportunity to claim their funds. Detailed instructions for searching the database and claiming funds can be found at http://www2.fdic.gov/funds/index.asp. *PR-56-2001, FDIC, 8/27/01.*

Report on Underwriting Practices—April and October 2002

The April 2002 issue of the FDIC's semiannual *Report on Underwriting Practices* reported slight increases in the risks associated with current underwriting practices, loan portfolios, and loan administration at FDIC-supervised banks. The frequency of risky practices in all major lending categories rose at least slightly, and in two of the categories—construction lending and commercial real estate lending—increases in the frequency of risky underwriting practices were noteworthy. The April report includes surveys from 1,149 FDIC-supervised banks that were examined during the six months ending March 31, 2002. This survey of loan underwriting practices is aimed at providing an early warning of potential problems in underwriting practices at FDIC-supervised, state-chartered nonmember banks. The focus of the survey is threefold: material changes in underwriting standards for new loans, degree of risk in current practices, and specific aspects of the underwriting standards for new loans. *Report on Underwriting Practices, FDIC, April 2002.*

In the October 2002 issue of the report, the most noteworthy changes reported in underwriting practices were a slight increase in the credit risk of banks' loan portfolios and increases in the riskiness of agricultural and construction lending. The October 2002 issue includes surveys from 1,201 FDIC-supervised banks that were examined during the six months April 1, 2002, through September 30, 2002. *Report on Underwriting Practices, FDIC, October 2002.*

Real Estate Survey—July 2002

The July 2002 issue of the *Survey of Real Estate Trends* reported continued deterioration in the nation's real estate markets during the first six months of 2002, although the rate of deterioration was slower than in the last six months of 2001. Reports of market imbalance strongly emphasized oversupply in the commercial markets, while tight conditions continued to be noted in residential markets. The proportion of respondents who

described single-family markets as tight—33 percent—was double the figure for the previous six-month period, and both sales volumes and home sale prices were reported to be higher than six months earlier. Weakness in local office markets continued to be widespread, with 65 percent of respondents reporting a worsening in office market conditions. However, a majority reported a decrease in speculative office construction. Reports of oversupply in retail and industrial markets were somewhat more frequent than they had been six months earlier: in retail markets, excess supply was observed by 68 percent of respondents, up from 65 percent in the previous survey; in industrial markets, excess supply was observed by 64 percent of respondents, up from 58 percent. The July report summarized the opinions of 252 survey respondents, who consisted of FDIC senior examiners and asset managers as well as bank examiners of the Federal Reserve Banks, the OCC, and the OTS. *Survey of Real Estate Trends, FDIC, July 2002.*

Insurance Funds' Financial Results for First Three Quarters of 2002

The FDIC reported that the Bank Insurance Fund (BIF) had comprehensive income (net income plus/minus current-period unrealized gains/losses on available-for-sale securities) of $944 million for the nine months ending September 30, 2002, compared with income of $859 million for the same period in 2001. Although net income declined by $341 million compared with the previous year's amount, unrealized gains on available-for-sale securities increased by $426 million. The decline in net income resulted primarily from lower earnings on U.S. Treasury obligations and higher estimated losses for anticipated bank failures and litigation activity. As of September 30, 2002, the BIF balance was approximately $31.4 billion, up from $30.4 billion at year-end 2001. The BIF reserve ratio fell from 1.26 percent at December 31, 2001, to 1.23 percent (as amended) at March 31, 2002, as a result of a $75 billion increase in estimated insured deposits. The deposit growth resulted primarily from a reporting change in the quarterly Call Reports that provide the source data for estimating insured deposits. This was the first time since 1995 that the reserve ratio fell below the mandated designated reserve ratio of 1.25 percent. The reserve ratio climbed back up to 1.26 percent at June 30, 2002; the increase resulted from an increase in the BIF balance of $490 million in the second quarter of 2002, and a $3 billion decrease in the estimated insured deposits.

The Savings Association Insurance Fund (SAIF) reported comprehensive income of $651 million for the first three quarters of 2002, compared with $56 million for the same period in 2001. The increase in comprehensive income was due primarily to higher estimated losses in 2001 for actual and expected thrift failures. The SAIF's fund balance as of September 30, 2002, was $11.6 billion, up from $10.9 billion at year-end 2001. The SAIF reserve ratio held steady at 1.36 percent between December 31, 2001, and March 31, 2002, but then increased to 1.38 percent at June 30, 2002. *PR-113-2002, FDIC, 10/25/02.*

Bank Failures

Superior Bank, FSB, Hinsdale, Illinois, was closed by the OTS on July 27, 2001, and the FDIC was named conservator. Superior Bank had total assets of approximately $2.3 billion and total deposits of approximately $1.6 billion. The FDIC Board of Directors decided the least-cost alternative was to organize a new institution that would operate under FDIC control. The insured deposits and substantially all the assets of Superior Bank were transferred to Superior Federal, FSB (New Superior), which was chartered on July 27, 2001. As part of this transaction, the FDIC provided a $1.5 billion line of credit to New Superior to support continued banking operations. The FDIC also hired savings bank executive John D. Broderick to serve as president and chief executive officer of New Superior while the FDIC searched for a buyer. On October 31, 2001, the FDIC Board of Directors approved the sale of the branches and deposits of New Superior to Charter One Bank, FSB, Cleveland, Ohio. Charter One agreed to pay the FDIC a premium of $52.4 mil-

lion to assume $1.1 billion of the deposits and $45 million of the assets held by the FDIC in conservatorship. On December 10, 2001, the FDIC and the OTS reached a resolution with the holding companies of Superior Bank on all matters arising out of the operation and failure of Superior. Under the agreement, the holding companies and their owners admitted no liability and agreed to pay the FDIC $460 million and other consideration. On February 15, 2002, the FDIC sold the servicing rights and the residual interests in $3.7 billion of securitized subprime mortgage loans to a subsidiary of Bear Stearns & Company for $471 million. Superior Bank was the first failure of an institution insured by the SAIF—but the third failure of an FDIC-insured institution—in 2001. *PR-52-2001, FDIC, 7/27/01; PR-55-2001, FDIC, 8/20/01; BBR, 8/27/01, p. 336; PR-78-2001, FDIC, 10/31/01; AB, 2/27/02.*

Sinclair National Bank, Gravette, Arkansas, was closed by the OCC on September 7, 2001, and the FDIC was appointed receiver. Sinclair National had total assets of approximately $30.7 million and total deposits of approximately $25.7 million. Delta Trust & Bank, Parkdale, Arkansas, paid the FDIC a premium of $551,000 for the right to assume the insured deposits and to purchase $4.9 million of Sinclair National's assets. The FDIC retained the remaining $25.8 million in assets for later disposition. Sinclair National was the third failure of a BIF-insured bank—and the fourth failure of an FDIC-insured institution—in 2001. *PR-63-2001, FDIC, 9/7/01.*

On January 11, 2002, the OCC closed Hamilton Bank NA, Miami, Florida, and the FDIC was named receiver. Hamilton Bank had total assets of approximately $1.3 billion and total deposits of approximately $1.2 billion. Israel Discount Bank of New York, New York, New York, assumed all the insured deposits of three branches, and those branches remain open. Israel Discount Bank also assumed the insured transaction deposits (checking, savings, and money market accounts) of Hamiliton's other six branches, but the branches were closed. Israel Discount Bank also acquired a nominal amount of Hamilton's assets, which mainly consisted of cash. Hamilton was the first failure of a BIF-insured bank in 2002 and the first bank failure in Florida since September 1999. *PR-3-2002, FDIC, 1/11/02.*

The Texas Banking Commissioner on January 18, 2002, closed Bank of Sierra Blanca, Sierra Blanca, Texas, and the FDIC was named receiver. Bank of Sierra Blanca had total assets of approximately $10.8 million and total deposits of approximately $9.8 million. The Security State Bank of Pecos, Pecos, Texas, paid a premium of $218,000 to assume the insured deposits and to purchase $3.5 million of Bank of Sierra Blanca's assets. The FDIC retained the remaining assets for later disposition. This was the second failure of a BIF-insured institution in 2002 and the first bank failure in Texas since 1999. *PR-5-2002, FDIC, 1/18/02.*

On February 1, 2002, the Ohio Superintendent of Financial Institutions closed The Oakwood Deposit Bank Company, Oakwood, Ohio, and the FDIC was named receiver. The Oakwood Deposit Bank had total assets of approximately $72.3 million and total deposits of approximately $60 million. The State Bank and Trust Company, Defiance, Ohio, paid a premium of $4.1 million to receive the failed bank's insured deposits and to purchase certain assets, including cash, securities at market value, loans fully secured by deposits, and performing and not adversely classified loans. The FDIC retained the remaining assets for later disposition. This was the third failure of a BIF-insured institution in 2002. *PR-11-2002, FDIC, 2/4/02.*

The OCC closed NextBank NA, Phoenix, Arizona, on February 7, 2002, and the FDIC was appointed receiver. The OCC acted after finding that the bank was operating in an unsafe and unsound manner and had experienced a substantial dissipation of assets and earnings. The OCC also found that there was no reasonable prospect for the bank to become adequately capitalized without federal assistance. NextBank, an Internet-only bank, solicited only certificates of deposit of $100,000 or more and had no checking or savings accounts. NextBank had total assets of $700 million and total deposits of $554 million, of

which $29.4 million exceeded the federal deposit insurance limit. Since there were no bids for NextBank's deposits, the FDIC approved a payoff of the insured deposits. NextBank was the fourth failure of a BIF-insured institution in 2002 and the first bank failure in Arizona since 1992. *PR-16-2002, FDIC, 2/7/02.*

On March 1, 2002, the OCC closed Net First National Bank, Boca Raton, Florida, and the FDIC was named receiver. Net First had assets of approximately $35 million and total deposits of $31 million. Bank Leumi USA, New York, New York, paid the FDIC a premium of $4.55 million to assume the insured deposits of Net First and to purchase approximately $6 million of the failed bank's assets. The FDIC retained the remaining assets for later disposition. Net First was the fifth failure of a BIF-insured institution—and the second failure in Florida—in 2002. *PR-26-2002, FDIC, 3/1/02.*

New Century Bank, Shelby Township, Michigan, was closed on March 28, 2002, by the Michigan Commissioner of the Office of Financial and Insurance Services, and the FDIC was named receiver. New Century had total assets of $19 million and total deposits of $18 million. The FDIC approved a payoff of the insured deposits, since there were no bids for the bank's deposits. New Century was the sixth failure of a BIF-insured institution in 2002 and the first bank failure in Michigan since 1998. *PR-38-2002, FDIC, 3/28/02.*

On June 26, 2002, the Connecticut Bank of Commerce, Stamford, Connecticut, was closed by the Banking Commissioner of the Connecticut Department of Banking, and the FDIC was named receiver. The Connecticut Bank of Commerce had assets of approximately $399 million and insured deposits of $213 million. Hudson United Bank, Mahwah, New Jersey, paid the FDIC a premium of $17.3 million to assume the insured deposits and to purchase certain assets of the failed bank. The FDIC retained the remaining assets for later disposition. Connecticut Bank of Commerce was the seventh failure of a BIF-insured institution in 2002. *PR-74-2002, FDIC, 6/26/02; PR-80-2002, FDIC, 6/28/02.*

Universal Federal Savings Bank, Chicago, Illinois, was closed by the OTS on June 27, 2002, and the FDIC was named receiver. Universal Federal had total assets of approximately $52 million and insured deposits of $40 million. Chicago Community Bank, Chicago, Illinois, paid a premium of approximately $3.1 million to purchase the failed bank's insured deposits and certain assets. The FDIC retained the remaining assets for later disposition. Universal Federal was the first failure of a SAIF-insured institution—but the eighth failure of an FDIC-insured institution—in 2002. *PR-76-2002, FDIC, 6/27/02; PR-81-2002, FDIC, 6/28/02.*

AmTrade International Bank of Georgia, Atlanta, Georgia, was closed on September 30, 2002, by Georgia's Commissioner of Banking and Finance, and the FDIC was named receiver. AmTrade was chartered as an international trade bank; its administrative offices were in Atlanta, and its sole deposit-production office was in Miami, Florida. The bank had approximately $12 million in total assets and $10.2 million in total deposits. After receiving no bids for the bank's deposits, the FDIC approved a payoff of the insured deposits. AmTrade was the ninth failure of an FDIC-insured institution in 2002 and the first in Georgia since 2000. *PR-100-2002, FDIC, 9/30/02.*

On November 8, 2002, the FDIC closed Bank of Alamo, Alamo, Tennessee, and took possession of the bank in its capacity as receiver. Bank of Alamo had total assets of approximately $69.4 million and total deposits of $55.3 million. An estimated $6 million of deposits in approximately 200 accounts exceeded the federal deposit insurance limit. After receiving no acceptable bids for the bank's deposits, the FDIC approved a payoff of the insured deposits. This was the tenth failure of an FDIC-insured institution in 2002. *PR-120-2002, FDIC, 11/8/02.*

The Farmers Bank & Trust of Cheneyville, Cheneyville, Louisiana, was closed by the Louisiana Commissioner of Financial Institutions on December 17, 2002, and the FDIC was named receiver. Farmers Bank had total assets of approximately $37 million and total deposits of $33 million, including approximately $1.8 million in

deposits that exceeded the federal deposit insurance limit. Sabine State Bank and Trust Company, Many, Louisiana, assumed the insured deposits of Farmers Bank, paying the FDIC a premium of 1.35 percent of these deposits, and purchased approximately $2.2 million of the failed bank's assets. Farmers Bank was the eleventh and final failure of an FDIC-insured institution in 2002 and the first bank failure in Louisiana since 1997. *PR-131-2002, FDIC, 12/17/02.*

Federal Reserve Board

New Board Term for Ferguson

On July 26, 2001, Roger W. Ferguson, Jr., began a new term as Vice Chairman of the Board of Governors of the Federal Reserve System. Dr. Ferguson joined the Board of Governors on November 5, 1997, when he was appointed to fill an unexpired term that ended in January 2000. President Clinton renominated him for a full term in 2000, but the Senate Banking Committee delayed all confirmation hearings until after the presidential election. On March 5, 2001, President Bush renominated Dr. Ferguson, and the Senate confirmed him on July 19, 2001. Before joining the Board of Governors, Dr. Ferguson had been a partner at the New York–based international management-consulting firm of McKinsey & Company. His new Board of Governors term expires January 31, 2014. *PR-FRB, 7/26/01; BBR, 7/30/01, p. 186.*

Four New Members of Board of Governors

Between December 2001 and August 2002, Susan Schmidt Bies, Mark W. Olson, Donald L. Kohn, and Ben S. Bernanke joined the Board of Governors.

Dr. Bies was sworn in on December 7, 2001, filling the seat previously held by Susan M. Phillips. Before becoming a member of the board, Dr. Bies had served in various positions at First Tennessee National Corporation, Memphis, Tennessee. Her two most recent positions there (from 1995 to 2001) were executive vice president for risk management and auditor. Dr. Bies's term on the Board of Governors expires January 31, 2012.

Mr. Olson was also sworn in on December 7, 2001, and filled the seat that had been vacated by the resignation of Alice M. Rivlin in July 1999. Mr. Olson served as president and CEO of Security State Bank, Fergus Falls, Minnesota, from 1976 to 1988 and was president of the American Bankers Association from 1986 to 1987. More recently, he was a partner at Ernst and Young LLP, where he started the firm's financial services regulatory practice and managed it until retiring from Ernst and Young in 1999. From 2000 to 2001 he served as staff director of the Securities Subcommittee of the Senate Banking, Housing, and Urban Affairs Committee. His board term expires January 31, 2010.

Dr. Kohn took office on August 5, 2002, filling the seat vacated by Laurence H. Meyer, whose term expired in January 2002. Dr. Kohn began his career with the Federal Reserve System in 1970, when he joined the Federal Reserve Bank of Kansas City as a financial economist. He was subsequently Associate Director of the Division of Research and Statistics (1981–1983), Deputy Staff Director for Monetary and Financial Policy (1983–1987), Director of the Division of Monetary Affairs (1987–2001), Secretary of the Federal Open Market Committee (1987–2002), and Adviser to the Board for Monetary Policy (2001–2002). Dr. Kohn's term on the Board of Governors expires January 31, 2016.

Dr. Bernanke also joined the Board of Governors on August 5, 2002, filling the seat vacated when Edward W. Kelley, Jr., resigned on December 31, 2001. Dr. Bernanke had been a professor of economics and public affairs at Princeton University since 1985 and in 1996 was appointed the Howard Harrison and Gabrielle Snyder Beck Professor of Economics and Public Affairs as well as chair of the Economics Department. He had been a visiting scholar at three Federal Reserve Banks: Philadelphia (1987–1989), Boston (1989–1990), and New York (1990–1991, 1994–1996). He served on the Academic Advisory Panel at the Federal Reserve Bank of New York from 1990 to

2002. Dr. Bernanke's term on the Board of Governors expires January 31, 2004.
www.federalreserve.gov.

State Member Banks' Ownership of Certain Financial Subsidiaries

On August 13, 2001, the FRB adopted a final rule that permits state-chartered banks that are members of the Federal Reserve System to own subsidiaries that engage in certain financial activities, such as general insurance, securities, and travel agency sales. However, bank subsidiaries are barred from real estate investment and development, insurance underwriting, and merchant banking. The rule outlines the criteria that banks must meet to own financial subsidiaries, including sufficient capitalization and strong management. The rule, which implements the financial subsidiaries feature of the 1999 Gramm-Leach-Bliley Act, is intended to establish parity between state member banks and national banks, which were given similar powers in 2000 by the OCC.
AB, 8/14/01; BBR, 8/27/01, pp. 309–10.

Revisions to Regulation K—International Banking Operations

Effective November 20, 2001, the FRB implemented comprehensive revisions to Regulation K, which governs international banking operations. The final rule expands permissible activities abroad for U.S. banking organizations and reduces the associated regulatory burden. The rule also streamlines the application and notice processes for foreign banks operating in the United States, thus reducing their regulatory burden. In addition, the rule implements recent statutory changes authorizing a bank to invest up to 20 percent of capital and surplus in Edge corporations, expands permissible foreign activities of U.S. banking organizations, liberalizes provisions regarding the qualification of foreign banking organizations for exemptions from the nonbanking prohibitions of Section 4 of the Bank Holding Company Act, and implements provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 that affect foreign banks. *PR-FRB, 10/17/01.*

Payments System Risk

The FRB announced on December 11, 2001, that it had revised its Policy Statement on Payments System Risk. The revised policy incorporates, with minor modifications, the FRB's May 30, 2001, interim policy. The revised policy allows certain depository institutions to pledge collateral to the Federal Reserve in order to access additional daylight overdraft capacity above their net debit caps. The policy modifies the net debit cap calculation for U.S. branches and agencies of foreign banks. The policy also modifies the time when electronic check presentments are posted to depository institutions' Federal Reserve accounts for purposes of measuring daylight overdrafts. In addition, the Federal Reserve retains the $50 million limit on the value of book-entry securities transfers. The revised policy statement became effective December 10, 2001, with the following exceptions: (1) revisions to the criteria used to determine the U.S. capital equivalency measure for foreign banking organizations took effect on February 21, 2002, and (2) the modification of the time for posting electronic check presentments to depository institutions' Federal Reserve accounts took effect on April 1, 2002. *PR-FRB, 12/11/01.*

Amendments to Regulation Z—Truth in Lending

On December 11, 2001, the Federal Reserve Board approved a final rule that amends Regulation Z (Truth in Lending) to curb predatory lending. The amendments broaden the scope of loans subject to the protections of the Home Ownership and Equity Protection Act (HOEPA) of 1994 by adjusting the price triggers that determine coverage under the act. The rate-based trigger is lowered by 2 percentage points for first-lien loans, and the fee-based trigger is revised to include optional insurance premiums and costs of similar credit protection products paid at closing. Certain acts and practices in connection with home-secured loans are prohibited; for example, creditors are restricted from engaging in repeated refinancings of their own HOEPA loans over a short period when the transactions are not in the borrower's interest. The final rule strengthens HOEPA's prohibition against extending credit

without regard to a consumer's repayment ability by requiring creditors to document and verify income for HOEPA-covered loans. Disclosures received by consumers before closing for HOEPA-covered loans include the total amount of money borrowed and whether that amount includes optional credit insurance or costs of similar products paid at closing. Compliance with the amendments became mandatory on October 1, 2002. *PR-FRB, 12/12/01.*

Increase in Home Mortgage Disclosure Act's Threshold for Exemption from Reporting

The FRB raised from $31 million to $32 million the asset-size exemption threshold for depository institutions that are required to report data under the Home Mortgage Disclosure Act (HMDA). In 2002, depository institutions with assets of $32 million or less became exempt from reporting data on their housing-related lending activities. The final rule amends Regulation C, which implements HMDA. HMDA requires most depository institutions to collect, report, and disclose data about applications for, and originations and purchases of, home mortgage loans, home improvement loans, and refinancings. Data reported include the type, purpose, and amount of the loan; the race or national origin, gender, and income of the loan applicant; and the location of the property. The purposes of HMDA include helping regulators (1) determine whether financial institutions are serving the housing needs of their communities, and (2) enforce fair lending regulations. The asset level that releases institutions from reporting data under HMDA is adjusted each year on the basis of changes in inflation as measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers. On December 24, 2002, the FRB announced that the asset-size exemption threshold would remain at $32 million throughout 2003. *PR-FRB, 12/19/01; PR-FRB, 12/24/02.*

Amendments to Regulation C—Home Mortgage Disclosure Act

On February 15, 2002, the FRB published amendments to Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). The amendments require lenders to disclose pricing data on higher-cost loans, expand the number of nondepository institutions subject to HMDA's reporting requirements, and revise certain regulatory definitions. The amendments also require that a nondepository lender report under HMDA if the lender originated $25 million or more in home purchase loans, including refinancings, in the prior year. The amendments also require the reporting of some home equity credit lines.

On June 21, 2002, the FRB published additional amendments requiring lenders to report the lien status of applications and originated loans and, in applications taken by telephone, to ask applicants their ethnicity, race, and gender. Compliance with the amendment requiring lenders to ask telephone applicants for monitoring information is mandatory for applications taken on or after January 1, 2003. Compliance with the other amendments will be mandatory for data collected on or after January 1, 2004. *BBR, 1/28/02, pp. 121–22; PR-FRB, 5/2/02; PR-FRB, 6/21/02.*

Final Regulation W

On October 31, 2002, the FRB approved a final Regulation W that comprehensively implements Sections 23A and 23B of the Federal Reserve Act, unifying in one public document the FRB's interpretations of those sections. Sections 23A and 23B and Regulation W restrict (1) loans by a depository institution to its affiliates, (2) asset purchases by a depository institution from its affiliates, and (3) other transactions between a depository institution and its affiliates. The purpose of Sections 23A and 23B and Regulation W is to limit both a bank's risk of loss in transactions with affiliates and its ability to transfer to its affiliates the benefits arising from its access to the federal insurance safety net. The final regulation becomes effective on April 1, 2003. *PR-FRB, 11/27/02.*

Amended Regulation A

On October 31, 2002, the FRB approved a final rule amending Regulation A by revising the

Federal Reserve System's discount window programs, which provide credit to help depository institutions meet temporary liquidity needs. The rule replaces adjustment credit, which is extended at a below-market rate, with a new type of discount window credit called primary credit, which is broadly similar to credit programs offered by many other major central banks. Primary credit is available for very short terms as a backup source of liquidity to depository institutions that are in sound financial condition. Federal Reserve Banks extend primary credit at a rate above the federal funds rate, thus eliminating the incentive for institutions to borrow for the purpose of exploiting the positive spread of money market rates over the discount rate. The Reserve Banks establish the primary credit rate at least every two weeks, subject to review by, and determination of, the Board of Governors, through the same procedure used to set the adjustment credit rate. The final rule includes a provision that could facilitate a reduction in the primary credit rate in a financial emergency. The final rule also establishes a secondary credit program that is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The FRB anticipates that Federal Reserve Banks will establish the secondary credit rate at a level 50 basis points above the primary credit rate. *PR-FRB, 10/31/02.*

Survey on Bank Lending Practices

In its October 2002 issue of the quarterly *Senior Loan Officer Opinion Survey on Bank Lending Practices*, the FRB reported that during the three-month period ending October 2002, both domestic and foreign banks had continued a trend of stricter business lending practices. Although the percentage of domestic banks reporting tightened standards for commercial and industrial (C&I) loans to large and middle-market firms during the period edged down to 20 percent from 22 percent in the July 2002 survey, the percentage that tightened their standards for business loans to small firms during the period jumped from 6 percent in the previous survey period to 20 percent. Both foreign and domestic institutions indicated that the most important reason for tightening standards and terms on C&I loans was a less-favorable economic outlook. Domestic and foreign institutions reported that the demand for C&I and commercial real estate loans weakened between the July and October surveys. Domestic banks attributed the decline in C&I loans to reduced demand from creditworthy borrowers, whereas foreign institutions reported that their own tighter lending standards played a role in the decline. For the report, the Federal Reserve surveyed loan officers from 55 large domestic banks and 20 foreign banking institutions. The survey focused on changes during the preceding three months in the supply of and demand for bank loans to households and businesses. *Senior Loan Officer Opinion Survey on Bank Lending Practices, FRB, October 2002.*

Office of the Comptroller of the Currency

Change in Deposits Required for Branches of Foreign Banks

On March 4, 2002, the OCC implemented more-flexible capital equivalency requirements for federal branches of foreign banks to reduce costs for institutions that present low levels of risk. Under the existing law, federal branches of foreign banks were required to maintain in trust accounts at other banks a capital equivalency deposit (CED) equal to 5 percent of their liabilities. The CED funds, which are intended to serve as a cushion against losses, could not be withdrawn without OCC permission. The OCC implemented two changes to this law: (1) low-risk branches are permitted to withdraw excess deposits without seeking prior OCC approval, and (2) the liability base over which the CEDs are calculated was redefined to exclude liabilities booked on a federal branch's international banking facility. However, several safeguards were maintained under the new approach. The OCC will continue to require a CED agreement with a foreign bank, and the assets in the account must be free from liens or claims other than those of the OCC. The OCC will continue to have rights to the CED in the event the federal branch goes into receivership. In addition, every federal branch must continue to

maintain a CED of at least $1 million, even if that amount is more than 5 percent of liabilities. *NR 2002-16, OCC, 3/4/02.*

Rule Amending Regulations on Banking and Electronic Technologies

On May 17, 2002, the OCC published in the *Federal Register* a final rule that gives national banks guidance on several aspects of their authority to engage in electronic commerce. One provision of the new rule permits national banks to act in the capacity of a "finder" between providers and buyers of financial and nonfinancial products and services that are fostered by new technologies such as the Internet. The rule offers guidance to national banks seeking to conduct new activities electronically by describing the factors the OCC uses to determine if an electronic activity is part of the business of banking. The rule also clarifies that a national bank's electronic activity will not be exempt from general OCC guidance applicable to the underlying activity conducted through conventional means. And when national banks share electronic space (such as Web pages or Web sites) with other businesses, the rule requires that the bank take reasonable steps to clearly, conspicuously, and understandably distinguish between products and services it offers and those the other business offers. *NR 2002-44, OCC, 5/16/02; BBR, 5/20/02, pp. 863–64.*

Survey of Credit Underwriting Practices

The OCC's eighth annual *Survey of Credit Underwriting Practices* reported that underwriting standards for commercial and retail loans tightened during the 12-month period ending March 31, 2002. For the second consecutive year, the majority of surveyed banks tightened commercial loan underwriting standards (67 percent of banks in 2002, compared with 55 percent in 2001). The survey found that most banks made no change to retail underwriting standards, and those that did primarily tightened standards (39 percent of banks). The 2002 survey covered the 62 largest national banks with an aggregate loan portfolio of $2 trillion, which represents approximately 90 percent of all outstanding loans in national banks. The survey, which is completed by OCC senior examiners, consists of a series of questions about 16 types of commercial and retail lending. The questions focus on the direction of lending standards and the level of inherent risk in the portfolios and products of the banks examined. *2002 Survey of Credit Underwriting Practices, OCC, June 2002.*

Office of Thrift Supervision

Swearing-in of Gilleran as New Director

James E. Gilleran was sworn in as director of the OTS on December 7, 2001. He served as chairman and chief executive officer of the Bank of San Francisco from 1994 to 2000 and as superintendent of the California State Banking Department from 1989 to 1994. He also served as chairman of the Conference of State Bank Supervisors (CSBS) from 1993 to 1994 and as a member of the CSBS's Bankers Advisory Council until 2000. Mr. Gilleran replaces outgoing director Ellen Seidman. *OTS 01-83, 12/7/01.*

Updated Handbook on Trust and Asset Management Services

On August 27, 2001, the OTS published a revised version of the *Trust and Asset Management Handbook*, which helps agency examiners plan and perform exams of thrift institutions' trust and asset management services. The revision highlights the OTS's emphasis on a risk-focused approach to examinations. The revised handbook contains a comprehensive review of the products and services, laws and regulations, and risks and fiduciary duties applicable to savings associations that engage in trust and asset management activities. *BBR, 9/10/01, p. 377.*

Revised Lending Rule

On December 20, 2001, the OTS issued a final rule that (1) allows federally chartered thrift institutions to expand the availability of low-cost credit to small business and agricultural borrowers, and

(2) provides additional flexibility for thrifts that invest in their communities. For loans meeting the definition under the Home Owners' Loan Act of lending to small businesses, the rule increases the dollar limit from $1 million to $2 million; for loans to farms, the limit is raised from $500,000 to $2 million. The rule provides an additional measure of flexibility for loans to certain individuals who use the loan proceeds for their small enterprises, as long as the proceeds are used for commercial, corporate, business, or agricultural purposes. The rule also permits thrifts to increase the amount of their total capital that they may commit to community development investments; the new limit is the greater of 1 percent of total capital or $250,000. The rule also provides thrifts with an enhanced ability to invest in state and local government obligations and gives them unlimited authority to invest in such obligations. The rule allows both real property and personal property to be the primary source of security for real estate loans. The final rule became effective January 1, 2002. *BBR, 12/24/01, p. 1010.*

Adjusted Capital Requirements for 1- to 4-Family Mortgages

On May 10, 2002, the OTS adjusted its capital requirements for one- to four-family residential first mortgage loans. Under the new requirements, a one- to four-family loan will qualify for 50 percent risk-weight capital treatment if the loan is underwritten in accordance with prudent underwriting standards, including standards in the Interagency Guidelines for Real Estate Lending. The OTS eliminated the requirement that a loan-to-value ratio of 80 percent or less is necessary for a loan to qualify for the 50 percent risk weight. In addition, the rule eliminates the requirement that a thrift institution deduct from capital the portion of a land loan or nonresidential construction loan exceeding an 80 percent loan-to-value ratio. *OTS 02-26, 5/9/02.*

Amendment to Alternative Mortgage Transaction Parity Act

The Alternative Mortgage Transaction Parity Act, adopted in 1982, grants certain state-chartered housing creditors parity with federally chartered lenders when making alternative mortgages. An alternative mortgage is a loan with payment features—such as variable rates or balloon payments—that vary from conventional fixed-rate, fixed-term mortgage loans. On September 26, 2002, the OTS announced a final rule that amended its regulations under the Parity Act to make state-chartered housing lenders subject to state, not OTS, rules governing prepayment penalties and late fees. The final rule becomes effective July 1, 2003. *BBR, 9/30/02, p. 528; OTS 02-44, 12/6/02.*

Federal Housing Finance Board

Appointment of Korsmo as Chairman

On November 29, 2001, John T. Korsmo was named a director of the Federal Housing Finance Board, and on December 21, 2001, he was designated the board's chairman. Mr. Korsmo replaces J. Timothy O'Neill, who had served as chairman since June 18, 2001, and remains a director. In 1998 Mr. Korsmo founded Korsmo Consulting Services, Inc., a health-care, political, and sports marketing consulting firm in Fargo, North Dakota. He served as policy and legislative director for North Dakota governor Ed Schafer in 1996 and 1997, and chaired the North Dakota Republican Party from 1993 to 1995. Until 1996, Mr. Korsmo was president and owner of Cass County Abstract Company, in Fargo, and founder and president of Red River Title Services in Moorehead, Minnesota. He was also founder and, from 1983 to 1992, president of the Title Company of Fargo, the first independent escrow and closing company in North Dakota and northwestern Minnesota. *Dow Jones Newswires, 12/19/01.*

Changes to Affordable Housing Program

On September 12, 2002, the Federal Housing Finance Board (FHFB) approved changes to the Affordable Housing Program, giving Federal Home Loan Banks additional tools to help first-time homebuyers. (The Affordable Housing Program provides direct subsidies or loans at subsidized rates to the Federal Home Loan Bank [FHLB]

System's member institutions to finance the purchase, construction, or rehabilitation of affordable housing units. The FHLB System contributes to the program the greater of 10 percent of net earnings or $100 million per year.) Previous FHFB regulations authorized the Federal Home Loan Banks each year to allocate for homeownership set-aside programs the greater of $3 million or 25 percent of their Affordable Housing Program contribution. The new rule allows each Federal Home Loan Bank to set aside specifically for first-time homebuyers an additional amount of up to the greater of $1.5 million or 10 percent of its annual Affordable Housing Program amount. The final rule also increases the maximum subsidy limit per household to $15,000 for homeownership set-aside programs in general. *FHFB 02-42, 9/12/02.*

National Credit Union Administration

Appointment of Dollar as Chairman

On September 13, 2001, President Bush appointed National Credit Union Administration (NCUA) board member Dennis Dollar as the agency's chairman. Mr. Dollar had served on the NCUA board since October 1997 and had been the acting chairman since February 2001. From 1992 to 1997, he served as the president and CEO of Gulfport VA Federal Credit Union. From 1976 to 1984 he served two terms in the Mississippi House of Representatives. His term on the NCUA board expires in 2003. *NR-NCUA, 09/17/01.*

Appointment of Two New Board Members

On March 22, 2002, Deborah Matz and JoAnn Johnson were confirmed as members of the NCUA Board of Directors. Ms. Matz filled the seat that had been held by Geoff Bacino until his term expired on December 20, 2001. Ms. Johnson filled the seat vacated by Yolanda Townsend Wheat on December 21, 2001.

Ms. Matz had most recently been the executive officer at the Liaison Office for North America of the Food and Agriculture Organization (FAO) of the United Nations. Before joining FAO, she served in the U.S. Department of Agriculture (1993–2001), where she held numerous high-level positions, including deputy assistant secretary for administration, chair of the loan resolution task force, and chief of staff to the administrators of the Farm Service Agency and the Farmers Home Administration. Ms. Matz had also served nine years as an economist with the Congressional Joint Economic Committee.

Ms. Johnson was a member of the Iowa Senate at the time of her appointment, having been elected to that body in 1994. She chaired the Senate's Ways and Means Committee from 1996 to 2000 and the Commerce Committee from 2000 until resigning her seat to accept the NCUA board position. *NR-NCUA, 1/23/02.*

Exemption of Healthy Credit Unions from Certain Regulations

In a final rule released on November 21, 2001, the NCUA declared that credit unions with high net worth and consistently strong supervisory ratings are exempt from a range of federal regulations. Credit unions that receive a composite safety and soundness rating of 1 or 2 for two consecutive examinations, have a net-worth ratio of 9 percent or higher, and are well capitalized under the NCUA's prompt corrective action regulations are automatically exempt from rules that require quarterly stress-testing of certain securities and from rules that limit how third parties handle investments. In addition, they need not obtain an appraisal for a loan unless the loan amount is $250,000 or higher. Other credit unions may also be eligible for the exemption; however, they must submit a formal application to the NCUA. The new rule, referred to as "RegFlex," became effective March 1, 2002. *BBR, 11/26/01, p. 867.*

"Access-Across-America" Initiative

On February 25, 2002, Chairman Dollar unveiled a program that focuses on creating economic empowerment by providing access to credit unions in neighborhoods and communities that lack

access to low-cost financial services. The program, labeled "Access Across America," is designed to establish partnerships between the NCUA and key federal departments and agencies to counter the growing problem of predatory lending as well as to broaden the access of underserved communities to affordable financial services. The NCUA will support underserved areas by chartering new, community-oriented credit unions, particularly in growing Hispanic communities; developing faith-based and campus credit unions; and championing the expansion of financial literacy programs developed by local credit unions in communities across the United States. *NR-NCUA, 2/25/02.*

STATE LEGISLATION AND REGULATION

All States: New Rules on Collateral

New rules governing how banks perfect liens and how borrowers file collateral statements took effect (for most states on July 1, 2001) under a revised Article 9 of the Uniform Commercial Code (UCC). Article 9 of the UCC governs what lenders can accept as collateral and how collateral agreements must be documented. The revised rules set parameters for using personal property as collateral for a loan, and change the filing system for financial statements that detail collateral. Previously the financial statements were filed where the collateral was located, which is often at the local level. Under the new rules, all financial statements have to be filed in just one place: the secretary of state's office in the debtor's home state. The new rules became effective for 46 states on July 1, 2001; Alabama, Florida, and Mississippi delayed implementation until January 1, 2002, and Connecticut until October 1, 2002. *AB, 7/5/01.*

California

Governor Gray Davis (D) signed bill A.B. 489 on October 10, 2001, aimed at curbing predatory lending practices by prohibiting licensed persons, such as real estate brokers or mortgage lenders, from engaging in specific acts that harm consumers. The new law is aimed at helping vulnerable people such as senior citizens, immigrants, and low-income families by focusing on the serious abuses practiced by the small minority of lenders that engage in unfair or deceptive practices. The new law prohibits repeated refinancings of mortgage loans in which lenders extract money for points and fees but provide no benefit to homeowners and leave them worse off financially than they were before the refinancings. In addition, the law prohibits brokers and lenders from steering borrowers toward loans with interest rates and terms that are higher than those for which they could qualify, and prohibits loans that the borrower would clearly not be able to repay. The law also bans incorporating into a loan, to inflate the amount of money being borrowed, points and fees of more than 6 percent of the loan amount to be financed. *BBR, 10/15/01, p. 587.*

Governor Davis also signed legislation on October 10, 2001, requiring credit card issuers to disclose to cardholders in their monthly statements the length of time it would take to pay off their balances if they made only the minimum monthly payments. The new disclosure requirement took effect July 1, 2002. *BBR, 10/22/01, p. 636.*

Colorado

Governor Bill Owens (R) signed H.B. 1259 on June 7, 2002, prohibiting lenders from engaging in certain practices on high-interest loans. The prohibited practices include the following: requiring the entire balance of the loan to be paid just a few years after the loan is issued, charging high fees for early repayment of loans, and refinancing a loan within one year (this prohibition applies only if the refinancing is not in the borrower's interest). *BBR, 6/17/02, p. 1053.*

Florida

On July 30, 2001, Governor Jeb Bush (R) signed a bill regulating payday loans in Florida. The new law, which became effective October 1, 2001, is designed to prevent fees associated with payday loans from escalating out of control. The law provides a backstop by limiting loans to $500, capping fees at 10 percent of the loan, and allowing only one payday loan at a time. The law also creates a 60-day grace period in which people who cannot repay loans can seek credit counseling and devise a repayment plan. *Knight-Ridder/Tribune Business News, 7/31/01.*

On April 22, 2002, Governor Bush signed into law a bill (S.B. 2262) that prohibits door-to-door solicitations, the financing of points and fees exceeding 3 percent of a loan amount, and other predatory mortgage lending practices. The Florida Home Loan Protection Act became effective October 2, 2002. *BBR, 4/29/02, p. 746.*

Governor Bush signed into law H.B. 3-E merging the comptroller and treasurer positions into one chief financial officer position as head of a new Department of Financial Services. The Department of Financial Services consists of 13 divisions and offices, including the Office of Financial Institutions and Securities Regulation, which will regulate credit unions, banks, finance companies, and the securities industry. The provisions related to the chief financial officer position became effective January 7, 2003. *BBR, 6/24/02, p. 1099.*

Georgia

On April 22, 2002, Governor Roy E. Barnes (D) signed a bill (H.B. 1361) that cracks down on the lending practices of predatory lenders who cater to the subprime residential housing market. The Georgia Fair Lending Act sets up several triggers; loans above a trigger will be considered high cost and will automatically have certain restrictions. The restrictions include no unreasonable prepayment penalties, no balloon payments, no negative amortization, no penalty interest rates, no excessive advance payments, and no mandatory arbitration. The law also bans lenders from selling single-premium credit life insurance and prohibits them from charging multiple late fees on a single payment. The law became effective October 1, 2002. *BBR, 4/29/02, p. 746.*

Illinois

By signing H.B. 1089 on August 10, 2001, Illinois Governor George Ryan (R) increased the basic loan limit for a single entity from 20 percent of a bank's unimpaired capital and surplus to 25 percent. The new law, known as Public Act 92-0336, brings Illinois into conformity with lending limits for national banks. *BBR, 8/27/01, pp. 326–27.*

Missouri

On June 27, 2002, Governor Bob Holden (D) signed a bill (S.B. 884) that caps interest rates on payday loans. Under the provisions of the new act, payday loans must have a term of between 14 and 31 days. Although the act stipulates that lenders may charge any simple interest or fees agreed to by the borrower, it caps the total amount of interest and fees at 75 percent of the initial loan amount. In addition, the act limits to six the number of times that a loan can be renewed and requires borrowers to begin repaying the principal of a loan before renewing it for the first time. Borrowers are also prohibited from repaying a loan with proceeds from another loan from the same lender. *BBR, 7/8/02, p. 59.*

New York

On October 3, 2002, Governor George E. Pataki (R) signed legislation to prohibit predatory lending practices in the subprime mortgage lending market. The law prohibits the financing of certain insurance products, restricts the use of balloon payments, and limits the financing of excessive points and fees. Under the law, a home loan is deemed void if a court finds that the lender intentionally violated the law. The law grants borrowers an affirmative defense against foreclosure when a loan has been made in violation of the law. It also allows for a private right of action against a

lender within six years of the origination of a loan. Other provisions of the law require greater disclosure to consumers; one such provision requires that high-cost loans clearly state at the top of mortgage documents that they are high-cost home loans. *BBR, 10/7/02, p. 551.*

North Carolina

In North Carolina, where engaging in the business of money transmission without a license is prohibited, a new law requires that businesses and individuals seeking to obtain a license must demonstrate a certain level of financial worth, post a surety bond, and pay an application fee. The law also requires annual and quarterly reports and license renewal fees, sets out specific requirements for the maintenance of records and a certificate of authority, and contains provisions covering the change in control of a license. Internet sites accessible to North Carolina residents are covered by the prohibitions. However, banks, credit unions, savings and loan institutions, government entities, and their contractors are exempted from the provisions. The new law became effective October 1, 2001. *BBR, 10/29/01, p. 697.*

Oregon

The National Association of Insurance Commissioners announced on April 30, 2002, that Oregon state insurance regulators and the OTS had signed an information-sharing agreement. The agreement provides for the sharing of nonpublic information on the financial solvency of insurance companies and of any depository institutions the companies own that fall within the jurisdiction of the state insurance commissioner and the OTS. The agreement covers insurance and thrift activities, as well as consumer complaints about the entities involved. Oregon is the 45th state that has signed a sharing agreement. *OTS 02-24, 4/30/02.*

RECENT ARTICLES AND STUDIES

A report issued by the Fannie Mae Foundation in August 2001 says that one-fourth of all lower-income families have no relationship with a bank, savings institution, credit union, or other mainstream financial services provider. America's most financially vulnerable households are turning increasingly to high-cost alternative financial service providers—fringe lenders—to meet their financial service needs. Service fees charged by fringe lenders typically are much higher than those charged by mainstream financial service providers. The report, entitled *Financial Services in Distressed Communities: Framing the Issue, Finding Solutions*, lists several reasons that many lower-income and minority households use fringe lenders, including a lack of physical proximity to mainline financial institutions, a lack of understanding of or trust in financial institutions, and a lack of basic consumer finance education. *Dow Jones Newswires, 8/2/01.*

A pair of studies released on August 29, 2001, conclude that banks that do business exclusively over the Internet are having a hard time compared with those that have traditional branch services. The first study, performed by Jupiter Media Metrix, found that Internet traffic to online-only banks fell 8 percent between July 2000 and July 2001. In contrast, the number of visitors to banks with both branches and online services, known as multichannel banks, climbed 111 percent during the same period. Jupiter analysts concluded that consumers prefer traditional banking and are more likely to conduct online banking with a financial services company that offers easy access to customer service, nearby automated teller machines, and nearby branches. The second study, conducted by Maritz Research, found that 47 percent of U.S. residents prefer banking at their local branches to banking over the Internet. This survey, which polled 1,005

adults randomly selected from around the United States, also found that 18 percent of consumers preferred ATMs and only 4 percent preferred banking over the Internet. *BBR, 9/10/01, p. 361.*

BANK AND THRIFT PERFORMANCE

First-Quarter 2002 Results for Commercial Banks and Savings Institutions

FDIC-insured commercial banks earned $21.7 billion during the first quarter of 2002, up from $19.8 billion in the first quarter of 2001. Key factors in the higher earnings were wider net interest margins at large banks and slow growth in noninterest expenses. Banks' annualized return on assets (ROA) was 1.33 percent in the first quarter, up from 1.26 percent one year earlier. The number of commercial banks on the FDIC's "Problem List" increased from 95 to 102 in the quarter, and assets of "problem" banks rose from $36 billion to $37 billion. Six insured commercial banks failed in the first quarter of 2002.

FDIC BIF-insured mutual savings institutions reported earnings of $3.6 billion in the first quarter of 2002, an increase of $715 million from the first quarter of 2001. The industry's ROA for the quarter was 1.12 percent, down from 1.18 percent in the fourth quarter of 2001 but up from 0.95 percent one year earlier. There were 22 "problem" thrifts, up slightly from 19 at year-end 2001; however, assets of "problem" thrifts increased dramatically during the first quarter, rising to $15.0 billion from $3.7 billion in the previous quarter. No thrifts failed during the first quarter of 2002. *FDIC Quarterly Banking Profile, First Quarter 2002.*

Second-Quarter 2002 Results for Commercial Banks and Savings Institutions

Continued strength in consumer loan demand, plus a favorable interest-rate environment, outweighed the negative effects of weakness in commercial loans for banks in the second quarter of 2002. Commercial banks' earnings rose to $23.4 billion in the second quarter, which is $1.7 billion higher than in the previous quarter. Commercial banks' average ROA was 1.41 percent in the second quarter of 2002, up from 1.33 percent in the first quarter of 2002 and from 1.21 percent in the second quarter of 2001. The number of commercial banks on the FDIC's "Problem List" increased from 102 to 115 during the quarter, but assets of "problem" banks declined from $37 billion to $36 billion. One bank failed during the second quarter.

FDIC BIF-insured mutual savings institutions, benefiting from a favorable interest-rate environment and gains on sales of securities, earned $3.9 billion in the three months from April through June 2002, which is $236 million higher than in the previous quarter and $519 million higher than one year earlier. The industry's ROA for the second quarter rose to 1.19 percent, up from 1.12 percent in the first quarter of 2002 and from 1.06 percent in the second quarter of 2001. The number of "problem" thrifts fell slightly from 22 to 21 during the quarter, and "problem" assets dropped sharply from $15.0 billion to $3.8 billion. One thrift failed and, with assistance, merged into a commercial bank. *FDIC Quarterly Banking Profile, Second Quarter 2002.*

Third-Quarter 2002 Results for Commercial Banks and Savings Institutions

FDIC-insured commercial banks earned $23.3 billion during the third quarter of 2002, falling slightly from $23.4 billion in the second quarter of 2002. Banks' average ROA was 1.37 percent in the third quarter, down from 1.41 percent in the second quarter but up from 1.17 percent in the third quarter of 2001. The number of commercial banks on the FDIC's "Problem List" increased from 115 to 126 in the quarter, and assets of "problem" banks rose from $36 billion to $38 billion. One commercial bank failed in the third quarter of 2002.

A favorable interest-rate environment helped FDIC BIF-insured mutual savings institutions realize $1.9 billion in gains from sales of securities, increasing industry earnings to just under $4.0 billion in the third quarter of 2002, up from $3.9 billion in the second quarter of 2002 and from $3.5 billion in the third quarter of 2001. The industry's ROA for the quarter was 1.20 percent, up from 1.19 percent in the second quarter of 2002 and from 1.08 percent one year earlier. The number of "problem" thrifts declined from 21 to 20 during the quarter, but assets of these institutions rose slightly from $3.8 billion to $3.9 billion. No thrifts failed during the quarter. *FDIC Quarterly Banking Profile, Third Quarter 2002.*

INTERNATIONAL DEVELOPMENTS

Canada

On June 14, 2001, the Canadian Parliament approved new framework legislation for Canada's financial services sector, clearing the way for increased competition in the industry. Bill C-8, An Act to Establish the Financial Consumer Agency of Canada and to Amend Certain Acts in Relation to Financial Institutions, was published by the Department of Finance on October 24, 2001. The legislation, which consists of 75 regulations, is expected to promote efficiency and growth in the financial services sector, foster international competitiveness and domestic competition, empower and protect consumers of financial services, and improve the regulatory environment. Key elements of the legislation include permission for financial institutions to engage in a broader range of investments in specific areas of electronic commerce, either through holding companies or through traditional parent-subsidiary structures; permission for financial institutions operating in Canada to establish regulated, nonoperating holding companies that are subject to less regulatory burden than chartered banks; creation of the Financial Consumer Agency of Canada to enforce consumer-oriented provisions of federal financial institution statutes; and provisions to ensure that the government's new entry regime for foreign banks (permitting foreign banks to directly operate branches in Canada) is consistent with the regulatory framework for domestic banks. Of the 75 regulations, 37 relate to the new framework's restructuring of the permitted investment regime, 18 relate to the new holding company regime for financial institutions, 6 relate to the creation of the new Financial Consumer Agency of Canada, 6 relate to changes to the foreign bank regime, and the remaining 8 are aimed at various other policy objectives. *BBR: 6/25/01, pp. 1081–83; 10/29/01, pp. 704–6; 11/12/01, pp. 792–93; 12/3/01, pp. 911–13.*

China

China's securities regulators issued new regulations allowing commercial banks to directly trade stocks for clients beginning May 1, 2002. Additionally, beginning August 1, 2002, all banks, both Chinese and foreign, became eligible to buy and sell foreign exchange to individuals, ending the People's Bank of China's monopoly in the foreign exchange market. *BBR: 4/29/02, pp. 758–59; 8/5/02, p. 252.*

Japan

Prime Minister Junichiro Koizumi's cabinet on November 12, 2002, established an office for speeding up the disposal of nonperforming loans. The Industry Reconstruction and Employment Strategy Headquarters, which is directed by Mr. Koizumi, was formed as an equity-issuing organization that is fully owned by the governmental Deposit Insurance Corporation (DIC). Its funds will be drawn from the DIC's financial rehabilitation fund or on a new account to be formed. *BBR, 11/18/02, pp. 824–25.*

On November 29, 2002, the Japanese government introduced a nonperforming loan workout schedule that features stricter bank asset inspections, launches a bank inspection team, and injects emergency central bank loans and public funds into nonviable banks. The workout schedule also highlights stricter implementation of prompt corrective measures on banks whose capital has been exhausted; the measures would require such banks to restore stable bank management within one year. In addition, such banks would be put under control of the government and the Bank of Japan as institutions that require "special assistance." *BBR, 12/2/02, p. 900.*